ANNUAL REPORT

2020

Merchants
Financial Group

OUR **MISSION**

To be the financial partner of choice, helping our customers and communities fulfill their hopes and dreams, because we're community members too.

CORE **VALUES**

WE are here to serve.
WE will be dependable.
WE will be fair and honest in all things.
WE will care for our employees, our customers and our shareholders.
WE value initiative, creativity and adaptivity to change.
WE will build trust; we will hold our customers' best interests at heart.
WE will conduct ourselves with integrity.
WE will inform people and communicate with all; we will listen.
WE embrace responsibility for our performance and financial results.
WE will direct our human and material resources toward achieving common goals.
WE value teamwork and will celebrate success together.

By honoring our stakeholder commitments and living our core values, we aspire to create a trusting environment… where every diverse stakeholder can expect fair and equitable treatment, feels included, and belongs.

CORE STAKEHOLDER **COMMITMENTS**

To Customers
To build loyal and mutually rewarding customer relationships by providing consistently exceptional experiences.

To Employees
To create and maintain an environment that promotes and rewards contribution, accountability, initiative, teamwork, learning, professional growth, and development.

To Our Communities
To help make each community we serve a better place in which to live and work through financial reinvestment, engaged market leadership impact, and the support of employee volunteer involvement.

To Shareholders
To obtain long-term shareholder value through quality growth and financial performance in the upper quartile of our peer group.

A Letter from Our

CHIEF EXECUTIVE OFFICER

Gregory M. Evans
President & Chief Executive Officer

As it did for everybody, 2020 presented significant and unusual challenges for Merchants Financial Group, Inc. Being tested, responding with resolve, and exceeding our earnings performance goals for the year resulted in tremendous gratification.

Given the extraordinary things that impacted our business, our net income performance of $21.5 million – the best earnings report in the 145-year history of the Company – is a tribute to our financial strength and the remarkable commitment of our employee team. I am tremendously proud of my co-workers for the intense dedication and adaptability demonstrated throughout the year.

While the earnings performance is admirable, we also managed to remain focused on critical strategic priorities as the world around us was changing in unanticipated ways. The most significant of those strategic accomplishments was the successful system conversion and merger of the First National Bank of Northfield into Merchants in May.

The impact of COVID-19

The impact of the global health pandemic on our business cannot be overstated. We were experiencing a strong start to 2020, when the world began to change rapidly in March. As developments unfolded, we were forced to respond with great urgency to an environment driven by fear of the unknown. Virtually every facet of our business required adaptation, most notably:

- Employee and community health and safety – We closed access to our bank lobbies on March 19 and by the time we re-opened on June 22, all offices were effectively provisioned with personal protective equipment necessary to maintain a safe service environment for our employees and customers. With accelerating virus surge late in the year, we again closed lobby access on November 9 and remained that way at year-end. At no point was it determined that one of our locations was a source of community spread of the virus.
- Operations – We quickly mobilized elements of our business continuity plan necessary to provision the distribution of our workforce. By April 1, more than 60% of our employees were working remotely. What we have learned about distributed workforce and productivity will provide us an opportunity to drive efficiency in the future, as most of our non-customer-facing people remain working from home.
- Performance management – While our earnings performance for 2020 exceeded our plan, how we got there had little semblance to our initial forecast. Market opportunities for commercial loan growth (typically our strongest earnings performance driver) were virtually non-existent and year-over-year loan growth was flat. Business caution combined with reduced outlets for consumer spending resulted in unprecedented deposit growth of 21%. As interest rates plummeted, putting our excess liquidity to work was a challenge and we experienced significant interest margin compression throughout the year. On the flip side, low interest rates drove a mortgage refinancing explosion and our position as a leader in residential mortgage lending was the largest contributor to our strong earnings. Our mortgage banking team originated nearly $952 million of volume, a 77% increase over 2019 volume of $538 million.

Customer care response

The challenges we encountered were real, but paled in comparison to those experienced by many of our friends and neighbors. Next to health and safety, the biggest source of fear and anxiety for many customers was their financial well-being. Many business customers had to shut down operations and consumer clients lost their jobs.

As a community bank and business leader in our markets, we embraced our responsibility to be a source of relief by immediately instituting loan payment deferment programs across all loan types to any borrowing customer in good standing. These programs were generally designed as 30 to 90-day extensions, depending on the type of loan. On a consolidated basis, we accommodated nearly 1,400 deferment requests. At year-end, we had a small number of borrowers representing $78.2 million in loan balances (4.38% of total loans and 28.83% of bank risk based capital) still on some form of deferment.

We also responded aggressively to the federal government's need to leverage the banking infrastructure to expedite business relief through the Small Business Administration's (SBA) Paycheck Protection Program (PPP). We originated nearly 1,600 PPP loans with total proceeds of $207 million and have heard from many of our customers that PPP was the lifeline that allowed local businesses to survive.

The important loan forgiveness for this SBA program began in the fourth quarter. At year-end, we had completed the forgiveness process for more than 550 loans. Most of our PPP efforts were focused to support existing customers to make certain that loyal clients were accommodated as a priority. Because of the familiarity we have with our clients and their documented need for PPP loan proceeds, we have not experienced any of the fraud fallout that has come under scrutiny by regulatory agencies monitoring the program.

Mindful of longer-term credit risk

At the start of the pandemic last spring, we were proactive in adding significantly to our Allowance for Loan/Lease Loss Reserves (ALLR) as an abundance of caution to buffer possible future loss exposure.

By Q4, we had completed intense stress testing of our consolidated loan portfolio. It should come as no surprise that elevated risk was primarily isolated to the hospitality industry. One source of Merchants' resiliency associated with credit risk cycles in the past is the healthy diversification of our consolidated portfolio. Exposure in the hospitality sector is just 4% of total loans. We made several risk rating adjustments for credit facilities in this category and at year-end our levels of criticized, classified and non-performing loans as a percentage of bank risk based capital were 46.45%, 33.60% and 7.36%, respectively.

We made large reversals out of income to make necessary ALLR adjustments totaling $11.9 million, bringing total reserves to $31.6 million – a 64% increase in provision compared to year-end 2019. ALLR is currently 1.77% of total loans, positioning us appropriately for elevated risk and conservatively to manage through any additional pandemic developments in the year ahead. While we experienced no quantifiable tangible losses as a direct result of COVID-19 at year-end, we remain on heightened alert to the potential for continued economic fallout the longer the pandemic persists.

Strategic focus for a vibrant future

The past year reaffirmed how challenges must be embraced as opportunities. The pandemic dictated the need to accept meaningful change, and all of us at Merchants have learned much as a result.

The increased investments we have made in technology and information security over the past five years allowed us to:

- Move to a distributed workforce relatively seamlessly with minimal risk.
- Focus on digital transformation by enhancing our electronic solutions to meet new remote banking needs of our customers.
- Develop an aggressive digital banking roadmap, which includes stabilization of the new systems implemented over the past 15 months and addresses high-priority e-banking system enhancements for the coming year.

The ongoing competitive and digital disruption of our industry accelerated exponentially as a result what transpired in 2020. All of us at Merchants are faced with the reality that workforce and customer behaviors have been altered with some form of permanency.

We responded by revisiting our long-range strategic plan and defining our desired future state as part of an intense planning engagement during the latter half of the year. Our strategic exercise included meaningful involvement with the Board of Directors. We challenged each other in healthy ways to assess our ability to continue to drive shareholder value at the level required to meet your expectations.

We have ultimately embraced a unanimous commitment to stay the course in pursuit of excellence and long-term relevance as an independent financial services Company. The Board has provided clear direction to the Executive Leadership Team of its expectations and articulated its absolute confidence in our ability to grow the business and optimize earnings. Fundamentally, that is what our long-term relevance is dependent upon.

One positive outcome of what we learned throughout 2020 is a keener sense of appreciation for the fabric of our communities, the importance of locally-owned businesses, and the presence of caring friends and neighbors. As a community bank, we play a more important role than ever in helping families and businesses fulfill their hopes and dreams and contributing to the vitality of our communities and this region. Our resolve in this regard has never been stronger. Thank you for your continued loyalty and support. You are a key contributor to our continued success.

Gregory Evans

Gregory M. Evans
President & Chief Executive Officer
Merchants Financial Group, Inc. and Merchants Bank, NA

A Letter from Our

CHIEF FINANCIAL OFFICER

Susan M. Savat
Chief Financial Officer

For several years, Merchants has focused on our strategic initiatives of enhancing digital banking solutions for our customers and employee leadership development and it certainly paid off in 2020. These successful efforts, as well as a lot of hard work by our team, allows us to celebrate a very financially successful year with you.

Reframing our perspective for 2020

Two years ago, we shared with you details of our new in-house leadership program, I Believe – Discovering the Leader in You, developed by our Training Director, Kristine Valk. When the 2019-2020 class shared their final presentations in June; one of the participants of that class, Lucas Stangl, Treasury Sales Support Lead; had the very creative thought to ask his classmates to create a Haiku as a way to share their experiences about the program. Since our Executive Leadership Team also was invited to listen to the presentations, we were asked to create a Haiku as well. Now, I try *not* to live up to the stereotype of a typical accountant, however, writing poems is definitely not my strong suit! Being that we were three months into the pandemic, after a lot of writer's block, I came up with the following:

The world is changing
Be good to yourself and others
Guiding light is needed

As you have just finished reading Greg's letter, you have seen how once again, Merchants responded to a changing world, was there for our employees and our customers and will continue to be the guiding light for our communities.

Financial highlights for a unique year

As the pandemic began, we adjusted forecasts each month to capture some of the financial risks and benefits of the changing environment. These forecasts included the expected loss of loan volume, margin compression, increased mortgage volume and refinance activity, SBA's Paycheck Protection Program (PPP) fees, and reserve needed based on the increased risk in the loan portfolio. While we were conservative in the forecasts, our actual performance was a pleasant surprise to us all.

We are thrilled to share net income of $21,511,521 for 2020. This is $1,946,892 over our plan and $1,744,306 over last year's results. As Greg indicated, our balance sheet changed significantly over the year. We saw our excess cash go from approximately $95 million to $424 million. And while we believe some excess cash balances are temporary due to PPP funds being held in business deposit accounts and minimal outlets for people to spend, we also believe that people are saving more in this environment of uncertainty and some of those habits will continue into the future.

Investments saw heavier cash flow and it was difficult to find appropriate re-investment options – in total, investment balances declined 14.35%. Loan balances, in total, increased 4.56%. Loan balances, excluding PPP loans, decreased $74.9 million or 4.39%.

The categories with the largest declines included commercial loans, agricultural loans and home equity loans. Demand deposit (checking account) balances grew $131.7 million or 31.0%, while interest bearing accounts (money market, savings, and certificate of deposit) grew $245 million or 17.6%. Even though deposits grew significantly, due to the drop in deposit interest rates, interest expense on deposits decreased 1.6% year-over-year.

Deposit Growth / Year-End Balances

Deposit Growth	Year-End Balances
31% ↑	**Demand Deposits** (Non-interest Bearing Checking) $556,799,704
20% ↑	**Interest Bearing Checking** $311,233,352
29% ↑	**Basic Savings** $117,919,349
61% ↑	**Diamond Money Market** $556,876,425
85% ↑	**Insured Cash Sweep Accounts** $221,966,307

2020 net income resulted in a return on average assets of 0.95%, which is up just slightly from 0.94% in 2019. The significant growth in deposits was the primary cause of the small increase. Return on average equity was 10.49% compared to 10.51% last year. Tangible capital to assets of 6.92% and common equity to assets of 8.45% are also low due to the significant and swift growth in assets with the compressed margin and limited time to develop earnings from those assets. Just for context, had deposits remained where they were on March 30, those two ratios would have been 8.08% and 9.86%, respectively. Capital balances grew $13.6 million or 6.87%.

A team effort makes a difference

We know we often talk about the benefits of our diversification, but it has again been a significant driver of our results. Some highlights include:

- Mortgage related net gain on sale of loans revenue of $23.3 million is $17.1 million over last year and a record of any year in recent history by 68.9%.
- Credit card interchange income is up 11.5% over last year.
- Debit card interchange income is up 6.7% over last year.
- Trust Department revenue of $1.8 million is an increase of 11.2% and total fiduciary asset balances is an impressive $450.3 million.

We did see some significant increase in employee expense year-over-year. Much had to do with meeting the needs of more than 4,000 mortgage customers who turned to us when they were ready to purchase, refinance or build a home this year. We added staff, paid out volume incentives (up 27.3% from 2019) and had significant overtime expense. In addition to the year's strong financial performance, we met the second tier of our company-wide success sharing plan and, with Board approval, were pleased to provide an 8% Employee Stock Ownership Program contribution.

We saw expenses increase in other areas, as well. Due to increased digital and security related technology investments, we had increases in computer expenses of 23.5%. Audit related fees increased 36.8% and our FDIC insurance credits were fully absorbed in the beginning of 2020 and total expense increased $1.1 million or 915.6% year-over-year. In addition, there were still quite a few First National Bank of Northfield acquisition and conversion/merger related expenses in 2020 as well as deposit premium amortization of over $900,000. Last, but not least, the addition of $11.9 million to the loan loss reserve certainly impacted earnings and we are thankful for the mortgage business that helped offset that expense.

2020 Mortgage Summary

58% ↑	**Retail Mortgages Closed** 2,427
58% ↑	**$ Retail Mortgages** $565,185,770
94% ↑	**Correspondent Mortgages Closed** 1,787
116% ↑	**$ Correspondent Mortgages** $386,644,766
278% ↑	**Gain on Sale to Secondary Market** $23,277,000

We knew when the pandemic began it would be a challenging year for the industry and our employees focused on controlling expenses that we could. Due to most education opportunities going online and at reduced costs, we had reduction in education and travel of over 50%. Other controllable expense categories also had reduced cost as compared to prior years.

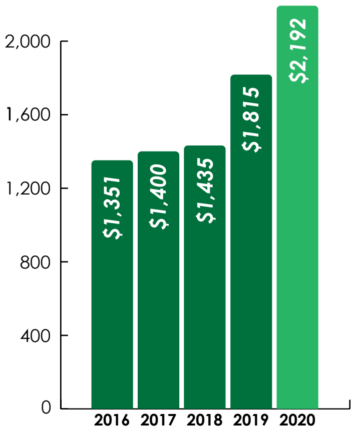
While this letter is a recap of 2020, I know we are all looking forward to a new year and the opportunities it will bring. With our continued focus on meeting the hopes and dreams of our customers and our ongoing commitment to the communities we serve, we are confident Merchants will continue to be a great place to work and bring value to our shareholders. Thank you.

Susan M Savat

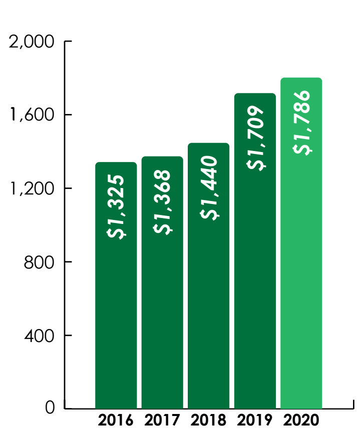
Susan M. Savat
Senior Vice President & Chief Financial Officer
Merchants Financial Group, Inc.

