

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2019

OR

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

For the transition period from _____ to _____

Commission file number: 000-25927

MACATAWA BANK CORPORATION

(Exact name of registrant as specified in its charter)

Michigan

(State or other jurisdiction of incorporation or organization)

38-3391345

(I.R.S. Employer Identification No.)

10753 Macatawa Drive, Holland, Michigan 49424

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444

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

Title of each class	Trading Symbol	Name of each exchange on which registered
Common stock	MCBC	NASDAQ

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

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

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant, as of June 30, 2019, was \$320,494,000 based on the closing sale price of \$10.26 as reported on the Nasdaq Stock Market. There were 34,101,918 outstanding shares of the Company's common stock as of February 20, 2020.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Company's Proxy Statement for the Annual Meeting of Shareholders to be held May 05, 2020 are incorporated by reference into Part III of this report.

MACATAWA BANK CORPORATION
FORM 10-K ANNUAL REPORT
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Forward-Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Macatawa Bank Corporation. Forward-looking statements are identifiable by words or phrases such as "outlook", "plan" or "strategy"; that an event or trend "could", "may", "should", "will", "is likely", or is "possible" or "probable" to occur or "continue", has "begun" or "is scheduled" or "on track" or that the Company or its management "anticipates", "believes", "estimates", "plans", "forecasts", "intends", "predicts", "projects", or "expects" a particular result, or is "committed", "confident", "optimistic" or has an "opinion" that an event will occur, or other words or phrases such as "ongoing", "future", "signs", "efforts", "tend", "exploring", "appearing", "until", "near term", "concern", "going forward", "focus", "starting", "initiative," "trend" and variations of such words and similar expressions. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, those related to future levels of earning assets, future composition of our loan portfolio, trends in credit quality metrics, future capital levels and capital needs, real estate valuation, future levels of repossessed and foreclosed properties and nonperforming assets, future levels of losses and costs associated with the administration and disposition of repossessed and foreclosed properties and nonperforming assets, future levels of loan charge-offs, future levels of other real estate owned, future levels of provisions for loan losses and reserve recoveries, the rate of asset dispositions, future dividends, future growth and funding sources, future cost of funds, future liquidity levels, future profitability levels, future interest rate levels, future net interest margin levels, the effects on earnings of changes in interest rates, future economic conditions, future effects of new or changed accounting standards, future loss recoveries, loan demand and loan growth, future amounts of unrecognized tax benefits and the future level of other revenue sources. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including deferred tax assets) and other real estate owned, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment) involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Our ability to sell other real estate owned at its carrying value or at all, successfully implement new programs and initiatives, increase efficiencies, maintain our current levels of deposits and other sources of funding, maintain liquidity, respond to declines in collateral values and credit quality, increase loan volume, originate high quality loans, maintain or improve mortgage banking income, realize the benefit of our deferred tax assets, continue payment of dividends and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Macatawa Bank Corporation, specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. Macatawa Bank Corporation does not undertake to update forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of this report. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and preceding forward-looking statements.

PART I

ITEM 1: Business.

As used in this report, the terms “we,” “us,” “our,” “Macatawa” and “Company” mean Macatawa Bank Corporation and its subsidiaries, unless the context indicates another meaning. The term “Bank” means Macatawa Bank.

Macatawa Bank Corporation is a Michigan corporation, incorporated in 1997, and is a registered bank holding company. It wholly-owns Macatawa Bank, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the FDIC. The Bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and have issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in our Consolidated Financial Statements. On December 31, 2019, the Company redeemed the \$20.0 million of pooled trust preferred securities associated with Macatawa Statutory Trust I. For further information regarding this redemption and consolidation, see the Notes to the Consolidated Financial Statements.

At December 31, 2019, we had total assets of \$2.07 billion, total loans of \$1.39 billion, total deposits of \$1.75 billion and shareholders’ equity of \$217.5 million. We recognized net income of \$32.0 million in 2019 compared to net income of \$26.4 million in 2018. Earnings before income tax in 2019 and 2018 improved over their respective previous years through growth in total revenue, primarily net interest income, while holding noninterest expenses flat. As of December 31, 2019, the Company’s and the Bank’s risk-based regulatory capital ratios were significantly above those required under the regulatory standards and the Bank continued to be categorized as “well capitalized” at December 31, 2019.

The Company paid a cash dividend of \$0.06 per share for the first, second and third quarters of 2018, and increased to \$0.07 per share for the fourth quarter of 2018 and each quarter of 2019.

Over the past several years, much progress has been made at reducing our nonperforming assets. The following table reflects period end balances of these nonperforming assets as well as total loan delinquencies.

(Dollars in thousands)	December 31,		
	2019	2018	2017
Nonperforming loans	\$ 203	\$ 1,304	\$ 395
Other repossessed assets	—	—	11
Other real estate owned	2,748	3,380	5,767
Total nonperforming assets	<u>\$ 2,951</u>	<u>\$ 4,684</u>	<u>\$ 6,173</u>
Total delinquencies 30 days or greater past due	<u>\$ 405</u>	<u>\$ 877</u>	<u>\$ 995</u>

We recorded a negative provision for loan losses of \$450,000 in 2019 due to net recoveries during the year and strong credit quality. Our earnings in 2018 were unfavorably impacted by a provision for loan losses of \$450,000 due primarily to a charge-off on a single commercial loan during the fourth quarter of 2018 and loan growth.

While we did experience net charge-offs in 2018, it came after we had experienced five consecutive full years of net recoveries. We again experienced net recoveries in 2019. The following table reflects the provision for loan losses for the past three years along with certain metrics that impact the determination of the level of the provision for loan losses.

(Dollars in thousands)	For the Year Ended December 31,		
	2019	2018	2017
Provision for loan losses	\$ (450)	\$ 450	\$ (1,350)
Net charge-offs (recoveries)	(774)	174	(988)
Net charge-offs (recoveries) to average loans	(0.06)%	0.01%	(0.08)%
Nonperforming loans to total loans	0.01%	0.09%	0.03%
Loans transferred to ORE to average loans	—	0.02%	0.01%
Performing troubled debt restructurings (“TDRs”) to average loans	0.99%	1.20%	1.72%

Economic conditions in our market areas of Grand Rapids and Holland, Michigan have been good during the past several years. The state of Michigan's unemployment rate at the end of 2019 was 3.9%. The Grand Rapids and Holland area unemployment rate was 2.3% at the end of 2019. Residential housing values and commercial real estate property values have increased in recent years.

It also appears that the housing market in our primary market area continues to be strong. In the Grand Rapids market during 2019, total living unit starts were up 12% over 2018 at 2,367 units and have been over 2,000 units in each of the past five years. The Holland-Grand Haven/Lakeshore region showed similar results with living units starts up 17% over 2018 at 1,822 units and the region had over 1,500 living unit starts in each of the past five years.

We experienced commercial loan growth in recent years. Most of our emphasis has been on growing commercial and industrial loans. These loans have increased steadily from \$465.2 million at December 31, 2017 to \$499.6 million at December 31, 2019. Commercial real estate loans have increased from \$541.9 million at December 31, 2017 to \$598.5 million at December 31, 2019. Consumer loans have decreased from \$313.2 million at December 31, 2017 to \$287.6 million at December 31, 2019. We believe we are positioned for loan growth in 2020.

We have no material foreign loans, assets or activities. No material part of our business is dependent on a single customer or very few customers. Our loan portfolio is not concentrated in any one industry.

Our headquarters and administrative offices are located at 10753 Macatawa Drive, Holland, Michigan 49424, and our telephone number is (616) 820-1444. Our internet website address is www.macatawabank.com. We make available free of charge through this website our annual report on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after filing or furnishing such reports with the Securities and Exchange Commission. The information on our website address is not incorporated by reference into this report, and the information on the website is not part of this report.

Products and Services

Loan Portfolio

We have historically offered a broad range of loan products to business customers, including commercial and industrial and commercial real estate loans, and to retail customers, including residential mortgage and consumer loans. Select, well-managed loan renewal activity is taking place and we are seeing growth in our commercial loan portfolios and pipelines. Following is a discussion of our various types of lending activities.

Commercial and Industrial Loans

Our commercial and industrial lending portfolio contains loans with a variety of purposes and security, including loans to finance operations and equipment. Generally, our commercial and industrial lending has been limited to borrowers headquartered, or doing business, in our primary market area. These credit relationships typically require the satisfaction of appropriate loan covenants and debt formulas, and generally require that the Bank be the primary depository bank of the business. These loan covenants and debt formulas are monitored through periodic, required reporting of accounts receivable aging schedules and financial statements, and in the case of larger business operations, reviews or audits by independent professional firms.

Commercial and industrial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself and economic conditions. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial Real Estate Loans

Our commercial real estate loans consist primarily of construction and development loans and multi-family and other non-residential real estate loans.

Construction and Development Loans. These consist of construction loans to commercial customers for the construction of their business facilities. They also include construction loans to builders and developers for the construction of one- to four-family residences and the development of one- to four-family lots, residential subdivisions, condominium developments and other commercial developments.

This portfolio can be affected by job losses, declines in real estate value, declines in home sale volumes, and declines in new home building. As such, we limit our exposure to residential land development and other construction and development loans.

Multi-Family and Other Non-Residential Real Estate Loans. These are permanent loans secured by multi-family and other non-residential real estate and include loans secured by apartment buildings, condominiums, small office buildings, small business facilities, medical facilities and other non-residential building properties, substantially all of which are located within our primary market area.

Multi-family and other non-residential real estate loans generally present a higher level of risk than loans secured by owner occupied one- to four-family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of these loans is typically dependent upon the successful operation of the related real estate project. For example, if leases are not obtained or renewed, or a bankruptcy court modifies a lease term, or a major tenant is unable to fulfill its lease obligations, cash flow from the project will be reduced. If cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Retail Loans

Our retail loans are loans to consumers and consist primarily of residential mortgage loans and consumer loans.

Residential Mortgage Loans. We originate construction loans to individuals for the construction of their residences and owner-occupied residential mortgage loans, which are generally long-term with either fixed or adjustable interest rates. Our general policy is to sell the majority of our fixed rate residential mortgage loans in the secondary market due primarily to the interest rate risk associated with these loans. For 2019, we retained loans representing 34% of the total dollar volume originated, compared to 66% in 2018.

Our borrowers generally qualify and are underwritten using industry standards for quality residential mortgage loans. We do not originate loans that are considered "sub-prime". Residential mortgage loan originations derive from a number of sources, including advertising, direct solicitation, real estate broker referrals, existing borrowers and depositors, builders and walk-in customers. Loan applications are accepted at most of our offices and online. The substantial majority of these loans are secured by one-to-four family properties in our market area.

Consumer Loans. We originate a variety of different types of consumer loans, including automobile loans, home equity lines of credit and installment loans, home improvement loans, deposit account loans and other loans for household and personal purposes. We also originate home equity lines of credit utilizing the same underwriting standards as for home equity installment loans. Home equity lines of credit are revolving line of credit loans. The majority of our existing home equity line of credit portfolio has variable rates with floors and ceilings, interest only payments and a maximum maturity of ten years.

The underwriting standards that we employ for consumer loans include a determination of the applicant's payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes a comparison of the value of the security, if any, in relation to the proposed loan amount. Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Loan Portfolio Composition

The following table reflects the composition of our loan portfolio and the corresponding percentage of our total loans represented by each class of loans as of the dates indicated.

(Dollars in thousands)	December 31									
	2019		2018		2017		2016		2015	
	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans	Amount	% of Total Loans
Real estate - construction (1)	\$ 72,404	5%	\$ 81,963	6%	\$ 78,487	6%	\$ 64,968	5%	\$ 90,039	7%
Real estate - mortgage	526,054	38	486,748	35	463,448	35	453,013	35	418,633	35
Commercial and industrial	499,572	36	513,345	36	465,208	35	449,342	35	377,298	31
Total commercial	1,098,030	79	1,082,056	77	1,007,143	76	967,323	76	885,970	73
Residential mortgage	211,049	15	238,174	17	224,452	17	217,614	17	209,972	18
Consumer	76,548	6	85,428	6	88,714	7	95,875	7	101,990	9
Total loans	1,385,627	100%	1,405,658	100%	1,320,309	100%	1,280,812	100%	1,197,932	100%
Less: allowance for loan losses	(17,200)		(16,876)		(16,600)		(16,962)		(17,081)	
Total loans, net	\$ 1,368,427		\$ 1,388,782		\$ 1,303,709		\$ 1,263,850		\$ 1,180,851	

(1) Consists of construction and development loans.

At December 31, 2019, there was no concentration of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the table above.

Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table shows the amount of total loans outstanding at December 31, 2019 which, based on maturity and repricing dates, are due in the periods indicated.

(Dollars in thousands)	Maturing			
	Within One Year	After One, But Within Five Years	After Five Years	Total
	Real estate - construction (1)	\$ 39,387	\$ 23,155	\$ 9,862
Real estate - mortgage	68,841	285,692	171,521	526,054
Commercial and industrial	269,361	180,091	50,120	499,572
Total commercial	377,589	488,938	231,503	1,098,030
Residential mortgage	728	3,770	206,551	211,049
Consumer	2,221	19,366	54,961	76,548
Total loans	\$ 380,538	\$ 512,074	\$ 493,015	\$ 1,385,627

Loans above:	Maturing or Repricing			
	With predetermined interest rates	With floating or adjustable rates	Total (excluding nonaccrual loans)	Nonaccrual loans
With predetermined interest rates	\$ 125,215	\$ 411,989	\$ 170,079	\$ 707,283
With floating or adjustable rates	572,476	61,923	43,742	678,141
Total (excluding nonaccrual loans)	\$ 697,691	\$ 473,912	\$ 213,821	1,385,424
Nonaccrual loans				203
Total loans				\$ 1,385,627

(1) Consists of construction and development loans.

Nonperforming Assets

Interest income totaling \$887,000 was recorded in 2019 on loans that were on a non-accrual status or classified as restructured as of December 31, 2019. Additional interest income of \$136,000 would have been recorded during 2019 on these loans had they been current in accordance with their original terms. More information about the levels of nonperforming loan balances through 2019 and our policy for placing loans on non-accrual status may be found in Item 7 of this report under the heading “Portfolio Loans and Asset Quality” included in “Management’s Discussion and Analysis of Results of Operations and Financial Condition.”

Loans at December 31, 2019 that were classified as substandard or worse per our internal risk rating system that would cause management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms are discussed in Item 7 of this report under the heading “Portfolio Loans and Asset Quality” included in “Management’s Discussion and Analysis of Results of Operations and Financial Condition.” At December 31, 2019, there were no other interest-bearing assets that would be required to be disclosed under Industry Guide 3, Item III, C. 1. or 2. if such assets were loans.

Loan Loss Experience

A summary of our loan balances at the end of 2018 and 2019 and the daily average balances of these loans as well as changes in the allowance for loan losses arising from loans charged-off and recoveries on loans previously charged-off, and additions to the allowance which we have expensed is shown in Item 7 of this report under the headings “Portfolio Loans and Asset Quality” and “Allowance for Loan Losses” included in “Management’s Discussion and Analysis of Results of Operations and Financial Condition.”

Additional information about our allowance for loan losses, including a table showing the allocation of the allowance for loan losses at the end of 2018 and 2019 and the factors which influenced management’s judgment in determining the amount of the additions to the allowance charged to operating expense, may be found in Item 7 of this report under the heading “Allowance for Loan Losses” in “Management’s Discussion and Analysis of Results of Operations and Financial Condition.”

Deposit Portfolio

We offer a broad range of deposit services, including checking accounts, savings accounts and time deposits of various types. Transaction accounts and savings and time certificates are tailored to the principal market area at rates competitive with those offered in the area. All deposit accounts are insured by the FDIC up to the maximum amount permitted by law.

We solicit deposit services from individuals, businesses, associations, churches, nonprofit organizations, financial institutions and government authorities. Deposits are gathered primarily from the communities we serve through our network of 26 branches. We offer business and consumer checking accounts, regular and money market savings accounts, and certificates of deposit with many term options. We operate in a competitive environment, competing with other local banks similar in size and with significantly larger regional banks. We monitor rates at other financial institutions in the area to ascertain that our rates are competitive with the market. We also attempt to offer a wide variety of products to meet the needs of our customers. We set our deposit pricing to be competitive with other banks in our market area.

We may utilize alternative funding sources as needed, including short-term borrowings, advances from the Federal Home Loan Bank of Indianapolis or the Federal Reserve Bank of Chicago, securities sold under agreements to repurchase (“repo borrowings”) and brokered deposits. We had no brokered deposits or repo borrowings at December 31, 2019 or 2018.

Deposit Portfolio Composition

The following table sets forth the average deposit balances and the weighted average rates paid.

	December 31					
	2019		2018		2017	
(Dollars in thousands)	Average Amount	Average Rate	Average Amount	Average Rate	Average Amount	Average Rate
Noninterest bearing demand	\$ 472,987	---%	\$ 467,663	---%	\$ 464,384	---%
Interest bearing demand	446,452	0.3	406,694	0.3	341,384	0.1
Savings and money market accounts	625,307	0.7	602,676	0.6	557,703	0.3
Time	148,189	1.9	109,715	1.3	85,921	0.8
Total deposits	<u>\$ 1,692,935</u>	<u>0.7%</u>	<u>\$ 1,586,748</u>	<u>0.5%</u>	<u>\$ 1,449,392</u>	<u>0.3%</u>

The following table summarizes time deposits in amounts of \$100,000 or more by time remaining until maturity as of December 31, 2019 (dollars in thousands).

Three months or less	\$ 19,819
Over 3 months through 6 months	16,452
Over 6 months through 1 year	28,495
Over 1 year	14,355
	<u>\$ 79,121</u>

As of the date of this report, the Bank had no material foreign deposits.

Securities Portfolio

Our securities portfolio is classified as either “available for sale” or “held to maturity.” Securities classified as “available for sale” may be sold prior to maturity due to changes in interest rates, prepayment risks, and availability of alternative investments, or to meet our liquidity needs.

The primary objective of our investing activities is to provide for the safety of the principal invested. Our secondary considerations include the maximization of earnings, liquidity and to help decrease our overall exposure to changes in interest rates. We have generally invested in bonds with lower credit risk, primarily those secured by government agencies or insured municipalities, to assist in the diversification of credit risk within our asset base. The commercial bond component of this category decreased by \$2.9 million in 2019.

These bonds represent financing provided to some of our non-profit commercial customers who qualified for borrowing on a tax-exempt basis. We have not experienced any credit losses within our securities portfolio.

The following table reflects the composition of our securities portfolio as of the dates indicated (including securities available for sale and held to maturity).

(Dollars in thousands)	December 31,		
	2019	2018	2017
U.S. Treasury and federal agency securities	\$ 74,749	\$ 95,398	\$ 101,964
U.S. Agency MBS and CMOs	46,201	32,890	23,385
Tax-exempt state and municipal bonds	128,682	115,461	127,884
Taxable state and municipal bonds	52,022	45,934	43,735
Corporate bonds	6,315	7,637	8,109
Other equity securities	—	—	1,470
Total	<u>\$ 307,969</u>	<u>\$ 297,320</u>	<u>\$ 306,547</u>

At December 31, 2019, other than our holdings in U.S. Treasury and U.S. Government Agency Securities, we had no investments in securities of any one issuer with an aggregate book value in excess of 10% of shareholders’ equity. At December 31, 2019, we had four investments totaling \$2.3 million in securities of issuers outside of the United States.

Schedule of Maturities of Investment Securities and Weighted Average Yields

The following is a schedule of investment securities maturities and their weighted average yield by category at December 31, 2019.

(Dollars in thousands)	Due Within One Year		One to Five Years		Five to Ten Years		After Ten Years	
	Amount	Average Yield	Amount	Average Yield	Amount	Average Yield	Amount	Average Yield
U.S. Treasury and federal agency securities	\$ 18,038	1.58%	\$ 38,289	1.72%	\$ 18,422	2.49%	\$ —	—%
U.S. Agency MBS and CMOs	—	—	183	2.35	1,360	2.69	44,658	2.62
Tax-exempt state and municipal bonds (1)	19,673	2.89	49,840	3.27	40,225	3.00	18,945	2.84
Taxable state and municipal bonds	8,954	2.19	31,103	2.42	10,924	2.33	1,041	2.25
Corporate bonds	3,054	2.08	3,260	1.35	—	—	—	—
Total (1)	<u>\$ 49,719</u>	<u>2.24%</u>	<u>\$ 122,675</u>	<u>2.55%</u>	<u>\$ 70,931</u>	<u>2.75%</u>	<u>\$ 64,644</u>	<u>2.68%</u>

(1) Yields on tax-exempt securities are computed on a fully taxable-equivalent basis.

Trust Services

We offer trust services to further provide for the financial needs of our customers. As of December 31, 2019, the Trust Department managed assets of approximately \$976.8 million. Our types of service include both personal trust and retirement plan services.

Our personal trust services include financial planning, investment management services, trust and estate administration and custodial services. As of December 31, 2019, personal trust assets under management totaled approximately \$550.2 million. Our retirement plan services encompass all types of qualified retirement plans, including profit sharing, 401(k) and pension plans. As of December 31, 2019, retirement plan assets under management totaled approximately \$426.6 million.

Market Area

Our primary market area includes Ottawa, Kent and northern Allegan Counties, all located in western Michigan. This area includes two mid-sized cities, Grand Rapids and Holland, and rural areas. Grand Rapids is the second largest city in Michigan. Holland is the largest city in Ottawa County. Both cities and surrounding areas have a solid and diverse economic base, which includes health and life sciences, tourism, office and home furniture, automotive components and assemblies, pharmaceutical, transportation, equipment, food and construction supplies. Grand Valley State University, a 25,000-student regional university with nearly 2,000 employees, has its three main campuses in our market area. GVSU and several smaller colleges and university affiliates located in our market area help stabilize the local economy because they are not as sensitive to the fluctuations of the broader economy. Companies operating in the market area include the Van Andel Institute, Steelcase, Herman Miller, Amway, Gentex, Spectrum Health, Haworth, Wolverine World Wide, Johnson Controls, General Motors, Gerber, Magna, SpartanNash and Meijer.

Competition

There are many bank, thrift, credit union and other financial institution offices located within our market area. Most are branches of larger financial institutions. We also face competition from finance companies, insurance companies, mortgage companies, securities brokerage firms, money market funds and other providers of financial services. Many of our competitors have been in business a number of years, have established customer bases, are larger and have higher lending limits than we do. We compete for loans, deposits and other financial services based on our ability to communicate effectively with our customers, to understand and meet their needs and to provide high quality customer service. Our management believes that our personal service philosophy, our local decision-making and diverse delivery channels enhances our ability to compete favorably in attracting individuals and small businesses. We actively solicit customers by offering our customers personal attention, professional service, and competitive interest rates.

Employees

As of December 31, 2019, we had 325 full-time equivalent employees consisting of 285 full-time and 79 part-time employees. We have assembled a staff of experienced, dedicated and qualified professionals whose goal is to meet the financial needs of our customers while providing outstanding service. The majority of our management team has at least 10 years of banking experience, and several key personnel have more than 20 years of banking experience. None of our employees are represented by collective bargaining agreements with us.

SUPERVISION AND REGULATION

The following is a summary of statutes and regulations affecting Macatawa Bank Corporation and Macatawa Bank. A change in applicable laws or regulations may have a material effect on us and our business.

General

Financial institutions and their holding companies are extensively regulated under federal and state law. Consequently, our growth and earnings performance can be affected not only by management decisions and general economic conditions, but also by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. Those authorities include, but are not limited to, the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”), the FDIC, the State of Michigan’s Department of Financial and Insurance Services (“DIFS”), the Internal Revenue Service, and state taxing authorities. The effect of such statutes, regulations and policies can be significant, and cannot be predicted with a high degree of certainty.

Federal and state laws and regulations generally applicable to financial institutions and their holding companies regulate, among other things, the scope of business, investments, reserves against deposits, capital levels relative to operations, lending activities and practices, the nature and amount of collateral for loans, the establishment of branches, mergers, consolidations and declaration and payment of dividends. The system of supervision and regulation applicable to us and our bank establishes a comprehensive framework for our respective operations and is intended primarily for the protection of the FDIC’s deposit insurance fund, our depositors, and the public, rather than our shareholders.

Federal law and regulations establish supervisory standards applicable to our lending activities, including internal controls, credit underwriting, loan documentation and loan-to-value ratios for loans secured by real property.

Recent Developments

Community Bank Leverage Ratio: Section 201 of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 (the “Act”) directed federal banking agencies to draft regulations establishing a new Community Bank Leverage Ratio (“CBLR”). The Act provides that the CBLR will apply to a “qualifying community bank” which the Act defines as a bank with consolidated assets of less than \$10 billion and satisfying additional criteria designed to disqualify institutions with a higher risk profile. Under the Act, qualifying community banks that meet or exceed the CBLR will be deemed to have satisfied all generally applicable leverage capital and risk-based capital requirements and will be considered “well capitalized” under the FDIC prompt corrective action provisions. The Act directed the Federal Reserve Board, the FDIC, and the Office of the Comptroller of the Currency to jointly determine a community bank leverage ratio percentage, not less than 8% nor more than 10%, that must be maintained to be deemed to have satisfied all generally applicable leverage capital and risk-based capital requirements and be considered well capitalized. The Act also directed agencies to establish procedures for dealing with a qualifying bank that subsequently falls below the new ratio.

The final regulation implementing Section 201 was released on November 13, 2019 (the “Final Rule”). Under the Final Rule, to be eligible to use the CBLR framework, a banking organization must not be an advanced approaches organization and must have (i) a leverage ratio of greater than 9%, (ii) total consolidated assets of less than \$10 billion, (iii) total off-balance sheet exposures of 25% or less of total consolidated assets, and (iv) total trading assets plus trading liabilities of 5% or less of total consolidated assets.

The Final Rule will be effective as of January 1, 2020. 84 FR 61787. Banking organizations may first utilize the CBLR framework in their bank call report or holding company FR Y-9C, as applicable, for the first quarter of 2020, i.e., as of March 31, 2020.

Macatawa Bank Corporation

General. Macatawa Bank Corporation is registered as a bank holding company with, and subject to regulation by, the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended (the “BHCA”). Under the BHCA, Macatawa Bank Corporation is subject to periodic examination by the Federal Reserve Board, and is required to file with the Federal Reserve Board periodic reports of our operations and such additional information as the Federal Reserve Board may require.

In accordance with Federal Reserve Board policy, Macatawa Bank Corporation is expected to act as a source of financial strength to the Bank and to commit resources to support the Bank. In addition, if the DIFS deems the Bank’s capital to be impaired, the DIFS may require the Bank to restore its capital by a special assessment upon Macatawa Bank Corporation as the Bank’s sole shareholder. If Macatawa Bank Corporation were to fail to pay any such assessment, the directors of the Bank would be required, under Michigan law, to sell all or part of the shares of the Bank’s stock owned by Macatawa Bank Corporation to the highest bidder at either a public or private auction and use the proceeds of the sale to restore the Bank’s capital.

Investments and Activities. In general, any direct or indirect acquisition by us of any voting shares of any bank which would result in our direct or indirect ownership or control of more than 5% of any class of voting shares of such bank, and any merger or consolidation between us and another bank holding company or financial holding company, will require the prior written approval of the Federal Reserve Board under the BHCA.

The merger or consolidation of the Bank with another bank, or the acquisition by the Bank of assets of another bank, or the assumption of liability by the Bank to pay any deposits of another bank, will require the prior written approval of the FDIC under the Bank Merger Act and DIFS under the Michigan Banking Code. In addition, in certain such cases, an application to, and the prior approval of, the Federal Reserve Board under the BHCA may be required.

Capital Requirements. The Federal Reserve Board uses capital adequacy guidelines in its examination and regulation of bank holding companies. If capital falls below minimum guidelines, a bank holding company may, among other things, be denied approval to acquire or establish additional banks or non-bank businesses.

Additional information on our capital ratios may be found in Item 7 of this report under the heading “Capital Resources” included in “Management’s Discussion and Analysis of Results of Operations and Financial Condition” and in Item 8 of this report in the Notes to the Consolidated Financial Statements, and is here incorporated by reference.

Dividends. Macatawa Bank Corporation is a corporation separate and distinct from the Bank. Most of our revenues are dividends paid by the Bank. Thus, Macatawa Bank Corporation’s ability to pay dividends to our shareholders is indirectly limited by restrictions on the Bank’s ability to pay dividends described below. Further, in a policy statement, the Federal Reserve Board has expressed its view that a bank holding company should not pay cash dividends if its net income available to shareholders for the past four quarters, net of dividends paid during that period, is not sufficient to fully fund the dividends, its prospective rate of earnings retention is not consistent with capital needs and overall current and prospective financial condition, or it will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve Board possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies. Similar enforcement powers over our Bank are possessed by the FDIC. The “prompt corrective action” provisions of federal law and regulation authorizes the FDIC to restrict the payment of dividends to Macatawa Bank Corporation by our Bank if the Bank fails to meet specified capital levels.

