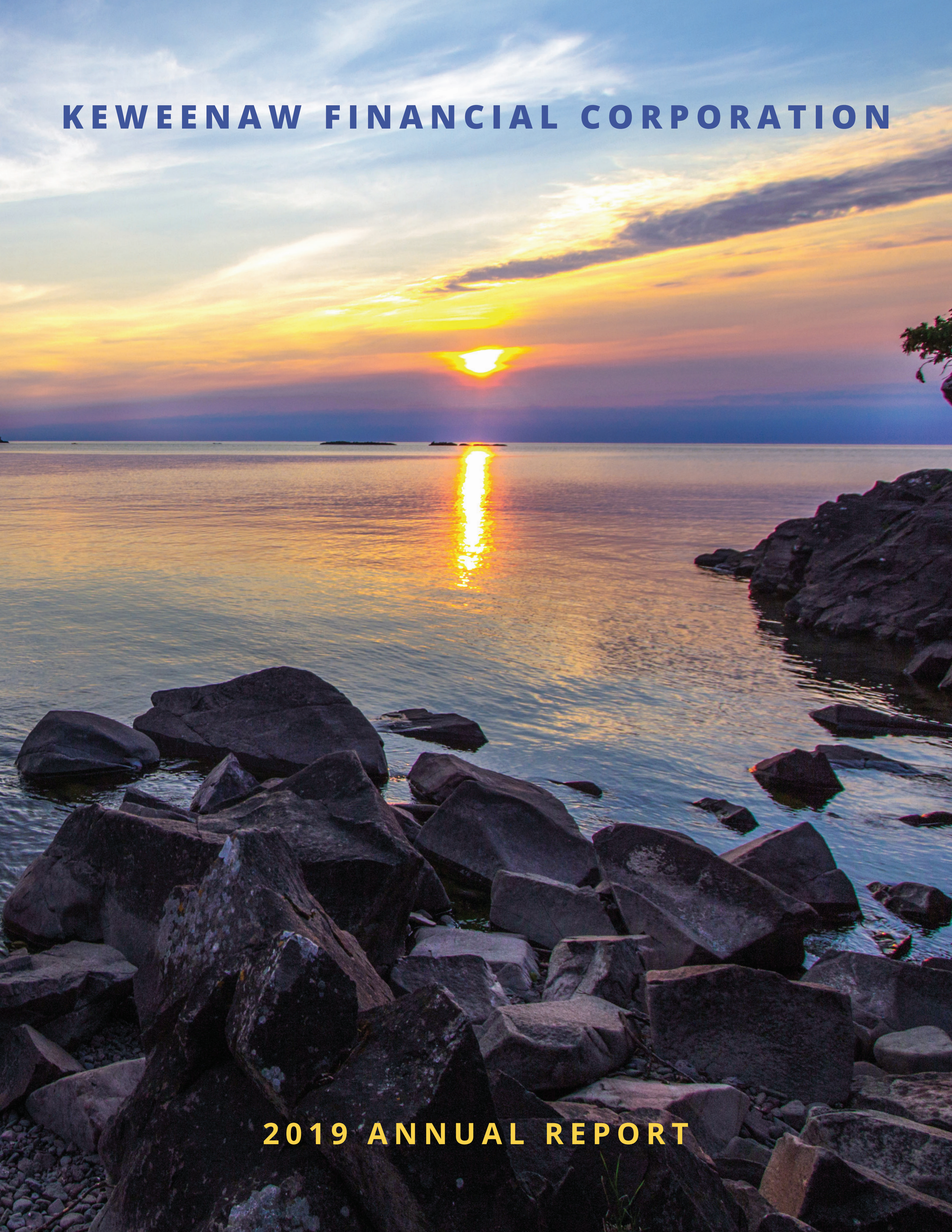
KEWEENAW FINANCIAL CORPORATION



2019 ANNUAL REPORT

Pictured: Standing (l-r): Susan LaFernier, James Fenton, James Northey, Neil Ahola, Michael Mikkola; Seated (l-r): Almor Penegor, Daniel Wisti, J. David Vlahos

Board of Directors — Keweenaw Financial Corporation and Superior National Bank

Neil J. Ahola	Owner & Manager, Memorial Chapel & Plowe Funeral Homes
James D. Fenton	President & Chief Financial Officer, McGann Building Supply
Susan J. LaFernier	Member, Keweenaw Bay Indian Community Tribal Council; Comptroller, Keweenaw Bay Indian Community Accounting Department
Michael S. Mikkola	Co-Owner, Tervo Agency
James E. Northey	Owner, Fintech Consultancy, LLC; Partner, Northern Perspectives, LLC
Almor D. Penegor	President, John & Arthur Penegor, Inc.
J.David Vlahos	President & Chief Executive Officer, Superior National Bank
Daniel J. Wisti	Attorney of Counsel, Numinen, DeForge & Toutant, P.C.

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Annual Meeting

Date
To be determined

Meeting Time
To be determined

Place
To be determined

Letter To Shareholders

To our Shareholders,

I am pleased to report record financial results and significant advancement towards our strategic initiatives in 2019. The future of Superior National Bank is bright as robust financial performance and steady growth are being boosted by our great team and strong economy.

Solid Balance Sheet
Total Bank assets grew 3 percent from $558 million at year-end 2018, to $573 million at year-end 2019. Deposits were up approximately 1 percent over the same time frame despite stiff local and national competition. Total loans grew nicely from $305 million in 2018 to $314 million in 2019. Total equity, due to retained earnings and unrealized gains in our investment portfolio, increased from $67 million to $77 million during the last year. Our equity to asset ratio was 13.4 percent as of year-end 2019.

Strong Earnings
Superior National Bank produced record net income of $7.0 million in 2019. This was 1.7 percent above 2018 net income of $6.9 million. The consolidated net income of Keweenaw Financial Corporation and Superior National Bank declined from $6.7 million in 2018 to $6.3 million due to one-time costs related to our acquisition of North Star Financial Holdings, Inc. and its subsidiary Main Street Bank. The average stock price (stock-split adjusted) rose $11.40 and the dividend per share was $1.33 providing a total return to shareholders of 19.61 percent for 2019.

Our strong earnings in 2019 were driven by a focus on customer service and strong credit quality. Delinquent loans and problem assets remained low allowing us to minimize provision for loan loss and collection expenses. Additionally, loan and deposit growth, along with record revenues from our Trust Department, helped drive net income.

Bank earnings will feel pressure from shrinking interest margins in 2020, mainly due to strong competition and a declining interest rate environment. However, we are optimistic that we can have another strong year if we remain focused on customer service, profitable growth, and maintaining an efficient operation.

A Commitment to our People and our Communities
Financial performance has been, and will continue to be, solid and profitable; but the heart and soul of what drives our success is our people and our customers. I am proud to say that our organizational culture has more energy and positivity than ever. Our team is motivated to make every day matter for the Bank and our communities.

The strategic planning process for 2020 put us in the position to recognize our strengths and develop core values to guide us into the future:

Customers First – Drives Every Decision
Caring About People – The Heart of All We Do
Innovative Thinking – Encouraging Ideas and Creative Solutions
Teamwork – Everyone and Every Voice Matters
Integrity – Do the Right Thing

Our mission moving forward says it all:

To Provide a Superior Experience Every Time

A Smart Acquisition

Over the last several years, we've been successful in fortifying our foundation. We've accumulated capital, built a great team, invested in technology, improved credit quality, and energized our workplace environment and culture. We were poised to seize an opportunity that would leverage our high-performing organization and increase shareholder value. Everything essential was in place.

In September 2019, we signed a definitive agreement to acquire North Star Financial Holdings, Inc. and its subsidiary Main Street Bank in a $42 million transaction. With assets over $270 million, Main Street Bank operates two retail branches, three mortgage loan offices, and one commercial loan office in Southeast Michigan. Main Street's location and team give us the opportunity to grow our loan portfolio and expand banking services in a growing market.

Located in geographically different regions of Michigan, Superior National Bank and Main Street Bank share the same culture, midwestern values, and commitment to serving customers and communities. The combined organization will provide new products and opportunities for customers to enhance their banking relationship:

- Superior National Bank adds Main Street's excellent residential mortgage division, which provides customers in the Upper Peninsula greater mortgage options.
- The Banks will have a larger lending capacity because of the overall size of the combined organization.
- Main Street customers will benefit from access to Superior National Bank's trust and financial services offerings.

The acquisition gives us greater capacity to invest further into technology, products, and services for our customers. The long-term impact will be smart, measured growth for Superior National Bank, with continued high levels of customer satisfaction.

At the beginning of February 2020, the acquisition of North Star Financial Holdings, Inc. and its subsidiary Main Street Bank was finalized. Main Street Bank will continue operating as a separate bank until later in 2020, when we expect to convert all locations to Superior National Bank offices.

A Bright Future

2019 could be called a monumental year for Keweenaw Financial Corporation. Superior National Bank produced record earnings while reaching an agreement to acquire a $270 million bank in Southeast Michigan.

As we chart our course for 2020, we are expanding our geographic reach and accelerating our potential for smart, measured growth. Our primary values of customer first and teamwork to create higher levels of service for customers will be embraced as we move forward. Together, we will advance technologies and synergize value added services for a larger and stronger banking organization.

For you, our valued shareholders, we are committed to providing competitive returns. As always, we appreciate the confidence you continue to place in Keweenaw Financial Corporation.