2020 FINANCIAL **CHARTS**

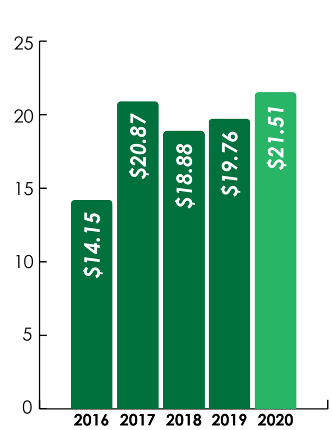
Company Growth



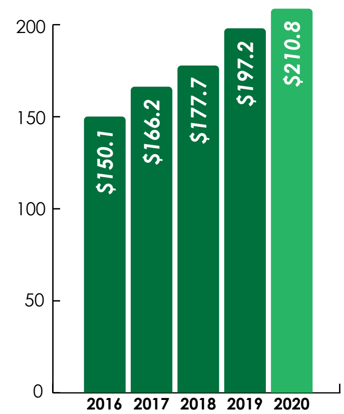
Total Deposits
$ in Millions



Total Loans
$ in Millions

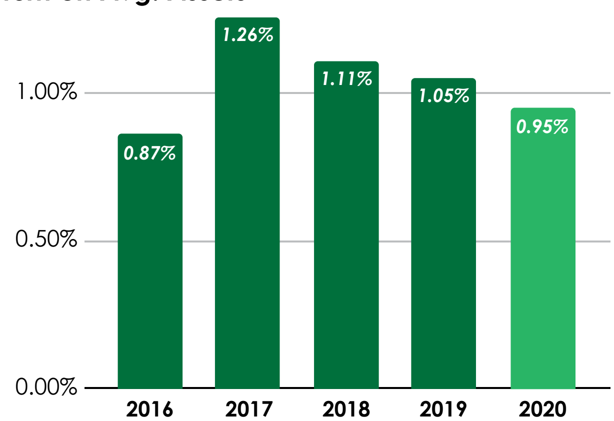


Total Net Income
$ in Millions

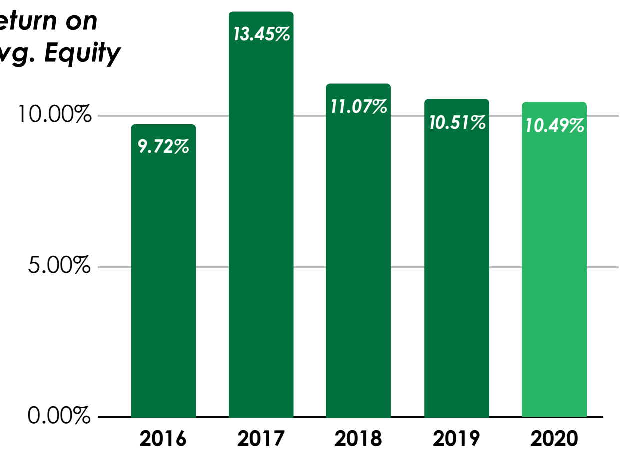


Total Equity Capital
$ in Millions

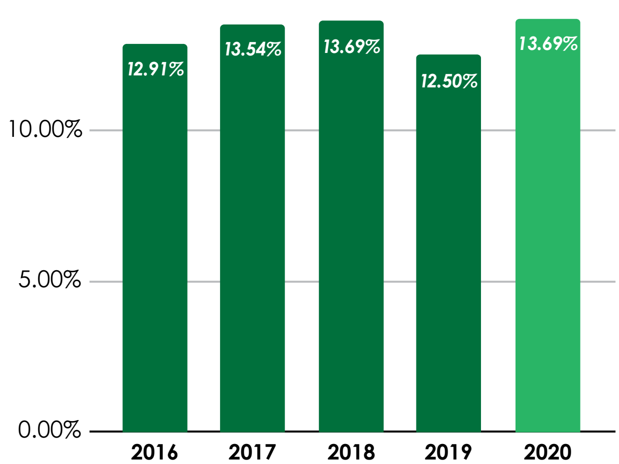
Return on Avg. Assets



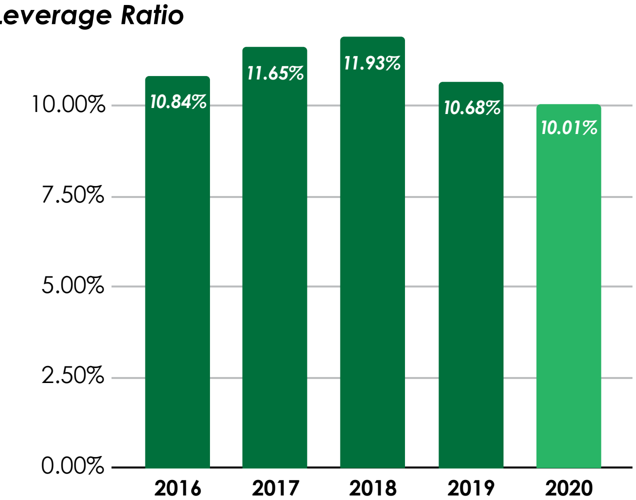
Return on Avg. Equity



Total Risk Based Capital



Leverage Ratio



CONSOLIDATED **FINANCIALS**

CONDENSED CONSOLIDATED STATEMENT OF CONDITION

Assets	12/31/20	12/31/19
Cash and Cash Equivalents	$ 423,574,639	$ 94,406,730
Investments	122,646,944	143,203,122
Loans and Leases, Net	1,745,361,071	1,682,399,317
Banking Houses, Furniture and Fixtures	29,772,266	30,434,001
Other Assets	173,541,256	162,250,621
Total	2,494,896,176	2,112,693,791

Liabilities & Equity		
Deposits	$ 2,191,771,249	$ 1,815,195,552
Other Liabilities	92,335,806	100,265,985
Equity	210,789,121	197,232,254
Total	2,494,896,176	2,112,693,791

CONDENSED CONSOLIDATED STATEMENT OF INCOME

Income	12/31/20	12/31/19
Interest Income	$ 90,333,907	$ 84,224,680
Interest Expense	13,109,141	14,194,186
Net Interest Income	77,224,766	70,030,494
Other Operating Income	44,291,804	26,301,262
Other Operating Expense	92,325,050	68,703,513
Income Before Taxes	29,191,520	27,628,243
Income Taxes	7,679,999	7,861,029
Net Income	$ 21,511,521	$ 19,767,214
Earnings Per Share*	$ 8.09	$ 7.41
Book Value Per Share*	$ 79.25	$ 73.94
Shares Outstanding	2,726,247	2,726,247

**Based on weighted average of shares outstanding for the year.*

EXCEPTIONAL EXPERIENCES IN UNPRECEDENTED TIMES

Continuing Our Service Commitment

Providing exceptional experiences is the heart of Merchants Bank's identity – it's simply who we are. From our humble beginnings in 1875 as a bank for the underserved working class of Winona to today, our service commitment has never wavered. What has changed over the years is how and where we provide personalized service. With advances in technology and shifts in customer preferences, we've adapted and created new ways to help our customers work toward their hopes and dreams. The ability to adjust our service channels was never more important than in 2020 as we embraced our responsibility to keep our customers, staff and communities healthy and safe.

Early in the year, our Executive Leadership Team recognized that closing Bank lobbies to prevent the spread of COVID-19 would be a necessary action. With this unprecedented decision, the biggest concern was Merchants' ability to allow customers to conduct banking business in a safe and healthy manner. While some alternative banking methods were already in place – for example, Online, Mobile and Telephone Banking – our team implemented other creative methods to continue working with customers. While bank lobbies were closed from March 19-June 22, 2020 and again from November 9 through year-end, Merchants provided service in as many ways possible to accommodate customers while keeping safety and health top of mind:

- Modified in-person options, including use of drive-up banking facilities for servicing deposit and loan account requests and banker lobby appointments by request in essential situations.
- Extended customer service phone tree to include 50 frontline staff to answer the influx of customer calls.
- Ability to receive and respond to customer inquires via secure message in Online Banking when new platform launched on March 17.
- Continued the use of online contact forms and added simplified "get in touch" forms to several pages of the website, resulting in more than 1,100 requests to connect website visitors and bankers.

With this combined approach, we were able to accommodate customer needs through modified in-person banking or digital banking tools until lobbies reopened. Coordinating our lobby reopenings in June involved individual input from each location to ensure our Preparedness Plan could be put into effect. From pinpointing specific hand sanitizing stations, removing furniture to accommodate social distancing and understanding guidance from state and local agencies, our locations came together in a short amount of time to ensure a smooth and safe reopening. From June through October, lobby traffic was slower than usual as customers continued to be cautious and developed new comfort levels with our alternative service channels. We credit our extraordinarily patient customers and flexible staff for making banking during this time as easy as possible for everyone.

> "All of our staff stepped up and were willing to do what was necessary to ensure the health and safety of all," said Beth Ede, Chief Human Resource Officer. "They embraced all aspects of our Preparedness Plan with the Merchants culture and spirit, showing courage, resilience, reliability and flexibility."


Beth Ede

While the COVID-19 pandemic not only interrupted banking business as usual, the economic impact was felt by many of our personal and business customers. As a long-term trusted financial partner for our customers, it was imperative that we provided effective, yet prudent, financial relief options for those facing these unexpected challenges. During 2020, we accommodated loan payment deferments to more than 1,100 personal and business customers in good standing. At year-end, a significant number of customers were back to making their regularly scheduled payments.

In addition to financial relief options, Merchants also assisted business customers with Paycheck Protection Program (PPP) financing through the Small Business Administration (SBA). As a SBA preferred lender, we were positioned well from the start of the program on April 3 to be a resource for our customers and guide them through the process from the initial application to tracking funds through separate deposit accounts and the loan forgiveness application process. Our bankers committed to understand the complex program details and stayed up-to-date on numerous law changes to deliver caring, thoughtful service to our business customers. We are proud to say that Merchants was one of Minnesota's PPP banking leaders, originating nearly 1,600 loans with total volume of approximately $207 million.

Mark Morse

"Having worked with us for almost two decades, Merchants Bank knows our business very well," explained Mark Morse, CEO of creative agency, Morsekode. "They proactively reached out about PPP and wanted to do whatever was necessary to help us submit an application so we could maintain our staff and even bring back some employees who were furloughed. Merchants Bank treated this like it was the most important thing in the world to them, because it was to us."

As always, our service commitment goes beyond our own customers to serving our local communities too. In 2020 one of our top priorities was doing our part to keep our communities healthy and safe amid the pandemic. Following guidance from local and state agencies, we implemented a number of protocols to ensure our staff and customers had minimal physical contact. In addition to the lobby closures and alternative banking methods mentioned, we also put into practice a work from home initiative that continues in 2021. When our lobbies closed initially in March, 84% of our staff who could work from home were provisioned to do so within two weeks. This shift to an almost entirely remote team is something that's unprecedented for Merchants Bank.

While lobbies were re-opened from June-October, most frontline staff resumed working in the Bank, while most of our support staff continued to work remotely. Some frontline and management staff implemented an in office/work from home rotation to prevent potential COVID-19 spread among key positions. We learned many lessons from our remote work protocol and look forward seeing how alternative work structures may be beneficial in the future.

Many community organizations across our footprint stepped up to provide extra funds, grants and programs to aid those affected by the pandemic. As Merchants remains a committed community supporter, it was important for us to contribute to initiatives that supported community members and businesses getting back on their feet again. We are proud to have contributed both financially and through volunteer efforts to several local organizations specifically for pandemic relief. It was a privilege to be in a financial position to give back to these important initiatives. Our commitment to serving our communities starts with taking care of our communities. Though 2020 may not have looked like any other year, Merchants' vision, values and teamwork continued to be a driving force in providing another year of exceptional experiences, in new ways, to take care of our customers, communities and each other.

Our frontline staff; including Dana Christiansen, a Customer Service Representative in Winona; exemplified our commitment to continue putting the customer first by providing service while adapting to health and safety protocols. Being there for customers as a trusted financial partner, even during difficult times, is something the Merchants team feels privileged to do.

Dana Christiansen

COMMITTED TO MAKING HOME OWNERS' **DREAMS COME TRUE**

Maximizing Technology and Relationship-Based Approach for Record Mortgage Year

Helping families find homes is one of our biggest joys at Merchants. As a trusted financial partner, we believe in helping everyone realize their hopes and dreams. For many in 2020 that was financing their home purchase or construction or taking advantage of the mortgage rates to save money by refinancing.

From the customer perspective, a mortgage involves various steps that a lender guides them through to a successful loan closing. Behind the scenes, our Mortgage Operations team supports the lender and customer by taking care of many details, including processing required documentation, reviewing documentation for loan approval (known as underwriting), and loan closing. All areas make mortgage one of the most successful and important business lines in our company and in 2020 that proved to be a significant driver of our earnings results.

Our retail mortgage operation offered through our 23 branches and Correspondent Mortgage Banking program made up of 115 locations in a six-state area contributed $30,785,944 in revenue to our bottom line in 2020. The ultimate result? We helped more than 4,000 individuals and families get into a new home or save money on their current mortgage by refinancing.

2020's unique rate environment

The substantial increase in mortgages year-over-year was mainly due to the low rate environment that started in 2019 and continued through 2020. As shown in the table, mortgage rates in 2020 reached the lowest recorded for Merchants Bank customers since 2015. Since rates can change daily due to market conditions, it's rare to see rates this low for consecutive months at a time. Low rates are beneficial to home buyers wanting to purchase a new home or current owners looking to save money by refinancing. Of the more than 4,200 mortgage loans completed in 2020, 21% were for purchase and 79% were refinances.

Year	15-Year Mortgage Rate*	30-Year Mortgage Rate*
Lowest rates in 2015	2.90%	3.65%
Lowest rates in 2016	2.50%	3.40%
Lowest rates in 2017	3.025%	3.775%
Lowest rates in 2018	3.525%	4.025%
Lowest rates in 2019	2.775%	3.275%
Lowest rates in 2020	2.275%	2.775%

Rates shown are historical rates offered by Merchants Bank in markets with a 1% origination fee.

Merchants is in the people business, even remotely

"In my 20 years in mortgage, I've never seen a busier year than 2020," said Toni Nisbit, Mortgage Operations Manager. "To accommodate the influx of mortgages our team critically reviewed our processes and systems for efficiencies that could help us meet loan processing turn times, which became more challenging in the last quarter as loan volume continued to increase."


Toni Nisbit

While lobbies were closed and most support staff was working from home, our team put in extra effort to make sure the mortgage process was still seamless for customers. As mortgage lenders received application information and additional documentation over the phone, via secure email or through our online application system, they were still able to provide personalized service without meeting in person.


McNamara Family

"I can't think of a way our refinance could have gone smoother," explained mortgage customer Tim McNamara. "Our lender, Jenna DeBaere in the Hastings office, was just a phone call away if we had questions about the process or why certain items were needed. Sending our loan documentation to her electronically couldn't have been easier."


Jenna DeBaere

Flexibility and efficiency made a difference

After application, mortgage documentation is sent to the Mortgage Operations team for the next steps. It involves detailed work – verifying customer information with employers, other financial institutions and more. While items reviewed in this process were valid for 120 days, the guidelines changed to 60 days after the economic impact of the pandemic started to affect applicant's financial situations.

With continual updates to guidance in 2020, the team quickly adjusted to new requirements and made process changes to ensure customers didn't feel the affects. In a matter of months, with the more than 40 staff working remotely (due to COVID-19 safety precautions), Mortgage Operations put into effect:

- Several automated enhancements in the mortgage loan software to help with efficiency and ensure accuracy during high loan volume.
- An automatic process to transfer loan information from the mortgage software to the Merchants main banking system, instead of manually entering data, as we have done for years.
- Expanded the use of online dashboards to identify bottlenecks in the workflow and help balance the workload remotely to efficiently process customer files.

Another key to keeping turnaround times in check was reorganizing the order in which mortgages were processed – this outstanding loan volume is sometimes referred to as the mortgage pipeline. Prior to April 2020, mortgages in the pipeline were processed on a first in, first out basis. As the pipeline grew, managing the mortgage rates customers had locked in became even more critical, both for the customer and the Bank. Mortgage Operations transitioned to processing mortgages by mortgage rate lock expiration date. By keeping a close eye on dates, we helped customers avoid additional fees to ensure they obtained the rate they originally locked. It's about understanding the entire process, not just a small piece of it, and how it all affects the customer.

"Jenna Hartman, our Underwriting Manager, plays a critical role in managing our pipeline, which includes loan files from our retail mortgage operation and correspondent banks. She constantly reviews our overall volume in the underwriting queue and prioritizes what needs to be done with others in Underwriting," explained Toni.


Jenna Hartman

Making the most of Secondary Market

While the Underwriting team focused on turnaround time for open loan files, our Secondary Market team worked hard to fine tune our process for purchasing loans from correspondent banks and delivering loans to secondary market mortgage investors like Fannie Mae and Freddie Mac. This complex work has an immediate impact on our mortgage income and was one of the main drivers of net income in 2020. To gain more efficiencies, Jen DeGeorge, Secondary Market Manager, and her team took advantage of newly upgraded pricing software with fully integrated services to eliminate duplicated work and manual data entry.


Jen DeGeorge

Toni shared that "the Secondary Market is such a specialized area and with Jen's leadership, we've made the most of our three-person team. Our pricing system was a big investment, but we were able to see immediate gains and deliver an average of 328 loans each month to our investors in a much more efficient fashion."

In 2020, Merchants processed nearly 4,000 loans to the secondary mortgage market with a total loan volume of $861,062,102. With the right team and the right technology, Merchants was able to leverage this area of the business for more sustainable, profitable outcomes.

Helping people with their home dreams continues to be a cornerstone at Merchants. With the changing dynamics of banking, our lenders and support team strive to maintain a high level of service in all areas to exceed customer expectations. To do so, several mortgage-related technology projects are already on the 2021 roadmap, in addition to reviewing opportunities to realign staff duties and leverage technology already in place to maximize loan processing workflow.

As always, when making these decisions "our top priority remains how we can serve the customer better and make a positive impact on their mortgage experience, even from behind-the-scenes," Toni said. "We have a strong, seasoned mortgage team that is always looking for ways to improve. I look forward to what we can continue to accomplish together. Because this year 'together' wasn't just about the Merchants team, our customers adjusted too as we worked with many of them remotely. We adjusted to better serve our stakeholders, to help them reach goals. We did it together."

DEEPENING CUSTOMER RELATIONSHIPS THROUGH HIGH-TECH TOOLS

Finding the Right Blend of Personal Experiences and Digital Banking

Reflecting on 2020, technology continued to be a crucial area of our strategic focus. While other community banks struggle to provide the tools customers simply expect, Merchants has been fortunate to have the vision and dedicated resources to put the right blend of high touch personal service and secure technology in place to meet our customers' needs.