In addition, the Michigan Business Corporation Act provides that dividends may be legally declared or paid only if after the distribution a corporation can pay its debts as they come due in the usual course of business and its total assets equal or exceed the sum of its liabilities plus the amount that would be needed to satisfy the preferential rights upon dissolution of any holders of preferred stock whose preferential rights are superior to those receiving the distribution.

Additional information about restrictions on the payment of dividends by the Bank may be found in Item 8 of this report in Notes 1 and 17 to the Consolidated Financial Statements and is here incorporated by reference.

Federal Securities Regulation. Our common stock is registered under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). We are subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act. We are subject to the Sarbanes-Oxley Act, which imposes numerous reporting, accounting, corporate governance and business practices on companies, as well as financial and other professionals who have involvement with the U.S. public markets. We are generally subject to these requirements and applicable SEC rules and regulations.

Macatawa Bank

General. Macatawa Bank is a Michigan banking corporation, and its deposit accounts are insured by the Deposit Insurance Fund (the “Insurance Fund”) of the FDIC. The Bank is subject to the examination, supervision, reporting and enforcement requirements of the DIFS, as the chartering authority for Michigan banks, and the FDIC, as administrator of the Insurance Fund. These agencies, and the federal and state laws applicable to the Bank and its operations, extensively regulate various aspects of the banking business, including, among other things, permissible types and amounts of loans, investments and other activities, capital adequacy, branching, interest rates on loans and on deposits, the maintenance of noninterest bearing reserves on deposit accounts, and the safety and soundness of banking practices.

Deposit Insurance. As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The FDIC has adopted a risk-based assessment system under which all insured depository institutions are placed into one of four categories and assessed insurance premiums, based upon their respective levels of capital and results of supervisory evaluation. Institutions categorized as well-capitalized (as defined by the FDIC) and considered healthy pay the lowest premium, while institutions that are categorized as less than adequately capitalized (as defined by the FDIC) and considered of substantial supervisory concern pay the highest premium. Risk classification of all insured institutions is made by the FDIC for each semi-annual assessment period.

The FDIC’s deposit insurance assessment base methodology uses average consolidated total assets less average tangible equity as the assessment base. Under this calculation, most well capitalized banks will pay 5 to 9 basis points annually, increasing up to 35 basis points for banks that pose significant supervisory concerns. This base rate may be adjusted for the level of unsecured debt and brokered deposits, resulting in adjusted rates ranging from 2.5 to 9 basis points annually for most well capitalized banks to 30 to 45 basis points for banks that pose significant supervisory concerns. We estimate our annual assessment rate to be 3 basis points in 2020. The FDIC Deposit Insurance Fund exceeded its targeted reserve ratio of 1.35% and the FDIC sent the Bank a letter dated January 24, 2019 notifying the Bank that it would be apportioned a share of the excess in the form of credits to offset future assessments. The preliminary assessment credit for the Bank was approximately \$438,000. Assessment credits of \$266,000 were applied in 2019, leaving approximately \$172,000 in assessment credits to be applied in 2020.

Capital Requirements. The FDIC has established the following minimum capital standards for FDIC insured banks: a leverage requirement consisting of a ratio of Tier 1 capital to total average assets and risk-based capital requirements consisting of a ratio of total capital to total risk-weighted assets, a ratio of Tier 1 capital to total risk-weighted assets, and a ratio of common equity Tier 1 (CET1) capital to risk weighted assets. Tier 1 capital consists principally of shareholders’ equity. Common equity Tier 1 capital excludes forms of stock that are not common stock.

Basel III. In July 2013, the Board of Governors of the Federal Reserve Board and the FDIC approved the rules implementing the Basel Committee on Banking Supervision’s capital guidelines for U.S. banks (commonly known as Basel III). The rules include a common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which effectively results in a minimum CET1 ratio of 7.0%. The minimum ratio of Tier 1 capital to risk-weighted assets is 6.0% (which effectively results in a minimum Tier 1 capital ratio of 8.5%), which effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer), and requires a minimum leverage ratio of 4.0%. The capital ratios for the Company and the Bank under Basel III continue to exceed the well capitalized minimum capital requirements.

Federal regulations define these capital categories as follows:

	CET1 Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Leverage Ratio
Well capitalized	6.5% or above	8% or above	10% or above	5% or above
Adequately capitalized	4.5% or above	6% or above	8% or above	4% or above
Undercapitalized	Less than 4.5%	Less than 6%	Less than 8%	Less than 4%
Significantly undercapitalized	Less than 3%	Less than 4%	Less than 6%	Less than 3%
Critically undercapitalized	—	—	—	Ratio of tangible equity to total assets of 2% or less

Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. Depending upon the capital category to which an institution is assigned, the regulators’ corrective powers include: requiring the submission of a capital restoration plan; placing limits on asset growth and restrictions on activities; requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; restricting transactions with affiliates; restricting the interest rate the institution may pay on deposits; ordering a new election of directors of the institution; requiring that senior executive officers or directors be dismissed; prohibiting the institution from accepting deposits from correspondent banks; requiring the institution to divest certain subsidiaries; prohibiting the payment of principal or interest on subordinated debt; and ultimately, appointing a receiver for the institution.

In general, a depository institution may be reclassified to a lower category than is indicated by its capital levels if the appropriate federal depository institution regulatory agency determines the institution to be otherwise in an unsafe or unsound condition or to be engaged in an unsafe or unsound practice. This could include a failure by the institution, following receipt of a less-than-satisfactory rating on its most recent examination report, to correct the deficiency.

As of December 31, 2019, the Bank was categorized as “well capitalized”. Additional information on our capital ratios may be found in Item 8 of this report in the Notes to the Consolidated Financial Statements, and is here incorporated by reference.

Dividends. Under Michigan law, the Bank is restricted as to the maximum amount of dividends it may pay on its common stock. The Bank may not pay dividends except out of net income after deducting its losses and bad debts. A Michigan state bank may not declare or pay a dividend unless the bank will have surplus amounting to at least 20% of its capital after the payment of the dividend.

Federal law generally prohibits a depository institution from making any capital distribution (including payment of a dividend) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. The FDIC may prevent an insured bank from paying dividends if the bank is in default of payment of any assessment due to the FDIC. In addition, the FDIC may prohibit the payment of dividends by the Bank, if such payment is determined to be an unsafe and unsound banking practice.

Additional information about restrictions on payment of dividends by the Bank may be found in Item 8 of this report in Notes 1 and 17 to the Consolidated Financial Statements, and is here incorporated by reference.

Insider Transactions. The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to Macatawa or any subsidiary of Macatawa, on investments in the stock or other securities of Macatawa or any subsidiary of Macatawa and the acceptance of the stock or other securities of Macatawa or any subsidiary of Macatawa as collateral for loans. Certain limitations and reporting requirements are also placed on extensions of credit by the Bank to its directors and officers, to Macatawa's directors and officers, to our principal shareholders and to "related interests" of such directors, officers and principal shareholders. In addition, federal law and regulations may affect the terms upon which any person becoming a director or officer of our company or any subsidiary or a principal shareholder in our company may obtain credit from banks with which the Bank maintains a correspondent relationship.

Safety and Soundness Standards. The federal banking agencies have adopted guidelines to promote the safety and soundness of federally insured depository institutions. These guidelines establish standards for, among other things, internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

Investments and Other Activities. Under federal law and FDIC regulations, FDIC insured state banks are prohibited, subject to certain exceptions, from making or retaining equity investments of a type, or in an amount, that are not permissible for a national bank. Federal law, as implemented by FDIC regulations, also prohibits FDIC insured state banks and their subsidiaries, subject to certain exceptions, from engaging as principal in any activity that is not permitted for a national bank or its subsidiary, respectively, unless the bank meets, and continues to meet, its minimum regulatory capital requirements and the FDIC determines the activity would not pose a significant risk to the Insurance Fund. Impermissible investments and activities must be divested or discontinued within certain time frames set by the FDIC in accordance with federal law.

Consumer Protection Laws. The Bank's business includes making a variety of types of loans to individuals. In making these loans, we are subject to state usury and regulatory laws and to various federal laws and regulations, including the privacy of consumer financial information provisions of the Gramm-Leach-Bliley Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Servicemembers Civil Relief Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Home Mortgage Disclosure Act, which prohibit discrimination, specify disclosures to be made to borrowers regarding credit and settlement costs, and regulate the mortgage loan servicing activities of the Bank, including the maintenance and operation of escrow accounts and the transfer of mortgage loan servicing. In receiving deposits, the Bank is subject to extensive regulation under state and federal law and regulations, including the Truth in Savings Act, the Expedited Funds Availability Act, the Electronic Funds Transfer Act, and the Federal Deposit Insurance Act. Violation of these laws could result in the imposition of significant damages and fines upon the Bank and its directors and officers.

Anti-Money Laundering and OFAC Regulation. A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The Bank Secrecy Act of 1970 ("BSA") and subsequent laws and regulations require the Bank to take steps to prevent the use of the Bank or its systems from facilitating the flow of illegal or illicit money or terrorist funds. Those requirements include ensuring effective Board and management oversight, establishing policies and procedures, performing comprehensive risk assessments, developing effective monitoring and reporting capabilities, ensuring adequate training and establishing a comprehensive independent audit of BSA compliance activities.

The USA PATRIOT Act of 2001 ("Patriot Act") significantly expanded the anti-money laundering ("AML") and financial transparency laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Regulations promulgated under the Patriot Act impose various requirements on financial institutions, such as standards for verifying client identification at account opening and maintaining expanded records (including "Know Your Customer" and "Enhanced Due Diligence" practices) and other obligations to maintain appropriate policies, procedures and controls to aid the process of preventing, detecting, and reporting money laundering and terrorist financing. An institution subject to the Patriot Act must provide AML training to employees, designate an AML compliance officer and annually audit the AML program to assess its effectiveness. The FDIC continues to issue regulations and additional guidance with respect to the application and requirements of BSA and AML.

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. Based on their administration by the United States Department of the Treasury's Office of Foreign Assets Control ("OFAC"), these are typically known as the "OFAC" rules. The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "United States persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to United States jurisdiction (including property in the possession or control of United States persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC.

Failure of a financial institution to maintain and implement adequate BSA, AML and OFAC programs, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution and result in material fines and sanctions.

Branching Authority. Michigan banks have the authority under Michigan law to establish branches anywhere in the State of Michigan, subject to receipt of all required regulatory approvals. Banks may establish interstate branch networks through acquisitions of other banks. The establishment of de novo interstate branches or the acquisition of individual branches of a bank in another state (rather than the acquisition of an out-of-state bank in its entirety) is allowed only if specifically authorized by state law.

Michigan law permits both U.S. and non-U.S. banks to establish branch offices in Michigan. The Michigan Banking Code permits, in appropriate circumstances and with the approval of the DIFS, (1) acquisition of Michigan banks by FDIC-insured banks, savings banks or savings and loan associations located in other states, (2) sale by a Michigan bank of branches to an FDIC-insured bank, savings bank or savings and loan association located in a state in which a Michigan bank could purchase branches of the purchasing entity, (3) consolidation of Michigan banks and FDIC-insured banks, savings banks or savings and loan associations located in other states having laws permitting such consolidation, (4) establishment of branches in Michigan by FDIC-insured banks located in other states, the District of Columbia or U.S. territories or protectorates having laws permitting a Michigan bank to establish a branch in such jurisdiction, and (5) establishment by foreign banks of branches located in Michigan. A Michigan bank holding company may acquire a non-Michigan bank and a non-Michigan bank holding company may acquire a Michigan bank.

Risk Factors.

ITEM 1A:

Risks related to the our Business

Earnings in recent years were supported, in part, by negative provisions for loan losses and non-recurring events, which will not necessarily be available in future years.

We were profitable in years 2017 through 2019. Earnings in those years were supported, in part, by negative provisions for loan losses and non-recurring events. We have recorded negative provisions for loan losses of \$450,000 and \$1.35 million for the years ended December 31, 2019, and 2017, respectively. We do not expect a similar level of negative provisions for loan losses in 2020, and non-recurring events with similar levels of positive impact on earnings are not likely to occur in 2020.

Our nonperforming assets and other problem loans could have an adverse effect on the Company's results of operations and financial condition

Our nonperforming assets (which includes non-accrual loans, foreclosed properties and other accruing loans past due 90 days or more) were approximately \$3.0 million at December 31, 2019. These assets could negatively impact operating results through higher loan losses, lost interest and higher costs to administer problem assets.

National, state and local economic conditions could have a material adverse effect on the Company's results of operations and financial condition

The results of operations for financial institutions, including our Bank, may be materially and adversely affected by changes in prevailing national, state and local economic conditions. Our profitability is heavily influenced by the quality of the Company's loan portfolio and the stability of the Company's deposits. Unlike larger national or regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in Ottawa, Kent and Allegan Counties of western Michigan. The local economic conditions in these areas have a significant impact on the demand for the Company's products and services, and the ability of the Company's customers to repay loans, the value of the collateral securing loans and the stability of the Company's deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities, an outbreak of a widespread epidemic or pandemic of disease (or widespread fear thereof) or other international or domestic occurrences, unemployment, changes in securities, financial, capital or credit markets or other factors, could impact national and local economic conditions and have a material adverse effect on the Company's results of operations and financial condition.

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

The risk of nonpayment of loans is inherent in all lending activities and nonpayment of loans may have a material adverse effect on our earnings and overall financial condition, and the value of our common stock. We make various assumptions and judgments about the collectability of our loan portfolio and provide an allowance for potential losses based on a number of factors. If our assumptions are wrong, our allowance for loan losses may not be sufficient to cover our losses, which could have an adverse effect on our operating results, and may cause us to increase the allowance in the future. The actual amount of future provisions for loan losses cannot now be determined and may exceed the amounts of past provisions for loan losses. Federal and state banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to increase our provision for loan losses or to recognize further loan charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses could have a negative effect on our regulatory capital ratios, net income, financial condition and results of operations.

We are subject to liquidity risk in our operations, which could adversely affect our ability to fund various obligations.

Liquidity risk is the possibility of being unable to meet obligations as they come due, pay deposits when withdrawn, and fund loan and investment opportunities as they arise because of an inability to liquidate assets or obtain adequate funding on a timely basis, at a reasonable cost and within acceptable risk tolerances. Liquidity is required to fund various obligations, including credit obligations to borrowers, mortgage originations, withdrawals by depositors, repayment of debt, operating expenses and capital expenditures. Liquidity of the Bank is derived primarily from retail deposit growth and retention, principal and interest payments on loans and investment securities, net cash provided from operations and access to other funding sources. Liquidity is essential to our business. We must maintain sufficient funds to respond to the needs of depositors and borrowers. An inability to raise funds through deposits, borrowings, the sale or pledging as collateral of loans and other assets could have a material adverse effect on our liquidity. An inability to retain the current level of deposits, including the loss of one or more of the Bank's larger deposit relationships, could have a material adverse effect on the Bank's liquidity. Our access to funding sources in amounts adequate to finance activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of the business activity due to a market down turn or regulatory action that limits or eliminates access to alternate funding sources, including brokered deposits discussed above. Our ability to borrow could also be impaired by factors that are nonspecific to the Company, such as severe disruption of the financial markets or negative expectations about the prospects for the financial services industry as a whole.

Our construction and development lending exposes us to significant risks.

Construction and development loans consist of loans to commercial customers for the construction of their business facilities. They also include construction loans to builders and developers for the construction of one- to four-family residences and the development of one- to four-family lots, residential subdivisions, condominium developments and other commercial developments. This portfolio may be particularly adversely affected by job losses, declines in real estate values, declines in home sale volumes, and declines in new home building. Declining real estate values may result in sharp increases in losses, particularly in the land development and construction loan portfolios to residential developers. This type of lending is generally considered to have more complex credit risks than traditional single-family residential lending because the principal is concentrated in a limited number of loans with repayment dependent on the successful completion and sales of the related real estate project. Consequently, these loans are often more sensitive to adverse conditions in the real estate market or the general economy than other real estate loans. These loans are generally less predictable and more difficult to evaluate and monitor and collateral may be difficult to dispose of in a market decline. Additionally, we may experience significant construction loan losses if independent appraisers or project engineers inaccurately estimate the cost and value of construction loan projects.

We have significant exposure to risks associated with commercial and residential real estate.

A substantial portion of our loan portfolio consists of commercial and residential real estate-related loans, including real estate development, construction and residential and commercial mortgage loans. As of December 31, 2019, we had approximately \$598.5 million of commercial real estate loans outstanding, which represented approximately 43.2% of our loan portfolio. As of that same date, we had approximately \$211.0 million in residential real estate loans outstanding, or approximately 15.3% of our loan portfolio. Consequently, real estate-related credit risks are a significant concern for us. The adverse consequences from real estate-related credit risks tend to be cyclical and are often driven by national economic developments that are not controllable or entirely foreseeable by us or our borrowers.

Commercial loans may expose us to greater financial and credit risk than other loans.

Our commercial loan portfolio, including commercial mortgages, was approximately \$1.1 billion at December 31, 2019, comprising approximately 79.2% of our total loan portfolio. Commercial loans generally carry larger loan balances and can involve a greater degree of financial and credit risk than other loans. Any significant failure to pay on time by our customers would hurt our earnings. The increased financial and credit risk associated with these types of loans are a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the size of loan balances, the effects of general economic conditions on income-producing properties and the increased difficulty of evaluating and monitoring these types of loans. In addition, when underwriting a commercial or industrial loan, we may take a security interest in commercial real estate, and, in some instances upon a default by the borrower, we may foreclose on and take title to the property, which may lead to potential financial risks for us under applicable environmental laws. If hazardous substances were discovered on any of these properties, we may be liable to governmental agencies or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination.

Our loan portfolio has and will continue to be affected by the housing market.

Loans to residential developers involved in the development or sale of 1-4 family residential properties were approximately \$36.3 million, \$35.3 million and \$30.8 million at December 31, 2019, 2018 and 2017, respectively. As we continue our on-going portfolio monitoring, we will make credit and reserve decisions based on the current conditions of the borrower or project combined with our expectations for the future. If the housing market deteriorates, we could experience higher charge-offs and delinquencies in this portfolio.

We may face pressure from historical purchasers of our residential mortgage loans to repurchase those loans or reimburse purchasers for losses related to those loans.

We generally sell the fixed rate long-term residential mortgage loans we originate on the secondary market and retain adjustable rate mortgage loans for our portfolios. Purchasers of residential mortgage loans, such as government sponsored entities, may seek to require sellers of residential mortgage loans to either repurchase loans previously sold or reimburse purchasers for losses related to loans previously sold when losses are incurred on a loan previously sold due to actual or alleged failure to strictly conform to the purchaser's purchase criteria. We may face claims from historical purchasers of our residential mortgage loans to repurchase those loans or reimburse purchasers for losses related to those loans and we may face increasing expenses to defend against such claims. If we are required in the future to repurchase loans previously sold, reimburse purchasers for losses related to loans previously sold, or if we incur increasing expenses to defend against such claims, our financial condition and results of operations would be negatively affected, and would lower our capital ratios as a result of increasing assets and lowering income through expenses and any loss incurred.

For the five-year period ended December 31, 2019, the Company has sold an aggregate of \$386.5 million of residential mortgage loans on the secondary market. As of December 31, 2019, the Company had no pending repurchase demands or claims related to residential mortgage loans sold on the secondary market during the five-year period ended December 31, 2019.

Changes in interest rates may negatively affect our earnings and the value of our assets.

Our earnings and cash flows depend substantially upon our net interest income. Net interest income is the difference between interest income earned on interest-earning assets, such as loans and investment securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Interest rates are sensitive to many factors that are beyond our control, including general economic conditions, competition and policies of various governmental and regulatory agencies and, in particular, the policies of the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investment securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect: (i) our ability to originate loans and obtain deposits; (ii) the fair value of our financial assets and liabilities, including our securities portfolio; and (iii) the average duration of our interest-earning assets. This also includes the risk that interest-earning assets may be more responsive to changes in interest rates than interest-bearing liabilities, or vice versa (repricing risk), the risk that the individual interest rates or rates indices underlying various interest-earning assets and interest-bearing liabilities may not change in the same degree over a given time period (basis risk), and the risk of changing interest rate relationships across the spectrum of interest-earning asset and interest-bearing liability maturities (yield curve risk), including a prolonged flat or inverted yield curve environment. Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations.

For several years prior to December 2015, the Federal Open Market Committee ("FOMC") kept the target federal funds between 0% and 0.25%. In December 2015, the FOMC increased the target federal funds rate by 25 basis points, representing the first increase in nearly a decade. Since then, the FOMC has increased the target federal funds rate by 25 basis points on eight separate occasions. The FOMC reduced the target federal funds rate two times in the third quarter and one time in the fourth quarter of 2019 by a total of 75 basis points in 2019. The extended lower interest rate environment has compressed our net interest spread and reduced our spread-based revenues, which has had an adverse impact on our revenue and results of operations.

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

The banking industry is heavily regulated under both federal and state law. These regulations are primarily intended to protect customers and the Deposit Insurance Fund, not our creditors or shareholders. We are subject to extensive regulation by the Federal Reserve, the FDIC and the DIFS, in addition to other regulatory and self-regulatory organizations. Future regulatory changes or accounting pronouncements may increase our regulatory capital requirements or adversely affect our regulatory capital levels. Regulations affecting banks and financial services companies undergo continuous change, and we cannot predict the ultimate effect of such changes, which could have a material adverse effect on our profitability or financial condition.

The Company could be adversely affected by the soundness of other financial institutions, including defaults by larger financial institutions.

The Company's ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of credit, trading, clearing, counterparty or other relationships between financial institutions. The Company has exposure to multiple counterparties, and the Company routinely executes transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, could lead to market-wide liquidity problems and losses or defaults by the Company or by other institutions. This is sometimes referred to as "systemic risk" and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges, with which the Company interacts on a daily basis, and therefore could adversely affect the Company.

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

We are and will continue to be dependent upon the services of our management team and other key personnel. Losing the services of one or more key members of our management team could adversely affect our operations.

Our controls and procedures may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. If we fail to identify and remediate control deficiencies, it is possible that a material misstatement of interim or annual financial statements will not be prevented or detected on a timely basis. In addition, any failure or circumvention of our other controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations and financial condition.

The Bank may be required to pay additional insurance premiums to the FDIC, which could negatively impact earnings.

Depending upon any future losses that the FDIC insurance fund may suffer, there can be no assurance that there will not be additional premium increases in order to replenish the fund. The FDIC may need to set a higher base rate schedule or impose special assessments due to future financial institution failures and updated failure and loss projections. Increased FDIC assessment rates could have an adverse impact on our results of operations.

If we cannot raise additional capital when needed, our ability to further expand our operations through organic growth and acquisitions could be materially impaired.

We are required by federal and state regulatory authorities to maintain specified levels of capital to support our operations. We may need to raise additional capital to support our current level of assets or our growth. Our ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. We cannot assure that we will be able to raise additional capital in the future on terms acceptable to us or at all. If we cannot raise additional capital when needed, our ability to expand our operations through organic growth or acquisitions could be materially limited. Additional information on the capital requirements applicable to the Bank may be found under the heading "Regulatory Capital" in Note 17 in Item 8.

We may be a defendant in a variety of litigation and other actions, which may have a material adverse effect on our financial condition and results of operations.

We may be involved from time to time in a variety of litigation arising out of our business. Our insurance may not cover all claims that may be asserted against us, and any claims asserted against us, regardless of merit or eventual outcome, may harm our reputation or cause us to incur unexpected expenses, which could be material in amount. Should the ultimate expenses, judgments or settlements in any litigation exceed our insurance coverage, they could have a material adverse effect on our financial condition and results of operations. In addition, we may not be able to obtain appropriate types or levels of insurance in the future, and we may not be able to obtain adequate replacement of our existing policies with acceptable terms, if at all.

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

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. We compete for deposits, loans and other financial services with numerous Michigan-based and out-of-state banks, thrifts, credit unions and other financial institutions as well as other entities which provide financial services, including technology-oriented financial services (FinTech) companies. Some of the financial institutions and financial services organizations with which we compete are not subject to the same degree of regulation as we are. Most of our competitors have been in business for many years, have established customer bases, are larger, and have substantially higher lending limits than we do. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. Competition for limited, high-quality lending opportunities and core deposits in an increasingly competitive marketplace may adversely affect our results of operations.

Evaluation of investment securities for other-than-temporary impairment involves subjective determinations and could materially impact our results of operations and financial condition.

The evaluation of impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of investments should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition or future recovery prospects, the effects of changes in interest rates or credit spreads and the expected recovery period. Estimating future cash flows involves incorporating information received from third-party sources and making internal assumptions and judgments regarding the future performance of the underlying collateral and assessing the probability that an adverse change in future cash flows has occurred. The determination of the amount of other-than-temporary impairments is based upon our periodic evaluation and assessment of known and inherent risks associated with the respective asset class. Such evaluations and assessments are revised as conditions change and new information becomes available. Our management considers a wide range of factors about the security issuer and uses reasonable judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Impairments to the carrying value of our investment securities may need to be taken in the future, which could have a material adverse effect on our results of operations and financial condition.

We depend upon the accuracy and completeness of information about customers.

In deciding whether to extend credit to customers, we rely on information provided to us by our customers, including financial statements and other financial information. We also rely on representations of customers as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. Our financial condition and results of operations could be negatively impacted to the extent that we extend credit in reliance on financial statements or other information provided by customers that is false, misleading or incomplete.

Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of computer systems or otherwise, or failure or interruption of the Company's communication or information systems, could severely harm the Company's business.

As part of its business, the Company collects, processes and retains sensitive and confidential client and customer information on behalf of the Company and other third parties. Despite the security measures the Company has in place for its facilities and systems, and the security measures of its third party service providers, the Company may be vulnerable to security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming and/or human errors or other similar events.

The Company relies heavily on communications and information systems to conduct its business. Any failure or interruption of these systems could result in failures or disruptions in the Company's customer relationship management, general ledger, deposit, loan and other systems. In addition, customers could lose access to their accounts and be unable to conduct financial transactions during a period of failure or interruption of these systems.

Any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information, whether such information is held by the Company or by its vendors, or failure or interruption of the Company's communication or information systems, could severely damage the Company's reputation, expose it to risks of regulatory scrutiny, litigation and liability, disrupt the Company's operations, or result in a loss of customer business, the occurrence of any of which could have a material adverse effect on the Company's business.

Cybersecurity incidents could disrupt business operations, result in the loss of critical and confidential information, and adversely impact our reputation and results of operations.

Cybersecurity threats and incidents can range from uncoordinated individual attempts to gain unauthorized access to information technology (IT) systems to sophisticated and targeted measures known as advanced persistent threats, directed at the Company and/or its third party service providers. While we have experienced, and expect to continue to experience, these types of threats and incidents, none of them to date have been material to the Company. Although we employ comprehensive measures to prevent, detect, address and mitigate these threats (including access controls, employee training, data encryption, vulnerability assessments, continuous monitoring of our IT networks and systems and maintenance of backup and protective systems), cybersecurity incidents, depending on their nature and scope, could potentially result in the misappropriation, destruction, corruption or unavailability of critical data and confidential or proprietary information (our own or that of third parties) and the disruption of business operations. The potential consequences of a material cybersecurity incident include reputational damage, litigation with third parties and increased cybersecurity protection and remediation costs, which in turn could materially adversely affect our results of operations.

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

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

An “ownership change” for purposes of Section 382 of the Internal Revenue Code could materially impair our ability to use our deferred tax assets.

At December 31, 2019, our gross deferred tax asset was \$4.1 million. Our ability to use our deferred tax assets to offset future taxable income will be limited if we experience an “ownership change” as defined in Section 382 of the Internal Revenue Code. In general, an ownership change will occur if there is a cumulative increase in our ownership by “5-percent shareholders” (as defined in the Code) that exceeds 50 percentage points over a rolling three-year period. A corporation that experiences an ownership change will generally be subject to an annual limitation on the use of its pre-ownership change deferred tax assets equal to the equity value of the corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate.

If an “ownership change” occurs, we could lose certain built-in losses that have not been recognized for tax purposes. The amount of the permanent loss would depend on the size of the annual limitation (which is in part a function of our market capitalization at the time of an “ownership change”) and the remaining carry forward period (U.S. federal net operating losses generally may be carried forward for a period of 20 years).

Our ability to maintain, attract and retain customer relationships is highly dependent on our reputation.

Our customers rely on us to deliver superior, personalized financial services with the highest standards of ethics, performance, professionalism and compliance. Damage to our reputation could undermine the confidence of our current customers and our ability to attract potential customers. Such damage could also impair the confidence of our contractual counterparties and vendors and ultimately affect our ability to effect transactions. Maintenance of our reputation depends not only on our success in maintaining our service-focused culture and controlling and mitigating the various risks described herein, but also on our success in identifying and appropriately addressing issues that may arise in areas such as potential conflicts of interest, anti-money laundering, client personal information and privacy issues, employee, customer and other third party fraud, record-keeping, regulatory investigations and any litigation that may arise from the failure or perceived failure of us to comply with legal and regulatory requirements.

