First Federal of Northern Michigan Bancorp, Inc.
Form 10KSB
March 29, 2006

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

[X] Annual Report Under to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2005

OR

[ ] Transition Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _______________ to ______________________

COMMISSION FILE NUMBER: 000-31957

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.
(Exact name of registrant as specified in its charter)

MARYLAND (State or other jurisdiction of incorporation or organization)	32-0135202 (I.R.S. Employer Identification Number)
100 S. SECOND AVENUE, ALPENA, MICHIGAN (Address of Principal Executive Offices)	49707 Zip Code

(989) 356-9041
(Registrant's telephone number)

Securities Registered Pursuant to Section 12(b) of the Act: NONE

Securities Registered Pursuant to Section 12(g) of the Act: COMMON STOCK, PAR VALUE $.01 PER SHARE (Title of Class)

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. [ ].

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past twelve 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.

1. YES X . NO .

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X].

Indicate by check mark whether the Registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). [ ].

The Registrant's revenues for the year ended December 31, 2005 were $15.1 million.

The aggregate market value of the voting stock held by non-affiliates of the Registrant, computed by reference to the last sale price on March 15, 2006 ($9.28 per share) was $25.9 million.

As of March 15, 2006, there were issued and outstanding 3,120,344 shares of the Registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

1. Proxy Statement for the 2006 Annual Meeting of Stockholders (Parts I and III).

2. Annual Report to Shareholders for the Year Ended December 31, 2005 (Part II).

Transitional Small Business Disclosure Format

YES _____. NO __X__.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

FORWARD-LOOKING STATEMENTS

This Annual Report contains certain "forward-looking statements" which may be identified by the use of words such as "believe," "expect," "anticipate," "should," "planned," "estimated" and "potential." Examples of forward-looking statements include, but are not limited to, estimates with respect to our financial condition, results of operations and business that are subject to various factors which could cause actual results to differ materially from these estimates and most other statements that are not historical in nature. These factors include, but are not limited to, general and local economic conditions, changes in interest rates, deposit flows, demand for mortgage, commercial and other loans, real estate values, competition, changes in accounting principles, policies, or guidelines, changes in legislation or regulation, and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing products and services.

FIRST FEDERAL OF NORTHERN MICHIGAN BANCORP, INC.

First Federal of Northern Michigan Bancorp, Inc. is a Maryland corporation that owns all of the outstanding shares of common stock of First Federal of Northern Michigan. At December 31, 2005, First Federal of Northern Michigan Bancorp, Inc. had consolidated assets of $282.8 million, deposits of $188.7 million and stockholders' equity of $36.7 million. As of December 31, 2005, First Federal of Northern Michigan Bancorp, Inc. had 3,115,510 shares of common stock issued and outstanding.

FIRST FEDERAL OF NORTHERN MICHIGAN

First Federal of Northern Michigan is a full-service, community-oriented savings bank that provides financial services to individuals, families and businesses from ten full-service facilities located in Alpena, Antrim, Cheboygan, Emmett, Iosco, Otsego, Montmorency and Oscoda Counties, Michigan. First Federal of Northern Michigan was chartered in 1957, and reorganized into the mutual holding company structure in 1994. First Federal of Northern Michigan became the wholly owned subsidiary of Alpena Bancshares, Inc., the predecessor company to First Federal of Northern Michigan Bancorp, Inc., in November 2000.

First Federal of Northern Michigan's business consists primarily of accepting deposits from the general public and investing those deposits, together with funds generated from operations and borrowings, in one- to four-family residential mortgage loans, commercial real estate loans, commercial business loans, consumer loans and in investment securities and mortgage-backed securities.

MARKET AREA AND COMPETITION

First Federal of Northern Michigan conducts operations through its main office in Alpena, Michigan, which is located in the northeastern lower peninsula of Michigan, and through its nine other branch offices in Michigan. The population of Alpena (city and township), from which the majority of our deposits is drawn, has decreased since 2000, and currently is approximately 21,000. The population of our primary market area, which includes Alpena County and seven surrounding counties, is approximately 187,000, and increased by 2.2% from 2000 to 2004. The population of our primary market area is expected to increase by 2.1% by 2009. Per capita income in our market area was $20,386 in 2004, which was 15.4% less than the national level, and 16.7% less than the state of Michigan as a whole, reflecting the largely

rural nature of our market area and the absence of more densely populated urban and suburban areas. Growth in per capita income in our market area is projected to increase only modestly over the next five years. The unemployment rate in our primary market area was 6.9% at December 31, 2005, compared to 4.9% nationally and 6.7% for the state of Michigan.

Alpena is the largest city located in the northeastern lower peninsula of Michigan. This area has long been associated with agricultural, wood and concrete industries. Tourism has also been a major industry in our primary market area. All of these industries tend to be seasonal and are strongly affected by state and national economic conditions.

Major employers in our primary market area include various public schools and governmental agencies, Alpena Regional Medical Center, Besser Company (a manufacturer of concrete products equipment), Lafarge Corporation (a limestone mining and cement producer), Treetops Sylvan Resort (an operator of resort properties), Garland Resort (an operator of resort properties), Otsego Memorial Hospital, Community Memorial Hospital, Decorative Panels International (a hardboard manufacturer), OMNI Metalcraft Corp. (a diversified manufacturer), Great Lakes Tissue (a paper manufacturer) and various other small companies.

As of December 31, 2005, First Federal of Northern Michigan was the only thrift institution headquartered in our market area. We encounter strong competition both in attracting deposits and in originating real estate and other loans. Our most direct competition for deposits has historically come from commercial banks, other savings institutions, and credit unions in our market area. Competition for loans comes from such financial institutions as well as mortgage banking companies. We expect continued strong competition in the foreseeable future, including increased competition from "super-regional" banks entering the market by purchasing other financial institutions. Many such institutions have greater financial and marketing resources than we have. We compete for savings deposits by offering depositors a high level of personal service and a wide range of competitively priced financial services. In recent years, additional strong competition for deposits has come from securities brokers. We compete for real estate loans primarily on the basis of the interest rates and fees we charge and through advertising. Strong competition for deposits and loans may limit our ability to grow and may adversely affect our profitability in the future.

LENDING ACTIVITIES

GENERAL. The largest part of our loan portfolio is mortgage loans secured by one- to four-family residential real estate. In recent years, we have sold into the secondary mortgage market most of the fixed-rate conventional one- to four-family mortgage loans that we originate that have terms of 15 years or more. We retain the servicing on a majority of the mortgages that we sell. To a lesser extent, we also originate commercial loans, commercial real estate loans and consumer loans. At December 31, 2005, we had total loans of $202.6 million, of which $100.0 million, or 49.3%, were one-to four-family residential real estate mortgage loans, $40.2 million, or 19.9%, were commercial real estate loans, and $26.7 million, or 13.1%, were commercial loans. Other loans consisted primarily of consumer loan, which totaled $25.9 million, or 12.8% of total loans, and construction loans, which totaled $10.0 million or 4.9% of total loans.

ONE- TO FOUR-FAMILY RESIDENTIAL REAL ESTATE LENDING. Our primary lending activity consists of originating one- to four-family owner-occupied residential mortgage loans, virtually all of which are collateralized by properties located in our market area. We also originate one- to four-family loans that pay interest only during the initial construction period (which generally does not exceed twelve months) and then pay interest and principal for the remainder of the loan term. We generally sell into the secondary mortgage market all of our one- to four-family fixed-rate mortgage loans with terms of 15 years or more and retain the loan servicing on a majority of these mortgage loans. One- to four-family residential mortgage loans are underwritten and originated according to policies and guidelines established by the secondary mortgage market agencies and approved by our Board of Directors. We utilize existing liquidity, savings deposit growth, loan repayments, and Federal Home Loan Bank advances to fund new loan originations.

We currently offer fixed rate one- to four-family residential mortgage loans with terms ranging from 15 to 30 years. One- to four-family residential mortgage loans often remain outstanding for significantly shorter periods than their contractual terms because borrowers may refinance or prepay loans at their option. The average length of time that our one- to four-family residential mortgage loans remain outstanding varies significantly depending upon trends in market interest rates and other factors. In recent years, the average maturity of our mortgage loans has decreased significantly because of the declining trend in market interest rates and the unprecedented volume of refinancing activity

resulting from such interest rate decreases. Accordingly, estimates of the average length of one- to four-family loans that remain outstanding cannot be made with any degree of certainty.

Originations of fixed rate mortgage loans are regularly monitored and are affected significantly by the level of market interest rates, our interest rate gap position, and loan products offered by our competitors. Our fixed rate mortgage loans amortize on a monthly basis with principal and interest due each month. To make our loan portfolio less interest rate sensitive, loans originated with terms of 15 years or greater are generally underwritten to secondary mortgage market standards and sold. Balloon mortgage loans with five-year terms and adjustable rate mortgage loans are generally underwritten to secondary mortgage market standards, but are retained in our loan portfolio.

We originate some fixed-rate loans that are generally amortized over 15 years but that have "balloon payments" that are due upon the maturity of the loan in five years. Upon maturity, the balloon mortgage loans are either underwritten as fixed-rate loans and sold in the secondary mortgage market or renewed at current market rates for an additional five-year term. While the majority of our balloon mortgage loans amortize over 15 years, some amortize over 10 or 30 years, and a limited number amortize over five years.