This past year has been the culmination of our three-year strategic plan, which included a digital banking roadmap focused on enhancing customer interaction and satisfaction. The roadmap included customer-facing tools/services and a plan to enhance our internal technology systems and processes to ensure information security and drive efficiency. In 2020, we launched several digital banking systems that will grow and adapt as our customers' needs continue to evolve.

Feature-rich digital banking for personal and small business customers

One of our biggest opportunities to ensure customer satisfaction is through robust online and mobile banking tools with a variety of self-service features. No other Bank service affects more customers – approximately 26,923 – and plays an important role in our successful blend of high touch, relationship-based experiences and high technology offerings. Led by Kerri Bronk, Senior Operations/e-Channel Officer, our implementation team of more than a dozen experts from across the company, worked tirelessly for over a year preparing to launch a new, feature-rich Online and Mobile Banking system in March 2020.

Amid lobby closings due to the pandemic, Merchants pushed ahead and went live with the new system on March 17, 2020. To assist our Electronic Banking department (working in a distributed manner) with the anticipated increase in calls due to the launch, 50 current frontline staff across our branches were added to a phone tree. Over the next month, this team fielded hundreds of phone calls, secure messages and more than 800 website contact forms to help customers smoothly transition to the new system.

At of the end of 2020, 32% of our personal and small business customers are Online or Mobile Banking users and login an average of 15 times a month to access account information or use one of the other enhancements, such as bill pay, Zelle™ for sending money via mobile device, real-time credit scores, mobile deposit, secure messaging with staff or personal budgeting tools.

"I can't say enough about the teamwork and dedication of my co-workers to ensure customers were taken care of when transitioning from one system to another. We launched during a challenging shift to drive-up only banking; everyone rose to the occasion, helping walk more than 17,500 customers through the enrollment process in the first two weeks," said Bronk.


Kerri Bronk

This system will allow us to add functionality that evolves to meet the needs of our customers – which is a key reason for the selection of this software partner and platform. As we've learned from customers in the past, it's crucial that Online and Mobile Banking tools not remain stagnant, but grow with customers' changing needs. Looking to 2021, several more enhancements are in the works, including:

- integrating our self-service debit card tool (CardValet) so customers can control their cards within Online Banking,
- improvements to mobile deposit,
- updates to bill pay including viewing summary information,
- as well as improving the overall stability and system access for customers logging in when nightly processing is occurring.

Sophisticated digital commercial banking tools

Our strategic focus on digital banking is important for commercial customers as well. In 2019, a significant project was launching our new Commercial Online Banking platform and that undertaking continued to be a focus for us in 2020.

With the launch of Commercial Online Banking, business customers now have single-sign on access to many sophisticated treasury management tools and conduct banking business remotely. If questions arise, our Treasury Management Sales staff are available to help, as well as our recently established Treasury Management Support department. Staffed full-time, Treasury Management Support helps business customers with technical implementation of treasury management tools, answers questions about the Commercial Online & Mobile Banking system and walks customers through setup of new tools and services. It's just another example of our commitment to blending high touch service by experts who care and secure, high technology banking at a time when the two could not be more important.

In the past year, Treasury Management Support has helped businesses from across our footprint and beyond add 294 new services. The team also tracks customer requests for digital banking enhancements to build a roadmap for new Commercial Online capabilities. "There's no better way to learn what's working and what's not than by listening to the customers using these tools daily. We want to make sure our Commercial Online Banking is progressive and provides a competitive edge through regular enhancements," said Andrew Guzzo, Winona & Southern Regional President and Executive Sponsor for the Commercial Online Banking project implementation.

Since launch, the team has already worked through several upgrades, including integrating Quickbooks, adding mobile deposit and continued development of the secure browser function that helps customers protect their banking information. Already on the enhancement list for 2021? Making eStatements available for customers with multiple businesses and deposit images viewable online.

In addition, our technology team continues to review opportunities for other treasury management tools and support systems. With the Positive Pay upgrade in conjunction with the Commercial Online Banking launch, customers have more control over which transactions are automatically processed from their account(s). To ensure more efficient processing, the technology supporting our Deposit on Demand system (allowing customers to deposit checks from their business) was outsourced. We will continue to look for ways to optimize technology services to complement our team and provide the best options for our customers.

Credit card upgrades provide benefits on commercial and personal side

Near year-end we upgraded our credit card system for businesses and also introduced a new mobile app. As with other digital banking tools, the credit card upgrades provide more self-service options for customers. With the Merchants Bank Credit Card app, personal and business customers can turn their card(s) on and off, control spending limits and more, monitor card usage, get potential fraud alerts and pay their credit card bill with a few taps to their mobile screen.

On the business side, this strategic upgrade gives additional benefits to businesses looking for more hands on control of their employee credit cards through purchasing cards. With purchasing cards, a business administrator can order/close employee cards and set custom spending limits through an online site (called eZ Business Card Management) without having to call our Credit Card team. eZ Business also allows businesses to enroll in Expense Management, a tool which provides sophisticated reporting on all credit card activity. This capability offers the high technology experience our customers deserve with the expertise and support of our knowledgeable Credit Card team.

A continued focus for attracting and retaining customers

Being a full-service banking provider today means having digital banking technology that marries self-service with feature-rich platforms. As a community bank, we find our sweet spot by offering valuable digital banking tools and a personal relationship with bankers who you can trust. We feel our customers can recognize the difference in this blended approach and it's what gives us a competitive edge to attract new generations of customers for years to come. As we look toward our technology roadmap for 2021, we know that each project will be thoughtfully guided by team members dedicated to making a difference in the lives of families and businesses we serve every day. As a trusted advisor, a true partner, we'll continue to strengthen the relationships that strengthen our communities.

Online and Mobile Banking – 2020 By the Numbers

Personal & Small Business		Commercial	
26,923	Users enrolled	1,212	Users enrolled
$36 Million	Bill payments processed	$8.1 Million	Bill payments processed
4.3	Average number of bills paid per month per user	$1.9 Billion	ACH transactions
$474.1 Million	Transfers completed	$1.2 Billion	Outgoing and incoming wires
$16.8 Million	Deposits made from a mobile device	$2.5 Million	Deposits made from a mobile device

MERCHANTS BANK
EXECUTIVE LEADERSHIP TEAM

Our commitment to community banking and community leadership starts with our Executive Leadership Team. We believe in building strong communities through strong leaders on our Executive Leadership Team and at every level of the organization. The Executive Leadership Team sets a course for Merchants' strategic growth, with guidance from our Boards, by staying true to our community banking philosophy and with emphasis on service above self, commitment to community and belief in mutual success.

Greg Evans
President & Chief Executive Officer, Merchants Financial Group, Inc. and Merchants Bank, NA

- 31 years of banking experience
- With Merchants since 1989

Serves on the Board of Directors for Winona Health and Chairs its Finance/Audit Committee; Board of Trustees, Finance Committee, and Development Committee for the Winona State University Foundation; Capital Campaign Steering Committee for the Winona Family YMCA, Minnesota Bankers Association Government Relations Council

Richard Barry
President, Merchants Bank Equipment Finance

- More than 25 years of equipment finance experience
- With Merchants since 2016

Active member of the Equipment Leasing and Finance Association and serves as an Election Judge in Eden Prairie, Minnesota

Beth Ede
Chief Human Resource Officer

- 25 years of human resources experience
- With Merchants since 2019

Serves on the Board of Directors for the Winona Area Society for Human Resource Management and the HR Committee for Habitat for Humanity Winona-Fillmore Counties

Andrew Guzzo
Regional President, Winona & Southern Regions

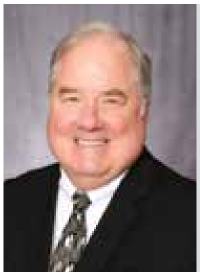
- 14 years of banking experience
- With Merchants since 2017

Serves on the Board of Directors for the Winona Family YMCA, Winona Community Foundation and Family & Children's Center, the Community Leadership Advisory Board for Winona State University College of Business and the President's Advisory Committee for Minnesota State College Southeast

Dan Massett
Regional President, Central Region

- More than 25 years of banking experience
- With Merchants since 2014

Serves on the Board of Directors for the Jones Family Foundation (Board Chair), Economic Initiative Corporation of Cannon Falls, Red Wing YMCA – Camp Pepin (Advisory Board Member); Finance Committee for Cannon Falls Schools and The Partner Table for Every Hand Joined



Mark McGrory
Chief Credit Officer

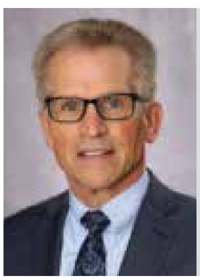
- 39 years of banking experience
- With Merchants since 1986

Serves on the HCO Golf Committee for Home and Community Options and is a member of the Civic Association and Elks Association

Sue Savat
Chief Financial Officer

- 24 years of banking experience
- With Merchants from 1992-1995 and since 2000

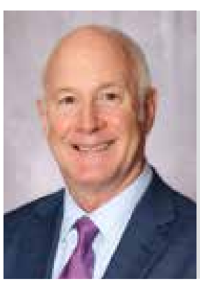
Serves on the Board of Directors for the Winona Area Catholic Schools Foundation (Treasurer), Department of Business Finance Advisory Board for Winona State University and the Finance and Retirement Committees for Winona Health



Lawrence (Skip) Stovern
Regional President, Twin Cities Region

- 42 years of banking experience
- With Merchants since 2007

Serves on the Board of Directors for Kids ‘n Kinship and is a member of the Apple Valley Chamber of Commerce and Dakota County Regional Chamber of Commerce



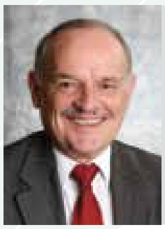
Stephen Swenson
Chief Information Officer

- More than 25 years in the information technology industry
- With Merchants since 2020

Serves on the Minnesota State College Southeast Information Technology Advisory Committee to help shape the future of the Network Administration & Technology and the Cyber and Information Security programs

MERCHANTS BANK
LOCAL LEADERSHIP

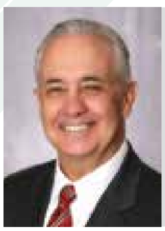
Our local leadership structure emphasizes the importance Merchants places on community involvement and connecting to the local economy. Our commitment to local leadership includes retaining Local Advisory Boards and staffing our locations with Market Presidents and Managers who embrace responsibility for representing the unique needs of local customers and communities, especially as we worked to keep our employees and communities healthy and safe in 2020.



Larry Accola
President, Eau Claire

- 49 years of banking experience
- With Merchants since 2015

Serves on the Board of Directors for the Eau Claire Kiwanis Club (Committee Chair), Advisory Board for the Chippewa Valley Technical College, City of Eau Claire Revolving Loan Funds Committee (Board Chairperson) and volunteers for the Eau Claire Community Table, Wisconsin Logging Museum, and Adopt a Highway



Richard Barry
President, Merchants Bank Equipment Finance

- More than 25 years of equipment finance experience
- With Merchants since 2016

Active member of the Equipment Leasing and Finance Association and serves as an Election Judge in Eden Prairie, Minnesota

Larry Bodin
President, La Crescent and Onalaska

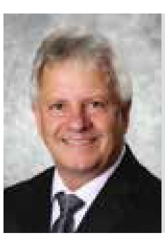
- More than 30 years of banking experience
- With Merchants since 2020

Serves on the Board of Directors for Chileda, Inc. and the VARC Foundation

Jon Dahl
President, Cannon Falls

- More than 35 years of banking experience
- With Merchants since 2020

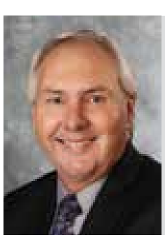
Serves on the Cannon Falls Rotary (Scholarship Committee), Cannon Falls Library Foundation Board, Cannon Arts Board (Treasurer), and is a member of the Cannon Falls Chamber of Commerce and Cannon Falls Economic Development Authority



Bruce Goblirsch
President, Hastings

- 34 years of banking experience
- With Merchants since 2002

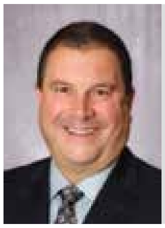
Serves as a Commissioner for the Hastings Economic Development and Redevelopment Authority (HEDRA) and the Growth Committee for the Hastings Area Chamber of Commerce



Ken Graner
President, Lanesboro and Rushford

- 39 years of banking experience
- With Merchants since 2009

Serves as a volunteer for Lanesboro Fire Department and Lanesboro Ambulance and is a member of the Lanesboro Chamber of Commerce and Sons of the American Legion



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- 14 years of banking experience
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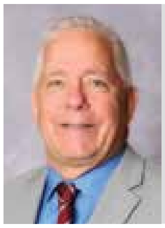
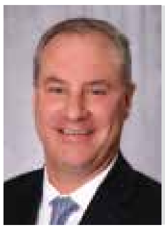


Jon Marley
President, St. Charles

- More than 30 years of banking and ag experience
- With Merchants since 2020

Serves on the St. Charles Economic Development Authority Board



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Regional President, Central Region

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- With Merchants since 2014

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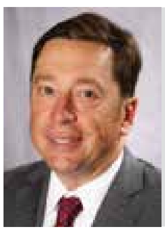
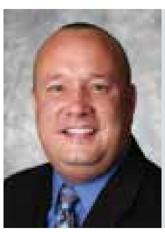


Dan Nistler
President, Rochester

- 21 years of banking experience
- With Merchants since 2013

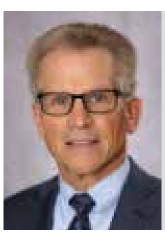
Serves on the Board of Directors for the Rochester Chamber of Commerce and KSMQ Public Television (Treasurer) and on the Rochester Advisory Group for Winona State University, Partnership Council for Greater Rochester Area Universities & Colleges and St. Francis Catholic Church (Finance Committee Chair)



Matt Schuldt
President, Caledonia and Spring Grove

- 19 years of banking experience
- With Merchants since 2014

Serves as President of the City of Caledonia Economic Development Association, President of the Houston County Economic Development Association, President of the ISD 299 Foundation Board and volunteers as a member of the Houston County Airport Commission, Caledonia Rotary, Caledonia Warriors Club Court, Caledonia Founder's Day Committee and Immanuel Lutheran Audit Committee



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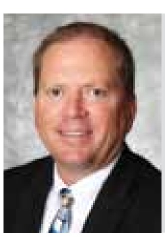


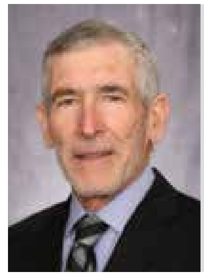
Dan Vlasak
President, Lakeville

- 31 years of banking experience
- With Merchants since 2009

Serves on the Board of Directors for the SBA 504 Development Corporation (Vice President) and the Lakeville Rotary

MERCHANTS FINANCIAL GROUP
BOARD OF DIRECTORS

Scott K. Biesanz
CHAIRMAN OF THE BOARD
Chairman of the Board
Goodson Tools & Supplies for Engine Building



Michael F. Cichanowski
Chief Executive Officer
Wenonah Canoe, Inc.

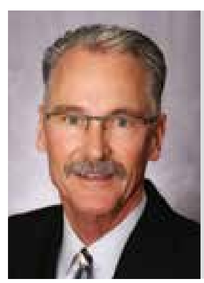
Gregory M. Evans
President & Chief Executive Officer
Merchants Financial Group, Inc. and Merchants Bank, NA

John H. Killen
Senior Vice President Hardgoods
President, WinCraft a Fanatics brand

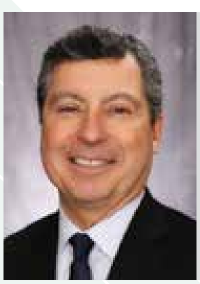
Richard T. Lommen, Jr.
President & Owner
Courtesy Corporation

Ann E. Merchlewitz
Senior Vice President & General Counsel
Saint Mary's University of Minnesota

Bradley J. Peterson
Chairman
Mississippi Welders Supply Co., Inc.



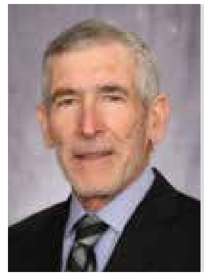
Bruce E. Ryan
President
Ryan Windows & Siding, Inc.



James A. Trenda, CPA
President
CP Advisors, LLC

MERCHANTS BANK
CHARTER BOARD OF DIRECTORS

Scott K. Biesanz
CHAIRMAN OF THE BOARD
Chairman of the Board
Goodson Tools & Supplies for Engine Building



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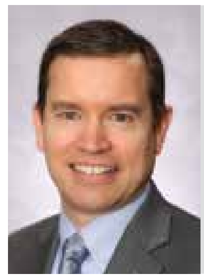
Merchants Financial Group, Inc. and Merchants Bank, NA



Richard J. Falck
Owner & Agent
RJF, Inc.