Employee misconduct could expose us to significant legal liability and reputational harm.

We are vulnerable to reputational harm because we operate in an industry in which integrity and the confidence of our customers are of critical importance. Our employees could engage in misconduct that adversely affects our customers, other employees, and/or our business. For example, if an employee were to engage in fraudulent, illegal, wrongful or suspicious activities, and/or activities resulting in consumer harm, we could be subject to litigation, regulatory sanctions or penalties, and suffer serious harm to our reputation (as a consequence of the negative perception resulting from such activities), financial position, customer relationships and ability to attract new customers. Our business often requires that we deal with confidential information. If our employees were to improperly use or disclose this information, even if inadvertently, we could suffer serious harm to our reputation, financial position and current and future business relationships. It is not always possible to deter employee misconduct, and the precautions we take to detect and prevent this activity may not always be effective. Misconduct or harassment by our employees, or even unsubstantiated allegations of misconduct or harassment, or improper use or disclosure of confidential information by our employees, even inadvertently, could result in a material adverse effect on our business, financial condition or results of operations.

Our operations could be interrupted if certain external vendors on which we rely experience difficulty, terminate their services or fail to comply with banking laws and regulations.

We depend to a significant extent on relationships with third party service providers. Specifically, we utilize third party core banking services and receive credit card and debit card services, branch capture services, Internet banking services and services complementary to our banking products from various third party service providers. If these third party service providers experience difficulties or terminate their services and we are unable to replace them with other service providers, our operations could be interrupted. It may be difficult for us to replace some of our third party vendors, particularly vendors providing our core banking, credit card and debit card services, in a timely manner if they were unwilling or unable to provide us with these services in the future for any reason. If an interruption were to continue for a significant period of time, it could have a material adverse effect on our business, financial condition or results of operations. Even if we are able to replace them, it may be at higher cost to us, which could have a material adverse effect on our business, financial condition or results of operations.

Uncertainty relating to the LIBOR calculation process and potential phasing out of LIBOR may adversely affect our results of operations.

On July 27, 2017, the Chief Executive of the United Kingdom Financial Conduct Authority, which regulates LIBOR, announced that it intends to stop persuading or compelling banks to submit rates for the calculation of LIBOR to the administrator of LIBOR after 2021. The announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. It is impossible to predict whether and to what extent banks will continue to provide LIBOR submissions to the administrator of LIBOR or whether any additional reforms to LIBOR may be enacted in the United Kingdom or elsewhere. At this time, no consensus exists as to what rate or rates may become acceptable alternatives to LIBOR and it is impossible to predict the effect of any such alternatives on the value of LIBOR-based securities and variable rate loans, subordinated debentures, or other securities or financial arrangements, given LIBOR's role in determining market interest rates globally. Uncertainty as to the nature of alternative reference rates and as to potential changes or other reforms to LIBOR may adversely affect LIBOR rates and the value of LIBOR-based loans and securities in our portfolio, and may impact the availability and cost of hedging instruments and borrowings. If LIBOR rates are no longer available, and we are required to implement alternative indices for the calculation of interest rates under our loan agreements with our borrowers, we may incur significant expenses in effecting the transition, and may be subject to disputes or litigation with customers over the appropriateness or comparability to LIBOR of the alternative indices, which could have an adverse effect on our results of operations.

Risks Associated With the Company's Stock

The market price of our common stock can be volatile, which may make it more difficult to resell our common stock at a desired time and price.

Stock price volatility may make it more difficult for a shareholder to resell our common stock when a shareholder wants to and at prices a shareholder finds attractive or at all. Our stock price can fluctuate significantly in response to a variety of factors, regardless of operating results. These factors include, among other things:

- Variations in our anticipated or actual operating results or the results of our competitors;
- Changes in investors' or analysts' perceptions of the risks and conditions of our business;
- The size of the public float of our common stock;
- Regulatory developments, including changes to regulatory capital levels, components of regulatory capital and how regulatory capital is calculated;
- Interest rate changes or credit loss trends;
- Trading volume in our common stock;
- Market conditions; and
- General economic conditions.

The Company may issue additional shares of its common stock in the future, which could dilute a shareholder's ownership of common stock.

The Company's articles of incorporation authorize its Board of Directors, without shareholder approval, to, among other things, issue additional shares of common or preferred stock. The issuance of any additional shares of common or preferred stock could be dilutive to a shareholder's ownership of Company common stock.

To the extent that the Company issues options or warrants to purchase common stock in the future and the options or warrants are exercised, the Company's shareholders may experience further dilution. Holders of shares of Company common stock have no preemptive rights that entitle holders to purchase their pro rata share of any offering of shares of any class or series and, therefore, shareholders may not be permitted to invest in future issuances of Company common or preferred stock.

Although publicly traded, our common stock has substantially less liquidity than the average liquidity of stocks listed on The Nasdaq Global Select Market.

Although our common stock is listed for trading on The Nasdaq Global Select Market, our common stock has substantially less liquidity than the average liquidity for companies listed on The Nasdaq Global Select Market. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This marketplace depends on the individual decisions of investors and general economic and market conditions over which we have no control. This limited market may affect a shareholder's ability to sell their shares on short notice, and the sale of a large number of shares at one time could temporarily depress the market price of our common stock. For these reasons, our common stock should not be viewed as a short-term investment.

The Company's common stock is not insured by any governmental entity.

Our common stock is not a deposit account or other obligation of any bank and is not insured by the FDIC or any other governmental entity. Investment in Company common stock is subject to risk, including possible loss.

The Company may issue debt and equity securities that are senior to Company common stock as to distributions and in liquidation, which could negatively affect the value of Company common stock.

The Company has in the past and may in the future increase its capital by entering into debt or debt-like financing or issuing debt or equity securities, which could include issuances of senior notes, subordinated notes, preferred stock or common stock. In the event of the Company's liquidation, its lenders and holders of its debt securities would receive a distribution of the Company's available assets before distributions to the holders of Company common stock. The Company's decision to incur debt and issue securities in future offerings will depend on market conditions and other factors beyond its control. The Company cannot predict or estimate the amount, timing or nature of its future offerings and debt financings. Future offerings could reduce the value of shares of Company common stock and dilute a shareholder's interest in the Company.

Our articles of incorporation and bylaws and Michigan laws contain certain provisions that could make a takeover more difficult.

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

The Michigan Business Corporation Act contains provisions intended to protect shareholders and prohibit or discourage certain types of hostile takeover activities. In addition to these provisions and the provisions of our articles of incorporation and bylaws, federal law requires the Federal Reserve Board's approval prior to acquisition of "control" of a bank holding company. All of these provisions may have the effect of delaying or preventing a change in control of the Company without action by our shareholders, and therefore, could adversely affect the price of our common stock.

If an entity holds as little as a 5% interest in our outstanding securities, that entity could, under certain circumstances, be subject to regulation as a "bank holding company."

Any entity, including a "group" composed of natural persons, owning or controlling with the power to vote 25% or more of our outstanding securities, or 5% or more if the holder otherwise exercises a "controlling influence" over us, may be subject to regulation as a "bank holding company" in accordance with the Bank Holding Company Act of 1956, as amended (the "BHC Act"). In addition, any bank holding company or foreign bank with a U.S. presence may be required to obtain the approval of the Federal Reserve Board under the BHC Act to acquire or retain 5% or more of our outstanding securities. Becoming a bank holding company imposes statutory and regulatory restrictions and obligations, such as providing managerial and financial strength for its bank subsidiaries. Regulation as a bank holding company could require the holder to divest all or a portion of the holder's investment in our securities or those nonbanking investments that may be deemed impermissible or incompatible with bank holding company status, such as a material investment in a company unrelated to banking.

Any person not defined as a company by the BHC Act may be required to obtain the approval of the Federal Reserve Board under the Change in Bank Control Act of 1978, as amended, to acquire or retain 10% or more of our outstanding securities.

Any person not otherwise defined as a company by the BHC Act and its implementing regulations may be required to obtain the approval of the Federal Reserve Board under the Change in Bank Control Act of 1978, as amended, to acquire or retain 10% or more of our outstanding securities. Applying to obtain this approval could result in a person incurring substantial costs and time delays. There can be no assurance that regulatory approval will be obtained.

ITEM 1B: Unresolved Staff Comments.

None.

ITEM 2: Properties.

We own or lease facilities located in Ottawa County, Allegan County and Kent County, Michigan. Our administrative offices are located at 10753 Macatawa Drive, Holland, Michigan 49424. Our administrative offices are approximately 49,000 square feet and contain our administration, human resources, trust, loan underwriting and processing, and deposit operations. We believe our facilities are well-maintained and adequately insured. We own each of the facilities except those identified in the "Use" column as "(Leased facility)". Our facilities as of February 20, 2020, were as follows:

<u>Location of Facility</u>	<u>Use</u>
10753 Macatawa Drive, Holland	Main Branch, Administrative, and Loan Processing Offices
815 E. Main Street, Zeeland	Branch Office
116 Ottawa Avenue N.W., Grand Rapids	Branch Office (Leased facility, lease expires August 2020)
126 Ottawa Avenue N.W., Grand Rapids	Loan Center (Leased facility, lease expires August 2020)
141 E. 8th Street, Holland	Branch Office
489 Butternut Dr., Holland	Branch Office
701 Maple Avenue, Holland	Branch Office
699 E. 16th Street, Holland	Branch Office
41 N. State Street, Zeeland	Branch Office
2020 Baldwin Street, Jenison	Branch Office
6299 Lake Michigan Dr., Allendale	Branch Office
132 South Washington, Douglas	Branch Office
4758 – 136th Street, Hamilton	Branch Office (Leased facility, lease expires December 2020)
3526 Chicago Drive, Hudsonville	Branch Office
20 E. Lakewood Blvd., Holland	Branch Office
3191 – 44th Street, S.W., Grandville	Branch Office
2261 Byron Center Avenue S.W., Byron Center	Branch Office
5271 Clyde Park Avenue, S.W., Wyoming	Branch Office
4590 Cascade Road, Grand Rapids	Branch Office
3177 Knapp Street, N.E., Grand Rapids	Branch Office
15135 Whittaker Way, Grand Haven	Branch Office
12415 Riley Street, Holland	Branch Office
2750 Walker N.W., Walker	Branch Office
1575 – 68th Street S.E., Grand Rapids	Branch Office
2820 – 10 Mile Road, Rockford	Branch Office
520 Baldwin Street, Jenison	Branch Office
2440 Burton Street, S.E., Grand Rapids	Branch Office
6330 28 th Street, S.E., Grand Rapids	Branch Office

ITEM 3: Legal Proceedings.

As of the date of this report, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking, to which Macatawa Bank Corporation or the Bank are a party or of which any of our properties are the subject.

ITEM 4: Mine Safety Disclosures.

Not applicable.

PART II

ITEM 5: Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Our common stock is quoted on The Nasdaq Global Select Market under the symbol MCBC. High and low closing prices (as reported on The Nasdaq Global Select Market) of our common stock for each quarter for the years ended December 31, 2019 and 2018 are set forth in the table below.

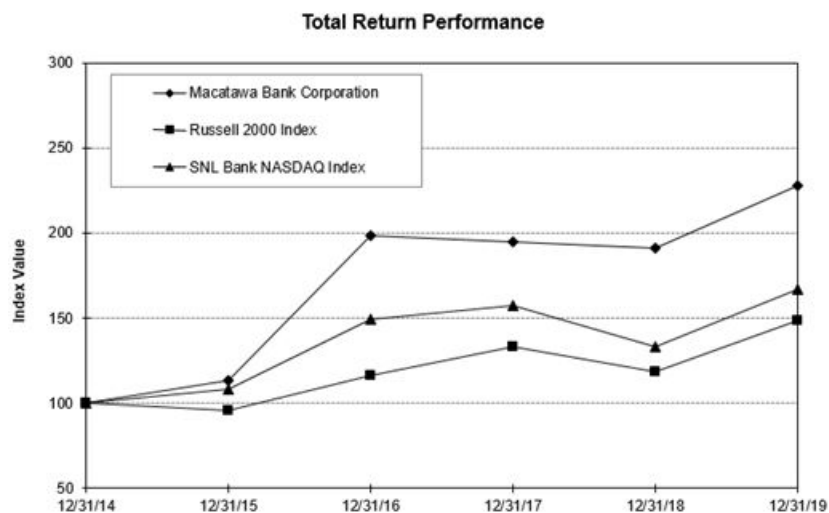
Quarter	2019			2018		
	High	Low	Dividends Declared	High	Low	Dividends Declared
First Quarter	\$ 11.16	\$ 9.32	\$ 0.07	\$ 10.63	\$ 9.75	\$ 0.06
Second Quarter	10.95	9.71	0.07	12.77	10.30	0.06
Third Quarter	10.98	9.67	0.07	12.77	11.64	0.06
Fourth Quarter	11.42	9.92	0.07	11.59	9.15	0.07

Information on restrictions on payments of dividends by us may be found in Item 1 of this report under the heading “Supervision and Regulation” and is here incorporated by reference. Information regarding our equity compensation plans may be found in Item 12 of this report and is here incorporated by reference.

On February 20, 2020, there were approximately 717 owners of record and approximately 4,980 beneficial owners of our common stock.

Shareholder Return Performance Graph

The following graph shows the cumulative total shareholder return on an investment in the Company’s common stock compared to the Russell 2000 Index and the SNL Bank NASDAQ Index. The comparison assumes a \$100 investment on December 31, 2014 at the initial price of \$5.00 per share (adjusted for all stock dividends and splits) and assumes that dividends are reinvested. The comparisons in this table are set forth in response to Securities and Exchange Commission (SEC) disclosure requirements and therefore are not intended to forecast or be indicative of future performance of the common stock.



Index	Period Ending					
	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19
Macatawa Bank Corporation	100.00	113.55	198.70	194.49	191.43	227.53
Russell 2000	100.00	95.59	115.95	132.94	118.30	148.49
SNL Bank NASDAQ	100.00	107.95	149.68	157.58	132.82	166.75

Issuer Purchases of Equity Securities

The following table provides information regarding the Company's purchase of its own common stock during the fourth quarter of 2019. All employee transactions are under stock compensation plans. These include shares of Macatawa Bank Corporation common stock surrendered for cancellation to satisfy tax withholding obligations that occur upon the vesting of restricted shares. The value of the shares withheld is determined based on the closing price of Macatawa Bank Corporation common stock at the date of vesting. The Company has no publicly announced repurchase plans or programs.

Macatawa Bank Corporation Purchases of Equity Securities

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>
October 1 - October 31, 2019		
Employee Transactions	—	—
November 1 - November 30, 2019		
Employee Transactions	6,034	\$ 10.70
December 1 - December 31, 2019		
Employee Transactions	2,914	\$ 11.08
Total for Fourth Quarter ended December 31, 2019		
Employee Transactions	8,948	\$ 10.82

ITEM 6: Selected Financial Data.

The following unaudited table sets forth selected historical consolidated financial information as of and for the years ended December 31, 2019, 2018, 2017, 2016 and 2015, which is derived from our audited consolidated financial statements. You should read this information in conjunction with our consolidated financial statements and related notes and “Management’s Discussion and Analysis of Results of Operations and Financial Condition” included elsewhere in this report.

(Dollars in thousands, except per share data)	As of and for the Year Ended December 31,				
	2019	2018	2017	2016	2015
Financial Condition					
Total assets	\$ 2,068,770	\$ 1,975,124	\$ 1,890,232	\$ 1,741,013	\$ 1,729,643
Securities	307,969	297,320	306,547	253,811	218,671
Loans	1,385,627	1,405,658	1,320,309	1,280,812	1,197,932
Deposits	1,753,294	1,676,739	1,579,010	1,448,724	1,435,512
Long-term debt	20,619	41,238	41,238	41,238	41,238
Other borrowed funds	60,000	60,000	92,118	84,173	96,169
Shareholders’ equity	217,469	190,853	172,986	162,239	151,977
Share Information*					
Basic earnings (loss) per common share	\$ 0.94	\$ 0.78	\$ 0.48	\$ 0.47	\$ 0.38
Diluted earnings (loss) per common share	0.94	0.78	0.48	0.47	0.38
Book value per common share	6.38	5.61	5.09	4.78	4.48
Tangible book value per common share	6.38	5.61	5.09	4.78	4.48
Dividends per common share	0.28	0.25	0.18	0.12	0.11
Dividend payout ratio	29.79%	32.05%	37.50%	25.53%	28.95%
Average dilutive common shares outstanding	34,056,200	34,018,554	33,952,872	33,922,548	33,891,429
Common shares outstanding at period end	34,103,542	34,045,411	33,972,977	33,940,788	33,925,113
Operations					
Interest income	\$ 75,942	\$ 69,037	\$ 57,676	\$ 52,499	\$ 49,386
Interest expense	12,455	9,411	5,732	4,959	5,306
Net interest income	63,487	59,626	51,944	47,540	44,080
Provision for loan losses	(450)	450	(1,350)	(1,350)	(3,500)
Net interest income after provision for loan losses	63,937	59,176	53,294	48,890	47,580
Total noninterest income	19,728	17,503	17,419	19,074	17,793
Total noninterest expense	44,224	44,329	43,688	45,782	46,953
Income before income tax	39,441	32,350	27,025	22,182	18,420
Federal income tax**	7,462	5,971	10,733	6,231	5,626
Net income attributable to common shares	31,979	26,379	16,292	15,951	12,794
Performance Ratios					
Return on average equity	15.66%	14.69%	9.60%	10.06%	8.68%
Return on average assets	1.59	1.40	0.93	0.95	0.79
Yield on average interest-earning assets	4.04	3.91	3.59	3.42	3.36
Cost on average interest-bearing liabilities	0.94	0.76	0.51	0.46	0.49
Average net interest spread	3.10	3.15	3.08	2.96	2.87
Average net interest margin	3.38	3.38	3.24	3.11	3.01
Efficiency ratio	53.14	57.47	62.98	68.73	75.89
Capital Ratios					
Period-end equity to total assets	10.51%	9.66%	9.15%	9.32%	8.79%
Average equity to average assets	10.17	9.51	9.69	9.47	9.10
Total risk-based capital ratio (consolidated)	15.78	15.54	14.99	14.88	14.80
Credit Quality Ratios					
Allowance for loan losses to total loans	1.24%	1.20%	1.26%	1.32%	1.43%
Nonperforming assets to total assets	0.14	0.24	0.33	0.72	1.06
Net charge-offs / (recoveries) to average loans	(0.06)	0.01	(0.08)	(0.10)	(0.14)

*Retroactively adjusted to reflect the effect of all stock splits and dividends

**2017 reflects the effect of “H.R.1”, also known as the “Tax Cuts and Jobs Act”, on the value of the Company’s net deferred tax assets which increased federal income tax expense by \$2,524,000. 2019 and 2018 reflect the effect of the reduced corporate tax rate from 35% to 21% under H.R.1 effective as of January 1, 2018.

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

Management’s discussion and analysis of results of operations and financial condition contains forward-looking statements. Please refer to the discussion of forward-looking statements at the beginning of this report.

The following section presents additional information to assess our results of operations and financial condition. This section should be read in conjunction with the consolidated financial statements and the supplemental financial data contained elsewhere in this report.

OVERVIEW

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. It wholly-owns Macatawa Bank, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the FDIC. The Bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and have issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in our Consolidated Financial Statements. On December 31, 2019, the Company redeemed the \$20.0 million of pooled trust preferred securities associated with Macatawa Statutory Trust I. For further information regarding consolidation, see the Notes to the Consolidated Financial Statements.

At December 31, 2019, we had total assets of \$2.07 billion, total loans of \$1.39 billion, total deposits of \$1.75 billion and shareholders’ equity of \$217.5 million. We recognized net income of \$32.0 million in 2019 compared to net income of \$26.4 million in 2018. Earnings before income tax in 2019 and 2018 improved over their respective previous years through growth in total revenue, primarily net interest income, while holding noninterest expenses stable. As of December 31, 2019, the Company’s and the Bank’s risk-based regulatory capital ratios were significantly above those required under the regulatory standards and the Bank continued to be categorized as “well capitalized” at December 31, 2019.

The Company paid a cash dividend of \$0.06 per share for the first, second and third quarters of 2018, and increased to \$0.07 per share for the fourth quarter of 2018 and each quarter of 2019.

Over the past several years, much progress has been made at reducing our nonperforming assets. The following table reflects period end balances of these nonperforming assets as well as total loan delinquencies.

(Dollars in thousands)	December 31, 2019	December 31, 2018	December 31, 2017
Nonperforming loans	\$ 203	\$ 1,304	\$ 395
Other repossessed assets	—	—	11
Other real estate owned	2,748	3,380	5,767
Total nonperforming assets	<u>\$ 2,951</u>	<u>\$ 4,684</u>	<u>\$ 6,173</u>
Total loan delinquencies 30 days or greater past due	<u>\$ 405</u>	<u>\$ 877</u>	<u>\$ 995</u>

We recorded a negative provision for loan losses of \$450,000 in 2019. We recorded a provision for loan losses of \$450,000 in 2018 due to net chargeoffs during the year and we recorded a negative provision for loan losses of \$1.35 million in 2017. The level of provisions in each year were impacted by recoveries from our collection efforts and certain declines in our historical charge-off levels from prior years.

While we had net charge-offs in 2018, this followed five consecutive full years of net recoveries. We again had net recoveries in 2019. The following table reflects the provision for loan losses for the past three years along with certain metrics that impact the determination of the level of the provision for loan losses.

(Dollars in thousands)	For the year ended December 31,		
	2019	2018	2017
Provision for loan losses	\$ (450)	\$ 450	\$ (1,350)
Net charge-offs / (recoveries)	(774)	174	(988)
Net charge-offs to average loans	-0.06%	0.01%	-0.08%
Nonperforming loans to total loans	0.01%	0.09%	0.03%
Loans transferred to ORE to average loans	0.00%	0.02%	0.01%
Performing troubled debt restructurings to average loans	0.99%	1.20%	1.72%

Economic conditions in our market areas of Grand Rapids and Holland, Michigan have been good during the past several years. The state of Michigan's unemployment rate at the end of 2019 was 3.9%. The Grand Rapids and Holland area unemployment rate was 2.3% at the end of 2019. Residential housing values and commercial real estate property values have increased in recent years.

It also appears that the housing market in our primary market area continues to be strong. In the Grand Rapids market during 2019, total living unit starts were up 12% over 2018 at 2,367 units and have been over 2,000 units in each of the past five years. The Holland-Grand Haven/Lakeshore region showed similar results with living units starts up 17% over 2018 at 1,822 units and the region had over 1,500 living unit starts in each of the past five years.

We experienced commercial loan growth in recent years. Most of our emphasis has been on growing commercial and industrial loans. These loans have increased steadily from \$465.2 million at December 31, 2017 to \$499.6 million at December 31, 2019. Commercial real estate loans have increased from \$541.9 million at December 31, 2017 to \$598.5 million at December 31, 2019. Consumer loans have decreased from \$313.2 million at December 31, 2017 to \$287.6 million at December 31, 2019. We believe we are positioned for loan growth in 2020.

RESULTS OF OPERATIONS

Summary: Net income was \$32.0 million (\$39.4 million on a pretax basis) for 2019, compared to \$26.4 million (\$32.4 million on a pretax basis) for 2018. Earnings per common share on a diluted basis were \$0.94 for 2019 and \$0.78 for 2018.

Generally, the improvement in Company earnings was the result of growth in revenue while expenses have been stable. The increase in revenue in 2019 compared to 2018 was due primarily to increased net interest income and gains on sales of mortgage loans. Net interest income increased to \$63.5 million in 2019 compared to \$59.6 million in 2018. Gain on sales of mortgage loans were \$2.3 million in 2019 compared to \$924,000 in 2018. Total noninterest expense was \$44.2 million in 2019 compared to \$44.3 million in 2018.

We recorded a negative provision for loan losses of \$450,000 in 2019 and a provision for loan losses of \$450,000 in 2018. These provisions resulted from low levels of nonperforming loans, strong asset quality and the levels of net loan charge-offs/recoveries realized in each of these periods. These items are discussed more fully below.

Net Interest Income: Net interest income totaled \$63.5 million during 2019 compared to \$59.6 million during 2018.

The increase in net interest income during 2019 compared to 2018 marked our fifth consecutive year with an increase in net interest income. This increase was due to an increase in average earning assets of \$113.5 million from \$1.77 billion in 2018 to \$1.89 billion in 2019 as well as improvement in yields on earning assets. Average yield on securities, interest earning assets and net interest margin are presented on a fully taxable equivalent basis. Our net interest income as a percentage of average interest-earning assets (i.e. "net interest margin" or "margin") was 3.38% for both the years ended December 31, 2019 and December 31, 2018.

The yield on earning assets increased 13 basis points from 3.91% for 2018 to 4.04% for 2019. The increase from 2018 to 2019 was generally due to increases in short-term interest rates including the federal funds rate, the prime rate and LIBOR throughout 2018, providing a higher average in 2019, despite the decreases in the federal funds rate in late 2019. Our margin in recent years has been negatively impacted by our decision to hold significant balances in liquid and short-term investments.

Net interest income for 2019 increased \$3.9 million compared to 2018. Of this increase, \$980,000 was due to changes in rates earned or paid, while \$2.9 million was from changes in the volume of average interest earning assets and interest bearing liabilities. The largest changes came in commercial loan interest income which increased by \$4.5 million in 2019. Of the \$4.5 million increase in interest income on commercial loans, \$2.2 million was due to increases in rates earned and \$2.3 million was due to increases in average balances.

Average interest earning assets totaled \$1.89 billion for 2019 compared to \$1.77 billion in 2018. Increases of \$81.8 million in average short-term investment balances and \$40.4 million in average loan balances from 2018 to 2019 were the primary drivers of the increase in total earning assets. Yield on commercial loans increased from 4.52% in 2018 to 4.72% in 2019. Yield on residential mortgage loans increased from 3.57% in 2018 to 3.72% in 2019, while yield on consumer loans increased from 4.79% in 2018 to 5.19% in 2019. The increases in yields on commercial loans and consumer loans, in particular, were the result of the predominance of loans in these categories with variable rates of interest tied to prime and LIBOR which increased significantly in 2017 through early 2019.

Our net interest margin for 2019 was negatively impacted from an 18 basis point increase in our cost of funds from 0.76% for 2018 to 0.94% for 2019. Average interest bearing liabilities increased from \$1.24 billion in 2018 to \$1.32 billion in 2019. Increases in the rates paid on certain deposit account types in response to market rates and additional other borrowings caused the increase in our cost of funds. While these costs have increased, the yields on our interest earning assets increased enough to offset this effect, allowing our net interest margin to remain unchanged from 2018 to 2019.

In 2020, we expect that net interest margin will be pressured by the recent decreases in the federal funds rate and our higher levels of short-term investment balances held.

The following table shows an analysis of net interest margin for the years ended December 31, 2019, 2018 and 2017 (dollars in thousands).

	For the years ended December 31,								
	2019			2018			2017		
	Average Balance	Interest Earned or Paid	Average Yield or Cost	Average Balance	Interest Earned or Paid	Average Yield or Cost	Average Balance	Interest Earned or Paid	Average Yield or Cost
Assets									
Taxable securities	\$ 174,121	\$ 3,864	2.22%	\$ 180,787	\$ 3,716	2.06%	\$ 158,805	\$ 2,869	1.81%
Tax-exempt securities (1)	121,905	3,518	3.71	123,923	3,464	3.60	105,460	2,244	3.38
Commercial loans (2)	1,062,549	50,873	4.72	1,012,413	46,369	4.52	957,987	39,658	4.08
Residential mortgage loans	230,551	8,572	3.72	235,378	8,399	3.57	219,111	7,608	3.46
Consumer loans	80,277	4,164	5.19	85,175	4,084	4.79	90,565	3,802	4.20
Federal Home Loan Bank stock	11,558	614	5.24	11,558	578	4.94	11,558	491	4.19
Federal funds sold and other short-term investments	206,140	4,337	2.08	124,374	2,427	1.92	83,844	1,004	1.18
Total interest earning assets (1)	1,887,101	75,942	4.04	1,773,608	69,037	3.91	1,627,330	57,676	3.59
Noninterest earning assets:									
Cash and due from banks	31,704			31,025			29,077		
Other	89,497			83,808			95,896		
Total assets	<u>\$ 2,008,302</u>			<u>\$ 1,888,441</u>			<u>\$ 1,752,303</u>		
Liabilities									
Deposits:									
Interest bearing demand	\$ 446,452	\$ 1,443	0.33%	\$ 406,694	\$ 1,130	0.28%	\$ 341,384	\$ 366	0.11%
Savings and money market accounts	625,307	4,554	0.73	602,676	3,317	0.55	557,703	1,591	0.28
Time deposits	148,189	2,857	1.93	109,715	1,434	1.30	85,921	654	0.76
Borrowings:									
Other borrowed funds	59,976	1,369	2.25	74,751	1,403	1.85	85,893	1,407	1.62
Long-term debt	41,182	2,232	5.35	41,238	2,127	5.09	41,238	1,714	4.10
Total interest bearing liabilities	1,321,106	12,455	0.94	1,235,074	9,411	0.76	1,112,139	5,732	0.51
Noninterest bearing liabilities:									
Noninterest bearing demand accounts	472,987			467,663			464,384		
Other noninterest bearing liabilities	10,018			6,077			6,004		
Shareholders' equity	204,191			179,627			169,776		
Total liabilities and shareholders' equity	<u>\$ 2,008,302</u>			<u>\$ 1,888,441</u>			<u>\$ 1,752,303</u>		
Net interest income									
		<u>\$ 63,487</u>			<u>\$ 59,626</u>			<u>\$ 51,944</u>	
Net interest spread (1)									
			3.10%			3.15%			3.08%
Net interest margin (1)									
			3.38%			3.38%			3.24%
Ratio of average interest earning assets to average interest bearing liabilities									
	142.84%			143.60%			146.32%		

(1) Yields are presented on a tax equivalent basis using a 21% tax rate for 2019 and 2018 and a 35% tax rate for 2017.