Best Regards,

J. David Vlahos

J. David Vlahos
President

Financial Highlights

	2019	2018	% Change
For the year			
Net income	$ 6,250,181	$ 6,723,619	-7.0%
Cash dividends	1,545,800	2,646,293	-41.6%
Return on average assets	1.10%	1.18%	-6.8%
Return on average equity	8.55%	9.58%	-10.8%
At year end			
Assets	$ 572,980,283	$ 558,432,121	2.6%
Deposits	488,698,064	484,186,024	0.9%
Loans, net	308,949,569	300,097,092	2.9%
Stockholders' equity	78,090,139	68,196,911	14.5%
Equity to assets ratio	13.63%	12.21%	11.6%
Per share data*			
Net income	$ 5.39	$ 5.55	-2.9%
Cash dividends	1.33	2.21	-39.8%
Book value	67.36	56.32	19.6%
Book value, excluding accumulated other comprehensive income (loss)	66.70	59.98	11.2%

**Per share data and historical stock comparison reflect the 3 for 1 stock split in 2019.*

Historical Stock Comparison

Year	Per Share Cash Dividend*	Year End Stock Price*
2010	$ 1.07	$ 35.33
2011	1.12	36.33
2012	1.12	38.56
2013	1.15	45.52
2014	1.17	55.10
2015	1.25	57.84
2016	1.29	58.32
2017	1.25	60.10
2018	2.21	64.93
2019	1.33	76.33**

***This price represents the average trading price over the last 90 days – not a guaranteed stock price.*

Total Return to Stockholder

Change in Stock Price	$ 11.40
Dividend	$ 1.33
Total Return ($)	12.73
Total Return (%)	19.61

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Report of Independent Auditors

Board of Directors and Stockholders
Keweenaw Financial Corporation
Hancock, Michigan

We have audited the accompanying consolidated financial statements of Keweenaw Financial Corporation and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2019 and 2018, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Keweenaw Financial Corporation and Subsidiary as of December 31, 2019 and 2018, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Andrews Hooper Pavlik PLC

Saginaw, Michigan
February 24, 2020

Consolidated Balance Sheets

	Year Ended December 31 2019	2018
Assets		
Cash and cash equivalents:		
Cash and due from banks	$ 14,432,581	$ 10,885,382
Federal funds sold	30,754,945	958
Total cash and cash equivalents	**45,187,526**	**10,886,340**
Interest-bearing time deposits in other financial institutions	9,101,558	12,104,487
Investment securities available for sale	195,848,735	219,951,799
Federal Reserve and Federal Home Loan Bank stock	1,534,750	1,534,750
Loans held for sale	–	560,216
Loans, less allowance for loan losses of $5,359,725 in 2019 and $5,086,793 in 2018	308,949,569	300,097,092
Bank premises and equipment, net	7,069,170	6,635,445
Accrued interest receivable	2,044,106	2,258,513
Other assets	3,244,869	4,403,479
Total assets	**$ 572,980,283**	**$ 558,432,121**
Liabilities and stockholders' equity		
Liabilities:		
Deposits:		
Demand	$ 102,716,934	$ 94,448,091
NOW	67,758,876	68,555,833
Money market	19,370,976	16,952,106
Savings	158,058,549	161,173,562
Time	140,792,729	143,056,432
Total deposits	**488,698,064**	**484,186,024**
Repurchase agreements	–	539,531
Accrued interest payable and other liabilities	6,192,080	5,509,655
Total liabilities	**494,890,144**	**490,235,210**
Stockholders' equity:		
Preferred stock: no par value; 50,000 shares authorized; none issued or outstanding in 2019 and 2018	–	–
Common stock: no par value; 2,000,000 shares authorized in 2019 and 2018; 1,159,350 shares issued and outstanding in 2019 and 2018	515,549	515,549
Retained earnings	76,817,295	72,112,914
Accumulated other comprehensive income (loss)	757,295	(4,431,552)
Total stockholders' equity	**78,090,139**	**68,196,911**
Total liabilities and stockholders' equity	**$ 572,980,283**	**$558,432,121**

See accompanying notes.

Consolidated Statements Of Income

	Year Ended December 31	
	2019	**2018**
Interest income:		
Loans, including fees	$ 17,548,097	$ 16,518,187
Securities:		
U.S. Treasury securities	70,499	71,729
U.S. Government agencies	2,652,745	2,717,957
Obligations of states and political subdivisions	1,625,724	2,130,480
Other securities	580,569	571,027
Other interest income	966,784	611,621
	23,444,418	**22,621,001**
Interest expense:		
Deposits and borrowed funds	3,158,236	2,712,580
Net interest income	**20,286,182**	**19,908,421**
Provision for loan losses	78,000	30,000
Net interest income after provision for loan losses	**20,208,182**	**19,878,421**
Noninterest income:		
Trust fees	1,536,480	1,403,210
Service charges on deposit accounts	718,405	808,530
Other service charges and fees	986,252	946,339
Net loss on sale of investment securities	(10,414)	(364,970)
Net gain on sale of loans	181,628	156,978
Other	221,484	70,481
	3,633,835	**3,020,568**
Noninterest expenses:		
Salaries and wages	7,440,339	6,686,391
Pensions and other employee benefits	2,394,459	2,220,110
Occupancy expenses, net	3,469,512	3,225,372
Postage and supplies	175,584	91,591
FDIC and general insurance	187,809	203,660
Legal and professional	1,096,628	558,628
Directors' fees	160,500	145,200
Regulatory exam fees	139,368	157,567
Marketing	127,266	138,798
Net cost of operations of other real estate - including write downs and gains/losses on sales	129,782	482,394
Other operating expenses	1,047,377	922,596
	16,368,624	**14,832,307**
Income before income tax expense	**7,473,393**	**8,066,682**
Income tax expense	1,223,212	1,343,063
Net income	**$ 6,250,181**	**$ 6,723,619**
Net income per share of common stock	**$ 5.39**	**$ 5.55**

See accompanying notes.

Consolidated Statements Of Comprehensive Income

	Year Ended December 31 2019	2018
Net income	$ 6,250,181	$ 6,723,619
Other comprehensive income (loss), net of tax:		
Unrealized holding gains (losses) arising during the period	5,180,620	(2,652,949)
Reclassification adjustment for net losses included in net income	8,227	288,326
Total other comprehensive income (loss)	**5,188,847**	**(2,364,623)**
Total comprehensive income	**$ 11,439,028**	**$ 4,358,996**

Consolidated Statements Of Changes In Stockholders' Equity

Years Ended December 31, 2019 and 2018

	Common Stock				
	Number of Shares	Assigned Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at January 1, 2018	1,250,931	$ 2,249,866	$ 72,035,245	$ (2,066,929)	$ 72,218,182
Net income for 2018			6,723,619		6,723,619
Other comprehensive loss				(2,364,623)	(2,364,623)
Common stock repurchases	(91,581)	(1,734,317)	(3,999,657)		(5,733,974)
Cash dividends paid ($2.21 per share)			(2,646,293)		(2,646,293)
Balance at December 31, 2018	**1,159,350**	**$ 515,549**	**$ 72,112,914**	**$ (4,431,552)**	**$ 68,196,911**
Net income for 2019			6,250,181		6,250,181
Other comprehensive income				5,188,847	5,188,847
Cash dividends paid ($1.33 per share)			(1,545,800)		(1,545,800)
Balance at December 31, 2019	**1,159,350**	**$ 515,549**	**$ 76,817,295**	**$ 757,295**	**$ 78,090,139**

See accompanying notes.

Consolidated Statements Of Cash Flows

	Year Ended December 31 2019	2018
Cash flows from operating activities		
Net income	$ 6,250,181	$ 6,723,619
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	422,599	395,166
Net amortization of investment securities	617,992	953,496
Deferred taxes (benefit)	64,000	(124,000)
Fair value increase at transfer of other real estate owned	(64,177)	–
Valuation writedowns of other real estate owned	39,336	144,510
Net loss (gain) on sale of other real estate owned	(58,650)	42,306
Loss (gain) on disposal of premises and equipment	880	(6,872)
Loss on sale of other repossessed assets	29,000	20,661
Realized net investment security losses	10,414	364,970
Gain on sale of loans	(181,628)	(156,978)
Proceeds from sale of mortgage loans held for sale	12,859,408	9,944,899
Origination of mortgage loans held for sale	(12,117,564)	(9,825,387)
Provision for loan losses	78,000	30,000
Net change in:		
Accrued interest receivable and other assets	94,370	(249,015)
Accrued interest payable and other liabilities	479,567	1,227,874
Net cash from operating activities	8,523,728	9,485,249
Cash flows from investing activities		
Decrease (increase) in interest-bearing time deposits in other financial institutions	3,002,929	(5,247,142)
Activity in investment securities available for sale:		
Purchases	(32,706,055)	(23,497,723)
Maturities, prepayments, calls, and sales	62,748,873	44,993,649
Loan originations and payments, net	(9,164,440)	(9,963,455)
Proceeds from bank owned life insurance policy	375,798	–
Proceeds from sales of other real estate owned	246,990	357,974
Proceeds from sale of premises and equipment	500	8,128
Proceeds from sales of other repossessed assets	1,000	45,000
Additions to Bank premises and equipment, net	(1,004,846)	(501,902)
Net cash from investing activities	23,500,749	6,194,529
Cash flows from financing activities		
Net change in demand, NOW, money market, and savings deposits	6,775,743	(385,786)
Net change in time deposits	(2,263,703)	(3,651,228)
Net change in repurchase agreements	(539,531)	(11,229,675)
Principal payments on note payable	(150,000)	–
Repurchase of common stock	–	(5,733,974)
Cash dividends	(1,545,800)	(2,646,293)
Net cash from financing activities	2,276,709	(23,646,956)
Net change in cash and cash equivalents	34,301,186	(7,967,178)
Cash and cash equivalents at beginning of year	10,886,340	18,853,518
Cash and cash equivalents at end of year	$ 45,187,526	$ 10,886,340
Supplemental cash flow information		
Transfer of loans to other real estate owned	$ 343,923	$ 434,029
Loans originated from sale of other real estate owned	109,960	234,900
Acquisition of wholly-owned subsidiary via issuing a note payable	500,000	–
Transfer of other real estate owned to other repossessed assets	–	33,000
Income taxes paid	1,276,000	1,006,476
Interest paid	3,117,749	2,666,369

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations

The accounting policies followed by Keweenaw Financial Corporation (Corporation) and its wholly owned subsidiary and the methods of applying these policies, which materially affect the determination of financial position, results of operations, and cash flows are summarized below.

Nature of Operations

The Corporation provides a variety of financial and trust services to individuals and corporate customers through Superior National Bank (Bank) and its branches located in Houghton, Baraga, and Keweenaw Counties in the State of Michigan. The Bank provides a wide range of traditional banking products and services, including automated teller machines, online banking, telephone banking, and automated bill-paying services, to both individual and corporate customers. The Bank's wholly owned subsidiary, Practical Security Solutions, LLC, provides cybersecurity consulting services.

The accounting and reporting policies of the Corporation conform to accounting principles generally accepted in the United States of America (U.S. GAAP) and to general practices within the banking and mortgage banking industries.