John H. Killen
Senior Vice President Hardgoods
President, WinCraft a Fanatics brand

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Courtesy Corporation

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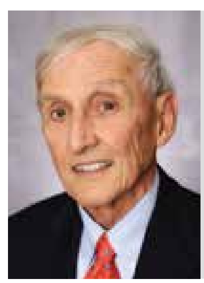
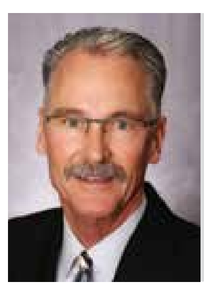


Timothy A. Murphy
Partner
Murphy Law Office, P.L.L.P.

Bradley J. Peterson
Chairman
Mississippi Welders Supply Co., Inc.



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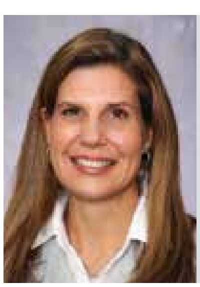
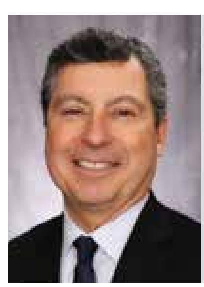


Jennifer R. Sawyer
Founder & Partner
Rebound Partners



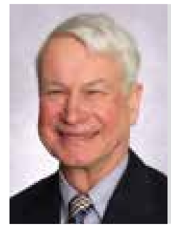
James A. Trenda, CPA
President
CP Advisors, LLC

MERCHANTS BANK ADVISORY BOARDS

CANNON FALLS, HAMPTON AND RED WING

John O. Althoff
Retired Owner
Althoff Hardware
Mayor of Cannon Falls

Leslie M. Anderson
Farmer & Real Estate Broker
Anderson Realty, LLC



Richard A. Peterson
Owner
Peterson Turkey Hatchery, Inc.

Mark A. Poss
Chief Executive Officer
Red Wing Publishing

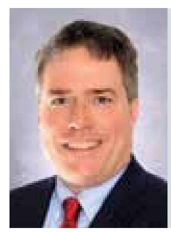
Gary R. Schmidgall
Senior Account Executive
Hancock Concrete Products, LLC

Brenda A. Stelter
Owner
Anchor Promotions, Apparel & Signage

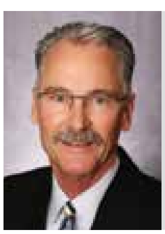
ROCHESTER

John C. Beatty
Attorney
Dunlap & Seeger, PA

Aaron J. Benike
President
Alvin E. Benike, Inc.



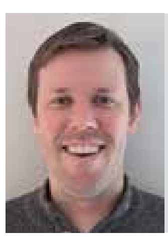
James A. Rogers III
Chief Business Development Officer
Mayo Clinic



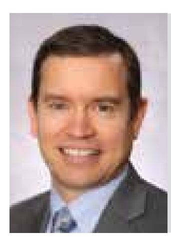
Bruce E. Ryan
President
Ryan Windows & Siding, Inc.

NORTHFIELD

Cheryl A. Buck
Director - Business Development
Professional Risk Managers' International Association



Matthew T. Christensen
Commercial Risk Advisor
WA Group



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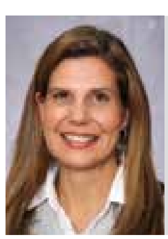
Owner & Agent
RJF, Inc.

Chris J. Kennelly
President
Northfield Construction Company, Bluewater Properties, G & H Management



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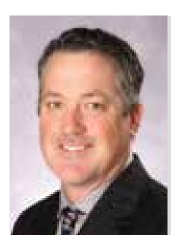
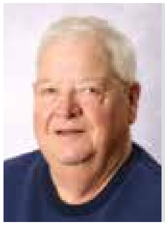
Founder & Partner
Rebound Partners



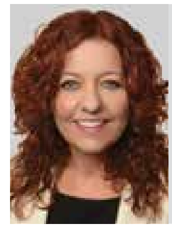
Kevin R. Wright
Managing Partner
Red Pine Communities

APPLE VALLEY, COTTAGE GROVE, HASTINGS, LAKEVILLE AND ROSEMOUNT

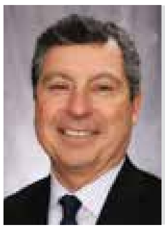


James L. Emond, Sr.
Realtor & Broker
RE/MAX Advantage Plus

Peggy P. Johnson
Community Relations Director
Dakota Electric Association



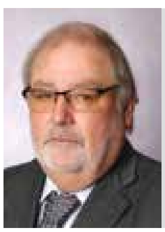
Heide C. Olson
Chief Executive Officer
All In One Accounting



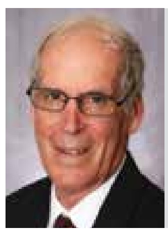
James A. Trenda
President
CP Advisors, LLC

Richard H. Welshons
President
DCA Title

LA CRESCENT AND ONALASKA



Dean L. Ashbacher
President & Chief Executive Officer
Truss Specialists, Inc.



Michael D. Cunningham
Partner, La Crescent Property Ventures, LLC
Former CEO, Owner
The Board Store Furniture & Home Improvements

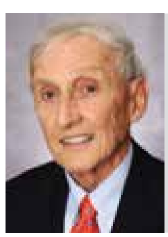
Robert A. Heth, Jr.
President
Heth Hardware, Inc.

Stephen D. Loehr
Vice President of Operations Support
Kwik Trip, Inc.

Richard T. Lommen, Jr.
President & Owner
Courtesy Corporation

CALEDONIA, LANESBORO, RUSHFORD AND SPRING GROVE

John D. Diersen
Owner & Farmer
Minnigan Hills Farm



Timothy A. Murphy
Partner
Murphy Law Office, P.L.L.P.

Joel B. Nelson
Owner
Lanesboro Sales Commission
Decorah Sales Commission

Curtis G. Roverud
Retired President
Roverud Construction, Inc.

Consolidated Financial Report

December 31, 2020
Merchants Financial Group, Inc. and Subsidiaries

CONTENTS

Independent Auditor's Report 25

Financial Statements

Consolidated balance sheets 26

Consolidated statements of income...27

Consolidated statements of comprehensive income 28

Consolidated statements of stockholders' equity.......................29

Consolidated statements of cash flows.......................................30

Notes to consolidated financial statements 31-70

Merchants
Financial Group

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RSM US LLP

Independent Auditor's Report

Audit Committee and Board of Directors
Merchants Financial Group, Inc. and Subsidiary

Report on the Financial Statements
We have audited the accompanying consolidated financial statements of Merchants Financial Group, Inc. and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2020 and 2019; the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for the years then ended; and the related notes to the consolidated financial statements (collectively, the financial statements).

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

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Merchants Financial Group, Inc. and Subsidiary as of December 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter
We have also audited, in accordance with auditing standards generally accepted in the United States of America, Merchants Financial Group, Inc. and Subsidiary's internal control over financial reporting as of December 31, 2020, based on criteria established in *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated February 5, 2021, expressed an unqualified opinion on the effectiveness of Merchants Financial Group, Inc. and Subsidiary's internal control over financial reporting.

RSM US LLP

Rochester, Minnesota
February 5, 2021

Merchants Financial Group, Inc. and Subsidiary

Consolidated Balance Sheets
December 31, 2020 and 2019
(In Thousands, Except Share Information)

Assets		**2020**		2019
Cash and cash equivalents (Note 2)	**$**	**423,575**	$	94,407
Federal funds sold		**395**		377
Available-for-sale securities (Notes 3 and 10)		**114,108**		132,924
Held-to-maturity securities (Notes 3 and 10)		**8,539**		10,278
Loans held for sale (Note 4)		**38,373**		36,260
Loans and direct financing leases, net (Notes 5, 10, 14 and 16)		**1,745,361**		1,682,399
Operating lease assets, net (Note 6)		**10,196**		8,705
Premises and equipment, net (Note 7)		**29,772**		30,434
Investment in restricted stock		**6,604**		5,792
Other real estate and other personal property owned (Note 8)		**2,713**		442
Accrued interest receivable and other assets		**15,263**		12,564
Cash value of life insurance		**47,971**		45,177
Mortgage servicing rights, net (Note 4)		**13,954**		13,730
Goodwill (Note 1)		**35,665**		35,665
Intangibles (Note 1)		**2,408**		3,540
Total assets	**$**	**2,494,897**	$	2,112,694

Liabilities and Stockholders' Equity

Liabilities				
Deposits (Note 9):				
Noninterest-bearing	**$**	**556,800**	$	425,141
Interest-bearing		**1,634,972**		1,390,055
Total deposits		**2,191,772**		1,815,196
Repurchase agreements (Note 10)		**12,716**		9,454
Notes payable (Note 11)		**17,420**		24,996
Subordinated debentures (Note 12)		**41,254**		41,254
Deferred taxes (Note 13)		**8,463**		13,168
Accrued interest payable and other liabilities (Note 13)		**12,483**		11,394
Total liabilities		**2,284,108**		1,915,462
Commitments, Contingencies and Credit Risk (Note 14)				
Stockholders' Equity (Note 17)				
Common stock, par value $0.025 per share; 4,000,000 shares authorized; shares issued: 2,726,247 in 2020 and 2019		**68**		68
Additional paid-in capital		**10,063**		10,058
Retained earnings		**206,822**		189,345
Accumulated other comprehensive gain (Note 3)		**1,511**		318
Unearned ESOP shares (Note 15)		**(7,675)**		(2,557)
Total stockholders' equity		**210,789**		197,232
Total liabilities and stockholders' equity	**$**	**2,494,897**	$	2,112,694

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Income
Years Ended December 31, 2020 and 2019
(In Thousands, Except Per Share Information)

	2020	2019
Interest income:		
Loans	$ 81,937	$ 72,191
Securities	3,007	4,153
Direct financing leases	3,603	6,161
Other	1,787	1,718
	90,334	84,223
Interest expense:		
Deposits	11,096	11,279
Notes payable, federal funds purchased and repurchase agreements	511	1,099
Subordinated debentures	1,502	1,815
	13,109	14,193
Net interest income	77,225	70,030
Provision for loan and lease losses (Note 5)	13,362	2,255
Net interest income after provision for loan and lease losses	63,863	67,775
Noninterest income:		
Trust department	1,812	1,630
Service charges and other fees	5,439	5,834
Loan servicing fees	6,990	6,708
Net gain on sale of available-for-sale securities (Note 3)	-	12
Net gain on sale of loans	23,277	6,156
Net gain (loss) on sale of other real estate and other personal property owned including writedowns (Note 8)	(18)	1
Other	6,791	5,960
	44,291	26,301
Noninterest expenses:		
Salaries and employee benefits (Note 15)	43,514	38,962
Occupancy	13,474	11,821
Net loss on disposal of premises and equipment	40	285
Mortgage servicing rights (Note 4)	7,985	4,109
Other	13,950	11,271
	78,963	66,448
Income before income taxes	29,191	27,628
Provision for income taxes (Note 13)	7,680	7,861
Net income	$ 21,511	$ 19,767
Earnings per common share (Note 1)	$ 8.09	$ 7.41

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income
Years Ended December 31, 2020 and 2019
(In Thousands)

	2020	2019
Net income	**$ 21,511**	$ 19,767
Other comprehensive income, net of reclassification adjustments and income tax effect:		
Change in unrealized gains on securities	**1,780**	2,631
Unrealized loss on interest rate swap	**(587)**	(801)
Total other comprehensive income	**1,193**	1,830
Comprehensive income	**$ 22,704**	$ 21,597

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2020 and 2019
(In Thousands, Except Per Share Information)

	Common Stock	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned ESOP Shares	Total
Balance, December 31, 2018	$ 68	$ 9,532	$ 173,348	$ (1,512)	$ (3,718)	$ 177,718
Cumulative change in accounting principle (Note 1)	-	-	98	-	-	98
Net income	-	-	19,767	-	-	19,767
Other comprehensive income (Note 3)	-	-	-	1,830	-	1,830
ESOP shares purchased	-	-	-	-	(379)	(379)
ESOP shares released for allocation (Note 15)	-	526	-	-	1,540	2,066
Cash dividends declared ($1.45 per share)	-	-	(3,868)	-	-	(3,868)
Balance, December 31, 2019	$ 68	$ 10,058	$ 189,345	$ 318	$ (2,557)	$ 197,232
Net income	-	-	21,511	-	-	21,511
Other comprehensive income (Note 3)	-	-	-	1,193	-	1,193
ESOP shares purchased	-	-	-	-	(6,035)	(6,035)
ESOP shares released for allocation (Note 15)	-	5	-	-	917	922
Cash dividends declared ($1.50 per share)	-	-	(4,034)	-	-	(4,034)
Balance, December 31, 2020	**$ 68**	**$ 10,063**	**$ 206,822**	**$ 1,511**	**$ (7,675)**	**$ 210,789**

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Cash Flows
Years Ended December 31, 2020 and 2019
(In Thousands)

	2020	2019
Cash Flows From Operating Activities		
Net income	$ 21,511	$ 19,767
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization and accretion of bond premiums and discounts	2,684	2,177
Provision for loan and lease losses (Note 5)	13,362	2,255
Net gain on sale of loans	(23,277)	(6,156)
Net change in fair value of loans held for sale	623	65
Proceeds from sales of loans held for sale	890,767	455,697
Originations and purchases of loans held for sale	(874,606)	(477,001)
Net gain on sale of available-for-sale securities (Note 3)	-	(12)
Mortgage servicing rights amortization and provision change (Note 4)	7,985	4,109
Depreciation expense	3,897	3,695
Net charge-offs/write-downs of OREO and other personal property owned (Note 8)	28	129
Loss on disposal of fixed assets	40	285
Deferred income taxes (Note 13)	(5,388)	(420)
Release of shares to ESOP	922	2,066
Increase in cash value of life insurance	(927)	(1,345)
Net gain on sale of OREO and other personal property owned (Note 8)	(10)	(130)
Other	(1,065)	(646)
Net cash provided by operating activities	**36,546**	4,535
Cash Flows From Investing Activities		
Cash flows from securities (Note 18)	20,334	15,573
(Purchases) sales of restricted stock	(812)	2,324
Net increase in federal funds sold	(18)	(377)
Net increase in loans and direct financing leases	(79,759)	(107,816)
Purchases of operating lease assets	(3,556)	(472)
Purchases of premises and equipment	(1,241)	(1,146)
(Purchases) proceeds of life insurance	(1,867)	579
Purchases of mortgage servicing rights	(3,829)	(2,062)
Proceeds from sales of equipment	31	-
Proceeds from sales of OREO and foreclosed assets	1,146	3,031
Net cash paid in business acquisition (Note 21)	-	(6,127)
Net cash used in investing activities	**(69,571)**	(96,493)
Cash Flows From Financing Activities		
Net increase in deposits	376,576	182,502
Net decrease in federal funds purchased	-	(63,699)
Net increase in repurchase agreements (Note 10)	3,262	561
Repayment of long-term borrowings	(11,376)	(1,986)
Proceeds from long-term borrowings	3,800	14,000
ESOP shares purchased	(6,035)	(379)
Cash dividends paid	(4,034)	(3,868)
Net cash provided by financing activities	**362,193**	127,131
Increase in cash and cash equivalents	**329,168**	35,173
Cash and Cash Equivalents		
Beginning	94,407	59,234
Ending	$ 423,575	$ 94,407

See Supplemental Cash Flow Disclosures (Note 18)

Note 1. Basis of Presentation

Nature of business: Merchants Financial Group, Inc. is a bank holding company with one wholly owned bank subsidiary, Merchants Bank, National Association. Merchants Bank, National Association has branch operations in Winona, Goodview, Rushford, Lanesboro, St. Charles, Rochester, La Crescent, Caledonia, Spring Grove, Cannon Falls, Red Wing, Hampton, Hastings, Apple Valley, Lakeville, Cottage Grove, Rosemount, and Northfield, Minnesota; and Onalaska and Eau Claire, Wisconsin. Merchants Bank, National Association provides retail, commercial loan and deposit services principally to customers within a 50-mile radius of its locations. Merchants Bank, National Association has a leasing division, Merchants Bank Equipment Finance, which operates in the Minneapolis–St. Paul metropolitan area.

On April 19, 2019 Merchants Financial Group, Inc. entered into a stock purchase agreement with a holding company that owned all of the issued and outstanding shares of common stock of First National Bank of Northfield. The sale was finalized on August 30, 2019.

Principles of consolidation: The accompanying consolidated financial statements include the accounts of Merchants Financial Group, Inc. and its wholly owned Subsidiary. These entities are collectively referred to herein as the Company. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of accounting estimates: The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term due to economic and legislative changes relate to the determination of the allowance for loan and lease losses, valuation of goodwill, valuation of securities and the fair value of mortgage servicing rights.

Trust and investment assets: The Bank operates trust and investment services. Assets under management by the trust and investment departments, other than trust cash on deposit at the Bank, are not included in these consolidated financial statements because they are not assets of the Company. Total managed trust assets were $363,628 and $302,290 as of December 31, 2020 and 2019, respectively.