(2) Loan fees of \$946,000, \$701,000 and \$701,000 for 2019, 2018 and 2017, respectively, are included in interest income. Includes average nonaccrual loans of approximately \$375,000, \$316,000 and \$492,000 for 2019, 2018 and 2017, respectively.

The following table presents the dollar amount of changes in net interest income due to changes in volume and rate.

	For the years ended December 31,					
	2019 vs 2018			2018 vs 2017		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
(Dollars in thousands)						
Interest income						
Taxable securities	\$ (140)	\$ 288	\$ 148	\$ 425	\$ 422	\$ 847
Tax-exempt securities	(78)	132	54	834	386	1,220
Commercial loans	2,351	2,153	4,504	2,337	4,374	6,711
Residential mortgage loans	(171)	344	173	576	215	791
Consumer loans	(243)	323	80	(236)	518	282
Federal Home Loan Bank stock	—	36	36	—	87	87
Federal funds sold and other short-term investments	1,707	203	1,910	618	805	1,423
Total interest income	3,426	3,479	6,905	4,554	6,807	11,361
Interest expense						
Interest bearing demand	\$ 117	\$ 196	\$ 313	\$ 82	\$ 682	\$ 764
Savings and money market accounts	129	1,108	1,237	138	1,588	1,726
Time deposits	604	819	1,423	217	563	780
Other borrowed funds	(302)	268	(34)	(192)	188	(4)
Long-term debt	(3)	108	105	—	413	413
Total interest expense	545	2,499	3,044	245	3,434	3,679
Net interest income	\$ 2,881	\$ 980	\$ 3,861	\$ 4,309	\$ 3,373	\$ 7,682

Provision for Loan Losses: The provision for loan losses for 2019 was a negative \$450,000 compared to \$450,000 for 2018. The level of provision in each period was the result of continued realization of recoveries, a reduction in the balances of and required reserves on nonperforming loans, and stabilizing real estate values on problem credits. While we did have net charge-offs in 2018, this followed a period when we experienced net recoveries in five consecutive full years and we again had net recoveries in 2019. Our low net charge-offs in 2018 and net recoveries in other recent years were attributable to positive results from our active collection efforts.

Our overall commercial loan grade has been below 4.00 for the past several years. Our weighted average commercial loan grade was 3.67 at December 31, 2019 and 3.68 at December 31, 2018.

The amounts of loan loss provision in each period were the result of establishing our allowance for loan losses at levels believed necessary based upon our methodology for determining the adequacy of the allowance. The sustained level of net recoveries over the past several years has had a significant effect on the historical loss component of our methodology. More information about our allowance for loan losses and our methodology for establishing its level may be found in this Item 7 of this report under the heading “Allowance for Loan Losses” below and in Item 8 of this report in Note 3 of the Consolidated Financial Statements.

Noninterest Income: Noninterest income totaled \$19.7 million in 2019 compared to \$17.5 million in 2018. The components of noninterest income are shown in the table below (in thousands):

	2019	2018
Service charges and fees on deposit accounts	\$ 4,415	\$ 4,377
Net gains on mortgage loans	2,347	924
Trust fees	3,812	3,643
ATM and debit card fees	5,753	5,535
Bank owned life insurance (“BOLI”) income	972	942
Investment services fees	1,246	989
Other income	1,183	1,093
Total noninterest income	\$ 19,728	\$ 17,503

Net gains on sales of mortgage loans increased \$1.4 million from 2018 to 2019 due to higher sales volumes in 2019. Net gains on mortgage loans included gains on the sale of real estate mortgage loans in the secondary market. We sell the majority of the fixed-rate mortgage loans we originate. We do not retain the servicing rights for the loans we sell.

A summary of gain on sales of loans and related loan volume was as follows (in thousands):

	For the Year Ended December 31,	
	2019	2018
Gain on sales of loans	\$ 2,347	\$ 924
Real estate mortgage loans originated for sale	\$ 82,281	\$ 33,907
Real estate mortgage loans sold	81,749	35,624
Net gain on the sale of mortgage loans as a percent of real estate mortgage loans sold ("Loan sale margin")	2.87%	2.59%

As demonstrated in the table above, volume of mortgage loans originated for sale was up significantly in 2019 compared to 2018. The declining interest rates in 2019 have significantly impacted mortgage sale production volume. During 2019, more of our mortgage production volume was in products we sell on the secondary market than in the prior year, also contributing to the increase in gains on sales of mortgage loans in 2019. In addition, during the past year we have seen a shift in our mortgage production from purchase activity to refinance activity.

Trust service revenue increased \$169,000 in 2019. This increase was due to growth in our trust service customer base and improvements in general market conditions through most of 2019.

ATM and debit card processing income increased \$218,000 in 2019 to \$5.8 million compared to \$5.5 million in 2018. This increase reflected a continued increase in usage from current customers and overall growth in the number of debit and ATM card customers. Promotional efforts to increase volume in these low cost transaction alternatives continued to be successful.

We did not sell any securities in 2019 or 2018. We continually review our securities portfolio and will dispose of securities that pose higher than desired credit or market risk.

Investment services fees increased \$257,000 in 2019. This increase was due to growth in our investment services customer base along with a shift in the choice of investments by customers to those with higher associated fees.

Earnings from bank owned life insurance increased by \$30,000 in 2019 compared to 2018 due to the general performance of the underlying investments. Other real estate rental income was \$495,000 in 2019 compared to \$506,000 in 2018. The year over year changes were a result of changes in rental arrangements on some of these properties.

Noninterest Expense: Noninterest expense was \$44.2 million in 2019 and \$44.3 million in 2018. The slight decrease in total noninterest expense reflected our active management of controllable costs. The components of noninterest expense are shown in the table below (in thousands):

	2019	2018
Salaries and benefits	\$ 24,679	\$ 25,207
Occupancy of premises	3,994	3,931
Furniture and equipment	3,420	3,125
Legal and professional	952	806
Marketing and promotion	919	881
Data processing	2,980	2,986
FDIC assessment	239	518
Interchange and other card expense	1,414	1,409
Bond and D&O insurance	413	440
Net (gains) losses on repossessed and foreclosed properties	(24)	(207)
Administration and disposition of problem assets	277	276
Outside services	1,778	1,696
Other noninterest expense	3,183	3,261
Total noninterest expense	\$ 44,224	\$ 44,329

Salaries and benefits expense was the largest component of noninterest expense and was \$24.7 million in 2019 and \$25.2 million in 2018. The decrease in 2019 was primarily driven by lower medical insurance costs resulting from lower claims experience in 2019, partially offset by an increase in variable compensation tied to higher mortgage loan production and investment services fees in 2019.

Costs associated with nonperforming assets remained at low levels, totaling \$253,000 in 2019 and \$69,000 in 2018. These costs included legal costs, repossessed and foreclosed property administration expense and losses (gains) on repossessed and foreclosed properties. Repossessed and foreclosed property administration expense included survey and appraisal, property maintenance and management and other disposition and carrying costs. Net gains on repossessed and foreclosed properties included both net gains and losses on the sale of properties and unrealized losses from value declines for outstanding properties. The increase in these costs in 2019 over 2018 was due to a higher level of realized gains on these properties in 2018.

These costs are itemized in the following table (in thousands):

	2019	2018
Legal and professional – nonperforming assets	\$ 121	\$ 93
Repossessed and foreclosed property administration	156	183
Net (gains) losses on repossessed and foreclosed properties	(24)	(207)
Total	<u>\$ 253</u>	<u>\$ 69</u>

During 2019, we did not add any other real estate properties and sold \$618,000 of other real estate and repossessed assets, allowing for another meaningful reduction in our year-end balance, bringing it from \$3.4 million at December 31, 2018 to \$2.7 million at December 31, 2019. During 2018, we received a distribution of \$675,000 from the sale of a property held by a partnership in which we had acquired an interest in satisfaction of a loan in the 1990s. This property had been carried at \$0, so the entire distribution resulted in net gain treatment. During 2019 we received an additional \$68,000 related to this property as a distribution of funds that had been held in escrow following the sale of the property in 2018. This additional distribution was treated as net gain in 2019. In 2018, we added \$293,000 in other real estate and sold \$2.4 million.

FDIC assessments decreased to \$239,000 in 2019 compared to \$518,000 in 2018 primarily due to our assessment category and assessment credits applied during 2019, resulting in no expense in the third and fourth quarters of 2019. Assessment credits of \$266,000 were applied in 2019, leaving approximately \$172,000 in assessment credits that will likely be applied in 2020. Further discussion regarding the determination of FDIC assessments for the Bank may be found in Item 1 of this report under the heading “Supervision and Regulation.”

Insurance costs for bond and directors and officers (“D&O”) insurance decreased from \$440,000 in 2018 to \$413,000 in 2019. The reduction experienced in 2019 was a result of the improvement in financial condition, which demonstrated to the insurance carriers our lower risk and resulted in a reduction in premiums charged.

Occupancy expense increased by \$63,000 in 2019 primarily due to an increase in outside grounds maintenance, property taxes, and building maintenance, partially offset by a decrease in building supplies and other occupancy costs. Furniture and equipment expense increased by \$295,000 in 2019 primarily due to an increase in equipment service contracts and software related to information security solutions, partially offset by a decrease in depreciation expense and equipment rental and repairs.

Data processing expenses were \$3.0 million in 2019 and 2018. Increases in data processing for our systems and card programs in 2019 were offset by a decrease in expense related to e-banking channels, such as online banking, mobile banking and electronic bill pay services.

Other noninterest expenses not discussed above were \$8.3 million in 2019 and \$8.1 million in 2018. The \$193,000 increase was primarily due to an increase in legal and professional and outside services expenses.

Federal Income Tax Expense: We recorded federal income tax expense of \$7.5 million in 2019 and \$6.0 million in 2018. Our effective tax rate was 18.92% for 2019 and 18.46% for 2018. In December 2017, the Tax Cuts and Jobs Act was enacted which changed the corporate federal income tax rate from 35% to 21%, beginning January 1, 2018. Accordingly, federal income tax expense for 2019 and 2018 was computed using the 21% corporate income tax rate.

FINANCIAL CONDITION

Summary: Total assets were \$2.07 billion at December 31, 2019, an increase of \$93.6 million from \$1.98 billion at December 31, 2018. This change reflected increases of \$101.2 million in cash and cash equivalents, \$12.4 million in securities held to maturity, \$3.4 million in other assets, \$2.9 million in loans held for sale and \$971,000 in bank owned life insurance, partially offset by decreases of \$20.0 million in our loan portfolio, \$1.4 million in premises and equipment and \$632,000 in other real estate owned. Total deposits increased by \$76.6 million and long-term debt was down by \$20.6 million at December 31, 2019 compared to December 31, 2018.

Total shareholders’ equity increased by \$26.6 million from December 31, 2018 to December 31, 2019. Shareholders’ equity was increased by \$32.0 million of net income in 2019, partially offset by cash dividends of \$9.5 million, or \$0.28 per share. Shareholders’ equity also increased by \$3.8 million in 2019 as a result of a swing in accumulated other comprehensive income due to the effect of interest rate movement on the fair value of our available for sale securities portfolio. As of December 31, 2019 and 2018, the Bank was categorized as “well capitalized” under applicable regulatory guidelines.

Cash and Cash Equivalents: Our cash and cash equivalents, which include federal funds sold and short-term investments, were \$272.5 million at December 31, 2019 compared to \$171.3 million at December 31, 2018. This \$101.2 million increase was primarily due to growth in year-end deposits which outpaced loan demand and growth in investments.

Securities: Securities available for sale were \$225.2 million at December 31, 2019 compared to \$227.0 million at December 31, 2018. The balance at December 31, 2019 primarily consisted of U.S. agency securities, agency mortgage backed securities and various municipal investments. Our held to maturity portfolio increased from \$70.3 million at December 31, 2018 to \$82.7 million at December 31, 2019. Our held to maturity portfolio is comprised of state aid notes and locally sourced municipal and commercial bonds. The commercial bond component of this category declined by \$2.9 million in 2019. These bonds represent financing provided to some of our non-profit commercial customers who qualified for borrowing on a tax-exempt basis.

Portfolio Loans and Asset Quality: Total portfolio loans decreased by \$20.0 million to \$1.39 billion at December 31, 2019 compared to \$1.41 billion at December 31, 2018. During 2019, our commercial portfolio increased by \$16.0 million, while our residential mortgage portfolio decreased by \$27.1 million and our consumer portfolio decreased by \$8.9 million.

The volume of residential mortgage loans originated for sale in 2019 increased significantly compared to 2018 due to the mortgage rate environment and customer preference for loan types that we sell, primarily longer term fixed rate mortgages. Residential mortgage loans originated for sale were \$82.3 million in 2019 compared to \$33.9 million in 2018.

We experienced year over year growth in commercial loan balances for the past three years, increasing \$39.8 million in 2017, \$74.9 million in 2018 and \$16.0 million in 2019. We plan to continue measured, high quality loan portfolio growth in 2020.

Commercial and commercial real estate loans remained our largest loan segment and accounted for 79.2% of the total loan portfolio at December 31, 2019 and 77.0% at December 31, 2018. Residential mortgage and consumer loans comprised 20.8% of total loans at December 31, 2019 and 23.0% at December 31, 2018.

A further breakdown of the composition of the loan portfolio is shown in the table below (in thousands):

	December 31, 2019		December 31, 2018	
	Balance	Percent of Total Loans	Balance	Percent of Total Loans
Commercial real estate: (1)				
Residential developed	\$ 14,705	1.1%	\$ 14,825	1.1%
Unsecured to residential developers	—	—	—	—
Vacant and unimproved	41,796	3.0	44,169	3.1
Commercial development	665	0.1	712	0.1
Residential improved	130,861	9.4	98,500	7.0
Commercial improved	292,799	21.1	295,618	21.0
Manufacturing and industrial	117,632	8.5	114,887	8.2
Total commercial real estate	598,458	43.2	568,711	40.5
Commercial and industrial	499,572	36.0	513,345	36.5
Total commercial	1,098,030	79.2	1,082,056	77.0
Consumer				
Residential mortgage	211,049	15.3	238,174	16.9
Unsecured	274	—	130	—
Home equity	70,936	5.1	78,503	5.6
Other secured	5,338	0.4	6,795	0.5
Total consumer	287,597	20.8	323,602	23.0
Total loans	\$ 1,385,627	100.0%	\$ 1,405,658	100.0%

(1) Includes both owner occupied and non-owner occupied commercial real estate.

Commercial real estate loans increased \$29.7 million since December 31, 2018 and accounted for 43.2% of our total loan portfolio at year-end 2019 and consisted primarily of loans to business owners and developers of owner and non-owner occupied commercial properties and loans to developers of single and multi-family residential properties. In the table above, we show our commercial real estate portfolio by loans secured by residential and commercial real estate, and by stage of development. Improved loans are generally secured by properties that are under construction or completed and placed in use. Development loans are secured by properties that are in the process of development or fully developed. Vacant and unimproved loans are secured by raw land for which development has not yet begun and agricultural land.

Our commercial and industrial loan portfolio decreased by \$13.8 million to \$499.6 million at December 31, 2019 and represented 36.0% of our total loan portfolio.

Our consumer residential mortgage loan portfolio, which also includes residential construction loans made to individual homeowners, comprised approximately 15.3% of portfolio loans at December 31, 2019 and 16.9% at December 31, 2018. We expect to continue to retain in our loan portfolio certain types of residential mortgage loans (primarily high quality, low loan to value, adjustable rate loans) in an effort to continue to diversify our credit risk and deploy our excess liquidity. A large portion of our residential mortgage loan production continues to be sold on the secondary market with servicing released.

The volume of residential mortgage loans originated for sale during 2019 increased significantly from 2018 as interest rates declined in 2019 and there was a shift in production from financing new home purchases to refinancings. In addition, customer preference drove more production in loan product types we sell on the secondary market (i.e. fixed-rate long-term mortgages). As of December 31, 2019, the Company had no repurchase demands or claims related to residential mortgage loans sold on the secondary market during the five-year period ended December 31, 2019.

Our portfolio of other consumer loans includes loans secured by personal property and home equity fixed term and line of credit loans. Consumer loans decreased by \$8.9 million to \$76.5 million at December 31, 2019 from \$85.4 million at December 31, 2018 primarily due to a decrease in home equity loans. Consumer loans comprised approximately 5.5% of our portfolio loans at December 31, 2019 and 6.1% at December 31, 2018.

The following table shows our loan origination activity for portfolio loans during 2019 and 2018, broken out by loan type and also shows average originated loan size (dollars in thousands):

	Year ended December 31, 2019			Year ended December 31, 2018		
	Portfolio Originations	Percent of Total Originations	Average Loan Size	Portfolio Originations	Percent of Total Originations	Average Loan Size
Commercial real estate:						
Residential developed	\$ 7,896	1.9%	\$ 316	\$ 16,237	3.1%	\$ 649
Unsecured to residential developers	5,500	1.3	2,750	—	—	—
Vacant and unimproved	6,788	1.6	617	21,568	4.2	830
Commercial development	—	—	—	350	0.1	175
Residential improved	56,482	13.4	362	104,229	20.2	617
Commercial improved	95,628	22.8	1,275	41,096	8.0	685
Manufacturing and industrial	21,752	5.2	906	50,642	9.8	1,178
Total commercial real estate	194,046	46.2	667	234,122	45.4	780
Commercial and industrial	143,926	34.2	702	163,852	31.7	618
Total commercial	337,972	80.4	679	397,974	77.1	704
Consumer						
Residential mortgage	41,712	9.9	262	73,440	14.2	271
Unsecured	—	—	—	32	—	16
Home equity	38,231	9.1	108	41,357	8.0	88
Other secured	2,395	0.6	21	3,417	0.7	22
Total consumer	82,338	19.6	132	118,246	22.9	132
Total loans	\$ 420,310	100.0%	374	\$ 516,220	100.0%	353

The table above demonstrates that our loan origination activity in 2019 was lower than in 2018. We believe the lower origination activity is primarily the result of reduced business activity occurring in our marketplace in response to uncertainty over economic and political conditions.

Our loan portfolio is reviewed regularly by our senior management, our loan officers, and an internal loan review team that is independent of our loan originators and credit administration. An administrative loan committee consisting of senior management and seasoned lending and collections personnel meets monthly to manage our internal watch list and proactively manage high risk loans.

When reasonable doubt exists concerning collectability of interest or principal of one of our loans, the loan is placed in nonaccrual status. Any interest previously accrued but not collected is reversed and charged against current earnings.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. At December 31, 2019, nonperforming assets totaled \$3.0 million compared to \$4.7 million at December 31, 2018. Additions to other real estate owned in 2019 were \$0, compared to \$293,000 in 2018. Based on the loans currently in their redemption period, we expect there to be few additions to other real estate owned in 2020. Proceeds from sales of foreclosed and repossessed properties were \$656,000 in 2019, resulting in a net realized gain on sale of \$38,000. Proceeds from sales of foreclosed properties were \$2.9 million in 2018 resulting in a net realized gain on sale of \$530,000. We expect the level of sales of foreclosed properties in 2020 to be lower than the level experienced in 2019.

Nonperforming loans include loans on nonaccrual status and loans delinquent more than 90 days but still accruing. As of December 31, 2019, nonperforming loans totaled \$203,000, or 0.01% of total portfolio loans, compared to \$1.3 million, or 0.09% of total portfolio loans, at December 31, 2018.

Nonperforming loans at December 31, 2019 consisted of \$98,000 of commercial real estate loans secured by various types of non-residential real estate and \$105,000 of consumer and residential mortgage loans.

Foreclosed and repossessed assets include assets acquired in settlement of loans. Foreclosed assets totaled \$2.7 million at December 31, 2019 and \$3.4 million at December 31, 2018. Of this balance at December 31, 2019, there were 6 commercial real estate properties totaling approximately \$2.7 million. All properties acquired through or in lieu of foreclosure are initially transferred at their fair value less estimated costs to sell and then evaluated monthly for impairment after transfer using a lower of cost or market approach. Updated property valuations are obtained at least annually on all foreclosed assets.

At December 31, 2019, our foreclosed asset portfolio had a weighted average age held in portfolio of 7.86 years. Below is a breakout of our foreclosed asset portfolio at December 31, 2019 and 2018 by property type and the percentages the property has been written down since taken into our possession and the combined writedown percentage, including losses taken when the property was loan collateral (dollars in thousands):

Foreclosed Asset Property Type	December 31, 2019			December 31, 2018		
	Carrying Value	Foreclosed Asset Writedown	Combined Writedown (Loan and Foreclosed Asset)	Carrying Value	Foreclosed Asset Writedown	Combined Writedown (Loan and Foreclosed Asset)
Single Family	\$ —	—%	—%	\$ —	—%	—%
Residential Lot	—	—	—	38	57.6	70.1
Multi-Family	—	—	—	—	—	—
Vacant Land	79	66.6	74.1	352	40.5	46.6
Residential Development	326	38.7	69.1	815	38.6	82.3
Commercial Office	—	—	—	—	—	—
Commercial Industrial	—	—	—	—	—	—
Commercial Improved	2,343	—	—	2,175	—	—
	<u>\$ 2,748</u>	11.7	25.8	<u>\$ 3,380</u>	19.2	55.4

The following table shows the composition and amount of our nonperforming assets (dollars in thousands):

	December 31,				
	2019	2018	2017	2016	2015
Nonaccrual loans	\$ 203	\$ 1,303	\$ 395	\$ 300	\$ 739
Loans 90 days or more delinquent and still accruing	—	1	—	—	17
Total nonperforming loans (NPLs)	203	1,304	395	300	756
Foreclosed assets	2,748	3,380	5,767	12,253	17,572
Repossessed assets	—	—	11	—	—
Total nonperforming assets (NPAs)	\$ 2,951	\$ 4,684	\$ 6,173	\$ 12,553	\$ 18,328
NPLs to total loans	0.01%	0.09%	0.03%	0.02%	0.06%
NPAs to total assets	0.14%	0.24%	0.33%	0.73%	1.06%

The following table shows the breakout of our troubled debt restructurings (“TDRs”) between performing and nonperforming at December 31, 2019 and 2018 (dollars in thousands):

	December 31, 2019			December 31, 2018		
	Commercial	Consumer	Total	Commercial	Consumer	Total
Performing TDRs	\$ 8,469	\$ 5,140	\$ 13,609	\$ 9,682	\$ 6,347	\$ 16,029
Nonperforming TDRs (1)	98	—	98	124	—	124
Total TDRs	\$ 8,567	\$ 5,140	\$ 13,707	\$ 9,806	\$ 6,347	\$ 16,153

(1) Included in nonperforming asset table above

The following table further shows the composition of our TDRs over the past five years (dollars in thousands):

	December 31,				
	2019	2018	2017	2016	2015
Commercial and industrial TDRs	\$ 5,797	\$ 6,502	\$ 6,403	\$ 5,994	\$ 7,611
Commercial real estate TDRs	2,770	3,305	7,332	11,933	17,871
Consumer TDRs	5,140	6,346	8,345	12,059	13,570
Total TDRs	\$ 13,707	\$ 16,153	\$ 22,080	\$ 29,986	\$ 39,052

We had a total of \$13.7 million and \$16.2 million of loans whose terms have been modified in TDRs as of December 31, 2019 and 2018, respectively. These loans may have involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. For each restructuring, a comprehensive credit underwriting analysis of the borrower’s financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally, if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan’s actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status. In situations where there is a subsequent modification or renewal and the loan is brought to market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, the TDR and impaired designations may be removed.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral, less estimated costs to sell. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by measuring cash flows using the new payment terms discounted at the original contractual rate.

Allowance for loan losses: Determining the appropriate level of the allowance for loan losses is highly subjective. Timely identification of risk rating changes within the commercial loan portfolio is key to our process of establishing an appropriate allowance balance. The internal risk rating system is discussed below.

The allowance for loan losses at December 31, 2019 was \$17.2 million, an increase of \$324,000, compared to \$16.9 million at December 31, 2018. The balance of the allowance for loan losses was 1.24% of total portfolio loans at December 31, 2019 compared to 1.20% of total portfolio loans at December 31, 2018. The allowance for loan losses to nonperforming loan coverage ratio remained high at 8473% at December 31, 2019 compared to 1294% at December 31, 2018.

The following is a summary of our portfolio loan balances at the end of each period and the daily average balance of these loans. It also includes changes in the allowance for loan losses arising from loans charged-off, recoveries on loans previously charged-off, and provisions for loan losses.

(Dollars in thousands)	December 31				
	2019	2018	2017	2016	2015
Portfolio loans:					
Average daily balance of loans for the year	\$ 1,372,905	\$ 1,332,450	\$ 1,265,353	\$ 1,218,901	\$ 1,151,101
Amount of loans outstanding at end of period	1,385,627	1,405,658	1,320,309	1,280,812	1,197,932
Allowance for loan losses:					
Balance at beginning of year	16,876	16,600	16,962	17,081	18,962
Provision for loan losses	(450)	450	(1,350)	(1,350)	(3,500)
Loans charged-off:					
Real estate - construction	—	—	—	—	—
Real estate - mortgage	(132)	—	—	—	(218)
Commercial and industrial	—	(1,206)	(108)	—	(172)
Total Commercial	(132)	(1,206)	(108)	—	(390)
Residential mortgage	—	—	(19)	(10)	(158)
Consumer	(147)	(129)	(139)	(195)	(154)
	(279)	(1,335)	(266)	(205)	(702)
Recoveries:					
Real estate - construction	177	238	333	426	699
Real estate - mortgage	211	685	488	664	565
Commercial and industrial	528	86	123	162	406
Total Commercial	916	1,009	944	1,252	1,670
Residential mortgage	64	55	66	33	415
Consumer	73	97	244	151	236
	1,053	1,161	1,254	1,436	2,321
Net (charge-offs) recoveries	774	(174)	988	1,231	1,619
Balance at end of year	\$ 17,200	\$ 16,876	\$ 16,600	\$ 16,962	\$ 17,081
Ratios:					
Net charge-offs (recoveries) to average loans outstanding	(0.06)%	0.01%	(0.08)%	(0.10)%	(0.14)%
Allowance for loan losses to loans outstanding at year-end	1.24%	1.20%	1.26%	1.32%	1.70%
Allowance for loan losses to nonperforming loans at year-end	8,473%	1,294%	4,203%	5,654%	2,259%

The continued reduction in net charge-offs over the last several years has had a significant effect on the historical loss component of our allowance for loan losses computation as have the improvements in our credit quality metrics.

The table below shows the changes in these metrics over the past five years:

(Dollars in millions)	2019	2018	2017	2016	2015
Commercial loans	\$ 1,098.0	\$ 1,082.1	\$ 1,007.1	\$ 967.3	\$ 886.0
Nonperforming loans	0.2	1.3	0.4	0.3	0.8
Other real estate owned and repo assets	2.7	3.4	5.8	12.3	17.6
Total nonperforming assets	3.0	4.7	6.2	12.6	18.3
Net charge-offs (recoveries)	(0.8)	0.2	(1.0)	(1.2)	(1.6)
Total delinquencies	0.4	0.9	1.0	1.4	1.4

Nonperforming loans have been low over the past several years. At December 31, 2019, we have had net loan recoveries in nineteen of the past twenty quarters. Perhaps even more importantly, our total delinquencies have continued to be minimal, and were just \$0.4 million at December 31, 2019.

These factors all provide for a reduction in our allowance for loan losses, and thus impact our provision for loan losses. The provision for loan losses was a negative \$450,000 for 2019 compared to \$450,000 for 2018. The provision in each period was due to the levels of nonperforming loans and net charge-off/recovery experience. We had net recoveries in 2019 totaling \$774,000 compared to net charge-offs of \$174,000 in 2018. The ratio of net charge-offs / (recoveries) to average loans was (0.06%) for 2019 compared to 0.01% for 2018.

We are encouraged by the low level of charge-offs over the past several years. We do, however, recognize that future charge-offs and resulting provisions for loan losses are expected to be impacted by the timing and extent of changes in the overall economy and the real estate markets.