Principles of Consolidation

The consolidated financial statements include the accounts of Keweenaw Financial Corporation and its wholly owned subsidiary, Superior National Bank. All material intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. The significant estimates incorporated into the Corporation's consolidated financial statements, which are susceptible to change in the near term, include the adequacy of the allowance for loan losses, the fair value of financial instruments, impaired loans, investments, deferred tax assets, and other real estate. Accordingly, actual results could differ from those estimates.

Labor Subject to Collective Bargaining Agreements

Approximately 23% of the Bank's employees are subject to a collective bargaining agreement, which expires on September 25, 2021.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Cash Flow Reporting

For the purpose of presentation in the consolidated statements of cash flows, cash and cash equivalents are defined to include cash on hand, demand deposits in other institutions, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, interest-bearing time deposits, bank premises and equipment, and repurchase agreement transactions.

Cash and Cash Equivalents

The Corporation maintains deposit accounts with other financial institutions, which generally exceed federally insured limits or are uninsured.

Interest-Bearing Time Deposits in Other Financial Institutions

Interest-bearing time deposits in other financial institutions are certificates of deposit which mature in the years ending 2020 through 2026 and are carried at cost.

Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, the Corporation uses various methods including market, income, and cost approaches. Based on these approaches, the Corporation often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and/or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Corporation utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the observability of the inputs used in the valuation techniques, the Corporation is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

- Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

- Level 2 – Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

- Level 3 – Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Fair Value Measurements (continued)

In determining the appropriate levels, the Corporation performs a detailed analysis of the assets and liabilities. At each reporting period, all assets and liabilities for which the fair value measurement is based on significant unobservable inputs are classified as Level 3.

For the years ended December 31, 2019 and 2018, the application of valuation techniques applied to similar assets and liabilities has been consistent.

Investment Securities

Management determines the appropriate classification of securities at the time of purchase. Securities classified as available for sale are reported at fair value, with unrealized gains and losses, net of related deferred income taxes, included in other comprehensive income/loss. Unrealized gains and losses on investment securities available for sale are based on the difference between book value and fair value of each security. Securities available for sale consist of those securities that management intends to use as part of its asset and liability management strategy which might be sold prior to maturity due to changes in interest rates, prepayment risks, and yields in addition to the availability of alternative investments, liquidity needs, or other factors. Equity securities with readily determinable fair values are carried at fair value, with changes in fair value reported in net income. Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment. Other securities, such as Federal Reserve and Federal Home Loan Bank stock, are carried at cost.

Fair value is based on quoted market prices, when available, or market prices provided by recognized broker dealers. If listed prices or quotes are not available, fair value is based upon externally developed models that use unobservable inputs due to the limited market activity of the instrument.

Interest income on securities includes amortization of purchase premium or accretion of discount. The amortized cost amount is the acquisition cost adjusted for amortization of premiums and accretions of discounts. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Realized gains and losses on dispositions are recorded on the trade date and are based on the net proceeds and the adjusted book value of the securities sold, using the specific identification method. Debt securities are written down to fair value when a decline in fair value is other than temporary.

The entire amount of impairment is recognized through earnings for debt securities with unrealized losses that management intends to sell or will more likely than not be required to sell before an anticipated recovery in fair value. Otherwise, declines in the fair value of debt securities below their cost that are other than temporary are split into two components as follows: (1) other-than-temporary impairment (OTTI) related to credit loss, which must be recognized in the statements of income; and (2) OTTI related to other factors, which is recognized in other comprehensive income. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost; (2) the financial condition and near term prospects of the issuer; and (3) the Corporation’s ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Federal Reserve Bank Stock

The Bank is a member of its regional Federal Reserve Bank (FRB). FRB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Federal Home Loan Bank Stock

The Bank is a member of the Federal Home Loan Bank (FHLB) System and is required to invest in capital stock of the FHLB of Indianapolis. The amount of the required investment is determined and adjusted by the FHLB.

Loans Held for Sale

Loans held for sale are reported at the lower of cost or market value in the aggregate, 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 without servicing rights being retained.

Loans

The Bank's loan portfolio includes residential real estate, commercial real estate, commercial, and consumer installment segments and classes.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses.

Interest income is reported on the simple interest method on the daily balance of the principal amount outstanding and includes amortization of net deferred loan fees and costs over the loan term. Accrual of interest is generally discontinued on (1) commercial loans 90 days past due as to either principal or interest, (2) real estate mortgage loans which are past due 90 days or more and on which collateral is inadequate to cover principal and interest, and (3) any loans, which management believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection is doubtful.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income at the time the loan is assigned nonaccrual status. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Loans (continued)

Loans classified as troubled debt restructurings (TDRs) are accounted for in generally the same manner as all other loans. If the loan is in accrual status at the time of the restructuring, the borrower has the ability to make the payments under the restructured terms, and the restructuring does not forgive principal, the loan remains on an accrual basis under the new terms. If there is a forgiveness of debt or partial charge-off, the loan will generally be placed on nonaccrual status with any accrued interest reversed against interest income. If a loan is in nonaccrual status at the time of a restructuring or subsequently becomes nonaccrual, it will remain in nonaccrual status until the borrower has demonstrated the ability to make the payments under the restructured terms by making a minimum of six months of payments. If the borrower makes the six months of payments without becoming past due 30 days or more, it will be returned to accrual status.

Allowance for Loan Losses

The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses, and decreased by charge-offs. Subsequent recoveries, if any, are credited to (increase) the allowance. The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management's periodic review of the collectability of the loans in light of historical loss experience, the nature and volume of the loan portfolio, information about specific borrower's ability to repay, estimated collateral values, prevailing local and national economic conditions, and other factors. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes the collectability of a loan balance is confirmed.

Regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans and other real estate. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is possible that the estimated losses on loans and other real estate may change in the near term. However, the amount of the change cannot be estimated.

The allowance consists of general, specific, and unallocated components as further described as follows:

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Allowance for Loan Losses (continued)

General Component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following loan segments: commercial, residential real estate, commercial real estate, and consumer installment loans. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels and trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and staff; national and local economic trends and conditions; changes in loan review and oversight; impact of competition and legal and regulatory requirements; changes in the value of underlying collateral; and the impact and effects of concentrations.

The qualitative factors are determined based on the various risk characteristics of each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

Residential Real Estate Loans – Loans in this segment are collateralized by residential real estate and repayment is dependent on the credit quality of the borrower and the value of the underlying collateral. Changes in business conditions, including unemployment rates and housing prices, and the local real estate market can affect the credit quality of this segment.

Commercial Real Estate Loans – Loans in this segment are collateralized by commercial real estate and repayment is dependent on the income-generating capacity of the business, the credit quality of the borrower, and the value of the underlying collateral. The underlying cash flows generated by the properties are adversely impacted by a downturn in the economy. Changes in business conditions and cash flows and the value of the underlying collateral can affect the credit quality of this segment.

Commercial Loans – Loans in this segment are generally collateralized by the assets of the business. Repayment is dependent on the income-generating capacity of the business. Changes in business conditions, a weakened economy, and resulting decreased consumer spending will affect the credit quality of this segment.

Consumer Installment Loans – Loans in this segment are generally collateralized by vehicles, other personal property, or are unsecured. Repayment is dependent on the credit quality of the borrower and their intent to repay and the value of the underlying collateral, if any. Changes in business conditions, unemployment rates, and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate the borrowers’ capacity to repay their obligations may be deteriorating.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Allowance for Loan Losses (continued)

Specific Component

The specific component relates to loans that are classified as impaired. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines 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 length of the delay, the reasons for the 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 loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent.

An allowance is established when the discounted cash flows (or collateral value) of the impaired loan are lower than the carrying value of the loan. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual residential real estate and consumer installment loans for impairment, unless such loans are subject to a troubled debt restructuring, collateral repossession, bankruptcy, or management has concerns about the borrower's ability to repay or concerns about the value of the underlying collateral.

The Bank may agree to modify the contractual terms of loans. When a loan is modified and a concession is made to a borrower experiencing financial difficulty, the modification is considered a TDR. All TDRs are classified as impaired loans.

Unallocated Component

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general reserves in the portfolio.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Corporation, 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 the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. If the transfer does not meet the conditions for sale accounting, the transfer is accounted for as secured borrowings with a pledge of collateral.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Additions and major replacements or improvements that extend useful lives are capitalized. Maintenance, repairs, and minor improvements are charged to expense as incurred. Depreciation is computed using the straight-line method over estimated useful lives for book purposes and is charged to operations. Depreciation is generally computed for tax purposes using an accelerated method. Deferred income taxes are provided on such differences. Gains and losses on premises and equipment disposed of are included in other operating income. Depreciation expense includes accretion related to the recognition of a service provider credit for future expenses of $147,142 at December 31, 2019 and 2018.

Other Real Estate Owned

Other real estate acquired through, or in lieu of, loan foreclosure is initially recorded at fair market value less estimated selling costs at the date of foreclosure establishing a new cost basis. At the date of acquisition or physical possession, and the following 90 days, losses are charged to the allowance for loan losses and increases in value are recorded as a recovery to the allowance for loan loss up to the extent of prior charge-offs and then to noninterest income. Costs of significant property improvements are capitalized, whereas costs relating to holding the property are expensed. After acquisition, valuations are periodically performed by management, and any subsequent writedowns are recorded as a charge to operations, if necessary, to reduce the carrying value of a property.

Bank-Owned Life Insurance

The Corporation purchased life insurance policies on certain key executives. Bank-owned life insurance is recorded at its cash surrender value and is included in other assets on the consolidated balance sheets.

Intangible Assets, Net

Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Intangible assets of $500,000 were acquired with the 2019 purchase of Practical Security Solutions, LLC. The intangible assets were recorded at fair value at the time of acquisition. Balances are amortized over a remaining useful life of fifteen years. Amortization expense was $8,333 in 2019. These intangible assets are tested for impairment annually. There was no impairment recorded in 2019.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Long-Term Assets

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

Repurchase Agreements

All repurchase agreement liabilities represent amounts advanced by various customers and are secured by securities owned, as they are not covered by general deposit insurance.

Pension and Profit Sharing Plans

Bank contributions to the plans are charged to current operations.

Income Taxes

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the federal income tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities.

A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. Income tax expense is the sum of the current year income tax due or refundable and the change in deferred tax assets and liabilities. The Corporation records interest and penalties related to tax positions as interest expense or other expense, respectively, in the consolidated statements of income.