Cash, cash equivalents and cash flows: For purposes of reporting cash flows, cash and cash equivalents includes cash on hand and amounts due from banks, including interest-bearing deposits in the Federal Reserve Bank. Cash flows from loans, federal funds sold/purchased, deposits and repurchase agreements are reported net. The Bank maintains cash in deposit accounts which, at times, may exceed federally insured limits. The Bank has not experienced any losses in such accounts. The Bank’s primary correspondent bank account is with U.S. Bank National Association.

Federal funds: The Company has federal funds sold/purchased with correspondent financial institutions intended to support short-term liquidity needs. Interest income and expense on federal funds sold/purchased is included in other interest income and notes payable, federal funds sold, and repurchase agreement interest expense in the consolidated statement of income.

Note 1. Basis of Presentation (Continued)

Securities: Debt securities for which the Company has both the positive intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost. Amortization of premiums and accretion of discounts, computed by the interest method over their contractual lives, are included in interest income.

Securities classified as available-for-sale include debt securities that the Company intends to hold for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations, and other similar factors. Securities available for sale are carried at fair value with unrealized gains or losses reported net of the related deferred tax effect in other comprehensive income. The amortization of premiums and accretion of discounts, computed by the interest method over their contractual lives, are recognized in interest income. Purchase premiums are recognized in interest income using the effective interest method to the first call date. Realized gains or losses, determined on the basis of the amortized cost of specific securities sold, are included in net income.

Declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale, below their amortized cost, that are determined to be other than temporary result in realized losses on the individual securities. If the Company (a) has the intent to sell a debt security or (b) more likely than not will be required to sell the debt security before its anticipated recovery, then the Company recognizes the entire unrealized loss in earnings as an other-than-temporary loss. If neither of these conditions are met, the Company evaluates whether a credit loss exists. The impairment is separated into (a) the amount of the total impairment related to the credit loss and (b) the amount of the total impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings, and the amount related to all other factors is recognized in other comprehensive income.

The assessment of whether such impairment has occurred is based on management's case-by-case evaluation of the underlying reasons for the decline in fair value. Management considers a wide range of factors in making this assessment. Those factors include, but are not limited to, the length and severity of the decline in value and changes in the credit quality of the issuer or underlying assets.

Loans held for sale: Loans the Company originates with the intent to sell in the secondary market are classified as held for sale. Loans held for sale consist of first mortgage loans that are secured by residential real estate. The Company elected the fair value option for loans held for sale, and accordingly, all loans held for sale are recorded at fair value.

The fair value of the loans held for sale also includes the fair value of mandatory delivery commitments to an end investor that are considered derivatives. These commitments include the investor's purchase price of a specific loan or pool of loans to be delivered to an investor by a certain date.

The fair value of loans held for sale is determined using current secondary market prices for loans with similar coupons, maturities and credit quality.

Loans and direct lease financing receivables (loans): Loans are stated at the amount of unpaid principal reduced by unearned income and an allowance for loan and lease losses.

Note 1. Basis of Presentation (Continued)

Interest on loans is recognized over the terms of the loans using the simple-interest method on principal amounts outstanding. The Company determines a loan to be delinquent when payments have not been made according to contractual terms, typically evidenced by nonpayment of a monthly installment by the due date. Accrual of interest is discontinued when management believes, after considering collection efforts and other factors, that the borrower's financial condition is such that collection of interest is doubtful. The accrual of interest is generally discontinued at the time the loan is 90 days delinquent, unless the credit is well-secured and in the process of collection. Cash collections on nonaccrual loans are credited to the loan receivable balance, and no interest income is recognized on those loans until the past-due principal balance has been collected. Accrual of interest is generally resumed when the customer is current on all principal and interest payments and has been paying on a timely basis for a period of time.

The Company's leasing operations consist of the leasing of various types of equipment and trucks used in manufacturing, construction and agricultural operations. For direct financing leases, the total net rentals receivable and the estimated residual value of the leased equipment, net of unearned income, are recorded as a net investment in direct financing leases, and the unearned income is recognized each month as it is earned so as to provide a constant periodic rate of return on the unrecovered investment.

Accrual of interest on impaired loans and leases is discontinued when management believes the borrower's financial condition is such that collection of interest is doubtful. Impaired loans also include loans that have been renegotiated in a troubled debt restructuring. Cash collections on impaired loans are generally credited to the loan balance, and no interest income is recognized on those loans until the principal balance has been determined to be collectible.

A loan or lease is classified as a troubled debt restructuring when a borrower is experiencing financial difficulties that lead to a restructuring of the loan or lease, and the Company grants concessions to the borrower in the restructuring that it would not otherwise consider. These concessions may include rate reductions, principal forgiveness, extension of maturity date, and other actions intended to minimize potential losses. A loan or lease that is modified at a market rate of interest may no longer be classified as a troubled debt restructuring in the calendar year subsequent to the restructuring if it is in compliance with the modified terms. Performance prior to the restructuring is considered when assessing whether the borrower can meet the new terms and may result in the loan being returned to accrual at the time of the restructuring or after a shorter performance period.

Allowance for loan and lease losses: The allowance for loan and lease losses is established through a provision for loan and lease losses charged to expense. Loans and direct financing leases are charged against the allowance for loan and lease losses when management believes that collectability of the principal is unlikely. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb estimated losses on existing loans, based on evaluation of the collectability of loans and prior loan loss experience. This evaluation also takes into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to pay. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan and lease losses and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examination.

Note 1. Basis of Presentation (Continued)

The allowance for loan and lease losses consists of specific and general components:

Specific components: The Company considers a loan impaired when it is probable the Company will be unable to collect all principal and interest payments due in accordance with the terms of the loan agreement. Impaired loans are measured based on the present value of expected future cash flows or, alternatively, the observable market price of the loans or the fair value of the collateral. However, for those loans that are collateral dependent (that is, if repayment of those loans is expected to be provided solely by the underlying collateral) and for which management has determined foreclosure is probable, the measure of impairment is based on the fair value of the collateral less estimated costs to sell.

General components: Nonimpaired loans are categorized into pools of loans with similar risk and loss characteristics and assessed for probable losses. These loan pools include commercial; commercial real estate; agricultural, including real estate; residential real estate; consumer; and direct financing leases. Historical loss experience, adjusted for qualitative factors, is multiplied by the total of each loan pool to determine an appropriate level of allowance by loan type.

These qualitative factors include consideration of the following: changes in the lending policies and procedures, including underwriting standards and collection, charge off, and recovery practices; changes in the national and local economic and business conditions and developments, including the condition of various market segments and COVID-19; changes in the nature and volume of the loan portfolio; changes in the experience, ability and depth of lending management and staff; changes in the trend of the volume and severity of past due and classified loans, nonaccrual loans, troubled debt restructurings and other loan modifications; changes in the quality of the institution's loan review system and the degree of oversight of the institution's board of directors; the existence and effect of any concentrations of credit, and changes in the level of such concentrations; the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio; foreclosure and personal bankruptcy trends; changes in levels and trends in charge offs and recoveries with consideration given to the year-to-date trends.

Acquired loans: Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date without a carryover of the related allowance for loan and lease losses. Purchased loans that are not impaired are accounted for in accordance with *FASB Accounting Standards Codification* (ASC) Topic 310-20, Nonrefundable Fees and Others Costs, as these loans do not have evidence of credit deterioration since origination. Purchased loans that have become impaired after origination but before acquisition (PCI Loans) are accounted for in accordance with ASC Topic 310-30. For nonimpaired purchased loans, the difference between the estimated fair value of the loans (computed on a loan-by-loan basis) and the principal outstanding is accreted or amortized into interest income over the remaining life of the loans.

In accordance with ASC 310-30, for PCI Loans, the difference between contractually required payments at acquisition and the cash flows expected to be collected is referred to as the nonaccretable difference. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows. Loans with no accretable yield are placed on nonaccrual and any payments received are credited to principal first, before any income will be recognized.

Note 1. Basis of Presentation (Continued)

Operating leases: For operating leases in which the Company is the lessor, the cost of the equipment is recorded as an asset and is depreciated over its estimated useful life and the rental income is recognized ratably as the lease rental payments are earned. Rental income is included in the caption, other noninterest income, in the consolidated statements of income.

Investment in restricted stock: The Company is a member of the Federal Home Loan Bank of Des Moines (FHLB) and, as such, is required to maintain a minimum investment in capital stock of the Federal Home Loan Bank that varies with the level of advances outstanding. The stock is bought from and sold to the FHLB based upon its $100 par value. The stock does not have a readily determinable fair value and, as such, is classified as restricted stock, carried at cost, and evaluated for impairment in accordance with guidance for depository and lending institutions. In accordance with this guidance, the stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted, (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance, (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB.

Management has determined that the FHLB stock and Federal Reserve Bank stock were not impaired at December 31, 2020 and 2019.

Premises and equipment: Premises and equipment are stated at cost less accumulated depreciation. Depreciation is provided principally on a straight-line basis over the estimated useful lives of the assets.

Gain on sale of loans: Mortgage banking activity revenue recognition begins when the Company is committed to originate a loan with a borrower at an agreed-upon interest rate (interest rate loan commitment, IRLC). The revenue recognition ends when the Company sells the loan to an investor (Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 815). The IRLC is considered a derivative and is recorded as an asset at its estimated fair value. The fair value of the IRLC is determined after considering the contractual loan origination-related fees, estimated sales premium, direct loan origination costs and the estimated fair value of the expected net future cash flows associated with servicing the loan. Also included in gain on sale of loans are the unrealized gains and losses from the various derivative instruments utilized by the Company to hedge the interest rate risk associated with its mortgage banking activities. These derivatives include the fair value of loan sales commitments and forward sale commitments. Further, the gain also includes the unrealized gains and losses on loans held for sale that occur during the period from the date of its funding through the date of its sale to an end investor.

Loans are accounted for as sold when control of the mortgage loans is surrendered. Control over mortgage loans is deemed to be surrendered when (1) the mortgage loans have been isolated from the Company, (2) the buyer has the right (free of conditions that constrain the buyer from taking advantage of that right) to pledge or exchange the mortgage loans, and (3) the Company does not maintain effective control of the mortgage loans through either (a) an agreement that entitles and obligates the Company to repurchase or redeem the mortgage loans before maturity or (b) the ability to unilaterally cause the buyer to return specific mortgage loans.

(In Thousands, Except Share Information)

Note 1. Basis of Presentation (Continued)

Loan servicing: The Company sells loans to investors in the secondary market and generally retains the right to service mortgage loans originated or purchased from unaffiliated correspondent banks. Mortgage servicing rights retained are initially measured at fair value and have been recognized as a separate asset and are being amortized in proportion to and over the period of estimated net servicing income.

Mortgage servicing rights are periodically evaluated for impairment based on the fair value of those rights. Fair values are estimated using discounted cash flows based on current market rates of interest. For purposes of measuring impairment, the rights must be stratified by one or more predominant risk characteristics of the underlying loans. The Company stratifies its capitalized mortgage servicing rights based on the interest rates of the underlying loans. The amount of impairment recognized is the amount, if any, by which the amortized cost of the rights for each stratum exceeds their fair value.

The Company recognizes it could experience some make-whole costs for loans serviced that are sold on the secondary market. If those mortgages go through foreclosure and there is a loss, the government sponsored entity may require the Company to cover any losses if it is proven that the Company failed to follow underwriting requirements at the time. In order to estimate the necessary reserve for this loss, management analyzed the historical claims rate and the loss severity for the origination years from 2000 through 2020 and applied that to the outstanding balances. As the government sponsored entities are no longer reviewing loans they acquired prior to 2009, a discount was applied to those remaining balances. Finally, management analyzed the improvement in the economy from 2009 to 2020 and applied an adjustment factor to recognize the improvement. The secondary market buyback reserve at December 31, 2020 and 2019 was $175.

Derivative assets and liabilities: All derivatives are recognized as either assets or liabilities in the consolidated balance sheets, measured at fair value, and are reported in accrued interest receivable and other assets on the balance sheet.

Goodwill: Represents the excess of the purchase price over the fair value of net assets acquired in business combinations. Goodwill is subject to an impairment test at least on an annual basis. The Company’s goodwill impairment assessments in 2020 and 2019 concluded no impairment existed. Any future impairment will be recorded as noninterest expense in the period of assessment.

Intangibles: The core deposit intangible represents the capacity of the deposit accounts acquired in an acquisition to generate future income. The core deposit intangible is being amortized over the estimated three to eight year lives attributed to the deposits acquired, on a straight-line basis. The amortization of the core deposit intangible was $1,132 and $425 in 2020 and 2019, respectively. Future amortization of the core deposit intangible is as follows:

Years Ending December 31,	
2021	$ 914
2022	697
2023	480
2024	263
2025	54
	$ 2,408

Note 1. Basis of Presentation (Continued)

Bank-owned life insurance: The Company owns life insurance policies on certain key employees. Bank-owned life insurance is recorded at its cash surrender value, or the amount that can be realized if lower.

Interest rate swaps: The Company uses derivative instruments to primarily protect against the risk of adverse interest rate movements on the cash flows of certain liabilities. Derivative instruments represent contracts between parties that usually require little or no initial net investment and result in one party delivering cash or another type of asset to the other party based upon a notional amount and an underlying asset as specified in the contract. A notional amount represents the number of units of a specific item, such as currency units. An underlying asset represents a variable, such as an interest rate or price index. The amount of cash or other asset delivered from one party to the other is determined based upon the interaction of the notional amount of the contract with the underlying asset. Derivatives can also be implicit in certain contracts and commitments and are reported in accrued interest receivable and other assets on the balance sheet.

Other real estate and other personal property owned: Other real estate owned (OREO) and other personal property owned represent properties acquired through foreclosure or other proceedings. OREO and other personal property owned are initially recorded at fair value of the properties less estimated costs of disposal. Any write-down to fair value less estimated costs of disposal at the time of transfer to OREO and other personal property owned is charged to the allowance for loan and lease losses. Property is evaluated regularly to ensure that the recorded amount is supported by its current fair value less estimated costs of disposal. Subsequent write-downs are charged to other noninterest expenses.

Deferred taxes: Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss or tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the amounts of assets and liabilities recorded for income tax and financial reporting purposes. Deferred tax assets are reduced by a valuation allowance when management determines that it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Employee stock ownership plan: The Company provides a noncontributory employee stock ownership plan covering substantially all employees eligible as to age and length of service. The amount of the contribution to the plan is determined annually at the discretion of the Board of Directors. Contributions are allocated to participants based on the ratio of each participant’s compensation to total compensation of all participants.

Salary 401(k) plan: The Company provides a 401(k) plan, which covers substantially all of the Company’s employees who are eligible as to age and length of service. A participant may elect to make contributions of up to the maximum allowed by law of the participant’s annual compensation. The Company makes matching contributions up to three hundred dollars for each participant. Matching contributions of $146 and $119 were made in 2020 and 2019, respectively.

Earnings per common share: Basic earnings per share is calculated by dividing net income by the weighted-average common shares outstanding during the year. ESOP shares allocated to participants and shares released for allocation are treated as outstanding for purposes of computing weighted-average common shares outstanding. The weighted-average number of shares of common stock used to compute basic earnings per share was 2,659,897 and 2,667,438 in 2020 and 2019, respectively.

Note 1. Basis of Presentation (Continued)

Comprehensive income: Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on cash flow hedges and available-for-sale securities, are reported on the consolidated statement of comprehensive income. Such items, along with net income, are components of comprehensive income. Gains and losses on available-for-sale securities are reclassified to net income as the gains or losses are realized upon sale of the securities. Other-than-temporary impairment charges are reclassified to net income at the time of the charge.

Subsequent events: In preparing these consolidated financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through February 5, 2021, the date the consolidated financial statements were available to be issued.

New Accounting Pronouncements:
In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): *Simplifying the Test for Goodwill Impairment*. The ASU simplifies the measurement of goodwill impairment by eliminating the requirement that an entity compute the implied fair value of goodwill based on the fair values of its assets and liabilities to measure impairment. Instead, goodwill impairment will be measured as the difference between the fair value of the reporting unit and the carrying value of the reporting unit. The ASU also clarifies the treatment of the income tax effect of tax deductible goodwill when measuring goodwill impairment loss. This ASU is effective for the Company in fiscal years beginning after December 15, 2022, with early adoption permitted. The Company is evaluating the effect of adopting ASU 2017-04. The adoption of this guidance is not expected to have a material impact on the consolidated financial statements.

Note 1. Basis of Presentation (Continued)

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*, which creates a new credit impairment standard for financial instruments. The existing incurred loss model will be replaced with a current expected credit loss ("CECL") model for both originated and acquired financial instruments carried at amortized cost and off-balance sheet credit exposures, including loans, loan commitments, held-to-maturity debt securities, financial guarantees, net investment in leases, and most receivables. Recognized amortized cost financial assets will be presented at the net amount expected to be collected through an allowance for credit losses. Expected credit losses on off-balance sheet credit exposures will be recognized through a liability. Expected credit losses on available-for-sale (“AFS”) debt securities will also be recognized through an allowance, however the allowance for an individual AFS debt security will be limited to the amount by which fair value is below amortized cost. Unlike current guidance, which requires certain favorable changes in expected cash flows to be accreted into interest income, both favorable and unfavorable changes in expected credit losses (and therefore the allowance) will be recognized through credit loss expense as they occur. With the exception of purchased financial assets with a more than insignificant amount of credit deterioration since origination, for which the initial allowance will be added to the purchase price of the assets, the initial allowance on financial assets subject to the scope (whether originated or acquired) will be recognized through credit loss expense.