Our allowance for loan losses is maintained at a level believed appropriate based upon our assessment of the probable estimated losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance and related provision for loan losses relies on several key elements, which include specific allowances for loans considered impaired, general allowance for commercial loans not considered impaired based upon applying our loan rating system, and general allocations based on historical trends for homogeneous loan groups with similar risk characteristics.

Impaired loans decreased \$3.4 million, or 19.5%, to \$13.9 million at December 31, 2019 compared to \$17.2 million at December 31, 2018. The specific allowance for impaired loans increased \$526,000 to \$1.6 million, or 11.7% of total impaired loans, at December 31, 2019 compared to \$1.1 million, or 6.4% of total impaired loans, at December 31, 2018.

Specific allowances are established on individually impaired credits where we believe it is probable that a loss may be incurred. Specific allowances are determined based on discounting estimated cash flows over the life of the loan or based on the fair value of collateral supporting the loan. For commercial real estate loans, generally appraisals are used to estimate the fair value of the collateral and determine the appropriate specific allowance. Estimated selling costs are also considered in the estimate. When it becomes apparent that liquidation of the collateral is the only source of repayment, the collateral shortfall is charged off rather than carried as a specific allowance.

The general allowance (referred to as “formula allowance”) allocated to commercial loans that were not considered to be impaired was based upon the internal risk grade of such loans. We use a loan rating method based upon an eight point system. Loans are stratified between real estate secured and non-real estate secured. The real estate secured portfolio is further stratified by the type of real estate. Each stratified portfolio is assigned a loss allocation factor. Generally, a worse grade assigned to a loan category results in a greater allocation percentage. Changes in risk grade of loans affect the amount of the allowance allocation.

The determination of our loss factors is based upon our actual loss history by loan grade and adjusted for significant factors that, in management’s judgment, affect the collectability of the portfolio as of the analysis date. We use a rolling 18 month (6 quarter) actual net charge-off history as the base for our computation for commercial loans. The 18 month period ended December 31, 2019 reflected net recoveries. We addressed this volatility in the qualitative factor considerations applied in our allowance computation. We also considered the extended period of improved asset quality in assessing the overall qualitative component. Considering the change in our qualitative factors and changes in our commercial loan portfolio balances, the general commercial loan allowance increased \$149,000 to \$12.9 million at December 31, 2019 compared to \$12.8 million at December 31, 2018. The general reserve increase was primarily due to commercial loan portfolio growth. The qualitative component of our allowance allocated to commercial loans was \$12.2 million at December 31, 2019, up from \$12.0 million at December 31, 2018.

Groups of homogeneous loans, such as residential real estate and open- and closed-end consumer loans, receive allowance allocations based on loan type. A rolling 12 month (4 quarter) historical loss experience period was applied to residential mortgage and consumer loan portfolios. As with commercial loans that are not considered impaired, the determination of the allowance allocation percentage is based principally on our historical loss experience. These allocations are adjusted for consideration of general economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience for these similar pools of loans. The homogeneous loan allowance was \$2.6 million at December 31, 2019 compared to \$3.0 million at December 31, 2018.

As noted above, the formula allowance allocated to commercial loans that are not considered to be impaired is calculated by applying historical loss factors to outstanding loans based on the internal risk rating of such loans. We use a loan rating method based upon an eight point system. Loans rated a 4 or better are considered of acceptable risk. Loans rated a 5 exhibit above-normal risk to the Company and warrant a greater level of attention by management. These loans are subject to on-going review and assessment by our Administrative Loan Committee. Loans rated a 6 or worse are considered substandard, doubtful or loss, exhibit a greater relative risk of loss to the Company based upon the rating and warrant an active workout plan administered by our Special Asset Group.

The qualitative factors assessed and used to adjust historical loss experience reflect our assessment of the impact of economic trends, delinquency and other problem loan trends, trends in valuations supporting underlying collateral, changes in loan portfolio concentrations, effect of changes in interest rates on loan collectability, competition and changes in internal credit administration practices have on probable losses inherent in our loan portfolio. Qualitative adjustments are inherently subjective and there can be no assurance that these adjustments have properly identified probable losses in our loan portfolio. More information regarding the subjectivity involved in determining the estimate of the allowance for loan losses may be found in this Item 7 of this report under the heading "Critical Accounting Policies and Estimates."

The following table shows the allocation of the allowance for loan losses by portfolio type at the dates indicated.

(Dollars in thousands)	December 31,									
	2019		2018		2017		2016		2015	
	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans	Allowance Amount	% of Each Category to Total Loans
Commercial and commercial real estate	\$ 14,191	79%	\$ 13,427	77%	\$ 13,106	76%	\$ 13,092	76%	\$ 13,320	75%
Residential mortgage	2,224	15	2,477	17	2,508	17	2,646	17	2,557	17
Consumer	785	6	972	6	986	7	1,224	7	1,204	8
Total	<u>\$ 17,200</u>	<u>100%</u>	<u>\$ 16,876</u>	<u>100%</u>	<u>\$ 16,600</u>	<u>100%</u>	<u>\$ 16,962</u>	<u>100%</u>	<u>\$ 17,081</u>	<u>100%</u>

The components of the allowance for loan losses were as follows:

(Dollars in thousands)	December 31,			
	2019		2018	
	Balance of Loans	Allowance Amount	Balance of Loans	Allowance Amount
Commercial and commercial real estate:				
Impaired with allowance recorded	\$ 6,658	\$ 1,245	\$ 7,541	\$ 630
Impaired with no allowance recorded	2,067	—	3,333	—
Loss allocation factor on non-impaired loans	1,089,305	12,946	1,071,182	12,797
	<u>1,098,030</u>	<u>14,191</u>	<u>1,082,056</u>	<u>13,427</u>
Residential mortgage and consumer:				
Reserves on troubled debt restructurings	5,140	379	6,347	468
Loss allocation factor	282,457	2,630	317,255	2,981
Total	<u>\$ 1,385,627</u>	<u>\$ 17,200</u>	<u>\$ 1,405,658</u>	<u>\$ 16,876</u>

With the exception of certain TDRs, impaired commercial loans at December 31, 2019 were classified as substandard or worse per our internal risk rating system. \$4.2 million of residential mortgage TDRs were associated with programs approved by the U.S. government during 2009 to minimize the number of consumer foreclosures. These loans involved the restructuring of terms on consumer mortgages to allow customers to mitigate foreclosure by meeting a lower loan payment requirement based upon their current cash flow. Also included in this category are certain consumer home equity loans that were restructured maturing home equity lines of credit that did not qualify for traditional term financing. We have been actively working with our customers to reduce the risk of foreclosure using these programs. Additional information regarding impaired loans at December 31, 2019 and 2018 may be found in Item 8 of this report in Note 3 to the Consolidated Financial Statements.

The increase in the level of the allowance for 2019 was due to growth in the commercial loan portfolio and an increase in specific reserves allocated to impaired loans, partially offset by the effect of stabilization in the loan grades and a reduction in qualitative factor allocations for commercial loans, which provided a lower allocation. Our weighted average loan grade was 3.74 at December 31, 2017, 3.68 at December 31, 2018 and 3.67 at December 31, 2019. The increase of \$764,000 in reserves on commercial loans for 2019 was due to a \$615,000 increase in specific reserves on impaired loans and a \$149,000 increase in the loss allocation factor on non-impaired loans, due to growth in commercial loans at December 31, 2019.

Of the \$17.2 million allowance at December 31, 2019, 10% related to specific allocations on impaired loans, 75% related to formula allowance on commercial loans and 15% related to general allocations for homogeneous loans. Of the \$16.9 million allowance at December 31, 2018, 6% related to specific allocations on impaired loans, 76% related to formula allowance on commercial loans and 18% related to general allocations for homogeneous loans. Of the \$15.6 million total formula based allowance for loan loss allocations at December 31, 2019, \$14.8 million is from general/environmental allocations and \$807,000 was driven from historical experience. Of the \$15.8 million total formula based allowance for loan loss allocations at December 31, 2018, \$14.9 million is from general/environmental allocations and \$872,000 driven from historical experience. The above allocations are not intended to imply limitations on usage of the allowance. The entire allowance is available for any loan losses without regard to loan type.

More information regarding steps to address the elevated levels of substandard, impaired and nonperforming loans may be found in this Item 7 of this report under the heading "Portfolio Loans and Asset Quality" above and in Item 8 of this report in Note 3 to the Consolidated Financial Statements.

Although we believe our allowance for loan losses has captured the losses that are probable in our portfolio as of December 31, 2019, there can be no assurance that all losses have been identified or that the allowance is sufficient. The additional efforts by management to accelerate the identification and disposition of problem assets discussed above, and the impact of the lasting economic slowdown, may result in additional losses in 2019.

Premises and Equipment: Premises and equipment totaled \$43.4 million at December 31, 2019 compared to \$44.9 million at December 31, 2018 as capital additions were more than offset by depreciation of current facilities during 2019.

Bank owned life insurance (BOLI): The Bank has purchased life insurance policies on certain officers. BOLI is recorded at its currently realizable cash surrender value and totaled \$42.2 million at December 31, 2019 compared to \$41.2 million at December 31, 2018. The increase in 2019 was due to the earnings of the policies during the year.

Deposits and Other Borrowings: Total deposits increased \$76.6 million to \$1.75 billion at December 31, 2019, as compared to \$1.68 billion at December 31, 2018. Noninterest checking account balances decreased \$3.0 million in 2019. Interest bearing demand account balances increased \$23.1 million and savings and money market account balances increased \$29.9 million in 2019 while our certificates of deposits (primarily short-term) increased by \$26.6 million in 2019. We believe our success in maintaining and increasing the balances of personal and business checking and savings accounts was primarily attributable to our focus on quality customer service, the desire of customers to deal with a local bank, the convenience of our branch network and the breadth and depth of our product line.

Noninterest bearing demand accounts comprised 27% of total deposits at December 31, 2019 compared to 29% of total deposits at December 31, 2018. Because of the generally low rates paid on interest bearing account alternatives, many of our business customers chose to keep their balances in these more liquid noninterest bearing demand account types. Interest bearing demand, money market and savings accounts, comprised 64% of total deposits at December 31, 2019 and 64% at December 31, 2018. Time accounts as a percentage of total deposits were 9% at December 31, 2019 and 7% at December 31, 2018.

Borrowed funds totaled \$80.6 million at December 31, 2019 including \$60.0 million in Federal Home Loan Bank advances and \$20.6 million in long-term debt associated with trust preferred securities. Borrowed funds totaled \$101.2 million at December 31, 2018 including \$60.0 million of Federal Home Loan Bank advances and \$41.2 million in long-term debt associated with trust preferred securities. Borrowed funds decreased by \$20.6 million in 2019 due to the redemption of \$20.6 million of long-term debt associated with trust preferred securities on December 31, 2019.

At December 31, 2019, Company had outstanding \$20.0 million aggregate liquidation amount of pooled trust preferred securities ("TRUPs") issued through its wholly-owned subsidiary grantor trust, Macatawa Statutory Trust II (issued \$20.0 million aggregate liquidation amount with a floating interest rate of three-month LIBOR plus 2.75%). As discussed above, on December 31, 2019, the Company redeemed the \$20.0 million trust preferred securities it had issued under its wholly-owned subsidiary grantor trust Macatawa Statutory Trust I. These securities had a floating interest rate of three-month LIBOR plus 3.05%.

Information regarding our off-balance sheet commitments may be found in Item 8 of this report in Note 15 to the Consolidated Financial Statements.

CAPITAL RESOURCES

Total shareholders' equity increased by \$26.6 million from December 31, 2018 to December 31, 2019. Shareholders' equity was increased by \$32.0 million of net income in 2019, partially offset by cash dividends of \$9.5 million, or \$0.28 per share. Shareholders' equity also increased by \$3.8 million in 2019 as a result of a swing in accumulated other comprehensive income due to the effect of interest rate movement on the fair value of our available for sale securities portfolio. As of December 31, 2019, the Bank was categorized as "well capitalized" under applicable regulatory guidelines.

Our regulatory capital ratios (on a consolidated basis) continue to significantly exceed the levels required to be categorized as "well capitalized".

The following table shows our regulatory capital ratios (on a consolidated basis) for the past three years.

	December 31,		
	2019	2018	2017
Total capital to risk weighted assets	15.8%	15.5%	15.0%
Common Equity Tier 1 to risk weighted assets	13.5	12.0	11.3
Tier 1 capital to risk weighted assets	14.7	14.5	13.9
Tier 1 capital to average assets	11.5	12.1	11.9

Our Board of Directors declared quarterly cash dividends to common shareholders beginning with the first quarter of 2014, and each subsequent quarter in 2014 through 2019. The declaration and payment of future dividends to common shareholders will be considered by the Board of Directors in its discretion and will depend on a number of factors, including our financial condition and anticipated profitability.

All of the \$20.0 million of trust preferred securities outstanding at December 31, 2019 qualified as Tier 1 capital.

Capital sources include, but are not limited to, additional private and public common stock offerings, preferred stock offerings and subordinated debt.

On July 3, 2013, the FDIC Board of Directors approved the Regulatory Capital Interim Final Rule, implementing Basel III. This rule redefined Tier 1 capital as two components (Common Equity Tier 1 and Additional Tier 1), created a new capital ratio (Common Equity Tier 1 Risk-based Capital Ratio) and implemented a capital conservation buffer. It also revised the prompt corrective action thresholds and made changes to risk weights for certain assets and off-balance-sheet exposures. Banks were required to transition into the new rule beginning on January 1, 2015. Based on our capital levels and balance sheet composition at December 31, 2019, we believe implementation of the new rule had no material impact on our capital needs.

Macatawa Bank:

The Bank was categorized as "well capitalized" at December 31, 2019 and 2018. The following table shows the Bank's regulatory capital ratios for the past three years.

	December 31,		
	2019	2018	2017
Average equity to average assets	11.8%	11.3%	11.6%
Total capital to risk weighted assets	15.3	15.1	14.6
Common Equity Tier 1 to risk weighted assets	14.3	14.1	13.5
Tier 1 capital to risk weighted assets	14.3	14.1	13.5
Tier 1 capital to average assets	11.2	11.8	11.6

LIQUIDITY

Liquidity of Macatawa Bank: The liquidity of a financial institution reflects its ability to manage a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus on developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for our investment and loan portfolios. Our sources of liquidity include our borrowing capacity with the FRB's discount window, the Federal Home Loan Bank, federal funds purchased lines of credit and other secured borrowing sources with our correspondent banks, loan payments by our borrowers, maturity and sales of our securities available for sale, growth of our deposits, federal funds sold and other short-term investments, and the various capital resources discussed above.

Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. Our liquidity management involves periodic monitoring of our assets considered to be liquid and illiquid, and our funding sources considered to be core and non-core and short-term (less than 12 months) and long-term. We have established parameters that monitor, among other items, our level of liquid assets to short-term liabilities, our level of non-core funding reliance and our level of available borrowing capacity. We maintain a diversified wholesale funding structure and actively manage our maturing wholesale sources to reduce the risk to liquidity shortages. We have also developed a contingency funding plan to stress test our liquidity requirements arising from certain events that may trigger liquidity shortages, such as rapid loan growth in excess of normal growth levels or the loss of deposits and other funding sources under extreme circumstances.

We maintain a non-core funding dependency ratio below our peer group average and have had no brokered deposits on our balance sheet since before December 2012. At December 31, 2019, the Bank held \$240.5 million of federal funds sold and other short-term investments as well as \$213.2 million of unpledged securities available for sale. In addition, the Bank's available borrowing capacity from correspondent banks was approximately \$370.1 million as of December 31, 2019.

In the normal course of business, we enter into certain contractual obligations, including obligations which are considered in our overall liquidity management.

The table below summarizes our significant contractual obligations at December 31, 2019 (dollars in thousands):

	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long term debt	\$ —	\$ —	\$ —	\$ 20,619
Time deposit maturities	120,799	29,474	1,852	—
Other borrowed funds	—	10,000	50,000	—
Operating lease obligations	331	236	66	—
Total	\$ 121,130	\$ 39,710	\$ 51,918	\$ 20,619

In addition to normal loan funding, we also maintain liquidity to meet customer financing needs through unused lines of credit, unfunded loan commitments and standby letters of credit. The level and fluctuation of these commitments is also considered in our overall liquidity management. At December 31, 2019, we had a total of \$502.2 million in unused lines of credit, \$65.6 million in unfunded loan commitments and \$15.3 million in standby letters of credit.

Liquidity of Holding Company: The primary sources of liquidity for the Company are dividends from the Bank, existing cash resources and the capital markets if the need to raise additional capital arises. Banking regulations and the laws of the State of Michigan in which our Bank is chartered limit the amount of dividends the Bank may declare and pay to the Company in any calendar year. Under the state law limitations, the Bank is restricted from paying dividends to the Company in excess of retained earnings. In 2018, the Bank paid dividends to the Company totaling \$11.1 million. In the same period, the Company paid dividends to its shareholders totaling \$8.5 million. In 2019, the Bank paid dividends to the Company totaling \$32.5 million. In the same period, the Company paid \$20.0 million to redeem trust preferred securities and paid \$9.5 million in dividends to its shareholders. The Company retained the remaining balance in each period for general corporate purposes. At December 31, 2019, the Bank had a retained earnings balance of \$66.7 million.

During 2019 and 2018, the Company received payments from the Bank totaling \$8.0 million and \$5.8 million, respectively, representing the Bank's intercompany tax liability for the 2019 and 2018 tax years, respectively, in accordance with the Company's tax allocation agreement.

The Company has the right to defer interest payments for 20 consecutive quarters on its trust preferred securities if necessary for liquidity purposes. During the deferral period, the Company may not declare or pay any dividends on its common stock or make any payment on any outstanding debt obligations that rank equally with or junior to the trust preferred securities.

The Company's cash balance at December 31, 2019 was \$7.3 million. The Company believes that it has sufficient liquidity to meet its cash flow obligations.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES:

To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and future results could differ. The allowance for loan losses, other real estate owned valuation, loss contingencies and income taxes are deemed critical due to the required level of management judgment and the use of estimates, making them particularly subject to change.

Our methodology for determining the allowance for loan losses and the related provision for loan losses is described above in the “Allowance for Loan Losses” discussion. This area of accounting requires significant judgment due to the number of factors which can influence the collectability of a loan. Unanticipated changes in these factors could significantly change the level of the allowance for loan losses and the related provision for loan losses. Although, based upon our internal analysis, and in our judgment, we believe that we have provided an adequate allowance for loan losses, there can be no assurance that our analysis has properly identified all of the probable losses in our loan portfolio. As a result, we could record future provisions for loan losses that may be significantly different than the levels that we recorded in 2019.

Assets acquired through or instead of foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. New real estate appraisals are generally obtained at the time of foreclosure and are used to establish fair value. If fair value declines, a valuation allowance is recorded through expense. Estimating the initial and ongoing fair value of these properties involves a number of factors and judgments including holding time, costs to complete, holding costs, discount rate, absorption and other factors.

Loss contingencies are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. This, too, is an accounting area that involves significant judgment. Although, based upon our judgment, internal analysis, and consultations with legal counsel we believe that we have properly accounted for loss contingencies, future changes in the status of such contingencies could result in a significant change in the level of contingent liabilities and a related impact to operating earnings.

Our accounting for income taxes involves the valuation of deferred tax assets and liabilities primarily associated with differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. At December 31, 2019, we had gross deferred tax assets of \$4.1 million and gross deferred tax liabilities of \$1.9 million resulting in a net deferred tax asset of \$2.2 million. Accounting standards require that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. At December 31, 2019, a valuation allowance of \$92,000 was maintained against a capital loss carryforward created by the liquidation of the assets of a partnership interest the Bank acquired through a loan settlement thereby reducing net deferred tax assets to \$2.1 million as of December 31, 2019. With the positive results in 2019 and positive future projections, we concluded at December 31, 2019 that no other valuation allowance on our net deferred tax asset was required. Changes in tax laws, changes in tax rates, changes in ownership and our future level of earnings can impact the ultimate realization of our net deferred tax asset.

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

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices.

Our balance sheet has sensitivity, in various categories of assets and liabilities, to changes in prevailing rates in the U.S. for prime rate, mortgage rates, U.S. Treasury rates and various money market indexes. Our asset/liability management process aids us in providing liquidity while maintaining a balance between interest earning assets and interest bearing liabilities.

We utilize a simulation model as our primary tool to assess the direction and magnitude of variations in net interest income and the economic value of equity (“EVE”) resulting from potential changes in market interest rates. Key assumptions in the model include contractual cash flows and maturities of interest-sensitive assets and interest-sensitive liabilities, prepayment speeds on certain assets, and changes in market conditions impacting loan and deposit pricing. We also include pricing floors on discretionary priced liability products which limit how low various checking and savings products could go under declining interest rates. These floors reflect our pricing philosophy in response to changing interest rates.

We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate shift, or shock, in interest rates under various scenarios, as calculated by discounting the estimated future cash flows using market-based discount rates.

The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of December 31, 2019 (dollars in thousands).

<u>Interest Rate Scenario</u>	<u>Economic Value of Equity</u>	<u>Percent Change</u>	<u>Net Interest Income</u>	<u>Percent Change</u>
Interest rates up 200 basis points	\$ 288,239	(1.19)%	\$ 66,859	5.05%
Interest rates up 100 basis points	291,433	(0.10)	65,388	2.74
No change	291,725	—	63,643	—
Interest rates down 100 basis points	271,864	(6.81)	61,861	(2.80)
Interest rates down 200 basis points	271,598	(6.90)	59,588	(6.37)

If interest rates were to increase, this analysis suggests that we are positioned for an increase in net interest income over the next twelve months. If interest rates were to decrease, this analysis suggests that we are positioned for a decrease in net interest income over the next twelve months.

We also forecast the impact of immediate and parallel interest rate shocks on net interest income under various scenarios to measure the sensitivity of our earnings under extreme conditions.

The quarterly simulation analysis is monitored against acceptable interest rate risk parameters by the Asset/Liability Committee and reported to the Board of Directors.

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

ITEM 8: Financial Statements and Supplementary Data.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Shareholders and Board of Directors
Macatawa Bank Corporation
Holland, Michigan

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Macatawa Bank Corporation (the “Company”) as of December 31, 2019 and 2018, the related consolidated statements of income, comprehensive income, changes in shareholders’ equity and cash flows and the related notes (collectively referred to as the “consolidated financial statements”) for the years then ended. In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2019 and 2018 and the results of operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and our report dated February 20, 2020, expressed an unqualified opinion thereon.

Basis for Opinion

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

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

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

/s/ BDO USA, LLP

We have served as the Company’s auditor since 2010.

Grand Rapids, Michigan
February 20, 2020

MACATAWA BANK CORPORATION
CONSOLIDATED BALANCE SHEETS
December 31, 2019 and 2018
(Dollars in thousands)

	2019	2018
ASSETS		
Cash and due from banks	\$ 31,942	\$ 40,526
Federal funds sold and other short-term investments	240,508	130,758
Cash and cash equivalents	272,450	171,284
Securities available for sale, at fair value	225,249	226,986
Securities held to maturity (fair value 2019 - \$85,128 and 2018 - \$71,505)	82,720	70,334
Federal Home Loan Bank (FHLB) stock	11,558	11,558
Loans held for sale, at fair value	3,294	415
Total loans	1,385,627	1,405,658
Allowance for loan losses	(17,200)	(16,876)
Net loans	1,368,427	1,388,782
Premises and equipment – net	43,417	44,862
Accrued interest receivable	4,866	5,279
Bank-owned life insurance (BOLI)	42,156	41,185
Other real estate owned - net	2,748	3,380
Net deferred tax asset	2,078	3,380
Other assets	9,807	7,679
Total assets	<u>\$ 2,068,770</u>	<u>\$ 1,975,124</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	\$ 482,499	\$ 485,530
Interest-bearing	1,270,795	1,191,209
Total deposits	1,753,294	1,676,739
Other borrowed funds	60,000	60,000
Long-term debt	20,619	41,238
Accrued expenses and other liabilities	17,388	6,294
Total liabilities	1,851,301	1,784,271
Commitments and Contingencies	—	—
Shareholders' equity		
Common stock, no par value, 200,000,000 shares authorized; 34,103,542 and 34,045,411 shares issued and outstanding at December 31, 2019 and December 31, 2018	218,109	217,783
Retained deficit	(2,184)	(24,652)
Accumulated other comprehensive income (loss)	1,544	(2,278)
Total shareholders' equity	217,469	190,853
Total liabilities and shareholders' equity	<u>\$ 2,068,770</u>	<u>\$ 1,975,124</u>

See accompanying notes to consolidated financial statements.

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
Years ended December 31, 2019 and 2018
(Dollars in thousands, except per share data)

	2019	2018
Interest income		
Loans, including fees	\$ 63,609	\$ 58,852
Securities		
Taxable	3,864	3,716
Tax-exempt	3,518	3,464
FHLB Stock	614	578
Federal funds sold and other short-term investments	4,337	2,427
Total interest income	75,942	69,037
Interest expense		
Deposits	8,854	5,881
Other borrowings	1,369	1,403
Long-term debt	2,232	2,127
Total interest expense	12,455	9,411
Net interest income	63,487	59,626
Provision for loan losses	(450)	450
Net interest income after provision for loan losses	63,937	59,176
Noninterest income		
Service charges and fees	4,415	4,377
Net gains on mortgage loans	2,347	924
Trust fees	3,812	3,643
ATM and debit card fees	5,753	5,535
BOLI income	972	942
Other	2,429	2,082
Total noninterest income	19,728	17,503
Noninterest expense		
Salaries and benefits	24,679	25,207
Occupancy of premises	3,994	3,931
Furniture and equipment	3,420	3,125
Legal and professional	952	806
Marketing and promotion	919	881
Data processing	2,980	2,986
FDIC assessment	239	518
Interchange and other card expense	1,414	1,409
Bond and D&O Insurance	413	440
Net gains on repossessed and foreclosed properties	(24)	(207)
Administration and disposition of problem assets	277	276
Other	4,961	4,957
Total noninterest expenses	44,224	44,329
Income before income tax	39,441	32,350
Income tax expense	7,462	5,971
Net income	\$ 31,979	\$ 26,379
Basic earnings per common share	\$ 0.94	\$ 0.78
Diluted earnings per common share	\$ 0.94	\$ 0.78
Cash dividends per common share	\$ 0.28	\$ 0.25

See accompanying notes to consolidated financial statements.

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years ended December 31, 2019 and 2018
(Dollars in thousands)

	2019	2018
Net income	\$ 31,979	\$ 26,379
Other comprehensive income:		
Unrealized gains (losses):		
Net change in unrealized gains (losses) on securities available for sale	4,834	(927)
Tax effect	(1,012)	194
Net change in unrealized gains (losses) on securities available for sale, net of tax	<u>3,822</u>	<u>(733)</u>
Less: reclassification adjustments:		
Reclassification for gains included in net income	—	—
Tax effect	—	—
Reclassification for gains included in net income, net of tax	<u>—</u>	<u>—</u>
Other comprehensive income (loss), net of tax	<u>3,822</u>	<u>(733)</u>
Comprehensive income	<u>\$ 35,801</u>	<u>\$ 25,646</u>

See accompanying notes to consolidated financial statements.

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2019 and 2018
(Dollars in thousands, except per share data)

	Common Stock	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2017	\$ 217,081	\$ (42,804)	\$ (1,291)	\$ 172,986
Cumulative effect adjustment upon adoption of ASU 2018-02	—	278	(278)	—
Balance, January 1, 2018, adjusted	\$ 217,081	\$ (42,526)	\$ (1,569)	\$ 172,986
Reclassification for equity securities upon adoption of ASU 2016-01	—	(24)	24	—
Net income	—	26,379	—	26,379
Cash dividends at \$0.25 per share	—	(8,481)	—	(8,481)
Repurchase of 13,351 shares for taxes withheld on vested restricted stock	(136)	—	—	(136)
Issuance of 45,000 shares for stock option exercise	386	—	—	386
Net change in unrealized gain (loss) on securities available for sale, net of tax	—	—	(733)	(733)
Stock compensation expense	452	—	—	452
Balance, December 31, 2018	\$ 217,783	\$ (24,652)	\$ (2,278)	\$ 190,853
Net income	—	31,979	—	31,979
Cash dividends at \$0.28 per share	—	(9,511)	—	(9,511)
Repurchase of 9,400 shares for taxes withheld on vested restricted stock	(101)	—	—	(101)
Net change in unrealized gain (loss) on securities available for sale, net of tax	—	—	3,822	3,822
Stock compensation expense	427	—	—	427
Balance, December 31, 2019	\$ 218,109	\$ (2,184)	\$ 1,544	\$ 217,469

See accompanying notes to consolidated financial statements.