Common Stock Repurchases

The Board approved the Keweenaw Financial Corporation Stock Repurchase Plan of 2016, which authorized the repurchase up to 37,000 of its outstanding shares of common stock upon privately negotiated terms, conditions, and prices. The Stock Repurchase Plan was extended for one-year periods in January 2018 and 2019. The Corporation repurchased 0 shares of common stock in 2019 and 2,072 shares of common stock for a total cost of $384,434 in 2018. In addition, the Bank purchased 28,455 shares outside the Stock Repurchase Plan in 2018 for a total cost of $5,349,540 as part of a Board approved resolution. In January 2020, the Stock Repurchase Plan was approved by the Board for an additional year.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Earnings Per Common Share

Earnings per share are computed based on the weighted-average number of shares of common stock outstanding. The weighted-average number of shares of common stock outstanding was 1,159,350 shares as of December 31, 2019, and 1,210,788 shares as of December 31, 2018.

Authorized Shares of Common Stock

The Board of Directors declared and authorized a three-for-one split of the common stock of the Corporation at their January 23, 2019 meeting. The transaction was effected in the nature of a stock dividend, equal to two additional shares of common stock for each share of common stock issued and outstanding to shareholders of record as of the close of business on February 13, 2019. Stockholders were notified of the event on February 14, 2019. Distribution of the additional shares issuable were effected through issuance of a total of 772,900 authorized but unissued shares of the Corporation's common stock. The Board of Directors also approved the adoption of book-entry registration on the Corporation's stock ledger. All share and per share amounts herein have been restated to reflect the stock split.

Off-Balance-Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commitments under credit arrangements, and letters of credit. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded in the financial statements when they become payable.

Fair Values of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 16. 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.

Advertising

The Bank expenses advertising costs as incurred.

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes the net change in unrealized gains and losses on securities available for sale, net of tax, which are also recognized as separate components of equity. Other comprehensive income (loss) also includes a reclassification adjustment for net gains and losses included in net income.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Restrictions on Cash

Cash on hand or on deposit with the Federal Reserve Bank of $8,085,000 at December 31, 2019, and $6,300,000 at December 31, 2018, was required to meet regulatory reserve requirements.

Dividend Restriction

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Corporation or by the Corporation to shareholders.

Loss Contingencies

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

Adoption of New Accounting Standards

On January 1, 2019, the Corporation adopted ASU 2016-02 Leases (Topic 842) and subsequent amendments thereto, which requires the Corporation to recognize most leases on the consolidated balance sheets. The Corporation adopted the standard under a modified retrospective approach as of the date of adoption and elected to apply several of the available practical expedients, including:

- Carryover of historical lease determination and lease classification conclusions
- Carryover of historical initial direct cost balances for existing leases
- Accounting for lease and non-lease components in contracts in which the Corporation is a lessee as a single lease component

Lease activity was rendered immaterial and as a result no lease liability or right-of-use asset was recorded in 2019. Additionally, there was no material impact to the timing of expense or income recognition in the Corporation's consolidated statements of income. The Corporation's leasing activities are further presented in Note 15, Leases.

Notes To Consolidated Financial Statements • December 31, 2019

1. Summary of Significant Accounting Policies and Nature of Operations (continued)

Subsequent Events

Subsequent events were evaluated through February 24, 2020 which was the date the financial statements were available to be issued.

2. Investment Securities

The amortized cost and fair values of investment securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) at December 31, were as follows:

2019	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agencies	$ 51,235,507	$ 399,802	$ (72,671)	$ 51,562,638
Corporate debt	20,435,140	237,382	(16,257)	20,656,265
Mortgage-backed securities	56,180,132	207,609	(429,710)	55,958,031
State and local governments	67,039,354	703,378	(70,931)	67,671,801
	$ 194,890,133	**$ 1,548,171**	**$ (589,569)**	**$ 195,848,735**

2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government and federal agencies	$ 68,732,431	$ 139,005	$ (1,277,706)	$ 67,593,730
Corporate debt	22,922,416	12,315	(364,958)	22,569,773
Mortgage-backed securities	50,812,523	10,100	(1,728,715)	49,093,908
State and local governments	83,093,987	104,534	(2,504,133)	80,694,388
	$ 225,561,357	**$ 265,954**	**$ (5,875,512)**	**$ 219,951,799**

Notes To Consolidated Financial Statements • December 31, 2019

2. Investment Securities (continued)

The amortized cost and fair values of investment securities available for sale by contractual maturity at December 31, 2019, are shown below. Expected maturities will 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.

	Amortized Cost	Fair Value
Due in one year or less	$ 14,036,779	$ 14,094,187
Due in one through five years	54,475,482	55,058,481
Due after five years through ten years	52,598,935	53,047,675
Due after ten years	17,598,805	17,690,361
Mortgage-backed securities	56,180,132	55,958,031
	$ 194,890,133	**$ 195,848,735**

Securities with unrealized losses not recognized in income at December 31, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows:

	Less Than Twelve Months		Twelve Months or More		Total	Total
2019	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Government and federal agencies	$ 9,330,635	$ 54,241	$ 5,340,067	$ 18,430	$ 14,670,702	$ 72,671
Corporate debt	4,870,053	16,257	–	–	4,870,053	16,257
Mortgage-backed securities	26,402,075	253,895	13,271,135	175,815	39,673,210	429,710
State and local governments	11,537,666	42,946	2,623,804	27,985	14,161,470	70,931
	$ 52,140,429	**$ 367,339**	**$ 21,235,006**	**$ 222,230**	**$ 73,375,435**	**$ 589,569**

Notes To Consolidated Financial Statements • December 31, 2019

2. Investment Securities (continued)

	Less Than Twelve Months		Twelve Months or More		Total	Total
2018	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Government and federal agencies	$ 4,353,577	$ 36,344	$ 48,128,385	$1,241,362	$ 52,481,962	$1,277,706
Corporate debt	10,463,738	109,959	8,091,892	254,999	18,555,630	364,958
Mortgage-backed securities	4,284,620	31,241	42,495,811	1,697,474	46,780,431	1,728,715
State and local governments	25,141,485	564,371	40,300,286	1,939,762	65,441,771	2,504,133
	$ 44,243,420	**$ 741,915**	**$ 139,016,374**	**$ 5,133,597**	**$ 183,259,794**	**$ 5,875,512**

At December 31, 2019, 89 debt securities had unrealized losses with aggregate depreciation of approximately 0.8% from the Bank's amortized cost basis, and 16 of the 89 securities were issued by a federal agency. Unrealized losses on obligations of U.S. Government and federal agencies, corporate debt, state and local governments, and mortgage-backed securities were not recognized into income because the securities were not deemed to be of low investment grade, management has the intent and ability to hold for the foreseeable future, and the decline in fair value is due to general economic conditions.

Proceeds from sales and maturities of investment securities available for sale during 2019 were $62,748,873. Net losses on those sales and maturities totaled $10,414.

Proceeds from sales and maturities of investment securities available for sale during 2018 were $44,993,649. Net losses on those sales and maturities totaled $364,970.

Investment securities with a book value of $18,559,581 at December 31, 2019, and investment securities with a book value of $23,269,977 at December 31, 2018, were pledged as collateral to secure repurchase agreements, public deposits, and for other purposes required by law.

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses

Loan segments at December 31 were as follows:

	2019	2018
Commercial	$ 46,154,886	$ 42,771,000
Commercial real estate	102,531,421	98,286,075
Residential real estate	119,170,241	119,306,780
Consumer installment	46,452,746	44,820,030
	314,309,294	305,183,885
Allowance for loan losses	(5,359,725)	(5,086,793)
Net loans	**$ 308,949,569**	**$ 300,097,092**

Changes in the allowance for loan losses by loan segment for the year ended December 31, 2019, were as follows:

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer Installment	Unallocated	Total
Balance at beginning of year	$ 347,042	$ 1,398,493	$ 1,778,016	$ 456,141	$ 1,107,101	$ 5,086,793
Provision charged to operations	106,671	(324,322)	(115,931)	76,020	335,562	78,000
Loans charged off	(164,143)	(13,108)	(68,181)	(288,683)	–	(534,115)
Recoveries	21,023	523,787	14,500	169,737	–	729,047
Balance at end of year	**$ 310,593**	**$ 1,584,850**	**$ 1,608,404**	**$ 413,215**	**$ 1,442,663**	**$ 5,359,725**

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

The following table presents the balance of loans by loan segment based on impairment method at December 31, 2019:

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer Installment	Unallocated	Total
Allowance for loan losses:						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	$ 40,647	$ 357,377	$ 651,763	$ 17,878	$ –	$ 1,067,665
Collectively evaluated for impairment	269,946	1,227,473	956,641	395,337	–	2,849,397
Unallocated to specific loan segments	–	–	–	–	1,442,663	1,442,663
Ending allowance balance	**$ 310,593**	**$ 1,584,850**	**$ 1,608,404**	**$ 413,215**	**$ 1,442,663**	**$ 5,359,725**
Loans:						
Individually evaluated for impairment	$ 1,554,940	$ 6,544,842	$ 5,818,352	$ 266,718	$ –	$ 14,184,852
Collectively evaluated for impairment	44,599,946	95,986,579	113,351,889	46,186,028	–	300,124,442
Ending loan balance	**$ 46,154,886**	**$ 102,531,421**	**$ 119,170,241**	**$ 46,452,746**	**$ –**	**$ 314,309,294**

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

Changes in the allowance for loan losses by loan segment for the year ended December 31, 2018 were as follows:

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer Installment	Unallocated	Total
Balance at beginning of year	$ 261,409	$ 1,395,252	$ 1,489,713	$ 349,234	$ 662,839	$ 4,158,447
Provision charged to operations	80,888	(1,085,118)	299,305	290,663	444,262	30,000
Loans charged off	(64,311)	(38,912)	(20,091)	(233,873)	–	(357,187)
Recoveries	69,056	1,127,271	9,089	50,117	–	1,255,533
Balance at end of year	**$ 347,042**	**$ 1,398,493**	**$ 1,778,016**	**$ 456,141**	**$ 1,107,101**	**$ 5,086,793**

The following table presents the balance of loans by loan segment based on impairment method at December 31, 2018:

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer Installment	Unallocated	Total
Allowance for loan losses:						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	$ 61,973	$ 348,368	$ 781,026	$ 18,230	$ –	$ 1,209,597
Collectively evaluated for impairment	285,069	1,050,125	996,990	437,911	–	2,770,095
Unallocated to specific loan segments	–	–	–	–	1,107,101	1,107,101
Ending allowance balance	**$ 347,042**	**$ 1,398,493**	**$ 1,778,016**	**$456,141**	**$ 1,107,101**	**$ 5,086,793**

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer Installment	Unallocated	Total
Loans:						
Individually evaluated for impairment	$ 1,104,621	$ 10,997,031	$ 6,808,334	$ 158,000	$ –	$ 19,067,986
Collectively evaluated for impairment	41,666,379	87,289,044	112,498,446	44,662,030	–	286,115,899
Ending loan balance	**$ 42,771,000**	**$ 98,286,075**	**$119,306,780**	**$44,820,030**	**$ –**	**$ 305,183,885**

The following table presents impaired loans individually evaluated for impairment by loan segment at December 31, 2019. The table below does not include those impaired loans collectively evaluated for impairment:

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial	$ 1,288,810	$ 1,284,883	$ –	$ 952,099	$ 89,146
Commercial real estate	2,389,196	2,141,866	–	4,519,492	208,564
Residential real estate	1,881,189	1,859,663	–	2,228,474	126,054
Consumer installment	140,545	140,545	–	100,563	11,014
Total impaired loans without a valuation allowance	**$ 5,699,740**	**$ 5,426,957**	**$ –**	**$ 7,800,628**	**$ 434,778**
Impaired loans with a valuation allowance:					
Commercial	$ 274,111	$ 270,057	$ 40,647	$ 377,682	$ 21,309
Commercial real estate	4,407,881	4,402,976	357,377	4,251,444	304,561
Residential real estate	3,988,180	3,958,689	651,763	4,084,869	228,911
Consumer installment	126,173	126,173	17,878	111,796	11,014
Total impaired loans with a valuation allowance	**$ 8,796,345**	**$ 8,757,895**	**$1,067,665**	**$ 8,825,791**	**$ 565,795**
Total impaired loans	**$14,496,085**	**$14,184,852**	**$1,067,665**	**$16,626,419**	**$1,000,573**

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

The following table presents impaired loans individually evaluated for impairment by loan segment at December 31, 2018. The table below does not include those impaired loans collectively evaluated for impairment:

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial	$ 627,358	$ 619,315	$ –	$ 716,658	$ 56,978
Commercial real estate	6,955,672	6,897,118	–	7,211,825	530,478
Residential real estate	2,598,785	2,597,285	–	2,656,255	157,240
Consumer installment	60,581	60,581	–	69,293	5,728
Total impaired loans without a valuation allowance	**$ 10,242,396**	**$ 10,174,299**	**$ –**	**$10,654,031**	**$ 750,424**
Impaired loans with a valuation allowance:					
Commercial	$ 487,713	$ 485,306	$ 61,973	$ 524,213	$ 36,612
Commercial real estate	4,103,644	4,099,913	348,368	4,126,022	260,566
Residential real estate	4,232,602	4,211,049	781,026	4,296,559	248,525
Consumer installment	97,466	97,419	18,230	114,688	8,601
Total impaired loans with a valuation allowance	**$ 8,921,425**	**$ 8,893,687**	**$1,209,597**	**$ 9,061,482**	**$ 554,304**
Total impaired loans	**$ 19,163,821**	**$19,067,986**	**$1,209,597**	**$19,715,513**	**$ 1,304,728**

The following table presents TDRs that occurred during 2019 by loan segment:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Valuation Allowance
Residential real estate	3	$ 225,540	$ 225,540	$ –
Consumer installment	2	35,443	35,443	3,000

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

The modification of the terms of such loans to borrowers with financial difficulty includes one or a combination of the following: a reduction in the stated interest rate of the loan; an extension of the maturity date; or some other modification deeming the loan a TDR. All TDRs are considered impaired loans in the calculation of the allowance for loan losses; therefore, management performs a reserve analysis on all loans that have been determined to be TDRs. The Corporation had a total TDR portfolio of $7,569,805 with a total valuation allowance of $586,451 as of December 31, 2019.

The following table presents TDRs by loan segment that had a payment default in 2019 within 12 months following modification:

	Number of Loans	Amount in Default
Commercial	1	$ 4,895
Residential real estate	1	144,172
Consumer installment	1	6,919

The following table presents TDRs that occurred during 2018 by loan segment:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Valuation Allowance
Commercial	1	$ 11,579	$ 11,579	$ –
Residential real estate	3	181,700	180,658	–
Consumer installment	4	60,903	60,903	3,892

The modification of the terms of such loans to borrowers with financial difficulty includes one or a combination of the following: a reduction in the stated interest rate of the loan; an extension of the maturity date; or some other modification deeming the loan a TDR. All TDRs are considered impaired loans in the calculation of the allowance for loan losses; therefore, management performs a reserve analysis on all loans that have been determined to be TDRs. The Corporation had a total TDR portfolio of $10,663,667 with a total valuation allowance of $735,976 as of December 31, 2018.

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

The following table presents TDRs by loan segment that had a payment default in 2018 within 12 months following modification:

	Number of Loans	Amount in Default
Commercial	5	$ 48,504
Commercial real estate	2	108,151
Residential real estate	1	48,193
Consumer installment	3	19,885

During 2019 and 2018, the Corporation has not committed to lend additional funds to any borrowers whose loan terms have been modified as a TDR.

Loans greater than 90 days past due and still accruing and nonaccrual loans were as follows at December 31:

	2019		2018	
	Past Due 90 Days or More Still Accruing	Nonaccrual	Past Due 90 Days or More Still Accruing	Nonaccrual
Commercial	$ –	$ 199,983	$ –	$ 42,161
Commercial real estate	–	651,321	–	415,610
Residential real estate	25,196	708,617	98,548	546,937
Consumer installment	8,714	2,434	43,706	7,982
	$ 33,910	**$ 1,562,355**	**$ 142,254**	**$ 1,012,690**

The following table presents the aging of all loans by segment at December 31, 2019:

	Past Due 30-89 Days	Past Due 90 Days or More	Total Past Due	Current	Total Loan Balance
Commercial	$ –	$ –	$ –	$ 46,154,886	$ 46,154,886
Commercial real estate	56,519	–	56,519	102,474,902	102,531,421
Residential real estate	965,960	25,196	991,156	118,179,085	119,170,241
Consumer installment	264,231	8,714	272,945	46,179,801	46,452,746
	$ 1,286,710	**$ 33,910**	**$ 1,320,620**	**$ 312,988,674**	**$ 314,309,294**

Notes To Consolidated Financial Statements • December 31, 2019

3. Loans and Allowance for Loan Losses (continued)

The following table presents the aging of all loans by segment at December 31, 2018:

	Past Due 30-89 Days	Past Due 90 Days or More	Total Past Due	Current	Total Loan Balance
Commercial	$ 756,570	$ –	$ 756,570	$ 42,014,430	$ 42,771,000
Commercial real estate	171,665	–	171,665	98,114,410	98,286,075
Residential real estate	1,571,924	98,548	1,670,472	117,636,308	119,306,780
Consumer installment	203,554	43,706	247,260	44,572,770	44,820,030
	$ 2,703,713	**$ 142,254**	**$ 2,845,967**	**$ 302,337,918**	**$ 305,183,885**

Credit Quality Information

The Bank uses the following eight grade, risk-rating system for all commercial and commercial real estate loans:

Grades 1 through 4
Loans in these categories exhibit an acceptable level of credit risk, ranging from “Exceptional” to “Satisfactory.” These are pass-rated loans.

Grade 5
“Other/Special Mention.” Loans in this category have potential weaknesses that deserve Bank management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects or in the Bank’s credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Grade 6
“Substandard.” Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Grade 7
“Doubtful.” Doubtful loans have all the weaknesses inherent in “Substandard” loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable. The possibility of loss is high, but because of certain important pending events that may strengthen the loan, its classification as loss is deferred until its exact status is known.

Grade 8
“Loss.” Loans in this category are considered uncollectible and of such little value, that their continuance as bankable assets is not warranted. This does not mean that the loan has absolutely no recovery or salvage value; rather, it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

3. Loans and Allowance for Loan Losses (continued)

The Bank utilizes a numeric grading system for loans to indicate the quality of the credit. At origination, grades are assigned to each commercial and commercial real estate loan by assessing information about the borrower's situation including cash flow analysis and estimated collateral values. The loan grade is reassessed at each renewal or refinance but any credit may receive a review based on lender identification of changes in the situation or behavior of the borrower. In addition to these methods of assigning loan grades, changes may occur through the loan review program or regulatory examination process.

The loan grades as of December 31, 2019 were as follows:

	Commercial	Commercial Real Estate
Pass (Grades 1-4)	$ 43,688,100	$ 95,789,674
Other/Special Mention	1,101,995	4,131,463
Substandard	1,364,791	2,610,284
Loss	–	–
Total	**$ 46,154,886**	**$102,531,421**

The loan grades as of December 31, 2018, were as follows:

	Commercial	Commercial Real Estate
Pass (Grades 1-4)	$ 40,059,480	$ 85,526,155
Other/Special Mention	1,662,232	6,022,671
Substandard	1,049,004	6,737,249
Loss	284	–
Total	**$ 42,771,000**	**$ 98,286,075**

The Bank considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential real estate and consumer installment loan segments, the Bank evaluates credit quality based on the aging status of the loan and by payment activity. Loans past due 90 days are classified as substandard. The following table presents the balance of residential real estate and consumer installment loans based on payment activity as of December 31, 2019:

	Residential Real Estate	Consumer Installment
Performing	$ 115,350,731	$ 46,309,884
Nonperforming	3,819,510	142,862
Total	**$ 119,170,241**	**$ 46,452,746**

3. Loans and Allowance for Loan Losses (continued)

The following table presents the balance of residential real estate and consumer installment loans based on payment activity as of December 31, 2018:

	Residential Real Estate	Consumer Installment
Performing	$ 113,650,552	$ 44,592,149
Nonperforming	5,656,228	227,881
Total	**$ 119,306,780**	**$ 44,820,030**

4. Other Real Estate Owned

Other real estate owned activity was as follows for the year ended December 31:

	2019	2018
Beginning balance	$ 279,811	$ 658,472
Loans transferred to real estate owned	343,923	434,029
Fair value increases at transfer	64,177	–
Transfers to other repossessed assets	–	(33,000)
Direct writedowns	(39,336)	(144,510)
Sales of real estate owned	(298,300)	(635,180)
End of year	**$ 350,275**	**$ 279,811**

The balance of other real estate owned, included in other assets on the consolidated balance sheets, includes foreclosed residential real estate properties of $0.3 million at December 31, 2019, and $0.1 million at December 31, 2018. These properties were recorded as a result of obtaining physical possession of the property. The recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process is $0.3 million at December 31, 2019, and $0.2 million at December 31, 2018.