Our one- to four-family residential mortgage loans customarily include due-on-sale clauses, which are provisions giving us the right to declare a loan immediately due and payable in the event, among other things, that the borrower sells or otherwise disposes of the underlying real property serving as security for the loan. Due-on-sale clauses are an important means of adjusting the rates on our fixed-rate mortgage loan portfolio, and we have generally exercised our rights under these clauses.

Regulations limit the amount that a savings institution may lend relative to the appraised value of the real estate securing the loan, as determined by an appraisal at the time of loan origination. Such regulations permit a maximum loan-to-value ratio of 100% for residential property and 90% for all other real estate loans. Our lending policies limit the maximum loan-to-value ratio on fixed-rate loans without private mortgage insurance to 90% of the lesser of the appraised value or the purchase price of the property serving as collateral for the loan.

We make one- to four-family real estate loans with loan-to-value ratios of up to 90%. However, for one- to four-family real estate loans with loan-to-value ratios of between 80% and 90%, we may require the total loan amount to be covered by private mortgage insurance. In 2005 we began making 80/20 loans and interest-only loans subject to Board-approved dollar limits to limit risk exposure. We require fire and casualty insurance, flood insurance when applicable, as well as title insurance, on all properties securing real estate loans made by us.

Beginning in November 2004 we initiated a "skip pay" program for customers with seasoned loans and with an exemplary past payment history. Under this program, for a fee, the customer may choose to skip a residential mortgage payment or a home equity line of credit payment. The program generated $35,000 in fee income in 2005.

COMMERCIAL REAL ESTATE LENDING. We also originate commercial real estate loans. At December 31, 2005, we had a total of 191 loans secured primarily by commercial real estate properties, unimproved vacant land and, to a limited extent, multifamily properties. Our commercial real estate loans are secured by income-producing properties such as office buildings, retail buildings and motels. Substantially all of our commercial real estate loans are secured by properties located in our primary market area. We have originated commercial construction loans that are originated as permanent loans but are interest-only during the initial construction period, which generally does not exceed nine months. At December 31, 2005, our commercial real estate loans totaled $40.3 million, or 19.84% of our total loans, and had an average principal balance of $210,995. The terms of each loan are negotiated on a case-by-case basis, although such loans typically amortize over 15 years and have a three- or five-year balloon feature. An origination fee of 0.5% to 1.0% is generally charged on commercial real estate loans. We generally make commercial real estate loans up to 75% of the appraised value of the property securing the loan. Our largest commercial real estate loan had a principal balance of $1.5 million and was secured by a commercial building and all corporate assets of the borrower. At December 31, 2005, this loan was performing according to its repayment terms.

Commercial real estate loans generally carry higher interest rates and have shorter terms than those on one- to four-family residential mortgage loans. However, loans secured by commercial real estate generally involve a greater degree of credit risk than one- to four-family residential mortgage loans and carry larger loan balances. This increased credit risk is a result of 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 loans secured by commercial real estate is typically dependent upon the successful operation of the business or the related real estate property. If the cash flow from the business operation is reduced, the borrower's ability to repay the loan may be impaired. This may be particularly true in the early years of the business operation when the risk of failure is greatest. Many of our commercial real estate loans have been made to borrowers whose business operations are untested, which increases our risk.

CONSUMER AND OTHER LOANS. We originate a variety of consumer and other loans, including loans secured by savings accounts, new and used automobiles, mobile homes, boats, recreational vehicles, and other personal property. As of December 31, 2005, consumer and other loans totaled $25.9 million, or 12.8% of our total loan portfolio. At such date, $891,500, or 3.4% of our consumer loans, were unsecured. As of December 31, 2005, home equity loans totaled $8.4 million, or 3.2% of our total loan portfolio, and automobile loans totaled $3.3 million, or 1.3% of our total loan portfolio. We originate automobile loans directly to our customers and have no outstanding agreements with automobile dealerships to generate indirect loans.

Our procedures for underwriting consumer loans include an assessment of an applicant's credit history and the ability to meet existing obligations and payments on the proposed loan. Although an applicant's creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the collateral security, if any, to the proposed loan amount.

Consumer loans generally entail greater risk than residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by assets that tend to depreciate rapidly, such as automobiles, mobile homes, boats and recreational vehicles. In addition, the repayment of consumer loans depends on the borrower's continued financial stability, as repayment is more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy than a single family mortgage loan.

COMMERCIAL LOANS. At December 31, 2005, we had $26.7 million in commercial loans which amounted to 13.1% of total loans. We make commercial business loans primarily in our market area to a variety of professionals, sole proprietorships and small businesses. Commercial lending products include term loans and revolving lines of credit. The maximum amount of a commercial business loan is our loans-to-one-borrower limit, which was $4.8 million at December 31, 2005. Such loans are generally used for longer-term working capital purposes such as purchasing equipment or furniture. Commercial loans are made with either adjustable or fixed rates of interest. Variable rates are generally based on the prime rate, as published in The Wall Street Journal, plus a margin. Fixed rate commercial loans are set at a margin above the Federal Home Loan Bank comparable advance rate.

When making commercial loans, we consider the financial statements of the borrower, our lending history with the borrower, the debt service capabilities of the borrower, the projected cash flows of the business and the value of the collateral. Commercial loans are generally secured by a variety of collateral, primarily accounts receivable, inventory and equipment, and are supported by personal guarantees. Depending on the collateral used to secure the loans, commercial loans are made in amounts of up to 75% of the value of the collateral securing the loan.

Commercial loans generally have greater credit risk than residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income, and which are secured by real property whose value tends to be more easily ascertainable, commercial loans generally are made on the basis of the borrower's ability to repay the loan from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. If the cash flow from the business operation is reduced, the borrower's ability to repay the loan may be impaired. This may be particularly true in the early years of the business operation when the risk of failure is greatest. Many of our commercial loans have been made to borrowers whose business operations are untested, which increases our risk. Moreover, any collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. We seek to minimize these risks through our underwriting standards. At December 31, 2005, our largest commercial loan was a $1.0 million loan for the borrower's working capital purposes secured by fixed assets located in our primary market area. This loan was performing according to its repayment terms at December 31, 2005.

CONSTRUCTION LOANS. We originate construction loans to local home builders in our market area, generally with whom we have an established relationship, and to individuals engaged in the construction of their residence. Our

construction loans totaled $10.0 million, or 4.9% of our total loan portfolio, at December 31, 2005. To a lesser extent, we also originate commercial construction loans.

Our construction loans to home builders are repaid on an interest-only basis for the term of the loan (which is generally six to 12 months), with interest calculated on the amount disbursed to the builders based upon a percentage of completion of construction. These loans have a maximum loan-to-value ratio of 80%, based on the appraised value. Interest rates are fixed during the construction phase of the loan. Loans to builders are made on either a pre-sold or speculative (unsold) basis. Construction loans to individuals who intend to occupy the completed dwelling are terminated and replaced with a new permanent loan at the end of the construction period. The permanent loans are generally originated pursuant to the same policy guidelines regarding loan-to-value ratios and interest rates that are used in connection with loans secured by one- to four-family residential real estate. Prior to funding a construction loan, we require an appraisal of the property from a qualified appraiser approved by us, and all appraisals are reviewed by us.

Construction lending exposes us to greater credit risk than permanent mortgage financing because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction costs is inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion is inaccurate, the value of the property may be insufficient to assure full repayment. Projects also may be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the repayment of the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. We have attempted to minimize these risks by, among other things, limiting our construction lending primarily to residential properties in our market area and generally requiring personal guarantees from the principals of corporate borrowers.

LOAN PORTFOLIO COMPOSITION. The following table sets forth the composition of our loan portfolio by type of loan at the dates indicated.

	At December 31,					
	2005		2004		2003	
	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)					
Real estate loans:						
Residential mortgage	$100,042	49.3%	$102,600	52.1%	$ 94,988	57.7%
Commercial mortgage	40,270	19.8%	29,690	15.1%	29,452	17.9%
Construction	10,030	4.9%	8,906	4.5%	5,907	3.6%
Non real estate loans						
Commercial	26,658	13.1%	30,174	15.3%	13,495	8.2%
Consumer and other loans	25,907	12.8%	25,544	13.0%	20,895	12.7%
Total Loans	$202,907	100.00%	$196,914	100.00%	$164,737	100.0%
Other items:						
Unadvanced construction loans	--		--		--	
Deferred loan origination costs ..	28		37		28	
Deferred loan origination fees ...	(336)		(349)		(269)	
Allowance for loan losses	(1,416)		(1,214)		(1,036)	
Total loans, net	$201,183		$195,388		$163,460	

LOAN MATURITY AND YIELD SCHEDULE. The following table summarizes the scheduled repayments of our loan portfolio at December 31, 2005. Demand loans, loans having no stated repayment or maturity, and overdraft loans are reported as being due in one year or less.