Expanded disclosures will also be required. Transition will generally be on a modified retrospective basis, with certain prospective application transition provisions for securities for which other-than-temporary impairment had previously been recognized and for assets that had previously been accounted for in accordance with Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality. This ASU is effective for the Company in fiscal years beginning after December 15, 2022. Early adoption is permitted. The Company is currently evaluating the impact of adopting this new guidance on the consolidated financial statements.

Note 2. Restrictions on Cash and Cash Equivalents

The subsidiary banks are required to maintain reserve balances, in cash on premises or on deposit with the Federal Reserve Bank, based upon a percentage of deposits. The total restricted cash balances as of December 31, 2020 and 2019, were $0 and $14,824, respectively.

(In Thousands, Except Share Information)

Note 3. Securities

The amortized cost and fair value of securities, with gross unrealized gains and losses, follows:

	December 31, 2020			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
GSE residential mortgage-backed securities	$ 70,932	$ 3,112	$ -	$ 74,044
GSE collateralized residential mortgage obligations	11,795	289	-	12,084
Obligations of states and political subdivisions	998	17	-	1,015
US government corporations and agencies	8,828	-	(77)	8,751
GSE commercial mortgage-backed securities	18,144	104	(34)	18,214
Total securities available for sale	$ 110,697	$ 3,522	$ (111)	$ 114,108
Securities held to maturity:				
GSE residential mortgage-backed securities	$ 6,130	$ 311	$ -	$ 6,441
GSE collateralized residential mortgage obligations	1,631	42	-	1,673
Obligations of states and political subdivisions	778	21	-	799
Total securities held to maturity	$ 8,539	$ 374	$ -	$ 8,913

	December 31, 2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
GSE residential mortgage-backed securities	$ 93,477	$ 1,203	$ (96)	$ 94,584
GSE collateralized residential mortgage obligations	16,378	12	(76)	16,314
Obligations of states and political subdivisions	1,266	11	-	1,277
US government corporations and agencies	11,298	-	(58)	11,240
GSE commercial mortgage-backed securities	9,565	-	(56)	9,509
Total securities available for sale	$ 131,984	$ 1,226	$ (286)	$ 132,924
Securities held to maturity:				
GSE residential mortgage-backed securities	$ 7,165	$ 206	$ -	$ 7,371
GSE collateralized residential mortgage obligations	2,160	-	(32)	2,128
Obligations of states and political subdivisions	953	14	-	967
Total securities held to maturity	$ 10,278	$ 220	$ (32)	$ 10,466

GSE indicates government-sponsored enterprises, such as Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC).

(In Thousands, Except Share Information)

Note 3. Securities (Continued)

Contractual maturities at December 31, 2020:

	Securities Held to Maturity		Securities Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in three months or less	$ 80	$ 80	$ 561	$ 562
Due after three months through 12 months	-	-	1	1
Due after one year through three years	166	168	247	252
Due after three years through five years	316	321	89	89
Due after five years through 15 years	216	230	100	111
	778	799	998	1,015
GSE residential mortgage-backed securities	6,130	6,441	70,932	74,044
US government corporations and agencies	-	-	8,828	8,751
GSE collateralized residential mortgage obligations	1,631	1,673	11,795	12,084
GSE commercial mortgage-backed securities	-	-	18,144	18,214
	$ 8,539	$ 8,913	$ 110,697	$ 114,108

Maturities of residential mortgage-backed securities and collateralized residential mortgage obligations are not readily determinable, since they may be prepaid without penalty.

There were no realized gains or losses in 2020 and $53 in realized gains and $41 in realized losses in 2019.

Changes in the unrealized gain (loss) on available-for-sale securities:

	Years Ended December 31	
	2020	2019
Balance, beginning	$ 677	$ (1,954)
Unrealized holding gain (loss) during the year	2,471	3,578
Less reclassification adjustment for gains realized in net income	-	(12)
Deferred tax effect of unrealized gain (loss)	(691)	(935)
Balance, ending	$ 2,457	$ 677

(In Thousands, Except Share Information)

Note 3. Securities (Continued)

Summary of accumulated other comprehensive income (loss):

	December 31 2020	December 31 2019
Available-for-sale securities	$ 2,457	$ 677
Interest rate swaps (Note 19)	(946)	(359)
Balance, ending	$ 1,511	$ 318

The following tables summarize the Company's investments in an unrealized loss position at December 31, 2020 and 2019, that are not deemed to be other-than-temporarily impaired:

December 31, 2020	Continuous Unrealized Losses Existing for 12 Months or Less		Continuous Unrealized Losses Existing for Greater Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities available for sale:						
US government corporations and agencies	$ -	$ -	$ 8,751	$ (77)	$ 8,751	$ (77)
GSE commercial mortgage-backed securities	6,972	(34)	-	-	6,972	(34)
Total securities available for sale	$ 6,972	$ (34)	$ 8,751	$ (77)	$ 15,723	$ (111)

December 31, 2019	Continuous Unrealized Losses Existing for 12 Months or Less		Continuous Unrealized Losses Existing for Greater Than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities available for sale:						
GSE residential mortgage-backed securities	$ 10,750	$ (22)	$ 16,216	$ (74)	$ 26,966	$ (96)
GSE collateralized residential mortgage obligations	9,659	(58)	5,642	(18)	15,301	(76)
US government corporations and agencies	1,000	(1)	10,240	(57)	11,240	(58)
GSE commercial mortgage-backed securities	9,509	(56)	-	-	9,509	(56)
Total securities available for sale	$ 30,918	$ (137)	$ 32,098	$ (149)	$ 63,016	$ (286)
Securities held to maturity:						
GSE collateralized residential mortgage obligations	$ -	$ -	$ 2,128	$ (32)	$ 2,128	$ (32)

(In Thousands, Except Share Information)

Note 3. Securities (Continued)

There were 4 securities in 2020 in unrealized loss positions at December 31, 2020. The Company believes the unrealized loss position in GSE residential mortgage-backed securities is temporary, as based on current estimated prepayment speeds the Company intends to hold these securities until paid-off, at which time the investments will pay face value. The Company does not believe there to be any deterioration in the credit quality of the bonds that would indicate other-than-temporary impairment, but rather, the unrealized loss is the result of either an increase in the general level of interest rates or other external economic factors.

Pledged securities: Securities with a carrying value of $91,234 and $100,219 at December 31, 2020 and 2019, respectively, were pledged to secure public deposits, FHLB repurchase agreements, and for other purposes as required or permitted by law.

Note 4. Loans Held for Sale and Loan Servicing

Loans held for sale consist of the following:

	December 31	
	2020	2019
Loans held for sale, unpaid principal balance	$ 37,369	$ 35,879
Fair value adjustment	1,004	381
Total loans held for sale	$ 38,373	$ 36,260

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans are as follows:

	December 31	
	2020	2019
Mortgage loan portfolios serviced for:		
FNMA	$ 2,286,473	$ 2,331,111
FHLMC	286,146	223,687
	$ 2,572,619	$ 2,554,798
Outstanding commitments at year-end:		
Commitments to fund loans	$ 122,953	$ 39,812
Commitments to sell loans	107,485	68,157

(In Thousands, Except Share Information)

Note 4. Loans Held for Sale and Loan Servicing (Continued)

Mortgage servicing rights, net of valuation allowance, are summarized as follows:

	Years Ended December 31	
	2020	2019
Balance at beginning of year, net	$ 13,730	$ 12,950
Mortgage servicing rights capitalized:		
Loans originated	4,380	2,827
Loans purchased	3,829	2,062
Amortization expense	(7,985)	(4,109)
Balance at end of year, net	$ 13,954	$ 13,730

The valuation allowance at December 31, 2020 and 2019 was not significant. The estimated fair value of the servicing assets aggregated $15,988 and $22,656 at December 31, 2020 and 2019, respectively. Fair value is estimated by discounting estimated future cash flows from the servicing assets using discount rates that approximate current market rates and using current expected future prepayment rates.

Note 5. Loans and Direct Financing Leases

Composition of loans and direct financing leases receivable:

	December 31	
	2020	2019
Commercial	$ 553,788	$ 440,563
Commercial real estate	736,315	730,880
Agricultural, including real estate	149,408	166,748
Residential real estate	214,123	230,993
Consumer	53,615	60,281
Direct financing leases	79,201	79,157
Total loans	1,786,450	1,708,622
Less unearned income on loans and leases	9,469	6,938
Less allowance for loan and lease losses	31,620	19,285
Loans receivable, net	$ 1,745,361	$ 1,682,399

Note 5. Loans and Direct Financing Leases (Continued)

Commercial loans also include loans originated under the Paycheck Protection Program (PPP). The PPP is a small business loan program established by the 2020 US Federal government Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to help certain businesses continue paying their workers. The PPP allows entities to apply for low-interest private loans to pay for their payroll and certain other costs. The loans may be partially or fully forgiven if the business keeps its employee counts and wages stable. Given the program is guaranteed by the Small Business Administration, the Company does not expect to realize credit losses on these loans. As such, no provision for loan losses has been reserved for the loans originated under the PPP. As of December 31, 2020, the Company had $152,732 of loans outstanding under this program. The Company's unearned income on loans and leases includes $3,574 of net deferred loan fees related to PPP loans at December 31, 2020.

Loans pledged to the Federal Home Bank of Des Moines for notes payable are discussed at Note 11.

Loans are made to individuals as well as commercial and tax-exempt entities. Specific loan terms vary as to interest rate, repayment and collateral requirements based on the type of loan requested and the creditworthiness of the prospective borrower. Credit risk tends to be geographically concentrated in that a majority of the loan customers are located in the markets serviced by the Company.

The Company’s extension of credit is governed by the individual loan policies that were established to control the quality of the Company’s loans. These policies and procedures are reviewed and approved by the Board of Directors on a regular basis.

Commercial loans: Commercial operating and term loans are originated in the Company’s primary service area. These loans are made to individuals, partnerships, corporations, limited liability partnerships and limited liability companies for the purpose of assisting in the development of a business enterprise. Loans to closely held businesses will generally be guaranteed in full or for a meaningful amount by the business’ major owners. Commercial loans are made based primarily on the historical and projected cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not perform as forecasted, and collateral securing loans may fluctuate in value due to economic or individual performance factors. Minimum standards and underwriting guidelines have been established for all commercial loan types.

Commercial real estate loans: The Company’s goal is to create and maintain a high-quality portfolio of commercial real estate loans with customers who meet the quality and relationship profitability objectives of the Company. Commercial real estate loans are subject to underwriting standards and processes similar to commercial operating and term loans. These loans are analyzed using projected cash flows, and the repayment of these loans is largely dependent on the successful operation of the property. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to the real estate market, such as geographic location and property type.

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Agricultural, including real estate: Agricultural operating and term loans are originated in the Company's primary service area and are generally used to purchase agricultural equipment or crop inputs. These loans are primarily secured by agricultural real estate and agricultural equipment or crops. Agricultural term and operating loans are made based primarily on the historical and projected cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not behave as forecasted, and collateral securing loans may fluctuate in value due to economic or individual performance factors. Minimum standards and underwriting guidelines have been established for all agricultural loan types.

The Company originates loans secured by agricultural real estate in its service area. Agricultural land in the Company's service area is considered to be prime agricultural land. These loans are underwritten using both a cash flow analysis and appraised values.

Residential real estate loans: The Company originates residential real estate loans in its service area. The underwriting process consists of a credit analysis, employment history, and an analysis of the secured real estate property. A significant portion of the residential real estate loans originated is sold in the secondary market and is required to meet the underwriting standards of the purchaser.

Consumer loans: The Company originates direct consumer loans, including personal, credit cards, recreational and vehicle loans, using a credit analysis as part of the underwriting process. Each loan type has a separate specified scoring that consists of several factors, including debt to income, type of collateral, loan to collateral value, credit history and the Company's relationship with the borrower.

Direct financing leases: Direct financing leases are originated in the forty-eight continental United States, and the equipment leased consists primarily of manufacturing, technology, transportation, construction, retail petroleum, commercial laundry and dry-cleaning, and agricultural equipment. Direct financing leases are made based primarily on the historical and projected cash flow of the lessee and secondarily on the underlying equipment leased to the lessee. The cash flows of lessees, however, may not perform as forecasted, and collateral securing these leases may fluctuate in value due to economic or individual performance factors. Minimum standards and underwriting guidelines have been established for all direct financing leases.

Minimum lease payments: At December 31, 2020, the minimum future lease payments, including guaranteed residual values, unearned initial direct costs and unearned amounts, due under the direct financing leases are as follows:

Years Ending December 31,	
2021	$ 27,550
2022	20,728
2023	14,893
2024	9,060
2025	5,538
Thereafter	1,432
	$ 79,201

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Loans receivable aging by class:

	December 31, 2020					
	Current	30–59 Days Past Due	60–89 Days Past Due	Loans Past Due 90 Days or More	Total Past Due	Total
Commercial	$ 548,572	$ 4,002	$ 749	$ 465	$ 5,216	$ 553,788
Commercial real estate	734,922	892	96	405	1,393	736,315
Agricultural, including real estate	149,011	-	397	-	397	149,408
Residential real estate	210,473	2,753	193	704	3,650	214,123
Consumer	52,781	746	-	88	834	53,615
Direct financing leases	78,308	743	-	150	893	79,201
Total loans	$ 1,774,067	$ 9,136	$ 1,435	$ 1,812	$ 12,383	$ 1,786,450
Nonperforming loans	$ 16,534	$ 792	$ 828	$ 1,812	$ 3,432	$ 19,966

	December 31, 2019					
	Current	30–59 Days Past Due	60–89 Days Past Due	Loans Past Due 90 Days or More	Total Past Due	Total
Commercial	$ 437,000	$ 2,058	$ 743	$ 762	$ 3,563	$ 440,563
Commercial real estate	728,670	1,268	742	200	2,210	730,880
Agricultural, including real estate	166,537	101	-	110	211	166,748
Residential real estate	227,112	2,266	1,191	424	3,881	230,993
Consumer	59,649	611	4	17	632	60,281
Direct financing leases	78,265	822	-	70	892	79,157
Total loans	$ 1,697,233	$ 7,126	$ 2,680	$ 1,583	$ 11,389	$ 1,708,622
Nonperforming loans	$ 19,279	$ 1,109	$ 303	$ 1,583	$ 2,995	$ 22,274

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Recorded investment in nonaccrual loans and loans past due 90 days or more and still accruing by class of loans as of December 31, 2020 and 2019, were as follows:

	Nonaccrual	Loans Past Due 90 Days or More and Still Accruing
2020		
Commercial	$ 4,451	$ 80
Commercial real estate	4,353	-
Agricultural, including real estate	6,526	-
Residential real estate	2,527	-
Consumer	88	76
Direct financing leases	1,715	150
Total	$ 19,660	$ 306
2019		
Commercial	$ 2,239	$ 314
Commercial real estate	5,649	-
Agricultural, including real estate	11,246	-
Residential real estate	2,170	127
Consumer	120	17
Direct financing leases	322	70
Total	$ 21,746	$ 528

The Company utilizes an internal asset classification system as a means of reporting problem and potential problem loans. Under the Company's risk rating system, the Company classifies problem and potential problem loans as "special mention," "substandard" and "doubtful." Substandard loans include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Loans classified as doubtful have all the weaknesses inherent in those classified as 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. Loans that do not currently expose the Company to sufficient risk to warrant classification in one of the aforementioned categories, but possess weaknesses that deserve management's close attention, are deemed to be special mention. Risk ratings are updated any time the situation warrants.

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Loans not meeting the criteria above that are analyzed individually as part of the above-described process are considered to be pass-rated loans. Residential real estate and consumer loans are included in groups of homogeneous loans with similar risk and loss characteristics that are not rated. The following tables present the risk category of loans by class of loans based on the most recent analysis performed and the contractual aging as of December 31, 2020:

	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 525,487	$ 2,012	$ 26,289	$ -	$ 553,788
Commercial real estate	664,545	27,551	44,219	-	736,315
Agricultural, including real estate	127,338	4,385	17,685	-	149,408
Direct financing leases	76,433	-	2,768	-	79,201
Total	$ 1,393,803	$ 33,948	$ 90,961	$ -	$ 1,518,712

	Pass	Special Mention	Substandard	Doubtful	Total
Current	$ 1,388,942	$ 33,948	$ 87,923	$ -	$ 1,510,813
Past due 30–59 days	4,216	-	1,421	-	5,637
Past due 60–89 days	414	-	828	-	1,242
Past due 90 days or more	231	-	789	-	1,020
Total	$ 1,393,803	$ 33,948	$ 90,961	$ -	$ 1,518,712

The following tables present the risk category of loans by class of loans based on the most recent analysis performed and the contractual aging as of December 31, 2019:

	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 411,265	$ 19,129	$ 10,169	$ -	$ 440,563
Commercial real estate	701,800	13,025	16,055	-	730,880
Agricultural, including real estate	106,794	16,745	43,209	-	166,748
Direct financing leases	74,131	2,745	2,281	-	79,157
Total	$ 1,293,990	$ 51,644	$ 71,714	$ -	$ 1,417,348

	Pass	Special Mention	Substandard	Doubtful	Total
Current	$ 1,289,662	$ 51,202	$ 69,608	$ -	$ 1,410,472
Past due 30–59 days	3,147	442	660	-	4,249
Past due 60–89 days	1,111	-	374	-	1,485
Past due 90 days or more	70	-	1,072	-	1,142
Total	$ 1,293,990	$ 51,644	$ 71,714	$ -	$ 1,417,348

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Commercial, commercial real estate, and agricultural, including real estate loans and direct financing leases are individually evaluated to determine if they are impaired. The Company generally evaluates residential real estate and consumer loans collectively for impairment, but such loans can be individually evaluated when included in a relationship with commercial, commercial real estate and agricultural-type loans. The Company evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. Loans for which credit quality or aging indicates potential weakness are placed on nonaccrual and are deemed to be nonperforming.