Expenses related to foreclosed assets for the year ended December 31 include:

	2019	2018
Net (gain) loss on sales	$ (58,650)	$ 42,306
Operating expenses, net of rental income	116,416	292,791
	$ 57,766	**$ 335,097**

Notes To Consolidated Financial Statements • December 31, 2019

5. Bank Premises and Equipment

The major classifications of Bank premises and equipment assets at December 31 are summarized as follows:

	2019	2018
Land and improvements	$ 1,429,425	$ 1,377,551
Buildings and improvements	8,811,080	8,164,473
Equipment (including software)	4,807,748	4,943,021
Leasehold improvements	513,263	488,120
	15,561,516	14,973,165
Accumulated depreciation/amortization	(8,492,346)	(8,337,720)
Bank premises and equipment, net	**$ 7,069,170**	**$ 6,635,445**

6. Time Deposits

The aggregate amount of time deposit accounts exceeding $250,000 was $31,057,368 at December 31, 2019, and $28,688,899 at December 31, 2018.

The contractual annual maturities of time deposits at December 31, 2019, were as follows:

2020	$ 61,020,667
2021	35,635,840
2022	23,135,331
2023	12,973,227
2024	8,023,515
Thereafter	4,149
	$ 140,792,729

7. Short-Term Borrowings

Short-term borrowings are generally comprised of federal funds purchased and repurchase agreements. Federal funds purchased are overnight borrowings from various correspondent banks. Repurchase agreements are advances by customers that are not covered by federal deposit insurance. This obligation of the Bank is secured by bank-owned securities held by a third-party safekeeping agent.

Short-term borrowings as of December 31 were as follows:

	Repurchase Agreements	Federal Funds Purchased
2019	–	–
Average interest rate at year end	N/A	N/A
Average balance during the year	N/A	$ 14,784
Average interest rate during the year	N/A	3.93%
Maximum balance during the year	N/A	$ 3,245,000
2018	$ 539,531	–
Average interest rate at year end	1.16%	N/A
Average balance during the year	$ 7,423,598	$ 122,356
Average interest rate during the year	1.11%	1.12%
Maximum balance during the year	$ 40,821,731	$ 4,230,000

The table below shows the remaining contractual maturity of agreements by collateral pledged.

	Remaining Contractual Maturity of the Agreements
	Overnight and Continuous
U.S. Government and federal agencies	$ 7,611,030
Corporate debt	4,132,195
State and local governments	7,067,073
Total securities	**$ 18,810,298**

The fair value of securities pledged to secure repurchase agreements may decline. The Corporation assigns collateral by par value. The Corporation manages this risk by having a policy to monitor the daily aggregate balance of pledged securities and assigning them above the gross outstanding balance of the repurchase agreements. Note 2 addresses the carrying amount of pledged collateral to secure repurchase agreements.

Notes To Consolidated Financial Statements • December 31, 2019

8. Pension and Profit Sharing Plans

All eligible non-officer employees of Superior National Bank have the following employee benefit plans available to them:

Pension Plan

Through November 28, 2015, the Bank contributed to a multiemployer defined benefit pension plan (Plan) established and maintained pursuant to a collective bargaining agreement between the Bank and the United Food and Commercial Workers Union (Union) to cover its union- represented employees.

On November 28, 2015, the Bank and the collective bargaining unit agreed to terminate participation in and withdraw from the Plan. Upon termination of its Plan, the Bank was subject to a withdrawal liability of $12,672,705. However, under ERISA 4219(c)(1)(B), the amount was subject to the 20-year payment cap. Therefore, the Bank's liability was computed to be $4,377,252, payable in monthly installments of $18,239, including interest of 7.5%, for a period of 20 years. As a result, the Bank recorded a liability and pension expense of $2,583,128 at November 28, 2015. This amount represents the net present value of the payment stream discounted at 2.64%. As payments are made, the Bank will reduce the liability and record pension expense based on the effective interest method. The remaining liability was $2,006,984 as of December 31, 2019, and $2,151,302 as of December 31, 2018, and total pension expense was $74,545 for the year ended December 31, 2019, and $72,605 for the year ended December 31, 2018. The first scheduled payment on the liability was made February 26, 2016. The Bank made payments to the Plan totaling $218,863 for the years ended December 31, 2019 and 2018, all of which related to the withdrawal from the Plan. If the Bank is in default on the payment of the liability or if the Plan's Board of Trustees determines that the Bank will not be able to make the payments due to bankruptcy or other events involving the Bank's credit, the entire liability may become payable in full.

In accordance with laws governing the Bank's termination of participation in and withdrawal from the Plan, if the Plan cannot meet its future obligations, the Bank may be required to pay additional amounts. If the Bank is required to pay any additional amount, that amount would be material to the Bank. As of December 31, 2019, the Bank has not been required to pay an additional amount to the Plan.

Notes To Consolidated Financial Statements • December 31, 2019

8. Pension and Profit Sharing Plans (continued)

401(k) Plan

For bargaining unit employees and certain non-bargaining employees, the Bank contributes to a 401(k) plan. Employees may voluntarily contribute to the 401(k) plan a portion of their salary up to the maximum allowed under the Internal Revenue Code. The Bank's contributions for bargaining unit employees totaled $58,399 for 2019 and $63,633 for 2018.

The following employee benefit plans are available to officers of Superior National Bank:

Profit Sharing Plan

Superior National Bank has a defined contribution profit sharing plan for the benefit of all salaried officers meeting the eligibility requirements as defined in the plan document. Employees may voluntarily contribute to the plan via salary deferrals, up to the maximum allowed under the Internal Revenue Code. The Bank's contributions are based on a percentage of the Bank's net income before federal and state income taxes and totaled $510,402 for 2019 and $424,908 for 2018.

Other

Superior National Bank has entered into deferred compensation agreements with certain officers. Some agreements call for payments to be made over a 10- to 15-year period. Employees become eligible for full benefits at the age of 62, or a reduced payment if the individual elects an earlier retirement date. This program is being funded by the purchase of life insurance policies. Some agreements allow for employees to voluntarily defer a portion of their salary and bonuses to an account where the Bank contributes the earnings on the account. The net amount of the premium and Bank contributions charged to expense was $67,619 for 2019 and $37,833 for 2018.

9. Interest Payments and Borrowings

The Bank has unsecured federal funds credit facilities of $10,000,000 and $5,000,000 made available by two financial institutions. Under the terms of agreements, the Bank may borrow amounts at the financial institutions' federal funds interest rate at the time of the borrowings. There were no amounts outstanding as of December 31, 2019 or 2018. In 2016, the Company established a $10,000,000 line-of-credit with a non-affiliated bank. There was no balance outstanding as of December 31, 2019, or December 31, 2018. In addition, the Bank has borrowing windows with the Federal Home Loan Bank of Indianapolis, which have limits based on collateral pledged. There were no advances outstanding at December 31, 2019, or December 31, 2018.

Notes To Consolidated Financial Statements • December 31, 2019

10. Regulatory Matters

The Bank is subject to regulatory capital requirements administered by the federal banking agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Failure to meet capital requirements can initiate regulatory action.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.00% for 2015 to 2.50% by 2019. The capital conservation buffer for 2019 is 2.50% and for 2018 is 1.875%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes, as of December 31, 2019, that the Bank meets all capital adequacy requirements to which it is subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. As of December 31, 2019, and 2018, the most recent notifications from the Office of the Comptroller of the Currency categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since those notifications that management believes have changed the Bank's category.

Actual and required capital amounts and ratios for 2019 and 2018 are presented below (dollar amounts are in thousands):

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
December 31, 2019						
Total capital to risk-weighted assets	$ 79,407	25.34%	$ 25,071	8.00%	$ 31,339	10.00%
Tier I capital to risk-weighted assets	75,472	24.08	18,803	6.00	25,071	8.00
Common Tier I	75,472	24.08	14,102	4.50	20,370	6.50
Tier I capital to average assets	75,472	13.02	23,185	4.00	28,981	5.00

Notes To Consolidated Financial Statements • December 31, 2019

10. Regulatory Matters (continued)

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2018						
Total capital to risk-weighted assets	$ 74,864	23.25%	$ 25,759	8.00%	$ 32,198	10.00%
Tier I capital to risk-weighted assets	70,826	22.00	19,319	6.00	25,759	8.00
Common Tier I	70,826	22.00	14,489	4.50	20,929	6.50
Tier I capital to average assets	70,826	12.39	22,866	4.00	28,583	5.00

Consolidated capital amounts and ratios are not included in the above table as they are not considered significant due to the Bank comprising approximately 99% of the consolidated assets of the Corporation.

The Bank is restricted, under applicable laws, in the payment of cash dividends. Amounts available for distribution as dividends without the prior approval of regulatory authorities approximated $5.0 million in 2019 and $1.5 million in 2018.

11. Commitments and Contingencies

In the ordinary course of business, the Bank makes commitments for possible future extensions of credit that are not reflected in the financial statements. The Bank was obligated on commercial standby letters of credit of approximately $882,000 as of December 31, 2019 and $953,000 as of December 31, 2018, and committed, but as yet undisbursed, loan proceeds and lines of credit of approximately $22,231,000 as of December 31, 2019 and $21,571,000 as of December 31, 2018. The Bank does not anticipate losses in connection with the commitments.