	Residential Mortgage		Commercial Mortgage		Construction	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
	(Dollars in thousands)					
Due During the Years Ending December 31,						
2006	$ 2,138	6.59%	$ 2,685	7.43%	$10,004	7.19%
2007	3,430	6.22%	1,776	6.69%	--	0.00%
2008	12,188	5.99%	8,549	6.94%	--	0.00%
2009 to 2010	6,264	6.18%	25,556	7.39%	26	7.75%
2011 to 2015	6,823	6.28%	1,052	5.96%	--	0.00%
2016 to 2020	17,861	5.70%	652	7.38%	--	0.00%
2020 and beyond	51,338	5.82%	--	0.00%	--	0.00%
Total	$100,042	5.91%	$40,270	7.23%	$10,030	7.19%

	Commercial		Consumer and Other		Total	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
	(Dollars in thousands)					
Due During the Years Ending December 31,						
2006	$14,980	7.59%	$ 850	7.04%	$ 30,657	7.36%
2007	1,241	7.20%	1,126	8.07%	7,573	6.77%
2008	5,135	6.96%	4,426	7.70%	30,298	6.67%
2009 to 2010	4,165	6.72%	8,366	7.52%	44,377	7.18%
2011 to 2015	659	6.90%	6,089	7.26%	14,623	6.69%
2016 to 2020	--	0.00%	2,034	7.59%	20,547	5.94%
2020 and beyond	478	7.39%	3,016	7.43%	54,832	5.92%
Total	$26,658	7.29%	$25,907	7.49%	$202,907	6.62%

FIXED-AND ADJUSTABLE-RATE LOAN SCHEDULE. The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at December 31, 2005 that are contractually due after December 31, 2006.

	Due After December 31, 2006		
	Fixed	Adjustable	Total
	(In thousands)		
Residential mortgage ..	$ 57,810	$40,094	$ 97,904
Commercial mortgage ...	26,249	11,335	$ 37,584
Construction	26	--	$ 26
Commercial	7,132	4,546	$ 11,678
Consumer and other	24,635	422	$ 25,057

Total loans	$115,852	$56,397	$172,249

LOAN ORIGINATIONS, PURCHASES, SALES AND SERVICING. While we originate both fixed-rate and adjustable-rate loans, our ability to generate each type of loan depends upon borrower demand, market interest rates, borrower preference for fixed- versus adjustable-rate loans, and the interest rates offered on each type of loan by other lenders in our market area. These lenders include competing banks, savings banks, credit unions, mortgage banking companies and life insurance companies that may also actively compete for local commercial real estate loans. Loan originations are derived from a number of sources, including real estate agent referrals, existing customers, borrowers, builders, attorneys, our directors and walk-in customers. Upon receiving a loan application, we obtain a credit report and employment verification to verify specific information relating to the applicant's employment, income, and credit standing. In the case of a real estate loan, we obtain a determination of value of the real estate intended to collateralize the proposed loan. Our lending limits vary by officer experience but range from $50,000 to $359,650. The loan committee must approve any loan from $359,650 up to $400,000, and any loan request over $400,000 must be approved by our Board of Directors. Consumer lending limits by officer range from $15,000 to $200,000. For secured commercial loans, the limit ranges from $150,000 to $400,000.

A commercial commitment letter specifies the terms and conditions of the proposed loan including the amount of the loan, interest rate, amortization term, a brief description of the required collateral, and required insurance coverage. Commitments are typically issued for 15-day periods. The borrower must provide proof of fire and casualty insurance on the property serving as collateral, which insurance must be maintained during the full term of the loan. A title insurance policy is required on all real estate loans. At December 31, 2005, we had outstanding loan commitments of $36.6 million, including unfunded commitments under lines of credit and commercial and standby letters of credit.

Our loan origination and sales activity may be adversely affected by a rising interest rate environment that typically results in decreased loan demand, while declining interest rates may stimulate increased loan demand. Accordingly, the volume of loan originations, the mix of fixed- and adjustable-rate loans, and the profitability of this activity can vary from period to period. One- to four-family residential mortgage loans are generally underwritten to current Freddie Mac seller/servicer guidelines, and closed on standard Freddie Mac documents. If such loans are sold, the sales are conducted using standard Freddie Mac purchase contracts and master commitments as applicable. All one- to four-family mortgage loans that we have sold to Freddie Mac have been sold on a non-recourse basis, whereby foreclosure losses are generally the responsibility of the purchaser and not First Federal of Northern Michigan.

We are a qualified loan servicer for Freddie Mac. Our policy has been to retain the servicing rights for all conforming loans sold, and to continue to collect payments on the loans, maintain tax escrows and applicable fire and flood insurance coverage, and supervise foreclosure proceedings if necessary. We retain a portion of the interest paid by the borrower on the loans as consideration for our servicing activities.

We require appraisals of real property securing loans. Appraisals are performed by independent appraisers, who are approved by our Board of Directors annually. We require fire and extended coverage insurance in amounts adequate to protect our principal balance. Where appropriate, flood insurance is also required. Private mortgage insurance is required for most residential mortgage loans with loan-to-value ratios greater than 80%.

LOAN ORIGINATION FEES AND COSTS. In addition to interest earned on loans, we generally receive fees in connection with loan originations. Such loan origination fees, net of costs to originate, are deferred and amortized using an interest method over the contractual life of the loan. Fees deferred are recognized into income immediately upon prepayment or subsequent sale of the related loan. At December 31, 2005, we had $308,000 of net deferred loan origination fees. Such fees vary with the volume and type of loans and commitments made and purchased, principal repayments, and competitive conditions in the mortgage markets, which in turn respond to the demand and availability of money. In addition to loan origination fees, we also generate other income through the sales and servicing of mortgage loans, late charges on loans, and fees and charges related to deposit accounts. We recognized fees and service charges of $1,030,000, $1,012,000 and $801,000 the years ended December 31, 2005, 2004 and 2003, respectively.

To the extent that originated loans are sold with servicing retained, we capitalize a mortgage servicing asset at the time of the sale in accordance with applicable accounting standards (Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"). The capitalized amount is amortized thereafter (over the period of estimated net servicing income) as a reduction of servicing fee income. The unamortized amount is fully charged to income when loans are prepaid. Originated mortgage servicing rights with an amortized cost of $751,000 were included in other assets at December 31, 2005.

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ORIGINATION, PURCHASE AND SALE OF LOANS. The table below shows our loan originations, purchases, sales, and repayments of loans for the periods indicated.

	YEARS ENDED DECEMBER 31,		
	2005	2004	2003
	(In Thousands)		
Loans receivable at beginning of period	$196,914	$164,496	$152,263
Originations:			
Real estate:			
Residential 1-4 family	54,767	60,361	132,146
Commercial and Multi-family	35,454	32,837	35,004
Consumer	12,569	17,901	18,176
Total originations	102,790	111,099	185,326
Loan purchases	8,149	11,715	--
Loan sales	(20,070)	(24,362)	(81,510)
Transfer of mortgage loans to foreclosed real estate	(695)	(79)	(441)

Repayments	(84,181)	(65,955)	(91,142)
Total loans receivable at end of period ..	$202,907	$196,914	$164,496

DELINQUENT LOANS, OTHER REAL ESTATE OWNED AND CLASSIFIED ASSETS

COLLECTION PROCEDURES. Our general collection procedures provide that before a mortgage, consumer or commercial loan becomes 16 days past due, a computer-generated late charge notice is sent to the borrower requesting payment. If delinquency continues, a second delinquent notice is mailed when the loan continues past due for 30 days. If a loan becomes 60 days past due, the loan becomes subject to possible legal action. We will generally send a "due and payable" letter upon a loan becoming 60 days delinquent. This letter grants the mortgagor 30 days to bring the account paid to date prior to the start of any legal action. If not paid, foreclosure proceedings are initiated after this 30-day period. To the extent required by regulations of the Department of Housing and Urban Development ("HUD"), generally within 45 days of delinquency, a Section 160 HUD notice is given to the borrower which provides access to consumer counseling services. General collection procedures may vary with particular circumstances on a loan by loan basis. Also, collection procedures for Freddie Mac serviced loans follow the Freddie Mac guidelines which are different from our general procedures.

LOANS PAST DUE AND NON-PERFORMING ASSETS. Loans are reviewed on a regular basis and are placed on non-accrual status when, in the opinion of management, the collection of additional interest is doubtful or when extraordinary efforts are required to collect the debt. Interest accrued and unpaid at the time a loan is placed on non-accrual status is charged against interest income.

Real estate acquired by us as a result of foreclosure or by deed in lieu of foreclosure is deemed real estate owned ("REO") until such time as it is sold. In general, we consider collateral for a loan to be "in-substance" foreclosed if: (i) the borrower has little or no equity in the collateral; (ii) proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral; and (iii) the borrower has either formally or effectively abandoned control of the collateral, or retained control of the collateral but is unlikely to be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future. Cash flow attributable to in-substance foreclosures is used to reduce the carrying value of the collateral.

When collateral, other than real estate, securing commercial and consumer loans is acquired as a result of delinquency or other reasons, it is classified as Other Repossessed Assets ("ORA") and recorded at the lower of cost or fair market value until it is disposed of.

When collateral is acquired or otherwise deemed REO/ORA, it is recorded at the lower of the unpaid principal balance of the related loan or its estimated net realizable value. This write down is recorded against the allowance for loan losses. Periodic future valuations are performed by management, and any subsequent decline in fair value is charged to operations. At December 31, 2005, we held $435,000 in properties that were classified REO/ORA.

DELINQUENT LOANS. The following table sets forth certain information with respect to our loan portfolio delinquencies at the dates indicated.