Impaired loans by class as of December 31, 2020 and 2019 were as follows:

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment
2020:				
Evaluated for impairment with a related allowance recorded:				
Commercial	$ 1,868	$ 1,868	$ 692	$ 1,485
Commercial real estate	2,062	2,062	866	1,031
Agricultural, including real estate	57	57	1	98
Residential real estate	153	153	11	111
Consumer	102	102	58	105
Direct financing leases	3,038	3,038	830	1,751
Evaluated for impairment with no related allowance recorded:				
Commercial	338	338	-	756
Commercial real estate	2,416	2,416	-	4,061
Agricultural, including real estate	8,607	8,607	-	10,376
Residential real estate	2,729	2,729	-	2,848
Consumer	12	12	-	42
Direct financing leases	61	61	-	103
Total	$ 21,443	$ 21,443	$ 2,458	$ 22,767
2019:				
Evaluated for impairment with a related allowance recorded:				
Commercial	$ 1,102	$ 1,102	$ 449	$ 870
Commercial real estate	-	-	-	-
Agricultural, including real estate	138	138	3	118
Residential real estate	70	70	17	123
Consumer	108	108	87	172
Direct financing leases	464	464	155	739
Evaluated for impairment with no related allowance recorded:				
Commercial	1,175	1,175	-	1,553
Commercial real estate	5,706	5,706	-	4,900
Agricultural, including real estate	12,144	12,144	-	12,018
Residential real estate	2,966	2,966	-	2,858
Consumer	73	73	-	76
Direct financing leases	144	144	-	96
Total	$ 24,090	$ 24,090	$ 711	$ 23,523

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Impaired loans also include loans modified in a troubled debt restructuring where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collections.

There were no loans modified by the Company during 2020 that were classified as a troubled debt restructuring.

The following is a summary of the Company's modified loans classified as troubled debt restructuring during 2019:

	Number of Contracts	Outstanding Recorded Investment Before Specific Reserve	Outstanding Recorded Investment After Specific Reserve
2019:			
Total debt restructuring:			
Agricultural, including real estate	1	$ 644	$ 644
Commercial	1	339	339
Total	2	$ 983	$ 983

There were no troubled debt restructurings modified during 2020 or 2019 that subsequently defaulted.

Under Interagency Statement ("Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)") issued by Federal banking agencies, financial institutions generally do not need to categorize COVID-19-related modifications as TDRs. As the result, loans that have been restructured for short term through the Company's loan deferral program for COVID-19 related hardships and meet certain other criteria specified in the Interagency Statement are not categorized as TDRs until the earlier of 60 days after the termination date of the national emergency or January 1, 2022.

The change in the allowance for loan and lease losses for the years ended December 31, 2020 and 2019, was as follows:

	Commercial	Commercial Real Estate	Agricultural	Residential Real Estate	Consumer	Direct Financing Leases	Total
Allowance for loan and lease losses:							
December 31, 2018	$ 2,496	$ 7,355	$ 2,550	$ 2,132	$ 1,022	$ 2,914	$ 18,469
Charge-offs	(409)	(93)	-	(120)	(624)	(1,028)	(2,274)
Recoveries	111	14	-	54	186	470	835
Provision for loan and lease losses	771	536	(55)	183	404	416	2,255
December 31, 2019	2,969	7,812	2,495	2,249	988	2,772	19,285
Charge-offs	(1,079)	(874)	-	(50)	(362)	(54)	(2,419)
Recoveries	191	195	-	30	115	861	1,392
Provision for loan and lease losses	2,339	7,875	42	1,139	369	1,598	13,362
December 31, 2020	$ 4,420	$ 15,008	$ 2,537	$ 3,368	$ 1,110	$ 5,177	$ 31,620

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

The allowance for loan and lease losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2020 and 2019, were as follows:

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
2020:			
Allowance for loan losses:			
Commercial	$ 692	$ 3,728	$ 4,420
Commercial real estate	866	14,142	15,008
Agricultural, including real estate	1	2,536	2,537
Residential real estate	11	3,357	3,368
Consumer	58	1,052	1,110
Direct financing leases	830	4,347	5,177
Total	$ 2,458	$ 29,162	$ 31,620
Loans balance:			
Commercial	$ 2,206	$ 551,582	$ 553,788
Commercial real estate	4,478	731,837	736,315
Agricultural, including real estate	8,664	140,744	149,408
Residential real estate	2,882	211,241	214,123
Consumer	114	53,501	53,615
Direct financing leases	3,099	76,102	79,201
Total	$ 21,443	$ 1,765,007	$ 1,786,450

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
2019:			
Allowance for loan losses:			
Commercial	$ 449	$ 2,520	$ 2,969
Commercial real estate	-	7,812	7,812
Agricultural, including real estate	3	2,492	2,495
Residential real estate	17	2,232	2,249
Consumer	87	901	988
Direct financing leases	155	2,617	2,772
Total	$ 711	$ 18,574	$ 19,285
Loans balance:			
Commercial	$ 2,277	$ 438,286	$ 440,563
Commercial real estate	5,706	725,174	730,880
Agricultural, including real estate	12,282	154,466	166,748
Residential real estate	3,036	227,957	230,993
Consumer	181	60,100	60,281
Direct financing leases	608	78,549	79,157
Total	$ 24,090	$ 1,684,532	$ 1,708,622

(In Thousands, Except Share Information)

Note 6. Operating Leases

Investment in operating lease assets includes the following as of December 31, 2020 and 2019:

	Years Ended December 31	
	2020	2019
Operating lease assets	$ 13,597	$ 11,015
Less accumulated depreciation	3,401	2,310
Net investment in operating leases	$ 10,196	$ 8,705

Future minimum lease payments receivable under operating leases as of December 31, 2020, are as follows:

Years Ending December 31,	
2021	$ 2,728
2022	2,616
2023	2,231
2024	1,985
2025	782
	$ 10,342

At December 31, 2020 and 2019, none of these operating leases were classified as nonaccrual.

Note 7. Premises and Equipment

	Useful Lives (Years)	December 31	
		2020	2019
Land and improvements	15–40	$ 8,668	$ 8,268
Buildings and improvements	10–40	34,881	34,644
Furniture and equipment	3–7	11,687	11,206
		55,236	54,118
Less accumulated depreciation		25,464	23,684
		$ 29,772	$ 30,434

(In Thousands, Except Share Information)

Note 8. Other Real Estate and Other Personal Property Owned

An analysis of activity for other real estate and other personal property owned is as follows:

	Years Ended December 31	
	2020	2019
Balance at beginning of year	$ 442	$ 1,745
Transfers from loans	3,435	1,727
Proceeds from sales	(1,146)	(3,031)
Net charge-offs/impairments	(28)	(129)
Net gain on sales	10	130
Balance at end of year	$ 2,713	$ 442

Expenses applicable to other real estate and other personal property owned assets include the following amounts reported in other noninterest expense:

	Years Ended December 31	
	2020	2019
Net gain on sales	$ (10)	$ (130)
Net charge-offs/impairments	28	129
Operating expenses, net of rental income	245	103
	$ 263	$ 102

Note 9. Deposits

	December 31	
	2020	2019
Demand deposits	$ 556,800	$ 425,141
Savings and NOW accounts	1,321,884	976,251
Time deposits	313,088	413,804
	$ 2,191,772	$ 1,815,196

(In Thousands, Except Share Information)

Note 9. Deposits (Continued)

The aggregate amount of time deposit accounts that exceed the FDIC insurance limit were $69,398 and $104,247 at December 31, 2020 and 2019, respectively.

At December 31, 2020, the scheduled maturities of time deposits are as follows:

Years Ending December 31,	
2021	$ 218,203
2022	69,868
2023	20,210
2024	4,081
2025	726
	$ 313,088

The Company participates and is a member of the Certificate of Deposit Account Registry Service (CDARS) deposit product program. Through CDARS, the Company may accept deposits in excess of the FDIC insured maximum from a depositor and place the deposits through a network to other CDARS member banks in increments of less than the FDIC insured maximum to provide the depositor full FDIC insurance coverage. Where the Company receives an equal dollar amount of deposits from other CDARS member banks in exchange for the deposits the Company places into the network, the Company records these as CDARS reciprocal deposits. At December 31, 2020 and 2019, CDARS reciprocal deposits totaled $1,482 and $36,480, respectively.

Note 10. Repurchase Agreements

	December 31	
	2020	2019
Customer repurchase agreements	$ 12,716	$ 9,454

Securities sold under agreements to repurchase are held by the Company. Customer repurchase agreements are due on demand with interest ranging from 0.50 percent to 0.55 percent.

The Company has an option to borrow from the FHLB under agreements to repurchase securities sold. The Company has pledged to the FHLB its FHLB stock, certain debt securities and loans with a carrying value of $608,144 and $575,168 at December 31, 2020 and 2019, respectively, to secure any borrowings. These securities and loans also collateralize the fixed-rate advances outstanding to the FHLB (see Note 11).

(In Thousands, Except Share Information)

Note 11. Notes Payable

Federal Home Loan Bank (FHLB) advances consist of fixed-rate advances with interest rates ranging from 2.03 percent to 2.14 percent, due quarterly. Advances are subject to various prepayment, call and conversion provisions. Advances are secured by securities and loans.

The Company has an ESOP loan with US Bank that bears interest at the one-month LIBOR plus 2.25 (at December 31, 2020, the interest rate is approximately 2.39 percent).

Future annual maturities are as follows:

Years Ending December 31,		
2021	$	2,500
2022		2,500
2023		4,500
2024		4,500
2025		3,420
	$	17,420

Note 12. Subordinated Debentures

Subordinated debentures of $12,903 are owed to Merchants Capital Trust I and bear interest at the three-month LIBOR plus 3.35 percent, but not to exceed 12.00 percent (at December 31, 2020, the interest rate is approximately 3.59 percent). They mature December 31, 2032. Early redemptions are permitted. The debentures are unsecured and are subordinate to all other indebtedness of the Company.

Subordinated debentures of $23,196 are owed to Merchants Capital Trust II and bear interest at the three-month LIBOR plus 1.30 percent (at December 31, 2020, the interest rate is approximately 1.54 percent). They mature October 31, 2037. Early redemptions are permitted. The debentures are unsecured and are subordinate to all other indebtedness of the Company.

Subordinated debentures of $5,155 are owed to Merchants Capital Trust—Jerema, Inc. Capital Trust I and mature July 23, 2034. The interest rate is equal to the three-month LIBOR plus 2.70 percent (at December 31, 2020, the interest rate is approximately 2.94 percent). Early redemptions are permitted. The debentures are unsecured and are subordinate to all other indebtedness of the Company.

The underlying capital securities of the trusts qualify under risk-based capital guidelines as Tier 1 capital for regulatory purposes to the extent they do not exceed 33 percent of Tier I capital, with the remainder allowed as Tier II capital.

(In Thousands, Except Share Information)

Note 13. Deferred Taxes

The cumulative tax effects of the temporary differences are shown in the following table:

	December 31 2020	December 31 2019
Deferred tax assets:		
Allowance for loan and lease losses	$ 7,256	$ 4,323
Deferred compensation	429	417
Other	951	311
Total deferred tax assets	8,636	5,051
Deferred tax liabilities:		
Direct financing leases	(9,607)	(11,046)
Mortgage servicing rights	(2,071)	(2,207)
Premises and equipment	(1,182)	(1,480)
Intangibles	(3,286)	(3,216)
Unrealized gain on available-for-sale securities	(953)	(270)
Total deferred tax liabilities	(17,099)	(18,219)
Net deferred tax liabilities	$ (8,463)	$ (13,168)

At December 31, 2020 and 2019, there was no valuation allowance for deferred tax assets. The provision for income taxes charged to operations consists of the following:

	Years Ended December 31 2020	Years Ended December 31 2019
Current tax expense	$ 12,667	$ 8,281
Deferred tax expense (benefit)	(4,987)	(420)
	$ 7,680	$ 7,861

The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income as follows:

	Years Ended December 31 2020	Years Ended December 31 2019
Computed "expected" tax expense	$ 6,130	$ 5,802
Increase (decrease) in income taxes resulting from:		
State income taxes, net of federal tax benefit	1,975	2,109
Tax-exempt interest income (net of disallowed expenses)	(218)	(179)
Other	(207)	129
	$ 7,680	$ 7,861

(In Thousands, Except Share Information)

Note 14: Commitments, Contingencies and Credit Risk

Financial instruments with off-balance-sheet risk: The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, credit card commitments and standby letters of credit. They involve, to varying degrees, elements of credit risk in excess of amounts recognized on the consolidated balance sheets.

The Company's exposure to credit loss in the event of nonperformance by the other parties to the financial instruments for these commitments is represented by the contractual amounts of the instruments. The Company uses the same credit policies in making commitments as it does for on-balance-sheet instruments. These commitments were as follows:

	December 31	
	2020	2019
Commitments to extend credit	$ 455,195	$ 402,155
Credit card commitments	81,204	79,440
Standby letters of credit	8,658	9,171
	$ 545,057	$ 490,766

Note 14. Commitments, Contingencies and Credit Risk (Continued)

Commitments to extend credit and credit card commitments: Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. If deemed necessary upon extension of credit, the amount of collateral obtained is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, crops, livestock, inventory, property and equipment, residential real estate and income-producing commercial properties. Credit card commitments are unsecured.

Standby letters of credit: Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Company deems necessary.

Financial instruments with concentrations of credit risk:

Concentration by institution: The nature of the Company's business requires that it maintain amounts due from banks that, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Note 15. Employee Stock Ownership Plan

The Company has a leveraged employee stock ownership plan (ESOP).

During 2020, the ESOP purchased 67,063 shares of the Company's common stock at $90.00 per share. Of the 67,063 shares, 5,060 were released as of December 31, 2020.

During 2019, the ESOP purchased 4,650 shares of the Company's common stock at $81.60 per share. Of the 4,650 shares, 1,037 and zero were released as of December 31, 2020 and 2019, respectively.

During 2018, the ESOP purchased 24,243 shares of the Company's common stock at $75.46 per share. Of the 24,243 shares, 14,604 and 11,946 were released as of December 31, 2020 and 2019, respectively.

During 2017, the ESOP purchased 49,402 shares of the Company's common stock at $60.22 per share. Of the 49,402 shares, 33,946 and 29,683 were released as of December 31, 2020 and 2019, respectively.

The ESOP shares were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to employees based on the proportion of loan principal paid during the year. The Company intends to make annual contributions to the ESOP sufficient for the ESOP to repay its loan, including interest. The shares pledged as collateral are deducted from stockholders' equity as unearned ESOP shares in the accompanying consolidated balance sheets. As shares are released from collateral, the Company reports compensation expense equal to the fair value of the shares, and the shares become outstanding for earnings per share computations. The Company obtains an annual independent appraisal of fair value of its common shares. The appraised fair value as of December 31, 2020 and 2019, was $90.00 per share and $81.60 per share, respectively.

(In Thousands, Except Share Information)

Note 15. Employee Stock Ownership Plan (Continued)

Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as compensation expense and may be used by the ESOP for debt service. Total ESOP compensation expense was $2,417 and $2,694 for the years ended December 31, 2020 and 2019, respectively.

Participants who receive shares of stock under the plan have a put option requiring the Company to repurchase the shares at fair value for a 60-day period after distribution of the shares and during the first 60 days of the next plan year. In addition, if a participant receives an offer from a third party to purchase the shares, the participant must first give the Company the option of purchasing the shares. In 2020, 83,349 shares were purchased from participants and retained by the ESOP, and in 2019, 19,666 shares were purchased and retained by the ESOP. In the event a terminated ESOP participant desires to sell his/her shares of the Company's stock, or for certain employees who elect to diversify their account balances, the Company may be required to purchase the shares from the participant at their fair market value. As permitted, the ESOP elected to purchase the shares in lieu of the Company. In addition, at December 31, 2020, 9,597 shares of the Company's stock, with an aggregate fair market value of approximately $863 are held by ESOP participants who will be eligible to elect their diversification privileges under the ESOP during the year ending December 31, 2021.