12. Income Taxes

The consolidated provision for federal income taxes for the year ended December 31 is comprised of the following components:

	2019	2018
Current expense	$1,159,000	$ 1,467,000
Deferred expense (benefit)	64,000	(124,000)
	$1,223,000	**$ 1,343,000**

Notes To Consolidated Financial Statements • December 31, 2019

12. Income Taxes (continued)

As of December 31, 2019, and 2018, the net deferred tax asset recorded is included in other assets. The net deferred tax assets include the following amounts as of December 31:

	2019	2018
Deferred tax assets:		
Nonaccrual interest	$ 11,000	$ 9,000
Deferred compensation	197,000	119,000
Other real estate	1,000	16,000
Allowance for loan losses	1,126,000	1,068,000
Unrealized losses on investment securities	–	1,178,000
Pension withdrawal liability	421,000	452,000
	1,756,000	2,842,000
Deferred tax liabilities:		
Depreciation	348,000	206,000
Unrealized gains on investment securities	202,000	–
Discount accretion	47,000	33,000
	597,000	239,000
Net deferred tax assets	**$ 1,159,000**	**$ 2,603,000**

A reconciliation of federal income tax expense to the amount of tax expense computed by applying the statutory federal income tax rate of 21% to income before income taxes for the year ended December 31 is as follows:

	2019	2018
Tax expense at statutory rate	$ 1,569,000	$ 1,694,000
Tax-exempt interest	(321,000)	(421,000)
Other	(25,000)	70,000
Federal income tax expense	**$1,223,000**	**$1,343,000**

Any potential liability for uncertain tax positions, including interest and penalties, has been recorded in deferred tax liabilities and has not been reclassified as a separate liability.

All tax years from 2016 and subsequent, remain open to examination by the Internal Revenue Service. The Corporation does not believe that the results from any examination of these open years would have a material adverse effect on the Corporation.

Notes To Consolidated Financial Statements • December 31, 2019

13. Related Party Transactions

In the ordinary course of business, the Bank makes loans to its officers and directors and its affiliated businesses and it expects to continue making such loans in the future. These loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than normal risk of collectability.

The activity in loans to officers and directors, including unused line of credit, for the year ended December 31, was as follows:

	2019	2018
Balances at January 1	$ 3,416,000	$ 2,142,000
New loans	763,250	1,717,000
Repayments	(795,250)	(443,000)
Balances at December 31	**$ 3,384,000**	**$ 3,416,000**

The amount of deposits of employees, officers, and directors approximated $4,980,000 as of December 31, 2019 and $4,472,000 as of December 31, 2018.

14. Concentration of Credit

All of the Bank's loans, commitments, and commercial and standby letters of credit have been granted to customers in the Bank's market area: primarily Houghton, Keweenaw, and Baraga counties in the Upper Peninsula of Michigan. Investments in state and municipal securities also involve governmental entities within the Bank's market area. The concentrations of credit by type of loan are set forth in Note 3. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial and standby letters of credit were granted primarily to commercial borrowers.

15. Leases

The Bank has three operating leases for branch offices. Future minimum lease payments for the year ended December 31 are as follows:

2020	$	61,384
2021		56,268
	$	**117,652**

Branch rental expense approximated $98,000 at December 31, 2019 and $95,000 at December 31, 2018.

Notes To Consolidated Financial Statements • December 31, 2019

16. Fair Values of Financial Instruments

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

Cash and Other Items: The carrying value of cash and cash equivalents, interest-bearing time deposits in other financial institutions, loans held for sale, accrued interest receivable, repurchase agreements, and accrued interest payable approximate fair value.

Investment Securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying amount is the estimated fair value for the investment in Federal Reserve and Federal Home Loan Bank stock.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for certain mortgage loans (e.g., one-to-four family residential), consumer loans, and other loans (e.g., commercial real estate and rental property mortgage loans, commercial and industrial loans, and agricultural loans) are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values.

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

16. Fair Values of Financial Instruments (continued)

The approximate carrying amount and estimated fair values of the Bank's financial instruments at December 31 were as follows:

	2019		2018	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets				
Cash and cash equivalents	$ 45,188,000	$ 45,188,000	$ 10,886,000	$ 10,886,000
Interest-bearing time deposits in other financial institutions	9,102,000	9,102,000	12,104,000	12,104,000
Investment securities available for sale	195,849,000	195,849,000	219,952,000	219,952,000
Federal Reserve and Federal Home Loan Bank stock	1,535,000	1,535,000	1,535,000	1,535,000
Loans held for sale	–	–	560,000	560,000
Loans, less allowance for loan losses	308,950,000	319,075,000	300,097,000	305,935,000
Accrued interest receivable	2,044,000	2,044,000	2,259,000	2,259,000
Liabilities				
Deposits	488,698,000	490,279,000	484,186,000	482,673,000
Repurchase agreements	–	–	540,000	540,000
Accrued interest payable	331,000	331,000	290,000	290,000

17. Comprehensive Income (Loss)

The Comprehensive Income topic of FASB ASC 220 requires the reporting of comprehensive income (loss) in addition to net income. Comprehensive income (loss) is a more inclusive financial reporting methodology that includes disclosure of certain financial information that, historically, has not been recognized in the calculation of net income.

The only item included in comprehensive income (loss) is the change in unrealized gains (losses) on investment securities classified as available for sale. The reclassification adjustment for gains (losses) is recorded as a separate line item on the consolidated statements of income. The before-tax and after-tax amounts for the year ended December 31 are summarized on the next page:

Notes To Consolidated Financial Statements • December 31, 2019

17. Comprehensive Income (Loss) (continued)

	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
2019			
Unrealized gains on securities:			
Unrealized holding gains arising during the period	$ 6,557,746	$ (1,377,126)	$ 5,180,620
Reclassification adjustment for net losses realized in net income	10,414	(2,187)	8,227
Total other comprehensive income	$ 6,568,160	$ (1,379,313)	$ 5,188,847
2018			
Unrealized losses on securities:			
Unrealized holding losses arising during the period	$ (3,358,164)	$ 705,215	$ (2,652,949)
Reclassification adjustment for net losses realized in net income	364,970	(76,644)	288,326
Total other comprehensive loss	$ (2,993,194)	$ 628,571	$ (2,364,623)

18. Fair Value

The Corporation utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Corporation may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, impaired loans, foreclosed assets, mortgage servicing rights, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting write downs of individual assets.

Notes To Consolidated Financial Statements • December 31, 2019

18. Fair Value (continued)

Following is a description of the valuation methodologies used for assets and liabilities recorded at fair value:

Investment Securities: Investment securities available for sale are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions, and other factors such as credit loss and liquidity assumptions and are considered Level 2. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party without making any adjustments. The third party generally obtains direct market prices; however, there are several market prices that are determined on a basis other than a direct market price, such as benchmark curves, sector groupings or matrix pricing. Because of these modeling techniques, the third party generally designates the investment securities as Level 2.

Other Real Estate: Upon transfer from the loan portfolio, other real estate is adjusted to and subsequently carried at the fair market value less cost to sell at the date of foreclosure. Fair value is based upon independent market prices, appraised values of the collateral, or management's estimate of the collateral. Level 3 other real estate assets consist primarily of properties in which the Bank has foreclosed but has not yet obtained physical possession. Therefore, the Bank determines the fair value of the properties based on an internal evaluation. The internal evaluation takes into consideration a combination of one or more of the following inputs: observation of condition of the exterior of the property; initial appraisals of the property when the loan was initially granted; comparable sales data; and list prices of comparable properties. After the Bank obtains physical possession, which typically occurs when the redemption period has expired, the Bank will obtain a current appraisal to determine the fair market value and the asset will generally be considered Level 2.

Loans: The Corporation does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and a specific allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with FASB Codification Section 942-310. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value, and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

The Corporation reviews the net realizable values of the underlying collateral for collateral dependent impaired loans on a quarterly basis for all loan types. To determine the collateral value, management utilizes independent appraisals or internal evaluations.

These valuations are reviewed to determine whether additional discount should be applied given the age of market information that may have been considered as well as other factors such as costs to carry and sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. These valuations are used to determine if any charge-offs or specific reserves are necessary. The Corporation may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.

Notes To Consolidated Financial Statements • December 31, 2019

18. Fair Value (continued)

Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Corporation records the impaired loan as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Corporation records the impaired loan as nonrecurring Level 3.

The Corporation utilizes the following information when measuring Level 3 other real estate and impaired loans:

Valuation Technique	Fair Value at December 31, 2019	Unobservable Inputs	Range
Other real estate			
Discounted appraisal value	$ 241,500	Real estate collateral appraisal marketability discount	30%
Impaired loans			
Discounted appraisal value	7,536,822	Real estate collateral appraisal marketability discount	0-40%
Discounted cash flows	48,963	Duration of cash flows	247 months
		Reduction of interest rate from original loan terms	0%

Valuation Technique	Fair Value at December 31, 2018	Unobservable Inputs	Range
Other real estate			
Discounted appraisal value	$ 44,100	Real estate collateral appraisal marketability discount	30%
Impaired loans			
Discounted appraisal value	7,271,378	Real estate collateral appraisal marketability discount	0-50%
Discounted cash flows	372,999	Duration of cash flows	167-259 months
		Reduction of interest rate from original loan terms	0%

Notes To Consolidated Financial Statements • December 31, 2019

18. Fair Value (continued)

Fair values of assets and liabilities measured on a recurring basis at December 31 were as follows:

	Fair Value Measurements at Reporting Date Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets/ Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2019				
U.S. Government and federal agencies	$ 51,562,638	$ –	$ 51,562,638	$ –
Corporate debt	20,656,265	–	20,656,265	–
Mortgage-backed securities	55,958,031	–	55,958,031	–
State and local governments	67,671,801	–	67,671,801	–
Total securities	**$ 195,848,735**	**$ –**	**$ 195,848,735**	**$ –**
2018				
U.S. Government and federal agencies	$ 67,593,730	$ –	$ 67,593,730	$ –
Corporate debt	22,569,773	–	22,569,773	–
Mortgage-backed securities	49,093,908	–	49,093,908	–
State and local governments	80,694,388	–	80,694,388	–
Total securities	**$ 219,951,799**	**$ –**	**$ 219,951,799**	**$ –**

Fair values of assets and liabilities measured on a nonrecurring basis at December 31 were as follows:

	Total	Level 1	Level 2	Level 3
2019				
Other real estate	$ 350,275	$ –	$ 108,775	$ 241,500
Impaired loans	7,585,785	–	–	7,585,785
Total assets	**$ 7,936,060**	**$ –**	**$ 108,775**	**$ 7,827,285**
2018				
Other real estate	$ 279,811	$ –	$ 235,711	$ 44,100
Impaired loans	7,644,377	–	–	7,644,377
Total assets	**$ 7,924,188**	**$ –**	**$ 235,711**	**$ 7,688,477**

19. Revenue From Contracts with Customers

The Corporation follows the revenue recognition principles in ASU 2014-09 *Revenue from Contracts with Customers* and all subsequent amendments to the ASU (collectively "ASC 606"). ASC 606 creates a single framework for recognizing revenue from contracts with customers that fell within its scope and revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as other real estate owned (OREO). The majority of the Corporation's revenues come from interest income and other sources, including loans, leases, securities and derivatives, that are outside the scope of ASC 606. The Corporation's services that fall within the scope of ASC 606 are presented within noninterest income and are recognized as revenue as the Corporation satisfies its obligation to the customer. Services within the scope of ASC 606 include service charges on deposit accounts, interchange income, trust fees, and the sale of OREO.