	Loan Delinquent For					
	60-89 Days		90 Days and Over		Total	
	Number	Amount	Number	Amount	Number	Amount
	(Dollars In Thousands)					
At December 31, 2005						
Residential Mortgages ..	24	$1,375	19	$1,684	43	$3,059
Commercial Mortgages ...	--	--	4	670	4	670
Construction	1	341	--	--	1	341
Commercial	8	506	2	115	10	621
Consumer	23	197	13	185	36	382
Total	56	$2,419	38	$2,654	94	$5,073
At December 31, 2004						
Residential Mortgages ..	6	$1,045	16	$ 960	22	$2,005
Commercial Mortgages ...	--	--	--	--	--	--
Construction	--	--	--	--	--	--
Commercial	2	195	1	105	3	300
Consumer	5	179	16	175	21	354
Total	13	$1,419	33	$1,240	46	$2,659
At December 31, 2003						
Residential Mortgages ..	23	$1,248	10	$ 617	33	$1,865
Commercial Mortgages ...	--	--	1	77	1	77
Construction	1	43	--	--	1	43
Commercial	3	221	--	--	3	221
Consumer	12	90	11	134	23	224
Total	39	$1,602	22	$ 828	61	$2,430

NONPERFORMING ASSETS. The following table sets forth the amounts and categories of our non-performing assets at the dates indicated. At each date presented, we had no troubled debt restructurings (loans for which a portion of interest or principal has been forgiven and loans modified at interest rates materially less than current market rates).

	AT DECEMBER 31,				
	2005	2004	2003	2002	20
	(Dollars in thousands)				
Non-Accrual Loans delinquent 90 days or more:					
Residential Mortgage	308	21	245	366	
Commercial Mortgage	1,006	442	1,040	--	
Construction	--	--	--	--	

Commercial	--	--	--	--	
Consumer and other	39	15	6	261	
Total non-accrual loans delinquent 90 days or more	$1,353	$ 478	$1,291	$ 627	$
Accrual loans delinquent 90 days or more:					
Residential Mortgage	1,684	960	617	566	4
Commercial Mortgage	670	--	--	--	
Construction	--	--	77	--	
Commercial	115	105	--	152	
Consumer and other	185	175	134	89	2
Total accrual loans delinquent 90 days or more	$2,654	$1,240	$ 828	$ 807	$ 6
Total nonperforming loans (1)	$4,007	$1,718	$2,119	$1,434	$ 6
Real Estate Owned and Other Repossessed Assets:					
Residential Mortgage	427	9	199	101	1
Commercial Mortgage	--	--	--	--	
Construction	--	--	--	--	
Commercial	--	--	--	--	
Consumer and other	8	20	--	27	
Total real estate owned (2)	$ 435	$ 29	$ 199	$ 128	$ 1
Total nonperforming assets	$4,442	$1,747	$2,318	$1,562	$ 8
Total nonperforming loans to net loans receivable	1.97%	0.87%	1.28%	0.94%	0.
Total nonperforming assets to total assets	1.57%	0.66%	1.04%	0.68%	0.

(1) All of our loans delinquent 90 days or more are classified as nonperforming.

(2) Represents the net book value of property acquired by us through foreclosure or deed in lieu of foreclosure. Upon acquisition, this property is recorded at the lower of its fair market value or the principal balance of the related loan.

CLASSIFICATION OF ASSETS. Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets such as debt and equity securities and real estate held for sale considered by the Office of Thrift Supervision to be of lesser quality as "substandard," "doubtful," or "loss" assets. An asset is considered "substandard" if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. "Substandard" assets include those characterized by the "distinct possibility" that the savings institution will sustain "some loss" if the deficiencies are not corrected. Assets classified as "doubtful" have all of the weaknesses inherent in those classified "substandard," with the added characteristic that the weaknesses present make "collection or liquidation in full," on the basis of currently existing facts, conditions, and values, "highly questionable and improbable." Assets classified as "loss" are those considered "uncollectible" and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not expose the savings institution to risk sufficient to warrant classification in one of the aforementioned categories, but which possess some weaknesses, are required to be designated "special mention" by management. Loans designated as special mention are generally loans that, while current in required payments, have exhibited some potential weaknesses that, if not corrected, could increase the level of risk in the future.

When we classify assets as either substandard or doubtful, we allocate a portion of the related general loss allowances to such assets as deemed prudent by management. The allowance for loan losses represents amounts that have been established to recognize losses inherent in the loan portfolio that are both probable and reasonably estimable at the date of the financial statements. When we classify problem assets as loss, we charge-off such amount. Our determination as to the classification of our assets and the amount of our loss allowances are subject to review by our regulatory agencies, which can order the establishment of additional loss allowances. Management regularly reviews our asset portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of management's review of our assets at December 31, 2005, classified assets consisted of substandard assets of $3.0 million, doubtful assets of $105,000 and no assets classified as loss.

We classify our assets pursuant to criteria similar to the classification structure provided in the OTS regulations. The following table sets forth the aggregate amount of our internally classified assets at the dates indicated.

	AT DECEMBER 31,				
	2005	2004	2003	2002	2001
	(In Thousands)				
Substandard assets	$3,045	$1,847	$2,295	$1,263	$2,198
Doubtful assets	105	105	105	370	--
Loss assets	--	--	--	--	--
Total classified assets ..	$3,150	$1,952	$2,400	$1,633	$2,198

Our investment in land and real estate at December 31, 2005 was classified as substandard by the Office of Thrift Supervision due to slower than expected sales of building lots and condominium units. This project (Wyndham Garden Estates) is an upscale condominium community comprised of 25 single-family building lots and 18 planned condominium units located in Alpena, Michigan. At December 31, 2005, all but six of the residential lots had been developed and sold and all condominium units were completed and all but one had been sold. Management believes this is a viable project with development and sales ongoing. At December 31, 2005, our investment in these properties was approximately $352,000, which is net of an allowance of $100,000 to record the investment at the lower of cost or fair value, less costs to sell. For reporting purposes, this investment is considered "impaired" under the definition of SFAS 144, Accounting for Impairment or Disposal of Long-Lived Assets.

ALLOWANCE FOR LOAN LOSSES. We provide for loan losses based on the allowance method. Accordingly, all loan losses are charged to the related allowance and all recoveries are credited to it. Additions to the allowance for loan losses are provided by charges to income based on various factors which, in management's judgment, deserve current recognition in estimating probable losses. Management regularly reviews the loan portfolio and makes provisions for loan losses in order to maintain the allowance for loan losses in accordance with accounting principles generally accepted in the United States of America. The allowance for loan losses consists of amounts specifically allocated to non-performing loans and other criticized or classified loans (if any) as well as general allowances determined for each major loan category. Commercial loans and loans secured by commercial real estate are evaluated individually for impairment. Other smaller-balance, homogeneous loan types, including loans secured by one- to four-family residential real estate and consumer installment loans, are evaluated for impairment on a collective basis. After we establish a provision for loans that are known to be non-performing, criticized or classified, we calculate percentage loss factors to apply to the remaining categories within the loan portfolio to estimate probable losses inherent in these categories of the portfolio. When the loan portfolio increases, therefore, the percentage calculation results in a higher dollar amount of estimated probable losses than would be the case without the increase, and when the loan portfolio decreases, the percentage calculation results in a lower dollar amount of estimated probable losses than would be the case without the decrease. These percentage loss factors are determined by management based on our historical loss experience and credit concentrations for the applicable loan category, which may be adjusted to reflect our evaluation of levels of, and trends in, delinquent and non-accrual loans, trends in volume and terms of loans, and local economic trends and conditions.

We consider commercial and commercial real estate loans and construction loans to be riskier than one- to four-family residential mortgage loans. Commercial and commercial real estate loans have greater credit risks compared to one- to four-family residential mortgage loans, as they typically involve large loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment experience on loans secured by income-producing properties typically depends on the successful operation of the related real estate project and thus may be subject to a greater extent to adverse conditions in the real estate market and in the general economy. Construction loans have greater credit risk than permanent mortgage financing because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction costs is inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion is inaccurate, the value of the property may be insufficient to assure full repayment. Projects also may be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the repayment of the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. The increased risk characteristics associated with commercial real estate and land loans and construction loans are considered by management in the evaluation of the allowance for loan losses and generally result in a larger loss factor applied to these segments of the loan portfolio in developing an estimate of the required allowance for loan losses.

We intend to increase our originations of commercial and commercial real estate loans, and we intend to retain these loans in our portfolio. Because these loans entail significant additional credit risks compared to one- to four-family residential mortgage loans, an increase in our origination (and retention in our portfolio) of these types of loans would, in the absence of other offsetting factors, require us to make additional provisions for loan losses.

The carrying value of loans is periodically evaluated and the allowance is adjusted accordingly. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, our regulatory agencies periodically review the allowance for loan losses. Such agencies may require us to recognize additions to the allowance based on their judgments of information available to them at the time of their examination

ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES. The following table sets forth the activity on our allowance for loan losses for the periods indicated.