Shares of the Company held by the ESOP at December 31, 2020 and 2019 are as follows:

	December 31	
	2020	2019
Allocated shares	397,220	437,503
Shares released for allocation	13,018	26,780
Unreleased (unearned) shares	90,711	36,666
Total shares held	500,949	500,949
Fair value of unreleased (unearned) shares	$ 7,533	$ 2,495

Note 16. Loans and Other Transactions With Related Parties

Officers and directors of the Company, including their families and companies of which they are principal owners, are considered to be related parties. These related parties were loan customers of, and had other transactions with, the Company in the ordinary course of business. In management's opinion, these loans and transactions were on the same terms as those for comparable loans and transactions with nonrelated parties. Total loans to related parties were approximately $32,930 and $49,511 at December 31, 2020 and 2019, respectively. Total deposits with related parties were approximately $22,391 and $12,479 at December 31, 2020 and 2019, respectively.

Note 17. Regulatory Capital Requirements

The Company (on a consolidated basis) and the subsidiary banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum ratios (set forth in the following table) of total and Tier I capital to risk-weighted assets, of Tier I capital to average assets, and common equity Tier 1 capital (all as defined in the regulations). Management believes, as of December 31, 2020, that the Company and Bank meet all capital adequacy requirements to which they are subject.

(In Thousands, Except Share Information)

Note 17. Regulatory Capital Requirements (Continued)

The following table presents regulatory capital information for the Company. Information presented for the years ended December 31, 2020 and 2019 reflects the transition to the Basel III capital standard from previous regulatory capital adequacy guidelines under the Basel I framework. The Basel III capital standard phased in through 2019 and revised the definition of capital, increased minimum capital ratios, introduced the regulatory capital buffers above those minimums, introduced a common equity Tier 1 capital ratio and revised the rules for calculating risk-weighted assets. The conservation buffer for each measure of total capital, common equity Tier 1 capital, and Tier 1 capital was 2.50%, respectively and is captured within the ratios below.

	Actual		Minimum Capital Requirements		Well Capitalized Standard	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2020:						
Total capital (to risk-weighted assets):						
Consolidated	$ 252,794	13.69%	$ 193,889	>10.50	N/A	N/A
Merchants Bank	245,421	13.31%	193,637	>10.50	$ 184,416	>10.0%
Common equity Tier 1 capital (to risk-weighted assets):						
Consolidated	181,173	9.81%	129,277	>7.0%	120,043	>6.5%
Merchants Bank	222,262	12.05%	129,115	>7.0%	119,892	>6.5%
Tier I capital (to risk-weighted assets):						
Consolidated	221,173	11.98%	156,926	>8.50%	N/A	N/A
Merchants Bank	222,262	12.05%	156,752	>8.50%	147,532	>8.0%
Leverage ratio:						
Consolidated	221,173	10.01%	88,381	>4.0%	N/A	N/A
Merchants Bank	222,262	9.03%	98,497	>4.0%	123,122	>5.0%
As of December 31, 2019:						
Total capital (to risk-weighted assets):						
Consolidated	$ 241,902	12.51%	$ 203,035	>10.50	N/A	N/A
Merchants Bank	204,018	11.57%	185,224	>10.50	$ 176,404	>10.0%
First National Bank Northfield	23,845	14.16%	17,684	>10.50	16,842	>10.0%
Common equity Tier 1 capital (to risk-weighted assets):						
Consolidated	182,616	9.44%	135,414	>7.0%	125,742	>6.5%
Merchants Bank	184,804	10.48%	123,483	>7.0%	114,662	>6.5%
First National Bank Northfield	23,773	14.12%	11,790	>7.0%	10,948	>6.5%
Tier I capital (to risk-weighted assets):						
Consolidated	222,616	11.51%	164,399	>8.50%	N/A	N/A
Merchants Bank	184,804	10.48%	149,943	>8.50%	141,123	>8.0%
First National Bank Northfield	23,773	14.12%	14,316	>8.50%	13,474	>8.0%
Leverage ratio:						
Consolidated	222,616	10.68%	83,377	>4.0%	N/A	N/A
Merchants Bank	184,804	10.09%	73,285	>4.0%	91,607	>5.0%
First National Bank Northfield	23,773	9.99%	9,523	>4.0%	11,904	>5.0%

(In Thousands, Except Share Information)

Note 17. Regulatory Capital Requirements (Continued)

In order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer, as described in the previous paragraph, composed of common equity Tier 1 capital above its minimum risk-based capital requirements. The buffer is measured relative to risk-weighted assets.

Note 18. Additional Cash Flow Information

Cash flows from securities:

	Years Ended December 31	
	2020	2019
Available-for-sale securities:		
Maturities and sales	$ 34,685	$ 27,878
Purchases	(16,023)	(14,391)
Held-to-maturity securities:		
Maturities	2,797	2,086
Purchases	(1,125)	-
	$ 20,334	$ 15,573
Supplemental disclosures of cash flow information:		
Cash payments for interest	$ 13,723	$ 13,919
Cash payments for income taxes	14,030	8,124
Supplemental schedule of noncash investing and financing activities:		
Other real estate and other personal property owned acquired in settlement of loans	$ 3,435	$ 1,727
Transfer of unrealized gain	-	98
Acquired assets and assumed liabilities, at fair value:		
Available-for-sale securities	-	19,255
Loans	-	164,781
Premises and equipment	-	3,622
Investment in restricted stock	-	1,081
Cash value of life insurance	-	3,701
Goodwill	-	12,975
Core deposit intangible	-	3,965
Accrued interest receivable and other assets	-	970
Total assets acquired	-	210,350
Deposits:		
Noninterest bearing	-	70,082
Interest bearing	-	127,583
Notes payable	-	4,982
Accrued interest payable and other liabilities	-	1,576
Total liabilities assumed	-	204,223
Net cash paid for acquired assets and assumed liabililites	$ -	$ (6,127)

Note 19. Interest Rate Swaps

The Company entered into an interest rate swap agreement in 2016 with a notional amount of $13.0 million. The interest rate swap contract was designated as a cash flow hedging instrument with the objective of protecting against the risk of adverse interest rate movements on the cash flows of Merchants Trust II preferred securities throughout the ten year period beginning January 30, 2017 and ending January 30, 2027 from the risk of variability of those payments resulting from changes in the three-month LIBOR. Under the swap, the Company will pay a fixed interest rate of 3.463% and receive a variable interest rate of three-month LIBOR plus a margin of 1.30% on the notional amount, with quarterly settlements. The rate received by the Company as of December 31, 2020 was 1.51%.

The Company entered into an interest rate swap agreement in 2020 with an original notional amount of $3.8 million and current notional amount of $3.4 million. The interest rate swap contract was designated as a cash flow hedging instrument with the objective of protecting against the risk of adverse interest rate movements on the cash flows of Merchants ESOP loan throughout the nine year period beginning July 22, 2020 and ending December 31, 2029 from the risk of variability of those payments resulting from changes in the three-month LIBOR. Under the swap, the Company will pay a fixed interest rate of 2.605% and receive a variable interest rate of one-month LIBOR plus a margin of 2.25% on the notional amount, with semi-annual settlements. The rate received by the Company as of December 31, 2020 was 2.39%.

The estimated fair value of the interest rate derivative contracts outstanding was a loss of $1,313 and a loss of $359 as of December 31, 2020 and 2019, respectively, and was included in other assets in the consolidated balance sheets.

The effective portion of the loss due to changes in the fair value of the derivative hedging instruments, a $587 loss and $801 loss for the year ended December 31, 2020 and 2019, respectively, is included in other comprehensive income, while the ineffective portion (indicated by the excess of the cumulative change in the fair value of the derivative over that which is necessary to offset the cumulative change in expected future cash flows on the hedge transaction) is included in other noninterest income or other noninterest expense. No ineffectiveness related to the interest rate derivative instruments was recognized during the reporting period. Therefore, changes in the fair value of the interest rate swaps have had no impact on net income.

There were no net cash flows as a result of the interest rate swap agreements for the years ended December 31, 2020 and 2019. Cash is only disbursed or received upon exceeding contractual thresholds.

The Company posted $1,430 cash as collateral related to the derivative contract at December 31, 2020 due to fluctuations in the market, and $620 cash as collateral related to the derivative contract at December 31, 2019.

There are no credit-risk-related contingent features associated with our derivative contract.

Note 20. Fair Value Measurements

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

ASC Topic 820 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert expected future amounts, such as cash flows or earnings, to a single present value amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

(In Thousands, Except Share Information)

Note 20. Fair Value Measurements (Continued)

The fair value hierarchy is as follows:

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

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

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Investment securities available for sale: The fair value of residential mortgage-backed securities and collateralized residential mortgage obligations is generally determined based on matrix pricing. Matrix pricing is a mathematical technique that utilizes observable market inputs including, for example, yield curves, credit ratings and prepayment speeds. Fair values determined using matrix pricing are categorized as Level 2 in the fair value hierarchy.

The fair value of investments in obligations of states and political subdivisions is generally based on a discounted cash flow model that uses significant inputs, such as credit rating, coupon rate, maturity date and call features, some of which are unobservable in the markets. Fair values determined using a discounted cash flow analysis with significant unobservable inputs are categorized as Level 3 in the fair value hierarchy. The activity of investments in obligations of states and political subdivisions for the years ended December 31, 2020 and 2019 are as follows:

	Years Ended December 31	
	2020	2019
Balance, beginning	$ 1,277	$ 247
Investment securities acquired in business combination	-	1,056
Maturities	(262)	(32)
Change in unrealized gain/loss	-	6
Balance, ending	$ 1,015	$ 1,277

Note 20. Fair Value Measurements (Continued)

Interest rate lock commitments and forward sale commitments: Interest rate lock commitments related to the origination of mortgage loans that will be sold are considered derivative instruments. The Company estimates the fair value of these derivatives using the difference between the guaranteed interest rate in the commitment and the current market interest rate plus the present value of estimated cash flow from servicing and marketing gains. To reduce the net interest rate exposure arising from its loan sale activity, the Company enters into a commitment to sell these loans at essentially the same time that the interest rate lock commitment on the loan is quoted. The commitments to sell loans are also considered derivative instruments, with estimated fair values based on changes in current market rates. These commitments are not designated as hedging instruments and, therefore, changes in fair value are recognized immediately into income. The fair values of the Company's derivative instruments are deemed to be Level 2 measurements and are included in the caption, accrued interest receivable and other assets, in the consolidated balance sheets. The volume of derivative activity is disclosed in Note 4. The gain/(loss) on the derivative instruments was $2,768 and $235 in 2020 and 2019, respectively, and is included in the caption, gain on sale of loans, in the consolidated statements of income.

Loans held for sale: Fair value of loans held for sale is based on commitments on hand from investors or prevailing market prices and the fair value of expected future servicing. The fair values of the Company's loans held for sale are deemed to be Level 2 measurements, and the change in fair value is included in the caption, gain on sale of loans, in the consolidated statements of income.

Interest Rate Swap: The Company utilizes an interest rate swap agreement to convert one of our variable rate trust preferred securities to a fixed rate and a variable rate ESOP loan to a fixed rate. These have been designated as a cash flow hedge. These interest rate swaps are recorded at fair value based on third party vendors who compile prices from various sources and may determine fair value of identical or similar instruments by using pricing models that consider observable market data. The fair value of the Company's interest rate swaps are deemed to be a Level 2 measurement and are included in other assets in the consolidated statements of financial condition.

(In Thousands, Except Share Information)

Note 20. Fair Value Measurements (Continued)

The following tables summarize financial assets and financial liabilities measured at fair value on a recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

	Fair Value Measurements at December 31, 2020	Level 1	Level 2	Level 3
Investment securities available for sale:				
GSE residential mortgaged-backed securities	$ 74,044	$ -	$ 74,044	$ -
GSE collateralized residential mortgage obligations	12,084	-	12,084	-
Obligations of states and political subdivisions	1,015	-	-	1,015
SBA loan pools	8,751	-	8,751	-
GSE commercial mortgage-backed securities	18,214		18,214	
Loans held for sale	38,373	-	38,373	-
Interest rate lock commitments	3,177	-	3,177	-
Forward sale commitments	(1,097)	-	(1,097)	-
Interest rate swaps	(1,313)	-	(1,313)	-
	$ 153,248	$ -	$ 152,233	$ 1,015

	Fair Value Measurements at December 31, 2019	Level 1	Level 2	Level 3
Investment securities available for sale:				
GSE residential mortgaged-backed securities	$ 94,308	$ -	$ 94,308	$ -
GSE collateralized residential mortgage obligations	16,314	-	16,314	-
Obligations of states and political subdivisions	1,277	-	-	1,277
SBA loan pools	11,240	-	11,240	-
GSE commercial mortgage-backed securities	9,509	-	9,509	-
Loans held for sale	36,260	-	36,260	-
Interest rate lock commitments	52	-	52	-
Forward sale commitments	(57)	-	(57)	-
Interest rate swaps	(359)	-	(359)	-
	$ 168,544	$ -	$ 167,267	$ 1,277

(In Thousands, Except Share Information)

Note 20. Fair Value Measurements (Continued)

Financial instruments recorded at fair value on a nonrecurring basis: The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements in accordance with generally accepted accounting principles.

Impaired loans and leases: The specific reserves for collateral-dependent impaired loans and leases are determined based on the fair value of collateral method in accordance with ASC Topic 310. Under the fair value of collateral method, the specific reserve is equal to the difference between the carrying value of the loan or lease and the fair value of the collateral less estimated selling costs. When a specific reserve is required for an impaired loan or lease, the impaired loan is essentially measured at fair value. The fair value of collateral for impaired loans was determined based on appraisals with further adjustments made to the appraised values due to various factors, including the age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. The fair value of collateral for leases was determined based on comparable equipment values with further adjustments made due to various factors, including the age of comparables, and known changes in the market and on the collateral. The resulting fair value measurement is disclosed in the nonrecurring hierarchy table. Where estimates of fair value used for other collateral supporting commercial loans or leases are based on assumptions not observable in the marketplace, such valuations have been classified as Level 3.

Other real estate and other personal property owned: Other real estate and other personal property owned, upon initial recognition, is measured and reported at fair value less estimated costs of disposal through a charge-off to the allowance for possible loan losses based upon the fair value of the other real estate and other personal property acquired. The fair value of other real estate and other personal property owned is estimated based on assumptions not observable in the marketplace, and such valuations have been classified as Level 3.

Assets measured at fair value on a nonrecurring basis are included in the tables below:

	Fair Value at December 31, 2020			
	Total	Level 1	Level 2	Level 3
Collateral-dependent impaired loans and leases	$ 4,822	$ -	$ -	$ 4,822
Other real estate owned and other personal property owned	2,713	-	-	2,713
	$ 7,535	$ -	$ -	$ 7,535

	Fair Value at December 31, 2019			
	Total	Level 1	Level 2	Level 3
Collateral-dependent impaired loans and leases	$ 1,171	$ -	$ -	$ 1,171
Other real estate owned and other personal property owned	442	-	-	442
	$ 1,613	$ -	$ -	$ 1,613

(In Thousands, Except Share Information)

Note 21. Business Combination

On August 30, 2019, the Company acquired substantially all the assets and assumed substantially all the liabilities of a holding company and it's wholly owned subsidiary, First National Bank of Northfield. This transaction expanded the Company's presence in Northfield, Minnesota with two locations in Northfield and a loan production office in Bloomington, Minnesota. The total cash outlay for the acquisition was $34,839.

The business combination was accounted for under the acquisition method of accounting. Accordingly, the results of operations have been included in the Company's results of operations for First National Bank of Northfield since the date of acquisition. Under this method of accounting, the assets acquired, liabilities assumed and consideration paid were recorded at their estimated fair values. The excess cost over the fair value of net assets acquired, in the amount of $12,975, was recorded as goodwill and allocated to the First National Bank of Northfield. The goodwill is not deductible for tax purposes.

Non-credit-impaired loans had an estimated fair value of $164,781 at the date of acquisition and contractual balance of $166,537. The difference of $1,756 will be amortized over the life of the loans.

Estimated fair values of assets acquired and liabilities assumed in the First National Bank of Northfield transaction, as of the closing date of the transaction were as follows:

	August 30, 2019
Assets:	
Cash and cash equivalents	$ 28,712
Available-for-sale securities	19,255
Loans	164,781
Premises and equipment	3,622
Investment in restricted stock	1,081
Cash value of life insurance	3,701
Goodwill	12,975
Core deposit intangible	3,965
Accrued interest receivable and other assets	970
Total assets acquired	$ 239,062
Liabilities:	
Deposits:	
Noninterest bearing	$ 70,082
Interest bearing	127,583
Notes payable	4,982
Accrued interest payable and other liabilities	1,576
Total liabilities assumed	204,223
Cash paid	$ 34,839

The Company recorded $312 in pretax professional and legal expenses associated with the acquisition and integration of First National Bank of Northfield for the year ended December 31, 2019.

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