Revenue from contracts with customers was as follows for the year ended December 31:

	2019	2018
Noninterest Income		
Trust fees	$ 1,536,480	$ 1,403,210
Service charges on deposit accounts	718,405	808,530
Other service charges and fees:		
Interchange fees	906,296	812,330
Other fees	79,956	134,009
Net (loss) on sale of investment securities*	(10,414)	(364,970)
Net gain on sale of loans*	181,628	156,978
Other income:		
Practical Security Solutions, LLC advisory fees	81,332	–
Other Income*	140,152	70,481
	$ 3,633,835	**$ 3,020,568**

All of the Corporation's revenue from contracts with customers in the scope of ASC 606 is recognized within noninterest income, with the exception of sales of OREO of $58,650 and ($42,306) for 2019 and 2018, respectively, that are included in noninterest expense. The table above presents the Corporation's sources of noninterest income for the years ended December 31, 2019 and 2018. Items outside of the scope of ASC 606 are noted as such (*). The other fees category includes approximately $50,200 and $52,500 of miscellaneous deposit fees which are within the scope of ASC 606, for 2019 and 2018, respectively.

Notes To Consolidated Financial Statements • December 31, 2019

19. Revenue From Contracts with Customers (continued)

Trust Fees: The Corporation earns fee income through its agreements with trust customers, for the management of assets for investment and/or to transact on their accounts. These fees are primarily earned over time as the Corporation provides services which are generally assessed monthly based on a tiered scale of the market value of assets under management (AUM). Fees that are transaction based, including trade execution services, are recognized at the point in time the transaction is executed. Other related services provided include financial planning services, estate administrative services, and other services, which are defined by a fixed fee schedule. Such fees are recognized when services are rendered.

Service Charges on Deposit Accounts and Other Miscellaneous Deposit Fees: The Corporation earns fees, based on a fixed fee schedule, from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM usage fees, wire transfer fees, stop payment charges, statement rendering and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Corporation fulfills the customer's request. Account maintenance fees, which relate primarily to monthly general maintenance, are earned over the course of a month, representing the period over which the Corporation satisfies the performance obligation. Overdraft service fees are recognized when the overdraft occurs. Deposit service charges are withdrawn from the customer's account balance. Safe deposit box rental fees are assessed and paid annually.

Interchange Fees: The Corporation earns interchange fees from cardholder transactions conducted through established payment networks. 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.

Practical Security Solutions, LLC Advisory Fees: The Corporation earns advisory fees from businesses through contracted cybersecurity advisory services. Advisory services are customized to organizational needs and regulatory requirements based on the results of proprietary cybersecurity readiness assessments, and may include development of policies and strategic plans, security training, incident response plans, simulation testing, and more. Fees are recognized within noninterest income over time as customers are billed for services performed.

Gains/Losses on Sales of OREO: The Corporation records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time the deed is executed. When the Corporation finances the sale of OREO to the buyer, the Corporation first estimates the potential gain or loss on sale. The Corporation will then assess whether the buyer is committed to perform their obligations under the loan agreement and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of property control to the buyer. In determining the gain or loss on the sale, the Corporation adjusts the transaction price and related gain or loss on sale if a significant financing component is present.

20. Acquisition of Practical Security Solutions, LLC

On October 1, 2019, the Bank completed the acquisition of Practical Security Solutions, LLC, a Delaware limited liability company engaged in the business of providing cybersecurity consulting services. Under the terms of the purchase agreement, the Bank purchased Practical Security Solutions, LLC in exchange for $500,000 paid over a period of four years, with the first payment made October 1, 2019 and the final payment due October 2023. This strategic decision was made due to the growing cybersecurity industry and the benefits that the firm's services will bring to the Bank. The Bank viewed this as a unique opportunity to align their interests and to increase and diversify non-interest income. The business was purchased at fair value and consisted of intangible assets which are amortized over a period of 15 years.

The Corporation formed Practical Security Solutions, LLC, a subsidiary of Superior National Bank, through this acquisition. Practical Security Solutions, LLC's results of operations were included in noninterest expense in the Corporation's consolidated financial statements from the date of acquisition. Acquisition-related expenses of $21,290 and amortization expense of $8,333 are included in the Corporation's consolidated statement of income for the year ended December 31, 2019.

21. Subsequent Event - Acquisition of North Star Financial Holdings, Inc.

On February 4, 2020, the Corporation acquired 100% of North Star Financial Holdings, Inc. (North Star), a Michigan corporation, located in Bingham Farms, in exchange for $42,000,000. Under the terms of the acquisition, all assets of North Star were distributed to the Corporation, and the separate corporate existence of North Star then ceased. All shares of North Star common stock were converted automatically into the right to receive a proportionate amount of cash equal to the merger consideration less adjustments. The transaction was consummated by the filing of a Certificate of Merger on February 4, 2020. Main Street Bank, a state-chartered bank previously owned by North Star, became a subsidiary of the Corporation as of the acquisition date. Main Street Bank reported approximately $276,000,000 in assets as of December 31, 2019.

The acquisition provides a great growth opportunity for the Bank and enables the expansion of banking services in a growing Michigan market. The two banks are geographically located in different regions of the State, but share the same culture, values, and commitment to their customers and communities. Operational synergies will assist in providing customers with excellent mortgage loan opportunities and a broader base of products. Trust and financial services will be offered in the new market area with plans to further invest in technology improvements benefiting all customers.

Acquisition-related costs of $518,600 are included in noninterest expense in the Corporation's consolidated statement of income for the year ended December 31, 2019. Results of Main Street Bank operations are not included in 2019 financial statements since the acquisition is rendered a subsequent event.

The fair value of acquired Main Street Bank assets and liabilities is currently being calculated by an independent, reputable firm and will be incorporated in 2020 financial statements once received.

Eagle Harbor Lighthouse

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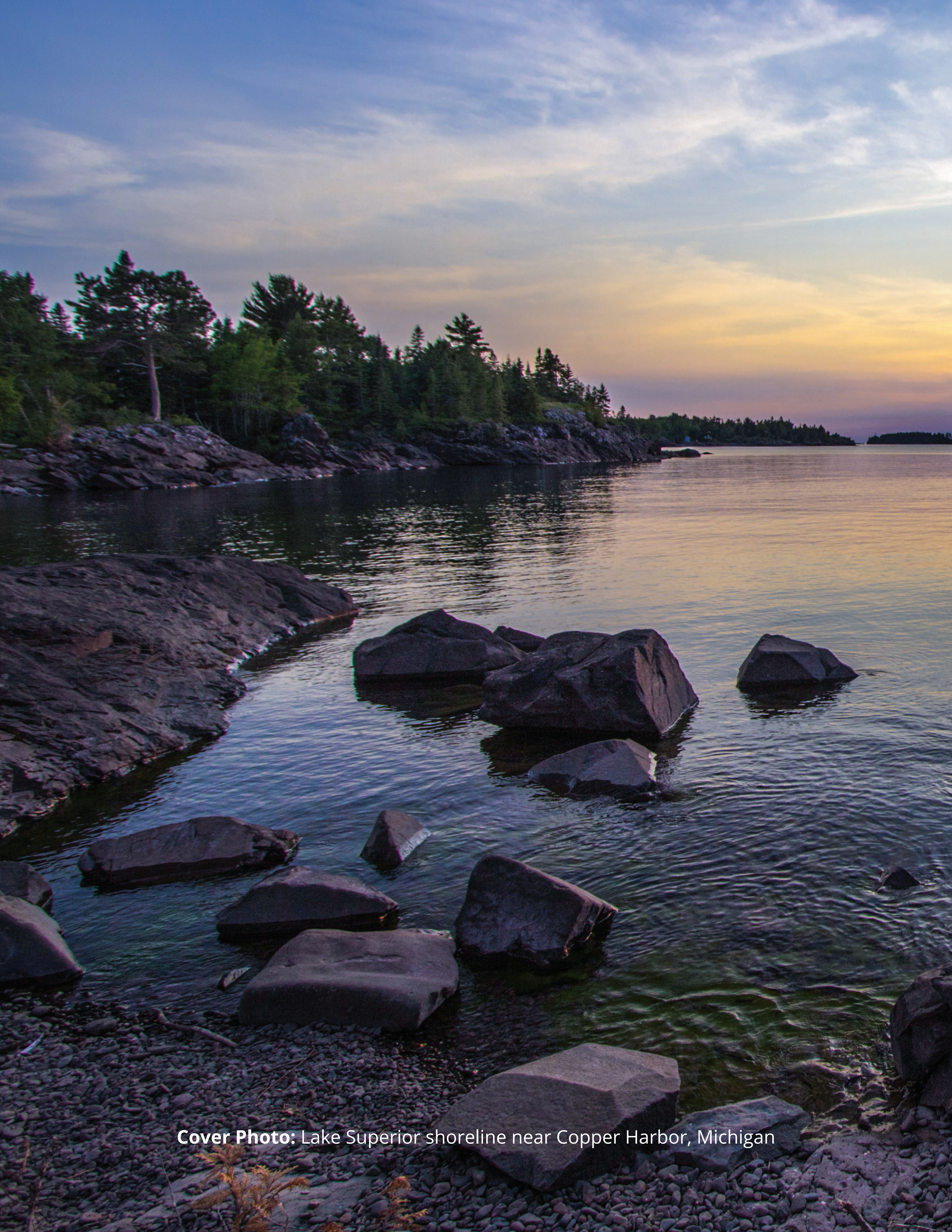
Cover Photo: Lake Superior shoreline near Copper Harbor, Michigan