	FOR THE YEARS ENDED DECEMBER			
	2005	2004	2003	2002
	(Dollars in thousands)			
Allowance at beginning of period	$1,214	$1,036	$ 922	$ 689
Charge-offs:				
Residential Mortgages	21	12	28	36
Commercial Mortgages	--	--	--	8
Construction	--	--	--	--
Commercial	57	--	--	--
Consumer and other	171	179	187	190
Total charge offs	249	191	215	234
Recoveries:				
Residential Mortgages	--	1	--	--
Commercial Mortgages	--	--	--	--
Construction	--	--	--	--
Commercial	--	--	--	--
Consumer and other	83	45	62	52
Total recoveries	83	46	62	52
Net (charge offs) recoveries	166	145	153	182
Provision for loan losses	368	323	267	415
Balance at end of year	$1,416	$1,214	$1,036	$ 922
Ratios:				
Net Charge-offs to average loans outstanding (annualized)	0.08%	0.07%	0.10%	0.12%
Allowance for loan loss to non-performing loans at end of period	35.34%	70.67%	48.90%	62.77%
Allowance for loan losses to total loans at end of period	0.70%	0.62%	0.63%	0.61%

MORTGAGE BANKING ACTIVITIES

Our mortgage banking activities involve the origination and subsequent sale into the secondary mortgage market of one- to four-family residential mortgage loans. When loans are sold into the secondary market, we generally retain the rights to service those loans thereby maintaining our customer relationships. We intend to use these customer relationships to cross-sell additional products and services. Loans that we sell are originated using the same personnel and the same underwriting policies as loans that we maintain in our portfolio. The decision whether to sell a loan is dependent upon the type of loan product and the term of the loan. In recent years, we have sold most of our fixed-rate one- to four-family residential loans with maturities of 15 years or greater, and have retained servicing on all of these loans.

Mortgage servicing involves the administration and collection of home loan payments. When we acquire mortgage servicing rights through the origination of mortgage loans and the subsequent sale of those loans with servicing rights retained, we allocate a portion of the total cost of the mortgage loans to the mortgage servicing rights based on their relative fair value. As of December 31, 2005, we were servicing loans sold to third parties totaling $139.1 million, and the mortgage servicing rights associated with such loans had a book value, at such date, of $751,000. Generally, the value of mortgage servicing rights increases as interest rates rise and decreases as interest rates fall, because the estimated life and estimated income from the underlying loans increase with rising interest rates and decrease with falling interest rates.

INSURANCE BROKERAGE ACTIVITIES

In March 2003, we acquired ICA, a licensed insurance agency, to increase and diversify our sources of non-interest income. ICA sells life, property, casualty and health insurance products and, to a lesser extent, non-insured investment products. All of these products are sold on an agency basis only. Unlike First Federal of Northern Michigan's net interest income and loan and deposit fee income, which are subject to and largely dependent on swings in market interest rates, the commissions earned on the sales of insurance and investment products generally are not affected by interest rate movements. As such, we expect the income contributed by ICA to add stability to our non-interest income specifically and net income generally.

ICA sells life, property, casualty and health insurance products to First Federal of Northern Michigan's borrower customers and others. For example, we routinely offer credit life insurance sold through ICA to all borrower customers of First Federal of Northern Michigan, and we expect that borrower customers will be a significant source of business for ICA in the future. In addition, ICA offers workers' compensation insurance, key-man life insurance and property and casualty insurance to our commercial borrowers, which often are small businesses, and we expect this activity to increase as we increase our origination of commercial and commercial real estate loans. Conversely, we expect to provide the community bank services of First Federal of Northern Michigan to the existing insurance clients of ICA. Finally, ICA and First Federal of Northern Michigan are now able to jointly offer complementary products, including Health Savings Accounts (HSAs) and High Deductible Health Insurance Plans (HDHPs) to customers of both entities and the public in general. An HSA is a tax-free savings account established by an eligible individual or by an employer for an eligible employee that works like an IRA, except that the money is intended to be used for qualified health care costs. An HSA plan combines an HDHP with a tax-deductible savings account. An HSA plan can result in lower health insurance premiums coupled with tax savings, enabling many people to substantially cut their health care cost. HSA-qualified health insurance typically costs 10-50% less than traditional full coverage health insurance because of the higher policy deductibles. HSA assets are required by Federal law to be held by a qualified trustee or custodian. First Federal of Northern Michigan has recently completed the requirements to become a qualified HSA custodian and ICA is able to offer HDHPs through Blue Cross/Blue Shield.

All of the revenue from our insurance segment is derived through sales commissions calculated as a percentage of the premium paid for the insurance product or the dollar value of the investment product. Generally, commission rates vary in amount depending on the type of insurance or investment product sold, as well as the volume and profitability to the underwriter of the business placed with it by ICA during specific periods. Sales commissions on insurance products generally are collected from the underwriter of the insurance and not from the insureds. Sales commissions on investment products generally are collected from the individual investor.

In recent years, approximately 75% of ICA's revenues have been derived from the sale of Blue Cross/Blue Shield health insurance products. For the twelve months ended December 31, 2005, 31% of ICA's health insurance revenues were generated through an exclusive Blue Cross/Blue Shield contract under which business members of 11 chambers of commerce in our market area use ICA as their insurance agency. ICA earns a 1.9% commission on insurance products sold to business members of the chambers of commerce, and earns a 7% commission on insurance products sold to others. ICA has been operating under this exclusive contract since 1988. The contract provides for an indefinite term, though it may be terminated by either party on 60 days notice. Blue Cross/Blue Shield may revise the schedule of commissions under the contract no more frequently than annually. Effective January 1, 2006, this exclusive contract was terminated. However, ICA will continue to receive commissions on insurance products sold through the chambers of commerce prior to the termination and can continue to sell health insurance products to non-chamber of commerce customers.

The insurance brokerage industry generally and ICA's activities specifically are affected by premium rate levels in the industry and available insurance capacity, since commissions generally are related to the premiums paid by insureds. Revenue is also affected by fluctuations in retained limits, insured values, the development of new products, markets and services, and the volume of business from new and existing clients.

ICA has operated in Alpena, Michigan since its inception in 1984 and currently employs six insurance agents. See "--Subsidiary Activity" for a further discussion of ICA. ICA also currently employs a broker that sell non-insured investment products in one of the branch offices of First Federal of Northern Michigan.

REAL ESTATE DEVELOPMENT ACTIVITIES

On a limited basis, we have purchased real estate for development through our subsidiary Financial Services & Mortgage Corporation. See "--Subsidiary Activity" for a discussion of our real estate development subsidiary, Financial Services & Mortgage Corporation. The last such purchase was a 37 acre lot which we purchased in 1994 for $130,000. As of December 31, 2005, we had sold 36 of the 43 lots comprising this property and two of the smaller lots had been combined into one lot, so that at December 31, 2005 six lots remained unsold. Our investment in land and real estate is "held for sale" and separately stated in the statement of financial condition, net of any allowance for impairment. Management is actively marketing the property by using local real estate agents to facilitate the sale of these properties. For reporting purposes, this investment is considered "impaired" under the definition in SFAS 144, Accounting for Impairment or Disposal of Long-Lived Assets. Accordingly, the investment is recorded at the lower of its cost or fair value less cost to sell, which may include realtor commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred.

Quarterly, management uses recent sales of comparable property to determine estimated future cash flows. The estimated future cash flows are used as the "fair value." The fair value, less cost to sell, is compared to the net carrying amount. If the fair value, less cost to sell, exceeds the recorded amount, a loss is recognized. Losses recognized for the initial and subsequent write-down to fair value, less cost to sell, are recognized in the "gain (loss) on the sale of real estate" line in the statement of income. A gain is recognized for any subsequent increase in fair value, less cost to sell, but not in excess of the cumulative loss previously recognized. A gain or loss not previously recognized that results from the sale of the property is recognized at the date of sale.

At December 31, 2005, our investment in these properties was approximately $352,000, which was net of an allowance of $100,000. At December 31, 2005, management prepared an analysis by obtaining an updated fair value, less cost to sell, on these properties. Based on the analysis, no further impairment or loss was identified and the allowance remained at $100,000.

INVESTMENT ACTIVITIES

Our investment securities portfolio comprises U.S. Government and state agency obligations and municipal obligations, mortgage-backed securities, Federal Home Loan Bank stock, corporate bonds and other investments. At December 31, 2005, we had no investments in unrated securities. At December 31, 2005, $52.1 million, or 95.2% of our investment portfolio was scheduled to mature in less than five years, and $3.8 million, or 6.8%, was scheduled to mature in over five years. At December 31, 2005, $9.2 million, or 16.7% of our investment portfolio was scheduled to mature in less than one year.

At December 31, 2005, we held U.S. Government and state agency obligations and municipal obligations classified as available-for-sale, with a fair market value of $48.8 million. While these securities generally provide lower yields than other investments such as mortgage-backed securities, our current investment strategy is to maintain investments in such instruments to the extent appropriate for liquidity purposes, as collateral for borrowings, and for prepayment protection.

We invest in mortgage-backed securities in order to: generate positive interest rate spreads with minimal administrative expense; lower credit risk as a result of the guarantees provided by Freddie Mac, Fannie Mae and Ginnie Mae; supplement local loan originations; reduce interest rate risk exposure; and increase liquidity. Our mortgage-backed securities portfolio consists of pass-through certificates. At December 31, 2005, mortgage-backed securities totaled $6.3 million, or 2.2% of total assets. At December 31, 2005, 66.8% of our mortgage-backed securities were secured by balloon loans. All of our pass-through certificates are insured or guaranteed by Freddie Mac, Ginnie Mae or Fannie Mae. Our policy is to hold mortgage-backed securities as available for sale.

We have interests in pools of single-family mortgages in which the principal and interest payments are passed from the mortgage originators, through intermediaries (generally government-sponsored agencies) that pool and repackage loans and sell the participation interest in the form of securities, to investors. These government-sponsored agencies include Freddie Mac, Ginnie Mae, or Fannie Mae. The underlying pool of mortgages can be comprised of either fixed-rate mortgage loans or adjustable-rate mortgage loans. The interest rate risk characteristics of the underlying pool of mortgages, i.e., fixed-rate or adjustable rate, are shared by the investors in that pool.