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2019 and 2018
(Dollars in thousands)

	2019	2018
Cash flows from operating activities		
Net income	\$ 31,979	\$ 26,379
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation, amortization and accretion	2,212	2,562
Stock compensation expense	427	452
Provision for loan losses	(450)	450
Origination of loans for sale	(82,281)	(33,907)
Proceeds from sales of loans originated for sale	81,749	35,624
Net gains on mortgage loans	(2,347)	(924)
Gain on sales of securities	—	—
Write-down of other real estate	14	323
Write-down of other assets held for sale	—	234
Net gain on sales of other real estate and repossessed assets	(38)	(530)
Net gain on sales of premises and equipment held for sale	(19)	—
Deferred income tax expense	290	502
Deferred tax asset valuation allowance change	—	92
Change in accrued interest receivable and other assets	(2,037)	(1,841)
Earnings in bank-owned life insurance	(972)	(942)
Change in accrued expenses and other liabilities	1,193	1,161
Net cash from operating activities	<u>29,720</u>	<u>29,635</u>
Cash flows from investing activities		
Loan originations and payments, net	20,805	(85,816)
Purchases of securities available for sale	(58,403)	(34,391)
Purchases of securities held to maturity	(20,478)	(7,623)
Proceeds from:		
Maturities and calls of securities	72,188	31,706
Sales of securities available for sale	—	—
Principal paydowns on securities	11,053	17,322
Sales of other real estate and repossessed assets	656	2,887
Sales of premises and equipment held for sale	342	—
Additions to premises and equipment	(1,041)	(1,283)
Net cash from investing activities	<u>25,122</u>	<u>(77,198)</u>
Cash flows from financing activities		
Change in deposits	76,555	97,729
Repayments and maturities of other borrowed funds	(30,619)	(52,118)
Proceeds from other borrowed funds	10,000	20,000
Proceeds from exercise of stock options	—	386
Cash dividends paid	(9,511)	(8,481)
Repurchase of shares for taxes withheld on vested restricted stock	(101)	(136)
Net cash from financing activities	<u>46,324</u>	<u>57,380</u>
Net change in cash and cash equivalents	101,166	9,817
Cash and cash equivalents at beginning of period	171,284	161,467
Cash and cash equivalents at end of period	<u>\$ 272,450</u>	<u>\$ 171,284</u>

See accompanying notes to consolidated financial statements.

MACATAWA BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
Years ended December 31, 2019 and 2018
(Dollars in thousands)

	<u>2019</u>	<u>2018</u>
Supplemental cash flow information		
Interest paid	\$ 12,440	\$ 9,513
Income taxes paid	7,200	5,300
Supplemental noncash disclosures:		
Transfers from loans to other real estate	—	293
Security settlement	9,901	—
Transfer from premises and equipment to other assets held for sale	—	557

See accompanying notes to consolidated financial statements.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation: The accompanying consolidated financial statements include the accounts of Macatawa Bank Corporation (“Macatawa” or the “Company”) and its wholly-owned subsidiary, Macatawa Bank (the “Bank”). All significant intercompany accounts and transactions have been eliminated in consolidation.

Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The Bank operates 26 full service branch offices providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan.

The Company owns all of the common securities of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are discussed in a separate note. Under generally accepted accounting principles, these trusts are not consolidated into the financial statements of the Company.

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

Concentration of Credit Risk: Loans are granted to, and deposits are obtained from, customers primarily in the western Michigan area as described above. Substantially all loans are secured by specific items of collateral, including residential real estate, commercial real estate, commercial assets and consumer assets. Commercial real estate loans are the largest concentration, comprising 43% of total loans at December 31, 2019. Commercial and industrial loans total 36%, while residential real estate and consumer loans make up the remaining 21%. Other financial instruments, which potentially subject the Company to concentrations of credit risk, include deposit accounts in other financial institutions.

Cash and Cash Equivalents: Cash and cash equivalents include cash on hand, demand deposits with other financial institutions and short-term securities (securities with maturities equal to or less than 90 days and federal funds sold).

Cash Flow Reporting: Cash flows are reported net for customer loan and deposit transactions, interest-bearing time deposits with other financial institutions and short-term borrowings with maturities of 90 days or less.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank of \$8.1 million and \$7.0 million at December 31, 2019 and 2018, respectively, was required to meet regulatory reserve and clearing requirements.

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities available for sale consist of those securities which might be sold prior to maturity due to changes in interest rates, prepayment risks, yield and availability of alternative investments, liquidity needs or other factors. Securities classified as available for sale are reported at their fair value and the related unrealized gain or loss is reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level yield method without anticipating prepayments. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available for sale or held-to-maturity are generally evaluated for OTTI under ASC Topic 320, *Investments — Debt and Equity Instruments*.

In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. Management has determined that no OTTI charges were necessary during 2019 and 2018.

Federal Home Loan Bank (FHLB) Stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as a long term investment, impairment is based on ultimate recovery of par value. Management has determined that there is no impairment of FHLB stock. Both cash and stock dividends are reported as income.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at fair value, as determined by outstanding commitments from investors. As of December 31, 2019 and 2018, these loans had a net unrealized gain of \$89,000 and \$10,000, respectively, which are reflected in their carrying value. Changes in fair value of loans held for sale are included in net gains on mortgage loans. Loans are sold servicing released; therefore no mortgage servicing right assets are established.

Loans: 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 accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income over the respective term of the loan using the level-yield method without anticipating prepayments.

Interest income on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer loans are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

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

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 recoveries, and decreased by charge-offs of loans. Management believes the estimated allowance for loan losses to be adequate based on known and inherent risks in the portfolio, past loan loss experience, information about specific borrower situations and estimated collateral values, economic conditions and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current qualitative environmental factors. The Company maintains a loss migration analysis that tracks loan losses and recoveries based on loan class as well as the loan risk grade assignment for commercial loans. At December 31, 2019 and 2018, an 18 month (six quarter) annualized historical loss experience was used for commercial loans and a 12 month (four quarter) historical loss experience period was applied to residential mortgage and consumer loan portfolios. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative environmental factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, competition, increasing interest rates, external factors and other considerations.

A loan is impaired when, based on current information and events, it is believed to be probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Commercial and commercial real estate loans with relationship balances exceeding \$500,000 and an internal risk grading of 6 or worse are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment and, accordingly, they are not separately identified for impairment disclosures.

Troubled debt restructurings are also considered impaired with impairment generally measured at the present value of estimated future cash flows using the loan's effective rate at inception or using the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral.

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 Company, 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 Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Foreclosed Assets : Assets acquired through or instead of loan foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed unless they add value to the property.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 15 years. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur and major improvements are capitalized.

Bank-Owned Life Insurance (BOLI): The Bank has purchased life insurance policies on certain officers. BOLI is recorded at its currently realizable cash surrender value. Changes in cash surrender value are recorded in other income.

Goodwill and Acquired Intangible Assets: Goodwill resulting from business combinations represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. The Company had no goodwill at December 31, 2019 and 2018.

Acquired intangible assets consist of core deposit and customer relationship intangible assets arising from acquisitions. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives, which range from ten to sixteen years. The Company had no acquired intangible assets at December 31, 2019 and 2018.

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. The Company had one property held for sale included in other assets that was determined to be impaired and an impairment charge of \$234,000 was applied at December 31, 2018. This property was sold in the fourth quarter of 2019 at a gain of \$19,000. The Company had no impairment of long term assets in 2019.

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

Mortgage Banking Derivatives : Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as derivatives not qualifying for hedge accounting. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. At times, the Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans.

Changes in the fair values of these interest rate lock and forward commitment derivatives are included in net gains on mortgage loans. The net fair value of mortgage banking derivatives was approximately \$36,000 and \$15,000 at December 31, 2019 and 2018, respectively.

Revenue Recognition: The Company recognizes revenues as they are earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The Company's primary source of revenue is interest income from the Bank's loans and investment securities. The Company also earns noninterest revenue from various banking services offered by the Bank.

Interest Income: The Company's largest source of revenue is interest income which is primarily recognized on an accrual basis based on contractual terms written into loans and investment contracts.

Noninterest Revenue: The Company derives the majority of its noninterest revenue from: (1) service charges for deposit related services, (2) gains related to mortgage loan sales, (3) trust fees and (4) debit and credit card interchange income. Most of these services are transaction based and revenue is recognized as the related service is provided.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivatives: Certain of our commercial loan customers have entered into interest rate swap agreements directly with the Bank. At the same time the Bank enters into a swap agreement with its customer, the Bank enters into a corresponding interest rate swap agreement with a correspondent bank at terms mirroring the Bank's interest rate swap with its commercial loan customer. This is known as a back-to-back swap agreement. Under this arrangement the Bank has two freestanding interest rate swaps, both of which are carried at fair value. As the terms mirror each other, there is no income statement impact to the Bank. At December 31, 2019, the total notional amount of such agreements was \$70.3 million and resulted in a derivative asset with a fair value of \$1.8 million which was included in other assets and a derivative liability of \$1.8 million which was included in other liabilities. At December 31, 2018, the total notional amount of such agreements was \$66.0 million and resulted in a derivative asset with a fair value of \$700,000 which was included in other assets and a derivative liability of \$700,000 which was included in other liabilities.

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

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

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

During the first quarter of 2018, the Company adopted ASU 2018-02, allowing for the reclassification of the income tax effects of the revaluation the deferred tax impact on accumulated other comprehensive income ("AOCI") due to the enactment of tax reform at the end of 2017. The Company's only component of AOCI is the fair value adjustment for securities available for sale. Upon adoption of this ASU, a transfer was made from AOCI to retained earnings in the amount of \$278,000.

Earnings Per Common Share: Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. All outstanding unvested restricted stock awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation and are included in both basic and diluted earnings per share. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. In the event of a net loss, our unvested restricted stock awards are excluded from both basic and diluted earnings per share.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale.

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.

Stock Splits and Dividends: Stock dividends in excess of 20% are reported as stock splits, resulting in no adjustment to the Company's equity accounts. Stock dividends for 20% or less are reported by transferring the fair value, as of the ex-dividend date, of the stock issued from retained earnings to common stock. Fractional share amounts are paid in cash with a reduction in retained earnings. All share and per share amounts are retroactively adjusted for stock splits and dividends.

Dividend Restriction: Banking regulations require maintaining certain capital levels and impose limitations on dividends paid by the Bank to the Company and by the Company to shareholders.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Segment Reporting: The Company, through the branch network of the Bank, provides a broad range of financial services to individuals and companies in western Michigan. These services include demand, time and savings deposits; lending; ATM and debit card processing; cash management; and trust and brokerage services. While the Company's management team monitors the revenue streams of the various Company products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the Company's banking operations are considered by management to be aggregated in one operating segment – commercial banking.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation.

Adoption of New Accounting Standards: Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. This ASU allows a company to make a one-time reclassification from accumulated other comprehensive income to retained earnings for the stranded tax effects resulting from the Tax Cuts and Jobs Act, which was enacted at the end of 2017. ASU 2018-02 is effective for all entities with periods beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period for which financial statements have not yet been issued. The amendments in ASU 2018-02 are to be applied either in the period of adoption, or retrospectively to each period in which the effect of the change in the US federal corporate income tax rate is recognized. The ASU requires a disclosure of the accounting policy for releasing income tax effects from accumulated other comprehensive income. The Company early adopted this ASU in the first quarter of 2018 and recorded a reclassification adjustment of \$278,000 decreasing accumulated other comprehensive income and increasing retained earnings, effective December 31, 2017, and has included discussion as part of the Income Taxes accounting policy disclosure.

FASB issued ASU 2016-02, *Leases*. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statement, with certain practical expedients available. As the Company owns most of its branch locations, this ASU applied primarily to operating leases and the impact of adoption of this ASU by the Company had a nominal impact and resulted a right-of-use asset of \$800,000 and a corresponding lease obligation liability of \$800,000 being established as of January 1, 2019. At December 31, 2019, the balance of the right of use asset was \$640,000 and the balance of the lease liability was \$642,000.

FASB issued ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*. This ASU simplifies and expands the eligible hedging strategies for financial and nonfinancial risks by more closely aligning hedge accounting with a company's risk management activities, and also simplifies the application of Topic 815, *Derivatives and Hedging*, through targeted improvements in key practice areas. This includes expanding the list of items eligible to be hedged and amending the methods used to measure the effectiveness of hedging relationships. In addition, the ASU prescribes how hedging results should be presented and requires incremental disclosures. These changes are intended to allow preparers more flexibility and to enhance the transparency of how hedging results are presented and disclosed. Further, the ASU provides partial relief on the timing of certain aspects of hedge documentation and eliminates the requirement to recognize hedge ineffectiveness separately in earnings in the current period. The impact of adoption of this ASU by the Company on January 1, 2019 was not material.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Newly Issued Not Yet Effective Standards:

FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This ASU provides financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date by replacing the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The new guidance eliminates the probable initial recognition threshold and, instead, reflects an entity's current estimate of all expected credit losses. The new guidance broadens the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually to include forecasted information, as well as past events and current conditions. There is no specified method for measuring expected credit losses, and an entity is allowed to apply methods that reasonably reflect its expectations of the credit loss estimate. Although an entity may still use its current systems and methods for recording the allowance for credit losses, under the new rules, the inputs used to record the allowance for credit losses generally will need to change to appropriately reflect an estimate of all expected credit losses and the use of reasonable and supportable forecasts. Additionally, credit losses on available-for-sale debt securities will now have to be presented as an allowance rather than as a write-down. ASU No. 2019-10 *Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842) – Effective Dates* updated the effective date of this ASU for smaller reporting companies, such as the Company, to fiscal years beginning after December 15, 2022. The Company selected a software vendor for applying this new ASU, began implementation of the software in the second quarter of 2018, completed integration during the third quarter of 2018 and ran parallel computations with both systems using the current GAAP incurred loss model in the fourth quarter of 2018. The Company went live with this software beginning in January 2019 for its monthly incurred loss computations and began modeling the new current expected credit loss model assumptions to the allowance for loan losses computation. In the second, third and fourth quarters of 2019, the Company modeled the various methods prescribed in the ASU against the Company's identified loan segments. The Company anticipates continuing to run parallel computations as it continues to evaluate the impact of adoption of the new standard.

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 2 – SECURITIES

The amortized cost and fair value of securities were as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2019				
<u>Available for Sale:</u>				
U.S. Treasury and federal agency securities	\$ 74,839	\$ 95	\$ (185)	\$ 74,749
U.S. Agency MBS and CMOs	45,795	474	(68)	46,201
Tax-exempt state and municipal bonds	44,718	1,244	—	45,962
Taxable state and municipal bonds	51,683	404	(65)	52,022
Corporate bonds and other debt securities	6,263	55	(3)	6,315
	<u>\$ 223,298</u>	<u>\$ 2,272</u>	<u>\$ (321)</u>	<u>\$ 225,249</u>
<u>Held to Maturity</u>				
Tax-exempt state and municipal bonds	<u>\$ 82,720</u>	<u>\$ 2,408</u>	<u>\$ —</u>	<u>\$ 85,128</u>
December 31, 2018				
<u>Available for Sale:</u>				
U.S. Treasury and federal agency securities	\$ 97,102	\$ 6	\$ (1,710)	\$ 95,398
U.S. Agency MBS and CMOs	33,287	97	(494)	32,890
Tax-exempt state and municipal bonds	45,212	246	(331)	45,127
Taxable state and municipal bonds	46,565	59	(690)	45,934
Corporate bonds and other debt securities	7,703	2	(68)	7,637
	<u>\$ 229,869</u>	<u>\$ 410</u>	<u>\$ (3,293)</u>	<u>\$ 226,986</u>
<u>Held to Maturity</u>				
Tax-exempt state and municipal bonds	<u>\$ 70,334</u>	<u>\$ 1,488</u>	<u>\$ (317)</u>	<u>\$ 71,505</u>

There were no sales of securities available for sale during the years ended December 31, 2019 and 2018.

Contractual maturities of debt securities at December 31, 2019 were as follows (dollars in thousands):

	Held-to-Maturity Securities		Available-for-Sale Securities	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 18,952	\$ 19,049	\$ 30,757	\$ 30,767
Due from one to five years	28,302	29,114	93,541	94,373
Due from five to ten years	16,841	17,505	53,366	54,090
Due after ten years	18,625	19,460	45,634	46,019
	<u>\$ 82,720</u>	<u>\$ 85,128</u>	<u>\$ 223,298</u>	<u>\$ 225,249</u>

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 2 – SECURITIES (Continued)

Securities with unrealized losses at December 31, 2019 and 2018, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (dollars in thousands):

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2019						
<u>Available for Sale:</u>						
U.S. Treasury and federal agency securities	\$ 15,009	\$ (97)	\$ 27,026	\$ (87)	\$ 42,035	\$ (184)
U.S. Agency MBS and CMOs	19,117	(56)	1,196	(12)	20,313	(68)
Tax-exempt state and municipal bonds	319	—	—	—	319	—
Taxable state and municipal bonds	8,569	(57)	2,981	(9)	11,550	(66)
Corporate bonds and other debt securities	932	—	852	(3)	1,784	(3)
Total	<u>\$ 43,946</u>	<u>\$ (210)</u>	<u>\$ 32,055</u>	<u>\$ (111)</u>	<u>\$ 76,001</u>	<u>\$ (321)</u>
<u>Held to Maturity:</u>						
Tax-exempt state and municipal bonds	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
December 31, 2018						
<u>Available for Sale:</u>						
U.S. Treasury and federal agency securities	\$ 1,974	\$ (26)	\$ 82,895	\$ (1,684)	\$ 84,869	\$ (1,710)
U.S. Agency MBS and CMOs	1,728	(13)	18,712	(481)	20,440	(494)
Tax-exempt state and municipal bonds	8,987	(69)	10,785	(262)	19,772	(331)
Taxable state and municipal bonds	4,035	(19)	37,021	(671)	41,056	(690)
Corporate bonds and other debt securities	2,698	(12)	8,170	(56)	10,868	(68)
Total	<u>\$ 19,422</u>	<u>\$ (139)</u>	<u>\$ 157,583</u>	<u>\$ (3,154)</u>	<u>\$ 177,005</u>	<u>\$ (3,293)</u>
<u>Held to Maturity:</u>						
Tax-exempt state and municipal bonds	<u>\$ 8,533</u>	<u>\$ (76)</u>	<u>\$ 4,683</u>	<u>\$ (241)</u>	<u>\$ 13,216</u>	<u>\$ (317)</u>

Other-Than-Temporary-Impairment

Management evaluates securities for OTTI at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. At December 31, 2019, 70 securities available for sale with fair values totaling \$76.0 million had unrealized losses totaling \$321,000. At December 31, 2019, no securities held to maturity had unrealized losses. Management has the ability and intent to hold the securities classified as held to maturity until they mature, at which time the Company will receive full value for the securities. In addition, management believes it is more likely than not that the Company will not be required to sell any of its investment securities before a recovery of cost. Management determined that the unrealized losses for each period were attributable to changes in interest rates and not due to credit quality. As such, no OTTI charges were necessary during 2019 and 2018.

Securities with a carrying value of approximately \$3.0 million and \$2.0 million were pledged as security for public deposits, letters of credit and for other purposes required or permitted by law at December 31, 2019 and 2018, respectively.

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS

Portfolio loans were as follows at year end (dollars in thousands):

	2019	2018
Commercial and industrial	<u>\$ 499,572</u>	<u>\$ 513,345</u>
Commercial real estate:		
Residential developed	14,705	14,825
Unsecured to residential developers	—	—
Vacant and unimproved	41,796	44,169
Commercial development	665	712
Residential improved	130,861	98,500
Commercial improved	292,799	295,618
Manufacturing and industrial	117,632	114,887
Total commercial real estate	<u>598,458</u>	<u>568,711</u>
Consumer		
Residential mortgage	211,049	238,174
Unsecured	274	130
Home equity	70,936	78,503
Other secured	5,338	6,795
Total consumer	<u>287,597</u>	<u>323,602</u>
Total loans	1,385,627	1,405,658
Allowance for loan losses	<u>(17,200)</u>	<u>(16,876)</u>
	<u>\$ 1,368,427</u>	<u>\$ 1,388,782</u>

The following tables present the activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2019 and 2018 (dollars in thousands):

2019	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 6,856	\$ 6,544	\$ 3,449	\$ 27	\$ 16,876
Charge-offs	—	(132)	(147)	—	(279)
Recoveries	528	388	137	—	1,053
Provision for loan losses	274	(279)	(430)	(15)	(450)
Ending Balance	<u>\$ 7,658</u>	<u>\$ 6,521</u>	<u>\$ 3,009</u>	<u>\$ 12</u>	<u>\$ 17,200</u>

2018	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
Beginning balance	\$ 6,478	\$ 6,590	\$ 3,494	\$ 38	\$ 16,600
Charge-offs	(1,206)	—	(129)	—	(1,335)
Recoveries	86	922	153	—	1,161
Provision for loan losses	1,498	(968)	(69)	(11)	450
Ending Balance	<u>\$ 6,856</u>	<u>\$ 6,544</u>	<u>\$ 3,449</u>	<u>\$ 27</u>	<u>\$ 16,876</u>

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method (dollars in thousands):

	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
December 31, 2019					
Allowance for loan losses:					
Ending allowance attributable to loans:					
Individually reviewed for impairment	\$ 1,213	\$ 32	\$ 379	\$ —	\$ 1,624
Collectively evaluated for impairment	6,445	6,489	2,630	12	15,576
Total ending allowance balance	<u>\$ 7,658</u>	<u>\$ 6,521</u>	<u>\$ 3,009</u>	<u>\$ 12</u>	<u>\$ 17,200</u>
Loans:					
Individually reviewed for impairment	\$ 5,797	\$ 2,928	\$ 5,140	\$ —	\$ 13,865
Collectively evaluated for impairment	493,775	595,530	282,457	—	1,371,762
Total ending loans balance	<u>\$ 499,572</u>	<u>\$ 598,458</u>	<u>\$ 287,597</u>	<u>\$ —</u>	<u>\$ 1,385,627</u>
December 31, 2018					
Allowance for loan losses:					
Ending allowance attributable to loans:					
Individually reviewed for impairment	\$ 449	\$ 181	\$ 468	\$ —	\$ 1,098
Collectively evaluated for impairment	6,407	6,363	2,981	27	15,778
Total ending allowance balance	<u>\$ 6,856</u>	<u>\$ 6,544</u>	<u>\$ 3,449</u>	<u>\$ 27</u>	<u>\$ 16,876</u>
Loans:					
Individually reviewed for impairment	\$ 7,375	\$ 3,499	\$ 6,347	\$ —	\$ 17,221
Collectively evaluated for impairment	505,970	565,212	317,255	—	1,388,437
Total ending loans balance	<u>\$ 513,345</u>	<u>\$ 568,711</u>	<u>\$ 323,602</u>	<u>\$ —</u>	<u>\$ 1,405,658</u>

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2019 (dollars in thousands):

December 31, 2019	Unpaid Principal Balance	Recorded Investment	Allowance Allocated
With no related allowance recorded:			
Commercial and industrial	\$ 180	\$ 180	\$ —
Commercial real estate:			
Residential developed	—	—	—
Unsecured to residential developers	—	—	—
Vacant and unimproved	130	130	—
Commercial development	—	—	—
Residential improved	377	377	—
Commercial improved	1,380	1,380	—
Manufacturing and industrial	—	—	—
	<u>1,887</u>	<u>1,887</u>	<u>—</u>
Consumer:			
Residential mortgage	—	—	—
Unsecured	—	—	—
Home equity	—	—	—
Other secured	—	—	—
	<u>—</u>	<u>—</u>	<u>—</u>
Total with no related allowance recorded	<u>\$ 2,067</u>	<u>\$ 2,067</u>	<u>\$ —</u>
With an allowance recorded:			
Commercial and industrial	\$ 5,617	\$ 5,617	\$ 1,213
Commercial real estate:			
Residential developed	76	76	3
Unsecured to residential developers	—	—	—
Vacant and unimproved	—	—	—
Commercial development	—	—	—
Residential improved	28	28	2
Commercial improved	578	578	16
Manufacturing and industrial	359	359	11
	<u>1,041</u>	<u>1,041</u>	<u>32</u>
Consumer:			
Residential mortgage	4,242	4,242	313
Unsecured	198	198	14
Home equity	677	677	50
Other secured	23	23	2
	<u>5,140</u>	<u>5,140</u>	<u>379</u>
Total with an allowance recorded	<u>\$ 11,798</u>	<u>\$ 11,798</u>	<u>\$ 1,624</u>
Total	<u>\$ 13,865</u>	<u>\$ 13,865</u>	<u>\$ 1,624</u>

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2018 (dollars in thousands):

December 31, 2018	Unpaid Principal Balance	Recorded Investment	Allowance Allocated
With no related allowance recorded:			
Commercial and industrial	\$ 2,515	\$ 1,375	\$ —
Commercial real estate:			
Residential developed	—	—	—
Unsecured to residential developers	—	—	—
Vacant and unimproved	143	143	—
Commercial development	—	—	—
Residential improved	140	140	—
Commercial improved	1,675	1,675	—
Manufacturing and industrial	—	—	—
	<u>1,958</u>	<u>1,958</u>	<u>—</u>
Consumer:			
Residential mortgage	—	—	—
Unsecured	—	—	—
Home equity	—	—	—
Other secured	—	—	—
	<u>—</u>	<u>—</u>	<u>—</u>
Total with no related allowance recorded	<u>\$ 4,473</u>	<u>\$ 3,333</u>	<u>\$ —</u>
With an allowance recorded:			
Commercial and industrial	\$ 6,000	\$ 6,000	\$ 449
Commercial real estate:			
Residential developed	172	172	2
Unsecured to residential developers	—	—	—
Vacant and unimproved	—	—	—
Commercial development	—	—	—
Residential improved	193	193	13
Commercial improved	794	794	155
Manufacturing and industrial	382	382	11
	<u>1,541</u>	<u>1,541</u>	<u>181</u>
Consumer:			
Residential mortgage	5,029	5,029	371
Unsecured	—	—	—
Home equity	1,318	1,318	97
Other secured	—	—	—
	<u>6,347</u>	<u>6,347</u>	<u>468</u>
Total with an allowance recorded	<u>\$ 13,888</u>	<u>\$ 13,888</u>	<u>\$ 1,098</u>
Total	<u>\$ 18,361</u>	<u>\$ 17,221</u>	<u>\$ 1,098</u>

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The following table presents information regarding average balances of impaired loans and interest recognized on impaired loans for the years ended December 31, 2019 and 2018 (dollars in thousands):

	<u>2019</u>	<u>2018</u>
Average of impaired loans during the period:		
Commercial and industrial	\$ 5,257	\$ 5,398
Commercial real estate:		
Residential developed	139	175
Unsecured to residential developers	—	—
Vacant and unimproved	99	208
Commercial development	—	32
Residential improved	430	845
Commercial improved	2,114	3,303
Manufacturing and industrial	368	357
Consumer	5,724	7,191
Interest income recognized during impairment:		
Commercial and industrial	945	1,034
Commercial real estate	188	219
Consumer	262	295
Cash-basis interest income recognized		
Commercial and industrial	955	1,034
Commercial real estate	192	172
Consumer	264	293

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

Nonaccrual loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2019 and 2018 (dollars in thousands):

December 31, 2019	Nonaccrual	Over 90 days Accruing
Commercial and industrial	\$ —	\$ —
Commercial real estate:		
Residential developed	—	—
Unsecured to residential developers	—	—
Vacant and unimproved	—	—
Commercial development	—	—
Residential improved	98	—
Commercial improved	—	—
Manufacturing and industrial	—	—
	<u>98</u>	<u>—</u>
Consumer:		
Residential mortgage	105	—
Unsecured	—	—
Home equity	—	—
Other secured	—	—
	<u>105</u>	<u>—</u>
Total	<u>\$ 203</u>	<u>\$ —</u>

December 31, 2018	Nonaccrual	Over 90 days Accruing
Commercial and industrial	\$ 874	\$ —
Commercial real estate:		
Residential developed	—	—
Unsecured to residential developers	—	—
Vacant and unimproved	—	—
Commercial development	—	—
Residential improved	15	—
Commercial improved	303	—
Manufacturing and industrial	—	—
	<u>318</u>	<u>—</u>
Consumer:		
Residential mortgage	111	—
Unsecured	—	—
Home equity	—	1
Other secured	—	—
	<u>111</u>	<u>1</u>
Total	<u>\$ 1,303</u>	<u>\$ 1</u>

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The following table presents the aging of the recorded investment in past due loans as of December 31, 2019 by class of loans (dollars in thousands):

December 31, 2019	30-90 Days	Greater Than 90 Days	Total Past Due	Loans Not Past Due	Total
Commercial and industrial	\$ —	\$ —	\$ —	\$ 499,572	\$ 499,572
Commercial real estate:					
Residential developed	—	—	—	14,705	14,705
Unsecured to residential developers	—	—	—	—	—
Vacant and unimproved	—	—	—	41,796	41,796
Commercial development	—	—	—	665	665
Residential improved	171	15	186	130,675	130,861
Commercial improved	103	—	103	292,696	292,799
Manufacturing and industrial	—	—	—	117,632	117,632
	<u>274</u>	<u>15</u>	<u>289</u>	<u>598,169</u>	<u>598,458</u>
Consumer:					
Residential mortgage	2	103	105	210,944	211,049
Unsecured	—	—	—	274	274
Home equity	8	—	8	70,928	70,936
Other secured	3	—	3	5,335	5,338
	<u>13</u>	<u>103</u>	<u>116</u>	<u>287,481</u>	<u>287,597</u>
Total	<u>\$ 287</u>	<u>\$ 118</u>	<u>\$ 405</u>	<u>\$ 1,385,222</u>	<u>\$ 1,385,627</u>

The following table presents the aging of the recorded investment in past due loans as of December 31, 2018 by class of loans (dollars in thousands):

December 31, 2018	30-90 Days	Greater Than 90 Days	Total Past Due	Loans Not Past Due	Total
Commercial and industrial	\$ —	\$ —	\$ —	\$ 513,345	\$ 513,345
Commercial real estate:					
Residential developed	—	—	—	14,825	14,825
Unsecured to residential developers	—	—	—	—	—
Vacant and unimproved	57	—	57	44,112	44,169
Commercial development	—	—	—	712	712
Residential improved	86	16	102	98,398	98,500
Commercial improved	100	303	403	295,215	295,618
Manufacturing and industrial	—	—	—	114,887	114,887
	<u>243</u>	<u>319</u>	<u>562</u>	<u>568,149</u>	<u>568,711</u>
Consumer:					
Residential mortgage	—	110	110	238,064	238,174
Unsecured	7	—	7	123	130
Home equity	67	1	68	78,435	78,503
Other secured	130	—	130	6,665	6,795
	<u>204</u>	<u>111</u>	<u>315</u>	<u>323,287</u>	<u>323,602</u>
Total	<u>\$ 447</u>	<u>\$ 430</u>	<u>\$ 877</u>	<u>\$ 1,404,781</u>	<u>\$ 1,405,658</u>

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The Company had allocated \$1,624,000 and \$1,098,000 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of December 31, 2019 and 2018, respectively. These loans may have involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. The Company has been active at utilizing these programs and working with its customers to reduce the risk of foreclosure. For commercial loans, these modifications typically include an interest only period and, in some cases, a lowering of the interest rate on the loan. In some cases, the modification will include separating the note into two notes with the first note structured to be supported by current cash flows and collateral, and the second note made for the remaining unsecured debt. The second note is charged off immediately and collected only after the first note is paid in full. This modification type is commonly referred to as an A-B note structure. For consumer mortgage loans, the restructuring typically includes a lowering of the interest rate to provide payment and cash flow relief. For each restructuring, a comprehensive credit underwriting analysis of the borrower’s financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally, if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan’s actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status.