Our investment policy also permits investment in corporate debt obligations. Although corporate bonds may offer higher yields than U.S. Treasury or agency securities of comparable duration, corporate bonds also have a higher risk of default due to possible adverse changes in the creditworthiness of the issuer.

We are required under federal regulations to maintain a minimum amount of liquid assets that may be invested in specified short term securities and certain other investments. We generally have maintained a portfolio of liquid assets that exceeds regulatory requirements. Liquidity levels may be increased or decreased depending upon the yields on investment alternatives and upon management's judgment as to the attractiveness of the yields then available in relation to other opportunities and its expectation of the level of yield that will be available in the future, as well as management's projections as to the short term demand for funds to be used in our loan origination and other activities.

SFAS No. 115 requires that, at the time of purchase, we designate a security as held to maturity, available for sale, or trading, depending on our ability and intent. Securities available for sale are reported at fair value. As of December 31, 2005, all of our investment securities were designated as available for sale except for a $1.8 million state municipal bond investment designated as held to maturity.

Investment Securities Portfolio. The following table sets forth the composition of our investment securities portfolio at the dates indicated.

	AT DECEMBER 31,					
	2005		2004		2003	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)					
Debt Securities:						
U.S. Government and agency obligations	$43,825	$43,260	$27,954	$27,862	$16,700	$17,06
State agency and municipal obligations	5,595	5,525	5,994	5,974	3,900	3,96
Corporate bonds and other obligations	--	--	--	--	6,163	6,14
Mortgage-backed securities:						
Pass-through securities:						
Fannie Mae	675	634	851	824	982	94
Freddie Mac	3,698	3,559	4,722	4,666	5,940	5,85
Ginnie Mae	2,086	2,057	2,552	2,556	521	53
Total debt securities	55,879	55,035	42,073	41,882	34,206	34,50
Marketable equity securities						
Common stock	2	163	2	184	17	16
Total equity securities	2	163	2	184	17	16

Total interest securities ...	$55,881	$55,198	$42,075	$42,066	$34,223	$34,67

Portfolio Maturities and Yields. The composition and maturities of the investment securities portfolio at December 31, 2005 are summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur. State and municipal securities yields have not been adjusted to a tax-equivalent basis.

	AT DECEMBER 31, 2005				
	One Year or Less		More than One Year Through Five years		More Th
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amor C
	(Dollars in Thousands)				
DEBT SECURITIES:					
U.S. Government and agency securities	$7,509	3.49%	$36,316	5.01%	$
State agency and municipal obligations	1,792	2.47%	2,228	4.18%	
Corporate bonds and other obligations ...	--	0.00%	--	0.00%	
Mortgage-backed securities					
Fannie Mae	--	0.00%	675	3.50%	
Freddie Mac	--	0.00%	3,536	3.65%	
Ginnie Mae	--	0.00%	--	0.00%	
Total debt securities	9,301		42,755		
MARKETABLE EQUITY SECURITIES:					
Common Stock	--	0.00%	--	0.00%	
Total investment securities	$9,301		$42,755		$

	AT DECEMBER 31, 2005				
	More than Ten Years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Fair Value	Weigh Aver Yie
	(Dollars in Thousands)				

DEBT SECURITIES:					
U.S. Government and agency securities	$ --	0.00%	$43,825	$43,260	3.5
State agency and municipal obligations	1,300	4.78%	5,595	5,525	3.7
Corporate bonds and other obligations ...	--	0.00%	--	--	0.0
Mortgage-backed securities					
Fannie Mae	--	0.00%	675	634	3.5
Freddie Mac	32	4.48%	3,698	3,559	3.6
Ginnie Mae	2,049	3.61%	2,086	2,057	3.6
Total debt securities	3,381		55,879	55,035	
MARKETABLE EQUITY SECURITIES:					
Common Stock	2	0.00%	2	163	0.0
Total investment securities	$3,383		$55,881	$55,198	

SOURCES OF FUNDS

GENERAL. Deposits are the major source of our funds for lending and other investment purposes. We generate deposits from our ten full-service offices in Alpena, Ossineke, Mio, Cheboygan, Oscoda, Lewiston, Mancelona, Alanson and Gaylord. In addition to deposits, we derive funds from borrowings, proceeds from the settlement of loan sales, the amortization and prepayment of loans and mortgage-backed securities, the maturity of investment securities, and operations. Scheduled loan principal repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced significantly by general interest rates and market conditions. Borrowings are used on a short-term basis to compensate for reductions in the availability of funds from other sources or on a longer term basis for general business purposes. We currently are managing liquidity levels and loan funding primarily through secondary mortgage market sales.

DEPOSITS. We generate deposits primarily from our market area by offering a broad selection of deposit instruments including NOW accounts, regular savings, money market deposits, term certificate accounts and individual retirement accounts. Deposit account terms vary according to the minimum balance required, the period of time during which the funds must remain on deposit, and the interest rate, among other factors. The maximum rate of interest which we must pay is not established by regulatory authority. The asset/liability committee regularly evaluates our internal cost of funds, surveys rates offered by competing institutions, reviews the cash flow requirements for lending and liquidity, and executes rate changes when deemed appropriate. We have sought to decrease the risk associated with changes in interest rates by offering competitive rates on some deposit accounts and by pricing certificates of deposit to provide customers with incentives to choose certificates of deposit with longer maturities. We also attract non-interest bearing commercial deposit accounts from our commercial borrowers and offer a competitive sweep product that is not insured by the FDIC. In recent periods, we generally have not obtained funds through brokers or through a solicitation of funds outside our market area. However, at December 31, 2005, we had $600,000 of brokered deposits. We offer a limited amount of certificates of deposit in excess of $100,000 which may have negotiated rates. Future liquidity needs are expected to be satisfied through the use of Federal Home Loan Bank borrowings as necessary. Management does not generally plan on paying above market rates on deposit products.

The following table sets forth the distribution of total deposit accounts, by account type, at the dates indicated.

	At December 31,					
	2005			2004		
	Amount	Percent of Total	Weighted Average Interest Rate	Amount	Percent of Total	We Av Inter
	(Dollars in thousands)					
Non-interest-bearing	$ 10,878	5.76%	NA	$ 10,929	5.99%	
NOW accounts	16,620	8.81%	0.32%	19,664	10.78%	0
Passbook	21,853	11.58%	0.30%	25,039	13.72%	0
Investment sweep account	5,250	2.78%	3.14%	3,147	1.72%	1
Money market accounts	11,544	5.12%	1.53%	16,837	9.22%	1
Time deposits that mature:						
Less than 12 months	82,397	43.66%	3.63%	32,224	17.66%	2
Within 12-36 months	30,324	16.07%	3.17%	60,894	33.37%	2
Beyond 36 months	8,554	4.53%	4.16%	11,436	6.27%	3
Jumbo	1,315	0.70%	4.26%	2,319	1.27%	5
Total deposits	$188,735	100.00%	2.56%	$182,489	100.00%	1

	At December 31,		
	2003		
	Amount	Percent of Total	Weighted Average Interest Rate
	(Dollars in thousands)		
Non-interest-bearing	$ 7,282	4.80%	NA
NOW accounts	13,596	8.96%	0.35%
Passbook	25,851	17.04%	0.30%
Investment sweep account	2,987	1.97%	0.73%
Money market accounts	11,613	7.66%	1.22%
Time deposits that mature:			
Less than 12 months	41,943	27.65%	1.49%
Within 12-36 months	31,934	21.05%	2.27%
Beyond 36 months	13,524	8.91%	4.74%
Jumbo	2,972	1.96%	5.79%
Total deposits	$151,702	100.00%	1.62%

TIME DEPOSIT RATES. The following table sets forth time deposits classified by rates as of the dates indicated (see Note 8 to our consolidated financial statements contained within Exhibit 13) for a more detailed breakdown by rate range):

	At December 31,		
Rate	2005	2004	2003
	(In Thousands)		
Less than 2%	$ 7,443	$ 22,980	$26,192
2.00 percent to 2.99 percent	20,199	24,924	14,384
3.00 percent to 3.99 percent	59,350	33,124	15,349
4.00 percent to 4.99 percent	25,470	10,227	12,498
5.00 percent to 6.99 percent	8,667	12,869	18,768
7.00 percent to 8.99 percent	1,461	2,749	3,183
	$122,590	$106,873	$90,374

TIME DEPOSIT MATURITIES. The following table sets forth the amount and maturities of time deposits at December 31, 2005.

Rate	Less Than One Year	1 - Less than 2 Years	2 - Less than 3 Years	3 - Less than 5 Years	5 years and Greater	Total
Less than 2%	$ 7,426	$ 17	$ --	$ --	$ --	$ 7,443
2.00 percent to 2.99 percent	18,248	368	652	773	158	20,199
3.00 percent to 3.99 percent	34,788	18,367	5,933	90	172	59,350
4.00 percent to 4.99 percent	19,793	3,684	211	1,347	435	25,470
5.00 percent to 6.99 percent	2,757	725	921	3,691	573	8,667
7.00 percent to 8.99 percent	--	147	--	1,314	--	1,461
	$83,012	$23,308	$7,717	$7,215	$1,338	$122,590

As of December 31, 2005, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to $100,000 was $30.2 million. The following table sets forth the maturity of those certificates as of December 31, 2005.

Maturity Period	Certificates of Deposit
	(In thousands)
Three months or less	$ 6,069

Three through six months ...	1,567
Six through twelve months ..	12,045
Over twelve months	10,485
Total	$30,166

BORROWINGS. Our borrowings consist primarily of advances from the Federal Home Loan Bank of Indianapolis. At December 31, 2005, we had access to additional Federal Home Loan Bank advances of up to $25.4 million. The following table sets forth information concerning balances and interest rates on our Federal Home Loan Bank advances and other borrowings at the dates and for the periods indicated.

	Years Ended December 31,		
	2005	2004	2003
	(Dollars in Thousands)		
Balance at end of period	$54,405	$56,001	$47,159
Average balance during period	$51,627	$54,473	$49,594
Maximum outstanding at any month end	$61,440	$63,758	$49,802
Weighted average interest rate at end of period	4.40%	4.50%	5.25%
Average interest rate during period	4.51%	3.71%	4.73%

SUBSIDIARY ACTIVITY

First Federal of Northern Michigan Bancorp, Inc.'s only direct subsidiary is First Federal of Northern Michigan.

First Federal of Northern Michigan has two wholly owned subsidiaries. First Federal of Northern Michigan and these subsidiaries have been consolidated in the financial statements and all inter-company balances and transactions have been eliminated in consolidation.

One subsidiary, Financial Services & Mortgage Corporation, leases, sells, develops and maintains real estate properties. For reporting purposes, Financial Services & Mortgage Corporation is included in our banking segment. As of December 31, 2005, First Federal of Northern Michigan's investment in Financial Services & Mortgage Corporation was $487,000. The primary asset of the subsidiary is an investment in land and real estate. See "Real Estate Development Activities." At December 31, 2005, Financial Services & Mortgage Corporation owned six developed building sites and one condominium, all of which were being offered for sale. Financial Services & Mortgage Corporation is not currently a party to any agreement that is material to First Federal of Northern Michigan Bancorp, Inc. on a consolidated basis.

First Federal of Northern Michigan's second subsidiary, ICA, is a licensed insurance agency engaged in the business of property, casualty and health insurance sales. ICA currently employs one broker that sell non-insured investment products in one branch office of First Federal of Northern Michigan. First Federal of Northern Michigan acquired ICA in June 2003 for $2.87 million. ICA's revenues are derived from the sale of life insurance, property and casualty insurance and health insurance. At December 31, 2005, life insurance revenues represented 6% of sales, property and casualty insurance revenues represented 21% of sales and health insurance sales represented 72% of sales. At December 31, 2005, 31% of the health insurance sales resulted from a contract under which 11 chambers of commerce in 10 surrounding counties offer their constituents the opportunity to purchase group health plans through ICA. This contract was terminated effective January 1, 2006, however ICA will continue to receive commissions on polices sold under this contract prior to December 31, 2005 and can continue to sell health products to non-chamber of commerce customers.

As part of the acquisition of ICA, First Federal of Northern Michigan entered into an employment agreement with one of ICA's former owners, which was set to expire in February 2006. However the former employee terminated the contract effective May 1, 2005. In addition, First Federal of Northern Michigan entered into an "earn out" agreement with one of the former ICA owners that pays up to $300,000 per year if certain net sales goals are achieved. One $300,000 payment was made in February 2004, the second in February 2005, and the final payment was made in January 2006.

PERSONNEL

As of December 31, 2005, the Bank had 86 full-time and 23 part-time employees. None of the Bank's employees is represented by a collective bargaining group. The Bank believes its relationship with its employees to be good. ICA had 19 full-time and 1 part-time employees as of the same date. First Federal of Northern Michigan Bancorp, Inc. and FSMC have no separate employees.

SUPERVISION AND REGULATION

GENERAL

As a federally chartered savings bank, First Federal of Northern Michigan is regulated and supervised by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. This regulation and supervision establishes a comprehensive framework of activities in which we may engage, and is intended primarily for the protection of the Federal Deposit Insurance Corporation's deposit insurance funds and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their

capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. After completing an examination, the federal agency critiques the financial institution's operations and assigns its rating (known as an institution's CAMELS). Under federal law, an institution may not disclose its CAMELS rating to the public. First Federal of Northern Michigan also is a member of, and owns stock in, the Federal Home Loan Bank of Indianapolis, which is one of the twelve regional banks in the Federal Home Loan Bank System. First Federal of Northern Michigan also is regulated, to a lesser extent, by the Board of Governors of the Federal Reserve System, governing reserves to be maintained against deposits and other matters. The Office of Thrift Supervision examines First Federal of Northern Michigan and prepares reports for consideration by our board of directors on any operating deficiencies. First Federal of Northern Michigan's relationship with our depositors and borrowers also is regulated to a great extent by both federal and state laws, especially in matters concerning the ownership of deposit accounts and the form and content of our loan documents.

There can be no assurance that changes to existing laws, rules and regulations, or any other new laws, rules or regulations, will not be adopted in the future, which could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition or prospects. Any change in these laws or regulations, or in regulatory policy, whether by the Federal Deposit Insurance Corporation, the Office of Thrift Supervision or Congress, could have a material adverse impact on our business, financial condition or operations.

FEDERAL BANKING REGULATION

BUSINESS ACTIVITIES. A federal savings bank derives its lending and investment powers from the Home Owners' Loan Act, and the regulations of the Office of Thrift Supervision. Under these laws and regulations, First Federal of Northern Michigan may invest in mortgage loans secured by residential and commercial real estate, commercial business and consumer loans, certain types of debt securities and certain other loans and assets. First Federal of Northern Michigan also may establish subsidiaries that may engage in activities not otherwise permissible for First Federal of Northern Michigan directly, including real estate investment, securities brokerage and insurance agency services.

CAPITAL REQUIREMENTS. Office of Thrift Supervision regulations require savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for institutions receiving the highest CAMELS rating) and an 8% risk-based capital ratio. The prompt corrective action standards discussed below, in effect, establish a minimum 2% tangible capital standard.

The risk-based capital standard for savings banks requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, assigned by the Office of Thrift Supervision capital regulation based on the risks inherent in the type of asset. Core capital is defined as common stockholders' equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, allowance for loan and lease losses up to a maximum of 1.25% of risk-weighted assets, and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital.

At December 31, 2005, First Federal of Northern Michigan's capital exceeded all applicable requirements. The following table sets forth the Bank's capital position at December 31, 2005 and 2004, as compared to the minimum capital requirements.

AT DECEMBER 31,

	2005		2004	
	Amount	Percent of Assets	Amount	Percent of Assets
	(Dollars in Thousands)			
Equity capital	$36,650	12.97%	$21,777	8.29%
Tangible Capital Requirement:				
Tangible capital level	32,181	11.54%	17,140	6.64%
Requirement	4,175	1.50%	3,873	1.50%
Excess	28,006	10.04%	13,267	5.14%
Core Capital Requirement:				
Core capital level	32,181	11.54%	17,140	6.64%
Requirement	11,134	4.00%	10,327	4.00%
Excess	21,047	7.54%	6,813	2.64%
Risk-based Capital Requirement:				
Risk-based capital level	33,669	18.03%	18,436	10.68%
Requirement	14,937	8.00%	13,806	8.00%
Excess	18,732	10.03%	4,630	2.68%

LOANS TO ONE BORROWER. A federal savings bank generally may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus on an unsecured basis. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2005, First Federal of Northern Michigan was in compliance with the loans-to-one-borrower limitations.

QUALIFIED THRIFT LENDER TEST. As a federal savings bank, First Federal of Northern Michigan is subject to a qualified thrift lender, or "QTL," test. Under the QTL test, First Federal of Northern Michigan must maintain at least 65% of its "portfolio assets" in "qualified thrift investments" in at least nine months of the most recent 12-month period. "Portfolio assets" generally means total assets of a savings institution, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the institution's business.

"Qualified thrift investments" include various types of loans made for residential and housing purposes, investments related to such purposes, including certain mortgage-backed and related securities, and loans for personal, family, household and certain other purposes up to a limit of 20% of portfolio assets. "Qualified thrift investments" also include 100% of an institution's credit card loans, education loans and small business loans. First Federal of Northern Michigan also may satisfy the QTL test by qualifying as a "domestic building and loan association" as defined in the Internal Revenue Code of 1986.

A savings bank that fails the QTL test must either convert to a bank charter or operate under specified restrictions. At December 31, 2005, First Federal of Northern Michigan maintained approximately 94.4% of its portfolio assets in qualified thrift investments, and therefore satisfied the QTL test.

CAPITAL DISTRIBUTIONS. Office of Thrift Supervision regulations govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the institution's capital account. A savings bank must file an application for approval of a capital distribution if:

- the total capital distributions for the applicable calendar year exceed the sum of the savings bank's net income for that year to date plus the savings bank's retained net income for the preceding two years;

- the savings bank would not be at least adequately capitalized following the distribution;

- the distribution would violate any applicable statute, regulation, agreement or Office of Thrift Supervision-imposed condition; or

- the savings bank is not eligible for expedited treatment of its filings.

Even if an application is not otherwise required, every savings bank that is a subsidiary of a holding company must still file a notice with the Office of Thrift Supervision at least 30 days before the board of directors declares a dividend or approves a capital distribution.