Based upon regulatory guidance issued in 2014, the Company has determined that in situations where there is a subsequent modification or renewal and the loan is brought to market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, the TDR and impaired loan designations may be removed. In addition, the TDR designation may also be removed from loans modified under an A-B note structure. If the remaining “A” note is at a market rate at the time of restructuring (taking into account the borrower’s credit risk and prevailing market conditions), the loan can be removed from TDR designation in a subsequent calendar year after six months of performance in accordance with the new terms. The market rate relative to the borrower’s credit risk is determined through analysis of market pricing information gathered from peers and use of a loan pricing model. The general objective of the model is to achieve a consistent return on equity from one credit to the next, taking into consideration differences in credit risk. In the model, credits with higher risk receive a higher potential loss allocation, and therefore require a higher interest rate to achieve the target return on equity.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral, less estimated costs to sell. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by measuring cash flows using the new payment terms discounted at the original contractual rate.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

The following table presents information regarding TDRs as of December 31, 2019 and 2018 (dollars in thousands):

	2019		2018	
	Number of Loans	Outstanding Recorded Balance	Number of Loans	Outstanding Recorded Balance
Commercial and industrial	7	\$ 5,797	18	\$ 6,502
Commercial real estate	15	2,770	22	3,305
Consumer	69	5,140	83	6,346
	<u>91</u>	<u>\$ 13,707</u>	<u>123</u>	<u>\$ 16,153</u>

The following table presents information related to accruing TDRs as of December 31, 2019 and 2018. The table presents the amount of accruing TDRs that were on nonaccrual status prior to the restructuring, accruing at the time of restructuring and those that were upgraded to accruing status after receiving six consecutive monthly payments in accordance with the restructured terms as of December 31, 2019 and 2018 (dollars in thousands):

	2019	2018
Accruing TDR - nonaccrual at restructuring	\$ —	\$ —
Accruing TDR - accruing at restructuring	8,295	10,336
Accruing TDR - upgraded to accruing after six consecutive payments	5,314	5,693
	<u>\$ 13,609</u>	<u>\$ 16,029</u>

The following tables present information regarding troubled debt restructurings executed during the years ended December 31, 2019 and 2018 (dollars in thousands):

	2019			2018		
	Number of Loans	Pre-TDR Balance	Writedown Upon TDR	Number of Loans	Pre-TDR Balance	Writedown Upon TDR
Commercial and industrial	—	\$ —	\$ —	2	\$ 244	\$ —
Commercial real estate	—	—	—	3	492	—
Consumer	3	53	—	10	456	—
	<u>3</u>	<u>\$ 53</u>	<u>\$ —</u>	<u>15</u>	<u>\$ 1,192</u>	<u>\$ —</u>

According to the accounting standards, not all loan modifications are TDRs. TDRs are modifications or renewals where the Company has granted a concession to a borrower in financial distress. The Company reviews all modifications and renewals for determination of TDR status. In some situations a borrower may be experiencing financial distress, but the Company does not provide a concession. These modifications are not considered TDRs. In other cases, the Company might provide a concession, such as a reduction in interest rate, but the borrower is not experiencing financial distress. This could be the case if the Company is matching a competitor's interest rate. These modifications would also not be considered TDRs. Finally, any renewals at existing terms for borrowers not experiencing financial distress would not be considered TDRs. As with other loans not considered TDR or impaired, allowance allocations are based on the historical based allocation for the applicable loan grade and loan class.

Payment defaults on TDRs have been minimal and during the twelve months ended December 31, 2019 and 2018 the balance of loans that became delinquent by more than 90 days past due or that were transferred to nonaccrual within 12 months of restructuring were not material.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

Credit Quality Indicators: The Company categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes commercial loans individually and classifies these relationships by credit risk grading. The Company uses an eight point grading system, with grades 5 through 8 being considered classified, or watch, credits. All commercial loans are assigned a grade at origination, at each renewal or any amendment. When a credit is first downgraded to a watch credit (either through renewal, amendment, loan officer identification or the loan review process), an Administrative Loan Review (“ALR”) is generated by the credit department and the loan officer. All watch credits have an ALR completed monthly which analyzes the collateral position and cash flow of the borrower and its guarantors. The loan officer is required to complete both a short term and long term plan to rehabilitate or exit the credit and to give monthly comments on the progress to these plans. Management meets quarterly with loan officers to discuss each of these credits in detail and to help formulate solutions where progress has stalled. When necessary, the loan officer proposes changes to the assigned loan grade as part of the ALR. Additionally, Loan Review reviews all loan grades upon origination, renewal or amendment and again as loans are selected through the loan review process. The credit will stay on the ALR until either its grade has improved to a 4 or the credit relationship is at a zero balance. The Company uses the following definitions for the risk grades:

1. Excellent - Loans supported by extremely strong financial condition or secured by the Bank’s own deposits. Minimal risk to the Bank and the probability of serious rapid financial deterioration is extremely small.

2. Above Average - Loans supported by sound financial statements that indicate the ability to repay or borrowings secured (and margined properly) with marketable securities. Nominal risk to the Bank and probability of serious financial deterioration is highly unlikely. The overall quality of these credits is very high.

3. Good Quality - Loans supported by satisfactory asset quality and liquidity, good debt capacity coverage, and good management in all critical positions. Loans are secured by acceptable collateral with adequate margins. There is a slight risk of deterioration if adverse market conditions prevail.

4. Acceptable Risk - Loans carrying an acceptable risk to the Bank, which may be slightly below average quality. The borrower has limited financial strength with considerable leverage. There is some probability of deterioration if adverse market conditions prevail. These credits should be monitored closely by the Relationship Manager.

5. Marginally Acceptable - Loans are of marginal quality with above normal risk to the Bank. The borrower shows acceptable asset quality but very little liquidity with high leverage. There is inconsistent earning performance without the ability to sustain adverse market conditions. The primary source of repayment is questionable, but the secondary source of repayment still remains an option. Very close attention by the Relationship Manager and management is needed.

6. Substandard - Loans are inadequately protected by the net worth and paying capacity of the borrower or the collateral pledged. The primary and secondary sources of repayment are questionable. Heavy debt condition may be evident and volume and earnings deterioration may be underway. It is possible that the Bank will sustain some loss if the deficiencies are not immediately addressed and corrected.

7. Doubtful - Loans supported by weak or no financial statements, as well as the ability to repay the entire loan, are questionable. Loans in this category are normally characterized less than adequate collateral, insolvent, or extremely weak financial condition. A loan classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses makes collection or liquidation in full highly questionable. The possibility of loss is extremely high, however, activity may be underway to minimize the loss or maximize the recovery.

8. Loss - Loans are considered uncollectible and of little or no value as a bank asset.

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

At year end, the risk grade category of commercial loans by class of loans was as follows (dollars in thousands):

December 31, 2019	1	2	3	4	5	6	7	8	Total
Commercial and industrial	\$ 15,000	\$ 11,768	\$ 158,851	\$ 290,267	\$ 17,664	\$ 6,022	\$ —	\$ —	\$ 499,572
Commercial real estate:									
Residential developed	—	—	312	14,393	—	—	—	—	14,705
Unsecured to residential developers	—	—	—	—	—	—	—	—	—
Vacant and unimproved	—	9,201	8,085	22,819	1,691	—	—	—	41,796
Commercial development	—	—	79	586	—	—	—	—	665
Residential improved	—	—	20,142	109,932	518	171	98	—	130,861
Commercial improved	—	6,893	67,915	213,790	3,847	354	—	—	292,799
Manufacturing & industrial	—	2,404	36,401	77,435	1,392	—	—	—	117,632
	<u>\$ 15,000</u>	<u>\$ 30,266</u>	<u>\$ 291,785</u>	<u>\$ 729,222</u>	<u>\$ 25,112</u>	<u>\$ 6,547</u>	<u>\$ 98</u>	<u>\$ —</u>	<u>\$ 1,098,030</u>
December 31, 2018	1	2	3	4	5	6	7	8	Total
Commercial and industrial	\$ 15,000	\$ 15,708	\$ 164,901	\$ 299,622	\$ 11,186	\$ 6,054	\$ 874	\$ —	\$ 513,345
Commercial real estate:									
Residential developed	—	—	—	14,220	605	—	—	—	14,825
Unsecured to residential developers	—	—	—	—	—	—	—	—	—
Vacant and unimproved	—	7,635	3,543	30,688	2,303	—	—	—	44,169
Commercial development	—	—	86	626	—	—	—	—	712
Residential improved	—	—	19,645	78,337	311	192	15	—	98,500
Commercial improved	—	5,292	62,756	222,152	4,751	364	303	—	295,618
Manufacturing & industrial	—	3,372	24,799	81,261	5,455	—	—	—	114,887
	<u>\$ 15,000</u>	<u>\$ 32,007</u>	<u>\$ 275,730</u>	<u>\$ 726,906</u>	<u>\$ 24,611</u>	<u>\$ 6,610</u>	<u>\$ 1,192</u>	<u>\$ —</u>	<u>\$ 1,082,056</u>

Commercial loans rated a 6, 7 or 8 per the Company's internal risk rating system are considered substandard, doubtful or loss, respectively.

Commercial loans classified as substandard or worse were as follows at year-end (dollars in thousands):

	2019	2018
Not classified as impaired	\$ 591	\$ —
Classified as impaired	6,054	7,802
Total commercial loans classified substandard or worse	<u>\$ 6,645</u>	<u>\$ 7,802</u>

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For consumer loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following tables present the recorded investment in consumer loans based on payment activity as of December 31, 2019 and 2018 (dollars in thousands):

December 31, 2019	Residential Mortgage	Consumer Unsecured	Home Equity	Consumer Other
Performing	\$ 210,946	\$ 274	\$ 70,936	\$ 5,338
Nonperforming	103	—	—	—
Total	<u>\$ 211,049</u>	<u>\$ 274</u>	<u>\$ 70,936</u>	<u>\$ 5,338</u>

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 3 – LOANS (Continued)

December 31, 2018	Residential Mortgage	Consumer Unsecured	Home Equity	Consumer Other
Performing	\$ 238,064	\$ 130	\$ 78,502	\$ 6,795
Nonperforming	110	—	1	—
Total	\$ 238,174	\$ 130	\$ 78,503	\$ 6,795

NOTE 4 – OTHER REAL ESTATE OWNED

Other real estate owned was as follows (dollars in thousands):

	2019	2018
Beginning balance	\$ 4,183	\$ 9,140
Additions, transfers from loans	—	293
Proceeds from sales of other real estate owned	(589)	(2,212)
Valuation allowance reversal upon sale	(453)	(2,893)
Gain (loss) on sales of other real estate owned	(29)	(145)
	3,112	4,183
Less: valuation allowance	(364)	(803)
Ending balance	<u>\$ 2,748</u>	<u>\$ 3,380</u>

Activity in the valuation allowance was as follows (dollars in thousands):

	2019	2018
Beginning balance	\$ 803	\$ 3,373
Additions charged to expense	14	323
Reversals upon sale	(453)	(2,893)
Ending balance	<u>\$ 364</u>	<u>\$ 803</u>

At December 31, 2019, the balance of other real estate owned included no foreclosed residential real estate properties recorded as a result of obtaining physical possession of the property. At December 31, 2019, the recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process was \$0.

NOTE 5 – FAIR VALUE

ASC Topic 820, *Fair Value Measurements and Disclosures*, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value include:

- Level 1 :** Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2 :** Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3 :** Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment Securities: The fair values of investment securities are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair values of certain securities held to maturity are determined by computing discounted cash flows using observable and unobservable market inputs (Level 3 inputs).

Loans Held for Sale: The fair value of loans held for sale is based upon binding quotes from third party investors (Level 2 inputs).

MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

NOTE 5 – FAIR VALUE (Continued)

Impaired Loans: Loans identified as impaired are measured using one of three methods: the loan's observable market price, the fair value of collateral or the present value of expected future cash flows. For each period presented, no impaired loans were measured using the loan's observable market price. If an impaired loan has had a charge-off or if the fair value of the collateral is less than the recorded investment in the loan, we establish a specific reserve and report the loan as nonrecurring Level 3. The fair value of collateral of impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned : Other real estate owned (OREO) properties are initially recorded at fair value, less estimated costs to sell when acquired, establishing a new cost basis. Adjustments to OREO are measured at fair value, less costs to sell. Fair values are generally based on third party appraisals or realtor evaluations of the property. These appraisals and evaluations may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized through a valuation allowance, and the property is reported as nonrecurring Level 3.

Interest Rate Swaps: For interest rate swap agreements, we measure fair value utilizing pricing provided by a third-party pricing source that that uses market observable inputs, such as forecasted yield curves, and other unobservable inputs and accordingly, interest rate swap agreements are classified as Level 3.

Assets measured at fair value on a recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2019				
Available for sale securities				
U.S. Treasury and federal agency securities	\$ 74,749	\$ —	\$ 74,749	\$ —
U.S. Agency MBS and CMOs	46,201	—	46,201	—
Tax-exempt state and municipal bonds	45,962	—	45,962	—
Taxable state and municipal bonds	52,022	—	52,022	—
Corporate bonds and other debt securities	6,315	—	6,315	—
Other equity securities	1,481	—	1,481	—
Loans held for sale	3,294	—	3,294	—
Interest rate swaps	1,830	—	—	1,830
Interest rate swaps	(1,830)	—	—	(1,830)
December 31, 2018				
Available for sale securities				
U.S. Treasury and federal agency securities	\$ 95,398	\$ —	\$ 95,398	\$ —
U.S. Agency MBS and CMOs	32,890	—	32,890	—
Tax-exempt state and municipal bonds	45,127	—	45,127	—
Taxable state and municipal bonds	45,934	—	45,934	—
Corporate bonds and other debt securities	7,637	—	7,637	—
Other equity securities	1,438	—	1,438	—
Loans held for sale	415	—	415	—
Interest rate swaps	700	—	—	700
Interest rate swaps	(700)	—	—	(700)

MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 December 31, 2019 and 2018

NOTE 5 – FAIR VALUE (Continued)

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>December 31, 2019</u>				
Impaired loans	\$ 5,151	\$ —	\$ —	\$ 5,151
Other real estate owned	405	—	—	405
<u>December 31, 2018</u>				
Impaired loans	\$ 3,211	\$ —	\$ —	\$ 3,211
Other real estate owned	1,205	—	—	1,205

Quantitative information about Level 3 fair value measurements measured on a non-recurring basis were as follows at year end (dollars in thousands).

	Asset Fair Value	Valuation Technique	Unobservable Inputs	Range (%)
<u>December 31, 2019</u>				
Impaired loans	\$ 5,151	Sales comparison approach	Adjustment for differences between comparable sales	1.5 to 20.0
		Income approach	Capitalization rate	9.5 to 11.0
Other real estate owned	405	Sales comparison approach	Adjustment for differences between comparable sales	3.0 to 20.0
		Income approach	Capitalization rate	9.5 to 11.0
<u>December 31, 2018</u>				
Impaired loans	\$ 3,211	Sales comparison approach	Adjustment for differences between comparable sales	1.0 to 15.0
		Income approach	Capitalization rate	9.5 to 11.0
Other real estate owned	1,205	Sales comparison approach	Adjustment for differences between comparable sales	3.0 to 20.0
		Income approach	Capitalization rate	9.5 to 11.0

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NOTE 5 – FAIR VALUE (Continued)

The carrying amounts and estimated fair values of financial instruments, not previously presented, were as follows at year end (dollars in thousands).

	Level in Fair Value Hierarchy	2019		2018	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets					
Cash and due from banks	Level 1	\$ 31,942	\$ 31,942	\$ 40,526	\$ 40,526
Federal funds sold and other short-term investments	Level 2	240,508	240,508	130,758	130,758
Securities held to maturity	Level 3	82,720	85,128	70,334	71,505
FHLB stock		11,558	NA	11,558	NA
Loans, net	Level 2	1,363,276	1,395,446	1,385,571	1,403,005
Bank owned life insurance	Level 3	42,156	42,156	41,185	41,185
Accrued interest receivable	Level 2	4,866	4,866	5,279	5,279
Financial liabilities					
Deposits	Level 2	(1,753,294)	(1,753,877)	(1,676,739)	(1,677,634)
Other borrowed funds	Level 2	(60,000)	(61,006)	(60,000)	(59,092)
Long-term debt	Level 2	(20,619)	(18,167)	(41,238)	(37,046)
Accrued interest payable	Level 2	(518)	(518)	(503)	(503)
Off-balance sheet credit-related items					
Loan commitments		—	—	—	—

The methods and assumptions used to estimate fair value are described as follows.

Carrying amount is the estimated fair value for cash and cash equivalents, bank owned life insurance, accrued interest receivable and payable, demand deposits, short-term borrowings and variable rate loans or deposits that reprice frequently and fully. Security fair values are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities as discussed above. For fixed rate loans, interest-bearing time deposits in other financial institutions and deposits, and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk (including consideration of widening credit spreads). Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance sheet credit-related items is not significant.

The estimated fair values of financial instruments disclosed above as of December 31, 2019 and 2018 follow the guidance in ASU 2016-01 which prescribes an “exit price” approach in estimating and disclosing fair value of financial instruments incorporating discounts for credit, liquidity and marketability factors.

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NOTE 6 – PREMISES AND EQUIPMENT – NET

Year-end premises and equipment were as follows (dollars in thousands):

	2019	2018
Land	\$ 15,861	\$ 15,861
Building	44,283	43,912
Leasehold improvements	263	263
Furniture and equipment	21,230	20,176
Construction in progress	124	508
	<u>81,761</u>	<u>80,720</u>
Less accumulated depreciation	<u>(38,344)</u>	<u>(35,858)</u>
	<u>\$ 43,417</u>	<u>\$ 44,862</u>

Depreciation expense was \$2,486,000 and \$2,493,000 for 2019 and 2018, respectively.

The Bank leases certain office and branch premises and equipment under operating lease agreements. Total rental expense for all operating leases aggregated to \$430,000 and \$440,000 for 2019 and 2018, respectively. Future minimum rental expense under noncancelable operating leases as of December 31, 2019 is as follows (dollars in thousands):

2020	\$ 331
2021	125
2022	111
2023	53
2024	14
Thereafter	—
	<u>\$ 634</u>

NOTE 7 – DEPOSITS

Deposits at year-end were as follows (dollars in thousands):

	2019	2018
Noninterest-bearing demand	\$ 482,499	\$ 485,530
Interest bearing demand	479,341	456,260
Savings and money market accounts	639,329	609,425
Certificates of deposit	152,125	125,524
	<u>\$ 1,753,294</u>	<u>\$ 1,676,739</u>

The following table depicts the maturity distribution of certificates of deposit at December 31, 2019 (dollars in thousands):

2020	\$ 120,799
2021	25,074
2022	4,400
2023	1,481
2024	371
Thereafter	—
	<u>\$ 152,125</u>

Time deposits that exceed the FDIC insurance limit of \$250,000 at year end 2019 and 2018 were approximately \$37.7 million and \$39.6 million, respectively.

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NOTE 8 - OTHER BORROWED FUNDS

Other borrowed funds include advances from the Federal Home Loan Bank and borrowings from the Federal Reserve Bank.

Federal Home Loan Bank Advances

At year-end, advances from the Federal Home Loan Bank were as follows (dollars in thousands):

<u>Principal Terms</u>	<u>Advance Amount</u>	<u>Range of Maturities</u>	<u>Weighted Average Interest Rate</u>
<u>December 31, 2019</u>			
Single maturity fixed rate advances	\$ 40,000	April 2021 to July 2024	2.50%
Putable Advances	20,000	November 2024	1.81%
	<u>\$ 60,000</u>		

<u>Principal Terms</u>	<u>Advance Amount</u>	<u>Range of Maturities</u>	<u>Weighted Average Interest Rate</u>
<u>December 31, 2018</u>			
Single maturity fixed rate advances	\$ 40,000	February 2019 to July 2024	2.27%
Putable Advances	20,000	November 2024	1.81%
	<u>\$ 60,000</u>		

Each advance is subject to a prepayment fee if paid prior to its maturity date. Fixed rate advances are payable at maturity. Amortizable mortgage advances are fixed rate advances with scheduled repayments based upon amortization to maturity. Advances were collateralized by residential and commercial real estate loans totaling \$498.1 million and \$476.4 million under a blanket lien arrangement at December 31, 2019 and 2018, respectively.

Scheduled repayments of FHLB advances as of December 31, 2019 were as follows (in thousands):

2020	\$ —
2021	10,000
2022	—
2023	10,000
2024	40,000
Thereafter	—
	<u>\$ 60,000</u>

Federal Reserve Bank Borrowings

The Company has a financing arrangement with the Federal Reserve Bank. There were no borrowings outstanding at December 31, 2019 and 2018, and the Company had approximately \$13.0 million and \$16.9 million in unused borrowing capacity based on commercial and mortgage loans pledged to the Federal Reserve Bank totaling \$15.2 million and \$18.2 million at December 31, 2019 and 2018, respectively.

MACATAWA BANK CORPORATION
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NOTE 9 – LONG TERM DEBT

The Company has pooled trust preferred securities (“TRUPs”) issued through its wholly-owned subsidiary grantor trusts. Macatawa Statutory Trust I issued \$619,000 of common securities to the Company and \$20.0 million aggregate liquidation amount of Preferred Securities with a floating interest rate of three-month LIBOR plus 3.05%, maturing on July 15, 2033. Macatawa Statutory Trust II issued \$619,000 of common securities and \$20.0 million aggregate liquidation amount of Preferred Securities with a floating interest rate of three-month LIBOR plus 2.75%, maturing on March 18, 2034. On December 31, 2019, the Company redeemed the \$20.0 million outstanding Preferred Securities and \$619,000 common securities associated with Macatawa Statutory Trust I.

The Company issued subordinated debentures (“Debentures”) to each trust in exchange for ownership of all of the common securities of each trust and the \$41,238,000 in proceeds of the offerings, which Debentures represent the sole asset of each trust. The Preferred Securities represent an interest in the Company’s Debentures, which have terms that are similar to the Preferred Securities. The Company is not considered the primary beneficiary of each trust (variable interest entity), therefore each trust is not consolidated in the Company’s financial statements, rather the Debentures are shown as a liability.

The Company has the option to defer interest payments on the Debentures from time to time for up to twenty consecutive quarterly payments, although interest continues to accrue on the outstanding balance. During any deferral period, the Company may not declare or pay any dividends on the Company’s common stock or preferred stock or make any payment on any outstanding debt obligations that rank equally with or junior to the Debentures. The Company also has the option to redeem and prepay the remaining TRUPs and the Debentures.

At December 31, 2019 and 2018, Debentures totaling \$20,619,000 and \$41,238,000, respectively, are reported in liabilities as long-term debt, and the common securities of \$619,000 and \$1,238,000, respectively, and unamortized debt issuance costs are included in other assets. The Preferred Securities may be included in Tier 1 capital (with certain limitations applicable) under current regulatory guidelines and interpretations. At December 31, 2019 and 2018, respectively, \$20.0 million and \$40.0 million of the Preferred Securities issued qualified as Tier 1 capital for regulatory capital purposes.

NOTE 10 – RELATED PARTY TRANSACTIONS

Loans to principal officers, directors, and their affiliates were as follows (dollars in thousands).

	2019	2018
Beginning balance	\$ 28,743	\$ 28,538
New loans and renewals	3,343	19,200
Repayments and renewals	(3,548)	(18,995)
Effect of changes in related parties	(144)	—
Ending balance	<u>\$ 28,394</u>	<u>\$ 28,743</u>

Deposits from principal officers, directors, and affiliates at December 31, 2019 and 2018 were \$15.9 million and \$112.7 million, respectively. The majority of the deposit balances for each year are associated with institutional accounts of affiliated organizations and were at market rates.

During 2015, the Bank entered into a back-to-back swap agreement (see Note 1 – Derivatives) with a company affiliated with one of the Company’s directors. Terms were at market rates and the total notional amount of the agreement was \$14.0 million and \$15.0 million at December 31, 2019 and 2018, respectively.

During 2019, the Bank engaged a company affiliated with one of the Company’s directors for the reconfiguration of a portion of the corporate office building. Total expenses related to this reconfiguration were not significant to the director’s company and terms were at market rates and were negotiated at arms’ length.

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NOTE 11 - STOCK-BASED COMPENSATION

On May 5, 2015, the Company's shareholders approved the Macatawa Bank Corporation Stock Incentive Plan of 2015 (the 2015 Plan). The 2015 Plan provides for grant of up to 1,500,000 shares of Macatawa common stock in the form of stock options or restricted stock awards to employees and directors. There were 1,213,776 shares under the "2015 Plan" available for future issuance as of December 31, 2019. The Company issues new shares under the 2015 Plan from its authorized but unissued shares.

Stock Options

Option awards are granted with an exercise price equal to the market price at the date of grant. Option awards have vesting periods ranging from one to three years and have ten year contractual terms.

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

There were no options granted during 2019 and 2018. Additionally, there were no options outstanding or exercisable at December 31, 2019 or 2018. Additional information related to stock options during each year follows (dollars in thousands):

	2019	2018
Intrinsic value of options exercised	\$ —	\$ 72
Cash received from option exercises	—	386
Tax benefit realized from option exercises	—	19

There was no compensation cost for stock options in 2019 and 2018.

As of December 31, 2019, there was no unrecognized cost related to nonvested stock options granted under the Company's stock-based compensation plans.

Restricted Stock Awards

Restricted stock awards have vesting periods of up to three years. A summary of changes in the Company's nonvested restricted stock awards for the year follows:

	Shares	Weighted-Average Grant-Date Fair Value	Aggregate Intrinsic Value
Outstanding at January 1, 2019	90,226	\$ 10.13	\$ 1,004,215
Granted	83,910	10.32	933,918
Vested	(36,770)	10.00	409,250
Forfeited	(16,379)	10.14	182,298
Outstanding at December 31, 2019	120,987	\$ 10.30	\$ 1,346,585

Compensation cost related to restricted stock awards totaled \$427,000 and \$452,000 for 2019 and 2018, respectively.

As of December 31, 2019, there was \$1,097,000 of total remaining unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock-based compensation plans. The cost is expected to be recognized over a weighted-average period of 1.53 years. The total grant date fair value of restricted stock awards vested during 2019 was \$368,000. The total grant date fair value of restricted stock awards vested during 2018 was \$436,000.

MACATAWA BANK CORPORATION
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NOTE 12 - EMPLOYEE BENEFITS

The Company sponsors a 401(k) plan which covers substantially all employees. Employees may elect to contribute to the plan up to the maximum percentage of compensation and dollar amount subject to statutory limitations. Beginning January 1, 2013, the Company's contribution was set using a matching formula of 100% of the first 3% of employee contributions and 50% of employee contributions in excess of 3%, up to 5%. The Company's contributions were approximately \$722,000 and \$717,000 for 2019 and 2018, respectively.