The Office of Thrift Supervision may disapprove a notice or application if:

- the savings bank would be undercapitalized following the distribution;

- the proposed capital distribution raises safety and soundness concerns; or

- the capital distribution would violate a prohibition contained in any statute, regulation or agreement.

LIQUIDITY. A federal savings bank is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation.

COMMUNITY REINVESTMENT ACT AND FAIR LENDING LAWS. All savings banks have a responsibility under the Community Reinvestment Act and related regulations of the Office of Thrift Supervision to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In connection with its examination of a federal savings bank, the Office of Thrift Supervision is required to assess the savings bank's record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A savings bank's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the Office of Thrift Supervision, as well as other federal regulatory agencies and the Department of Justice. First Federal of Northern Michigan received a "Satisfactory" Community Reinvestment Act rating in its most recent federal examination.

TRANSACTIONS WITH RELATED PARTIES. A federal savings bank's authority to engage in transactions with its "affiliates" is limited by Office of Thrift Supervision regulations and Regulation W of the Federal Reserve Board, which implements Sections 23A and 23B of the Federal Reserve Act. The term "affiliates" for these purposes generally means any company that controls or is under common control with an institution. First Federal of Northern Michigan Bancorp, Inc. and its non-savings institution subsidiaries will be affiliates of

First Federal of Northern Michigan. In general, transactions with affiliates must be on terms that are as favorable to the savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the savings bank's capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the savings bank. In addition, Office of Thrift Supervision regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary.

First Federal of Northern Michigan's authority to extend credit to its directors, executive officers and 10% stockholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders (i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, and (ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of First Federal of Northern Michigan's capital. In addition,

extensions of credit in excess of certain limits must be approved by First Federal of Northern Michigan's board of directors.

ENFORCEMENT. The Office of Thrift Supervision has primary enforcement responsibility over federal savings banks and has the authority to bring enforcement action against all "institution-affiliated parties," including stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors of the savings bank, receivership, conservatorship or the termination of deposit insurance. Civil penalties cover a wide range of violations and actions, and range up to $25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as $1 million per day. The Federal Deposit Insurance Corporation also has the authority to recommend to the Director of the Office of Thrift Supervision that enforcement action be taken with respect to a particular savings bank. If action is not taken by the Director, the Federal Deposit Insurance Corporation has authority to take action under specified circumstances.

STANDARDS FOR SAFETY AND SOUNDNESS. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. The federal banking agencies adopted Interagency Guidelines Prescribing Standards for Safety and Soundness to implement the safety and soundness standards required under federal law. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The guidelines address internal controls and information systems, internal audit systems, credit underwriting, loan documentation, interest rate risk exposure, asset growth, compensation, fees and benefits. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan.

PROMPT CORRECTIVE ACTION REGULATIONS. Under the prompt corrective action regulations, the Office of Thrift Supervision is required and authorized to take supervisory actions against undercapitalized savings banks. For this purpose, a savings bank is placed in one of the following five categories based on the savings bank's capital:

- well-capitalized (at least 5% leverage capital, 6% tier 1 risk-based capital and 10% total risk-based capital);

- adequately capitalized (at least 4% leverage capital, 4% tier 1 risk-based capital and 8% total risk-based capital);

- undercapitalized (less than 3% leverage capital, 4% tier 1 risk-based capital or 8% total risk-based capital);

- significantly undercapitalized (less than 3% leverage capital, 3% tier 1 risk-based capital or 6% total risk-based capital); or

- critically undercapitalized (less than 2% tangible capital).

Generally, the Office of Thrift Supervision is required to appoint a receiver or conservator for a savings bank that is "critically undercapitalized." The regulation also provides that a capital restoration plan must be filed with the Office of Thrift Supervision within 45 days of the date a savings bank receives notice that it is "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." In addition, numerous mandatory supervisory actions become immediately applicable to the savings bank, including, but not limited to, restrictions on growth, investment activities, capital distributions and affiliate transactions. The Office of Thrift Supervision may also take any one of a number of discretionary supervisory actions against undercapitalized savings banks, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At December 31, 2005, First Federal of Northern Michigan met the criteria for being considered "well-capitalized."

INSURANCE OF DEPOSIT ACCOUNTS. Deposit accounts in First Federal of Northern Michigan are insured by the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation, generally up to a maximum of $100,000 per separately insured depositor. First Federal of Northern Michigan's deposits, therefore, are subject to Federal Deposit Insurance Corporation deposit insurance assessments. The Federal Deposit Insurance Corporation has adopted a risk-based system for determining deposit insurance assessments. The Federal Deposit Insurance Corporation is authorized to raise the assessment rates as necessary to maintain the required ratio of reserves to insured deposits of 1.25%. In addition, all Federal Deposit Insurance Corporation-insured institutions must pay assessments to the Federal Deposit Insurance Corporation at an annual rate of approximately .0212% of insured deposits to fund interest payments on federal agency bonds maturing in 2017 that were issued to recapitalize the predecessor to the Savings Association Insurance Fund.

On February 15, 2006, federal legislation to reform federal deposit insurance was enacted. This new legislation requires, among other things, the merger of the Savings Association Insurance Fund and the Bank Insurance Fund into a unified insurance deposit fund and an increase in the amount of federal deposit insurance coverage from $100,000 to $130,000 (with a cost of living adjustment to become effective in five years). The Act also requires the reserve ratio to be modified to provide for a range between 1.15% and 1.50% of estimated insured deposits. The new legislation requires the Federal Deposit Insurance Corporation to issue regulations implementing the law. The changes required by the law will not become effective until final regulations have been issued, which must be no later than 270 days from the date of the enactment of the legislation.

PROHIBITIONS AGAINST TYING ARRANGEMENTS. Federal savings banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the savings bank or its affiliates or not obtain services of a competitor of the savings bank.

FEDERAL HOME LOAN BANK SYSTEM. First Federal of Northern Michigan is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions. As a member of the Federal Home Loan Bank of Indianapolis, First Federal of Northern Michigan is required to acquire and hold shares of capital stock in the Federal Home Loan Bank in an amount equal to at least 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its borrowings from the Federal Home Loan Bank, whichever is greater. As of December 31, 2005, First Federal of Northern Michigan was in compliance with this requirement.

FEDERAL RESERVE SYSTEM

Federal Reserve Board regulations require savings banks to maintain non-interest-earning reserves against their transaction accounts, such as negotiable order of withdrawal and regular checking accounts. At December 31, 2005, First Federal of Northern Michigan was in compliance with these reserve requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the Office of Thrift Supervision.

THE USA PATRIOT ACT

The USA PATRIOT Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. Certain provisions of the Act impose affirmative obligations on a broad range of financial institutions, including federal savings banks, like First Federal of Northern Michigan. These obligations include

enhanced anti-money laundering programs, customer identification programs and regulations relating to private banking accounts or correspondence accounts in the United States for non-United States persons or their representatives (including foreign individuals visiting the United States).

First Federal of Northern Michigan has established policies and procedures to ensure compliance with the USA PATRIOT Act's provisions, and the impact of the USA PATRIOT Act on our operations has not been material.

PRIVACY REQUIREMENTS OF THE GRAMM-LEACH-BLILEY ACT

The Gramm-Leach-Bliley Act of 1999 provided for sweeping financial modernization for commercial banks, savings banks, securities firms, insurance companies, and other financial institutions operating in the United States. Among other provisions, the Gramm-Leach-Bliley Act places limitations on the sharing of consumer financial information with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution's privacy policy and provide such customers the opportunity to "opt out" of the sharing of personal financial information with unaffiliated third parties.

HOLDING COMPANY REGULATION

First Federal of Northern Michigan Bancorp, Inc. is a unitary savings and loan holding company, subject to regulation and supervision by the Office of Thrift Supervision. The Office of Thrift Supervision has enforcement authority over First Federal of Northern Michigan Bancorp, Inc. and its non-savings institution subsidiaries. Among other things, this authority permits the Office of Thrift Supervision to restrict or prohibit activities that are determined to be a risk to First Federal of Northern Michigan.

Under prior law, a unitary savings and loan holding company generally had no regulatory restrictions on the types of business activities in which it could engage, provided that its subsidiary savings association was a qualified thrift lender. The Gramm-Leach-Bliley Act, however, restricts unitary savings and loan holding companies not existing on, or applied for before, May 4, 1999, to those activities permissible for financial holding companies or for multiple savings and loan holding companies. First Federal of Northern Michigan Bancorp, Inc. is not a grandfathered unitary savings and loan holding company and, therefore, is limited to the activities permissible for financial holding companies or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance, incidental to financial activities or complementary to a financial activity. A multiple savings and loan holding company is generally limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the Office of Thrift Supervision, and certain additional activities authorized by Office of Thrift Supervision regulations.

Federal law prohibits a savings and loan holding company, directly or indirectly, or through one or more subsidiaries, from acquiring control of another savings institution or holding company thereof, without prior written approval of the Office of Thrift Supervision. It also prohibits the acquisition or retention of, with specified exceptions, more than 5% of the equity securities of a company engaged in activities that are not closely related to banking or financial in nature or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Office of Thrift Supervision must consider the financial and managerial resources and future prospects of the savings institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act of 2002 was enacted in response to public concerns regarding corporate accountability. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing impro