NOTE 13 - EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per common share are as follows (dollars in thousands, except per share data):

	2019	2018
Net income	\$ 31,979	\$ 26,379
Weighted average shares outstanding, including participating stock awards - Basic	34,056,200	34,018,259
Dilutive potential common shares:		
Stock options	—	295
Weighted average shares outstanding - Diluted	34,056,200	34,018,554
Basic earnings per common share	\$ 0.94	\$ 0.78
Diluted earnings per common share	\$ 0.94	\$ 0.78

NOTE 14 - FEDERAL INCOME TAXES

Income tax expense was as follows (dollars in thousands):

	2019	2018
Current	\$ 7,172	\$ 5,377
Deferred	290	502
Change in valuation allowance	—	92
	\$ 7,462	\$ 5,971

The difference between the financial statement tax expense and amount computed by applying the statutory federal tax rate to pretax income was reconciled as follows (dollars in thousands):

	2019	2018
Statutory rate	21%	21%
Statutory rate applied to income before taxes	\$ 8,283	\$ 6,794
Adjust for:		
Tax-exempt interest income	(703)	(700)
Bank-owned life insurance	(204)	(198)
Change in valuation allowance	—	92
Other, net	86	(17)
	\$ 7,462	\$ 5,971

MACATAWA BANK CORPORATION
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NOTE 14 - FEDERAL INCOME TAXES (Continued)

The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and tax planning strategies. At December 31, 2018, a valuation allowance of \$92,000 was established for a capital loss carryforward related to the liquidation of assets of a partnership interest the Bank acquired through a loan settlement. This valuation allowance was maintained at December 31, 2019. Management believes it is more likely than not that all of the remaining deferred tax assets will be realized against deferred tax liabilities and projected future taxable income.

The net deferred tax asset recorded included the following amounts of deferred tax assets and liabilities (dollars in thousands):

	2019	2018
Deferred tax assets		
Allowance for loan losses	\$ 3,612	\$ 3,544
Nonaccrual loan interest	182	268
Valuation allowance on other real estate owned and property held for sale	76	218
Unrealized loss on securities available for sale	—	606
Other	248	302
Gross deferred tax assets	4,118	4,938
Valuation allowance	(92)	(92)
Total net deferred tax assets	4,026	4,846
Deferred tax liabilities		
Depreciation	\$ (1,053)	\$ (1,005)
Prepaid expenses	(172)	(200)
Unrealized gain on securities available for sale	(406)	—
Other	(317)	(261)
Gross deferred tax liabilities	(1,948)	(1,466)
Net deferred tax asset	\$ 2,078	\$ 3,380

There were no unrecognized tax benefits at December 31, 2019 and 2018 and the Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. The Company is no longer subject to examination by the Internal Revenue Service for years before 2015.

NOTE 15 – COMMITMENTS AND OFF BALANCE-SHEET RISK

Some financial instruments are used to meet customer financing needs and to reduce exposure to interest rate changes. These financial instruments include commitments to extend credit and standby letters of credit. These involve, to varying degrees, credit and interest rate risk in excess of the amount reported in the financial statements.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment, and generally have fixed expiration dates. Standby letters of credit are conditional commitments to guarantee a customer's performance to a third party. Exposure to credit loss if the other party does not perform is represented by the contractual amount for commitments to extend credit and standby letters of credit. Collateral or other security is normally not obtained for these financial instruments prior to their use and many of the commitments are expected to expire without being used.

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NOTE 15 – COMMITMENTS AND OFF BALANCE-SHEET RISK (Continued)

A summary of the contractual amounts of financial instruments with off-balance-sheet risk was as follows at year-end (dollars in thousands):

	2019	2018
Commitments to extend credit	\$ 65,648	\$ 77,391
Letters of credit	15,303	15,802
Unused lines of credit	502,200	486,203

The notional amount of commitments to fund mortgage loans to be sold into the secondary market was approximately \$11.0 million and \$4.1 million at December 31, 2019 and 2018, respectively.

At year-end 2019 approximately 79.5% of the Bank's commitments to make loans were at fixed rates, offered at current market rates. The remainder of the commitments to make loans were at variable rates tied to LIBOR and the prime rate and generally expire within 30 days. The majority of the unused lines of credit were at variable rates tied to LIBOR and the prime rate.

NOTE 16 – CONTINGENCIES

The Company and its subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business. As of December 31, 2019, there were no material pending legal proceedings to which we or any of our subsidiaries are a party or which any of our properties are the subject.

NOTE 17 – SHAREHOLDERS' EQUITY**Regulatory Capital**

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

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.

In July 2013, the Board of Governors of the Federal Reserve Board and the FDIC approved the rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). The rules include a common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which effectively results in a minimum CET1 ratio of 7.0%. The minimum ratio of Tier 1 capital to risk-weighted assets is 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5%), which effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer), and requires a minimum leverage ratio of 4.0%.

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NOTE 17 – SHAREHOLDERS’ EQUITY (Continued)

Actual capital levels (dollars in thousands) and minimum required levels were as follows at year-end:

	Actual		Minimum Capital Adequacy		Minimum Capital Adequacy With Capital Buffer		To Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2019								
CET1 capital (to risk weighted assets)								
Consolidated	\$ 215,925	13.5%	\$ 72,187	4.5%	\$ 112,290	7.0%	N/A	N/A
Bank	228,761	14.3	72,182	4.5	112,284	7.0	\$ 104,263	6.5%
Tier 1 capital (to risk weighted assets)								
Consolidated	235,925	14.7	96,249	6.0	136,353	8.5	N/A	N/A
Bank	228,761	14.3	96,243	6.0	136,344	8.5	128,324	8.0
Total capital (to risk weighted assets)								
Consolidated	253,125	15.8	128,332	8.0	168,436	10.5	N/A	N/A
Bank	245,961	15.3	128,324	8.0	168,425	10.5	160,405	10.0
Tier 1 capital (to average assets)								
Consolidated	235,925	11.5	82,130	4.0	N/A	N/A	N/A	N/A
Bank	228,761	11.2	82,070	4.0	N/A	N/A	102,587	5.0
December 31, 2018								
CET1 capital (to risk weighted assets)								
Consolidated	\$ 193,131	12.0%	\$ 72,381	4.5%	\$ 102,540	6.4%	N/A	N/A
Bank	226,531	14.1	72,371	4.5	102,526	6.4	\$ 104,536	6.5%
Tier 1 capital (to risk weighted assets)								
Consolidated	233,131	14.5	96,508	6.0	126,667	7.9	N/A	N/A
Bank	226,531	14.1	96,495	6.0	126,649	7.9	128,660	8.0
Total capital (to risk weighted assets)								
Consolidated	250,007	15.5	128,678	8.0	158,837	9.9	N/A	N/A
Bank	243,407	15.1	128,660	8.0	158,814	9.9	160,825	10.0
Tier 1 capital (to average assets)								
Consolidated	233,131	12.1	76,963	4.0	N/A	N/A	N/A	N/A
Bank	226,531	11.8	76,902	4.0	N/A	N/A	96,128	5.0

Approximately \$20.0 million and \$40.0 million of trust preferred securities outstanding at December 31, 2019 and 2018, respectively, qualified as Tier 1 capital.

The Bank was categorized as “well capitalized” at December 31, 2019 and 2018.

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NOTE 18 – CONDENSED FINANCIAL STATEMENTS (PARENT COMPANY ONLY)

Following are condensed parent company only financial statements (dollars in thousands):

CONDENSED BALANCE SHEETS

	2019	2018
ASSETS		
Cash and cash equivalents	\$ 7,289	\$ 6,425
Investment in Bank subsidiary	230,305	224,253
Investment in other subsidiaries	650	1,441
Other assets	107	227
Total assets	\$ 238,351	\$ 232,346
LIABILITIES AND SHAREHOLDERS' EQUITY		
Long-term debt	20,619	41,238
Other liabilities	263	255
Total liabilities	20,882	41,493
Total shareholders' equity	217,469	190,853
Total liabilities and shareholders' equity	\$ 238,351	\$ 232,346

CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	2019	2018
INCOME		
Dividends from subsidiaries	\$ 32,610	\$ 11,121
Other	—	—
Total income	32,610	11,121
EXPENSE		
Interest expense	2,232	2,127
Other expense	720	679
Total expense	2,952	2,806
Income before income tax and equity in undistributed earnings of subsidiaries	29,658	8,315
Equity in undistributed earnings of subsidiaries	1,678	17,484
Income before income tax	31,336	25,799
Income tax benefit	(643)	(580)
Net income	\$ 31,979	\$ 26,379
Comprehensive income	\$ 35,801	\$ 25,646

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NOTE 18 – CONDENSED FINANCIAL STATEMENTS (PARENT COMPANY ONLY) (Continued)

CONDENSED STATEMENTS OF CASH FLOWS

	2019	2018
Cash flows from operating activities		
Net income	\$ 31,979	\$ 26,379
Adjustments to reconcile net income to net cash from operating activities:		
Equity in undistributed earnings of subsidiaries	(1,678)	(17,484)
Stock compensation expense	47	52
Change in other assets	120	(154)
Change in other liabilities	8	(109)
Net cash from operating activities	<u>30,476</u>	<u>8,684</u>
Cash flows from investing activities		
Investment in subsidiaries	619	—
Net cash from investing activities	<u>619</u>	<u>—</u>
Cash flows from financing activities		
Proceeds from issuance of common stock	—	386
Repayment of other borrowings	(20,619)	
Cash dividends paid	(9,511)	(8,481)
Common stock issuance costs	—	—
Repurchases of shares	(101)	(136)
Net cash from financing activities	<u>(30,231)</u>	<u>(8,231)</u>
Net change in cash and cash equivalents	864	453
Cash and cash equivalents at beginning of year	6,425	5,972
Cash and cash equivalents at end of year	<u>\$ 7,289</u>	<u>\$ 6,425</u>

NOTE 19 – QUARTERLY FINANCIAL DATA (Unaudited)

(Dollars in thousands except per share data)

	Interest Income	Net Interest Income	Provision for Loan Losses	Net Income	Earnings Per Common Share	
					Basic	Diluted
2019						
First quarter	\$ 19,189	\$ 16,021	\$ (250)	\$ 7,646	\$ 0.22	\$ 0.22
Second quarter	19,239	15,955	(200)	8,003	0.24	0.24
Third quarter	19,079	15,836	—	8,158	0.24	0.24
Fourth quarter	18,435	15,675	—	8,172	0.24	0.24
2018						
First quarter	\$ 16,019	\$ 14,182	\$ (100)	\$ 5,755	\$ 0.17	\$ 0.17
Second quarter	16,836	14,653	(300)	6,728	0.20	0.20
Third quarter	17,687	15,162	—	6,852	0.20	0.20
Fourth quarter	18,496	15,628	850	7,043	0.21	0.21

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

None.

ITEM 9A: Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures.

Under the supervision of and with the participation of our management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (Exchange Act), as of December 31, 2019. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as the Company’s are designed to do, and management necessarily was required to apply its judgment in evaluating whether the benefits of the controls and procedures that the Company adopts outweigh their costs. Our management, including our CEO and CFO, after evaluating the effectiveness of the Company’s disclosure controls and procedures, have concluded that, as of December 31, 2019, the Company’s disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within time periods specified in the Commission’s rules and forms.

(b) Changes in Internal Controls.

There were no changes in the Company’s internal controls over financial reporting during the quarter ended December 31, 2019 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

(c) Management’s Report on Internal Control over Financial Reporting.

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company’s internal control system was designed by, or under the supervision of, our CEO and CFO and effected by our Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements and related notes for external purposes in accordance with generally accepted accounting principles in the United States of America.

An internal control system, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable, not absolute, assurance that the control system’s objectives have been met. The inherent limitations include the realities that judgments in decision-making can be deficient and breakdowns can occur because of simple errors or mistakes.

Company management assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2019. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework (2013)*. Based on this assessment, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2019 based on those criteria.

BDO USA, LLP, an independent registered public accounting firm that audited the consolidated financial statements included herein, has issued an attestation report on our internal control over financial reporting as of December 31, 2019, as stated in their report below.

(d) Report of Independent Registered Public Accounting Firm.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Shareholders and Board of Directors
Macatawa Bank Corporation
Holland, Michigan

Opinion on Internal Control over Financial Reporting

We have audited Macatawa Bank Corporation’s (the “Company’s”) internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the “COSO criteria”). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the consolidated balance sheets of the Company as of December 31, 2019 and 2018, the related consolidated statements of income, comprehensive income, changes in shareholders’ equity and cash flows for the years then ended and the related notes and our report dated February 20, 2020 expressed an unqualified opinion thereon.

Basis for Opinion

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

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

Definition and Limitations of Internal Control over Financial Reporting

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

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

/s/ BDO USA, LLP

Grand Rapids, Michigan
February 20, 2020

ITEM 9B: Other Information.

None.

PART III

ITEM 10: Directors, Executive Officers and Corporate Governance.

The information under the headings “The Board of Directors – General, – Qualifications and Biographical Information, and – Board Committees – Audit Committee,” “Executive Officers,” “Delinquent Section 16(a) Reports,” “Corporate Governance – Code of Ethics” and “Shareholder Proposals” in our definitive Proxy Statement relating to our May 5, 2020 Annual Meeting of Shareholders is here incorporated by reference.

ITEM 11: Executive Compensation.

Information under the heading “Executive Compensation” in our definitive Proxy Statement relating to our May 5, 2020 Annual Meeting of Shareholders is here incorporated by reference.

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

Information under the heading “Ownership of Macatawa Stock” in our definitive Proxy Statement relating to our May 5, 2020 Annual Meeting of Shareholders is here incorporated by reference.

The following table sets forth certain information regarding the Company’s equity compensation plans as of December 31, 2019. The following information has been adjusted to reflect the effect of all stock dividends and stock splits.

Plan Category	Equity Compensation Plan Information		
	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average Exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders (1)	0	N/A	1,213,776
Equity compensation plans not approved by security holders	0	N/A	0
Total	0	N/A	1,213,776

(1) Consists of the Macatawa Bank Corporation Stock Incentive Plan of 2015. The number of shares reflected in column (c) above with respect to the Macatawa Bank Corporation Stock Compensation Plan of 2015 (1,213,776 shares) represents shares that may be issued other than upon the exercise of an outstanding option, warrant or right. This plan contains customary anti-dilution provisions that are applicable in the event of a stock split or certain other changes in capitalization.

The Company has no equity compensation plans not approved by shareholders.

ITEM 13: Certain Relationships and Related Transactions, and Director Independence.

Information under the headings “Transactions with Related Persons” and “The Board of Directors – Board Committees” in our definitive Proxy Statement relating to our May 5, 2020 Annual Meeting of Shareholders is here incorporated by reference.

ITEM 14: Principal Accountant Fees and Services.

Information under the headings “Independent Auditors – Fees and – Audit Committee Approval Policies” in our definitive Proxy Statement relating to our May 5, 2020 Annual Meeting of Shareholders is here incorporated by reference.

PART IV

ITEM 15: Exhibits and Financial Statement Schedules.

- (a) 1. The following documents are filed as part of Item 8 of this report:
 Report of Independent Registered Public Accounting Firm
 Consolidated Balance Sheets as of December 31, 2019 and 2018
 Consolidated Statements of Income for the years ended December 31, 2019 and 2018
 Consolidated Statements of Comprehensive Income for the years ended December 31, 2019 and 2018
 Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2019 and 2018
 Consolidated Statements of Cash Flows for the years ended December 31, 2019 and 2018
 Notes to Consolidated Financial Statements
- (a) 2. Financial statement schedules are omitted because they are not required or because the information is set forth in the consolidated financial statements or related notes.
- (a) 3. The following exhibits are filed as part of this report:

Exhibit Number and Description

3.1	Restated Articles of Incorporation. Previously filed with the Commission on October 27, 2016 in Macatawa Bank Corporation's Quarterly Report on Form 10-Q, Exhibit 3.1. Here incorporated by reference.
3.2	Bylaws. Previously filed with the Commission on February 19, 2015 in Macatawa Bank Corporation's Annual Report on Form 10-K for the year ended December 31, 2014, Exhibit 3.2. Here incorporated by reference.
4.1	Restated Articles of Incorporation. Exhibit 3.1 is here incorporated by reference.
4.2	Bylaws. Exhibit 3.2 is here incorporated by reference.
4.3	Long-Term Debt. The registrant has outstanding long-term debt which at the time of this report does not exceed 10% of the registrant's total consolidated assets. The registrant agrees to furnish copies of the agreements defining the rights of holders of such long-term debt to the SEC upon request.
4.4	Description of Rights of Shareholders.
10.1*	Form of Restricted Stock Agreement. Previously filed with the Commission on February 14, 2019 in Macatawa Bank Corporation's Annual Report on Form 10-K for the year ended December 31, 2018, Exhibit 10.1. Here incorporated by reference.
10.2*	Macatawa Bank Corporation Stock Incentive Plan of 2015. Previously filed with the Commission on March 20, 2015 in Macatawa Bank Corporation's 2015 Definitive Proxy Statement on Form DEF 14A. Here incorporated by reference.
10.3*	Change in control agreements between Macatawa Bank Corporation and its Chief Executive Officer, its Chief Operating Officer, and its Chief Financial Officer. Previously filed with the Commission on Form 8-K on June 22, 2015, Exhibits 10.1 and 10.2, and on Form 8-K on February 1, 2017, Exhibit 10.1. Here incorporated by reference.
10.4*	Form of Indemnity Agreement between Macatawa Bank Corporation and certain of its directors. Previously filed with the Commission on February 18, 2016 in Macatawa Bank Corporation's Annual Report on Form 10-K for the year ended December 31, 2015, Exhibit 10.10. Here incorporated by reference.
10.5*	Board Representation Agreement dated November 5, 2008, between Macatawa Bank Corporation and White Bay Capital, LLC. Previously filed with the Commission on February 19, 2015, in Macatawa Bank Corporation's Annual Report on Form 10-K for the year ended December 31, 2014, Exhibit 10.11. Here incorporated by reference.
21	Subsidiaries of the Registrant. One or more subsidiaries were omitted from this exhibit in accordance with Item 601(b)(21)(ii) of Regulation S-K.
23.1	Consent of BDO USA, LLP, independent registered public accounting firm.
24	Powers of Attorney.
31.1	Certification of Chief Executive Officer.
31.2	Certification of Chief Financial Officer.
32.1	Certification pursuant to 18 U.S.C. § 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

* Management contract or compensatory plan.

The Registrant will furnish a copy of any exhibits listed on the Exhibit Index to any shareholder of the Registrant without charge upon written request to Chief Financial Officer, Macatawa Bank Corporation, 10753 Macatawa Drive, Holland, Michigan 49424.

ITEM 16: Form 10-K Summary.

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, dated February 20, 2020.

MACATAWA BANK CORPORATION

/s/ Ronald L. Haan
Ronald L. Haan
Chief Executive Officer
(Principal Executive Officer)

/s/ Jon W. Swets
Jon W. Swets
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

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

Signature

*/s/ Richard L. Postma February 20, 2020
Richard L. Postma, Chairman of the Board

/s/ Ronald L. Haan February 20, 2020
Ronald L. Haan, Chief Executive Officer

*/s/ Douglas B. Padnos February 20, 2020
Douglas B. Padnos, Director

*/s/ Michael K. Le Roy February 20, 2020
Michael K. Le Roy, Director

*/s/ Charles A. Geenen February 20, 2020
Charles A. Geenen, Director

*/s/ Birgit M. Klohs February 20, 2020
Birgit M. Klohs, Director

*/s/ Robert L. Herr February 20, 2020
Robert L. Herr, Director

*/s/ Thomas P. Rosenbach February 20, 2020
Thomas P. Rosenbach, Director

*By: /s/ Jon W. Swets
Jon W. Swets
Attorney-in-Fact

Macatawa Bank Corporation “the Company” authorized capital stock consists of 200,000,000 shares of Common Stock and 500,000 shares of preferred stock, no par value (the “Preferred Stock”). As of the December 31, 2019, there were 34,103,542 shares of Common Stock issued and outstanding. No shares of Preferred Stock were outstanding at December 31, 2019.

Michigan law allows the Company’s Board of Directors to issue additional shares of stock up to the total amount of Common Stock and Preferred Stock authorized without obtaining the prior approval of the shareholders. Computershare is the transfer agent for the Common Stock.

Common Stock

Dividend Rights. Subject to any prior rights of holders of Preferred Stock then outstanding, the holders of the Common Stock will be entitled to dividends when, as and if declared by the Company’s Board of Directors out of funds legally available therefor. Under Michigan law, dividends may be legally declared or paid only if after the distribution the corporation can pay its debts as they come due in the usual course of business and the corporation’s total assets equal or exceed the sum of its liabilities plus the amount that would be needed to satisfy the preferential rights upon dissolution of any holders of Preferred Stock then outstanding whose preferential rights are superior to those receiving the distribution.

Funds for the payment of dividends by the Company are expected to be obtained primarily from dividends of the Bank. There can be no assurance that the Company will have funds available for dividends, or that if they are available, that dividends will be declared by the Company’s Board of Directors.

Voting Rights. Subject to the rights, if any, of holders of shares of Preferred Stock then outstanding, all voting rights are vested in the holders of shares of Common Stock. Each share of Common Stock entitles the holder thereof to one vote on all matters, including the election of directors. The Company’s Board of Directors is classified into three classes, each class to be as nearly equal in number as possible. Shareholders of the Company do not have cumulative voting rights. The Company’s Articles of Incorporation (“Articles”) require an affirmative vote of at least 80% of the outstanding shares of voting stock, voting as a single class, to amend or repeal Article VIII, Article IX, Article X, or Article XI of the Articles.

Preemptive Rights. Holders of Common Stock do not have preemptive rights.

Liquidation Rights. Subject to any rights of any Preferred Stock then outstanding, holders of Common Stock are entitled to share on a pro rata basis in the net assets of the Company which remain after satisfaction of all liabilities.

Reports to Shareholders. The Company will furnish its shareholders with annual reports containing audited financial information and, for the first three quarters of each fiscal year, quarterly reports containing unaudited financial information.

Shares Available for Issuance. The availability for issuance of a substantial number of shares of Common Stock and Preferred Stock at the discretion of the Board of Directors will provide the Company with the flexibility to take advantage of opportunities to issue such stock in order to obtain capital, as consideration for possible acquisitions and for other purposes (including, without limitation, the issuance of additional shares through stock splits and stock dividends in appropriate circumstances). There are, at present, no plans, understandings, agreements or arrangements concerning the issuance of additional shares of the Company capital stock, except for the shares of Common Stock reserved for issuance under the Company’s stock compensation plans.

Uncommitted authorized but unissued shares of Common Stock may be issued from time to time to such persons and for such consideration as the Board of Directors of the Company may determine and holders of the then outstanding shares of Common Stock may or may not be given the opportunity to vote thereon, depending upon the nature of any such transactions, applicable law and the judgment of the Board of Directors of the Company regarding the submission of such issuance to the Company's shareholders. As noted, the Company's shareholders will have no preemptive rights to subscribe to newly issued shares.

Moreover, it will be possible that additional shares of Common Stock would be issued for the purpose of making an acquisition by an unwanted suitor of a controlling interest in the Company more difficult, time consuming or costly or would otherwise discourage an attempt to acquire control of the Company. Under such circumstances, the availability of authorized and unissued shares of Common Stock may make it more difficult for shareholders to obtain a premium for their shares. Such authorized and unissued shares could be used to create voting or other impediments or to frustrate a person seeking to obtain control of the Company by means of a merger, tender offer, proxy contest or other means. Such shares could be privately placed with purchasers who might cooperate with the Board of Directors of the Company in opposing such an attempt by a third party to gain control of the Company. The issuance of new shares of Common Stock could also be used to dilute ownership of a person or entity seeking to obtain control of the Company. Although the Company does not currently contemplate taking any such action, shares of Company capital stock could be issued for the purposes and effects described above, and the Board of Directors reserves its rights (if consistent with its fiduciary responsibilities) to issue such stock for such purposes.

Preferred Stock

The Board of Directors of the Company is authorized to issue Preferred Stock, in one or more series, from time to time, with such voting powers, full or limited, or without voting powers, and with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as may be provided in the resolution or resolutions adopted by the Board of Directors. The authority of the Board of Directors includes, but is not limited to, the determination or fixing of the following with respect to shares of such class or any series thereof: (i) the number of shares and designation of such series; (ii) the dividend rate and whether dividends are to be cumulative; (iii) whether shares are to be redeemable, and, if so, whether redeemable for cash, property or rights; (iv) the rights to which the holders of shares shall be entitled, and the preferences, if any, over any other series; (v) whether the shares shall be subject to the operation of a purchase, retirement or sinking fund, and, if so, upon what conditions; (vi) whether the shares shall be convertible into or exchangeable for shares of any other class or of any other series of any class of capital stock and the terms and conditions of such conversion or exchange; (vii) the voting powers, full or limited, if any, of the shares; (viii) whether the issuance of any additional shares, or of any shares of any other series, shall be subject to restrictions as to issuance, or as to the powers, preferences or rights of any such other series; and (ix) any other preferences, privileges and powers and relative, participating, optional or other special rights and qualifications, limitations or restrictions. The Board of Directors, without stockholder approval, can issue Preferred Stock with voting and conversion rights which could adversely affect the voting power of the Common Stock.

EXHIBIT 21

Subsidiaries of Registrant

Macatawa Bank - 100% owned
Incorporated as a Michigan Banking Corporation
10753 Macatawa Drive
Holland, Michigan 49424

Macatawa Statutory Trust II - 100% owned
Statutory Trust under the laws of the State of Delaware
10753 Macatawa Drive
Holland, Michigan 49424

Consent of Independent Registered Public Accounting Firm

Macatawa Bank Corporation
Holland, Michigan

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 333-88572, 333-88574, No. 333-116914, and No. 333-134502) of Macatawa Bank Corporation of our reports dated February 20, 2020, relating to the consolidated financial statements, and the effectiveness of Macatawa Bank Corporation's internal control over financial reporting.

/s/ BDO USA, LLP

Grand Rapids, Michigan
February 20, 2020

EXHIBIT 24

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 16, 2020

/s/ Richard L. Postma

(signature)

Richard L. Postma

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 15, 2020

/s/ Ronald L. Haan

(signature)

Ronald L. Haan

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 16, 2020

/s/ Douglas B. Padnos

(signature)

Douglas B. Padnos

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 26, 2020

/s/ Michael K. Le Roy

(signature)

Michael K. Le Roy

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 16, 2020

/s/ Charles A. Geenen

(signature)

Charles A. Geenen

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 16, 2020

/s/ Birgit M. Klohs

(signature)

Birgit M. Klohs

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 20, 2020

/s/ Robert L. Herr

(signature)

Robert L. Herr

(type or print name)

LIMITED POWER OF ATTORNEY

The undersigned, in his or her capacity as a director or officer, or both, of Macatawa Bank Corporation, does hereby appoint Richard L. Postma, Ronald L. Haan, and Jon W. Swets, or any one or more of them, his or her attorneys or attorney, with full power of substitution, to execute in his or her name an Annual Report of Macatawa Bank Corporation on Form 10-K for its fiscal year ended December 31, 2019, and any amendments to that report, and to file it with the Securities and Exchange Commission. Each attorney shall have power and authority to do and perform in the name and on behalf of the undersigned, in any and all capacities, every act to be done in the premises as fully and to all intents and purposes as the undersigned could do in person, and the undersigned hereby ratifies and approves the acts of such attorneys.

Dated: January 16, 2020

/s/ Thomas P. Rosenbach

(signature)

Thomas P. Rosenbach

(type or print name)

EXHIBIT 31.1

**Certification Pursuant to Section 302 of
the Sarbanes-Oxley Act of 2002**

I, Ronald L. Haan, certify that:

1. I have reviewed this annual report on Form 10-K of Macatawa Bank Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: February 20, 2020

/s/ Ronald L. Haan
Ronald L. Haan
Chief Executive Officer

EXHIBIT 31.2

Certification Pursuant to Section 302 of
the Sarbanes-Oxley Act of 2002

I, Jon W. Swets, certify that:

1. I have reviewed this annual report on Form 10-K of Macatawa Bank Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: February 20, 2020

/s/ Jon W. Swets
Jon W. Swets
Senior Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBIT 32.1

Pursuant to 18 U.S.C. § 1350, each of the undersigned hereby certifies in his capacity as an officer of Macatawa Bank Corporation (the “Company”) that the Annual Report of the Company on Form 10-K for the accounting period ended December 31, 2019 fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that the information contained in such report fairly presents, in all material respects, the financial condition of the Company at the end of such period and the results of operations of the Company for such period.

/s/ Ronald L. Haan

Ronald L. Haan
Chief Executive Officer
(Principal Executive Officer)

/s/ Jon W. Swets

Jon W. Swets
Senior Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

Dated: February 20, 2020
