Growing strong communities together.


Rochester


Northfield


Winona

Winona


Caledonia


Goodview

2023 Annual *report*

Merchants
Financial Group

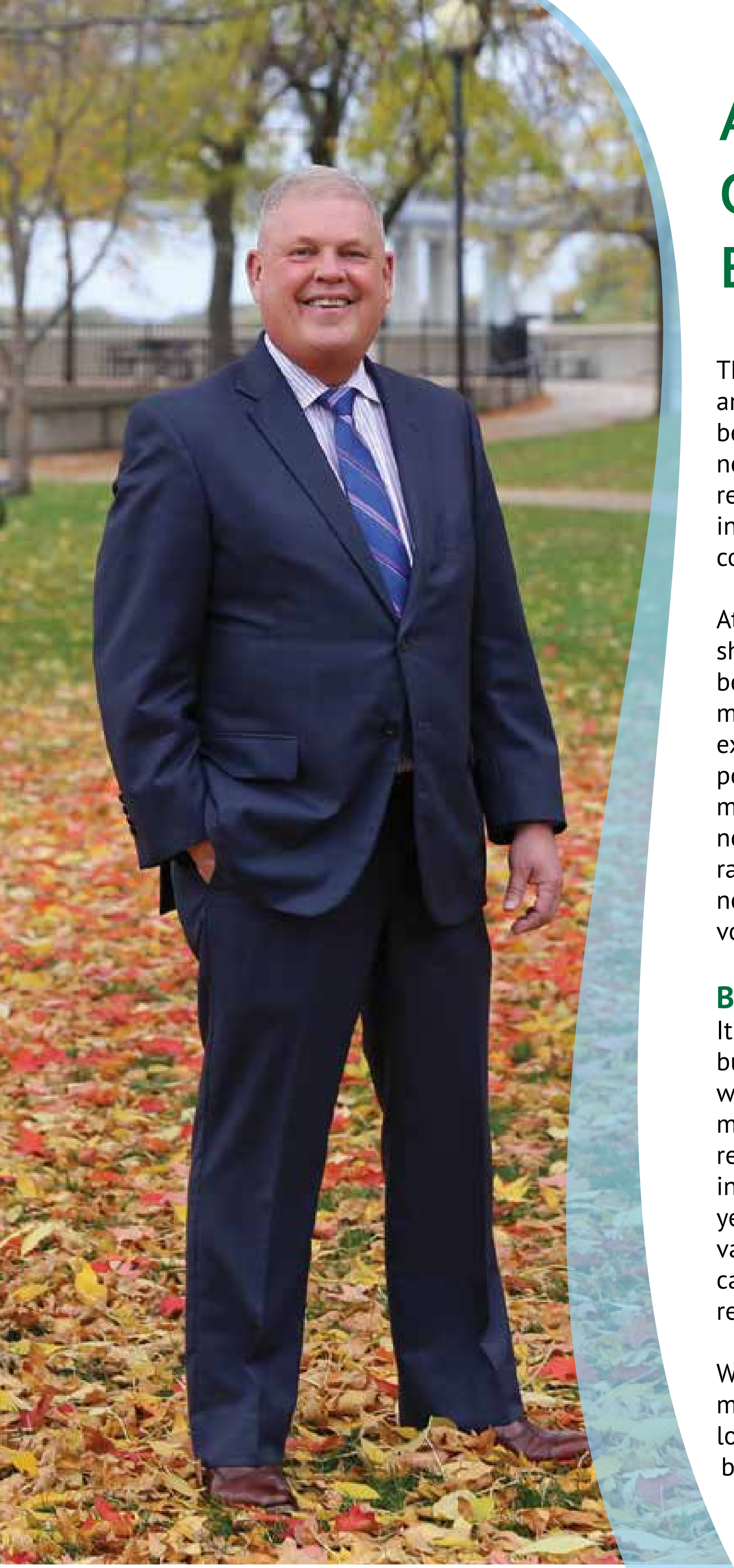
At Merchants, our philosophy can be boiled down to one simple word:

we

Community banking has never just been about what's good for the bank - or just about what's good for the community. It's about coming together to find common ground, mutual goals and a shared vision for the future. It's the intersection of community aspirations and the financial means to get there. It's about what we do together.

Merchants is proud to be the backbone of our communities. And our more than 400 employees strive every day to make the places we live and work better. Our team is committed to continuing to live out the community banking philosophy that's driven us for the last 149 years. It's woven into the story of who Merchants has always been and who, with your partnership, we will always be.

Our customers and community members are always sharing stories of "we." We're honored to share a few of them with you here.



A Letter From Our Chief Executive Officer

The banking industry was put to a stern test in 2023, and I'm proud of the resilience that continues to be a bedrock of Merchants Financial Group, Inc. While our net income for the year declined by 16.18% from our record year in 2022, year-end earnings of $25.5 million in what was a challenging environment represent the continued strength and stability of this Company.

At the beginning of 2023, it was clear the dramatic shift in monetary policy by the Federal Reserve that began in March of 2022 to curb inflation would create meaningful challenges for all banks. Turbulence was exacerbated at the end of the first quarter when two poorly-managed regional banks with risky business models failed. Historically, isolated bank failures have not been uncommon, but amid Fed-driven interest rate sensitivity, news coverage fueled an over-hyped notion of an industry in peril and markets reacted with volatility.

Better Positioned Than Most

It was always going to be a stormy environment in 2023, but the added volatility forced all banks to navigate with even more intense liquidity and interest rate risk management headwinds. Through it all, Merchants remained better positioned than most while the entire industry demonstrated throughout the balance of the year that it is largely safe, stable and resilient. Like the vast majority of community banks, Merchants is well-capitalized, well-managed and well-supervised by our regulators.

We experienced continued strong loan growth in 2023, most of it coming during the first half of the year. Total loans increased 15.0% from year-end 2022 to $2.16 billion. New loan volume tapered by year-end, and our pipeline for growth to begin 2024 is relatively soft.

Our credit administration team continues to support strong loan growth while doing an extraordinary job of identifying, monitoring and mitigating risk in the consolidated portfolio. We have conducted proactive debt service stress testing on existing borrowing relationships and the

Greg Evans
President &
Chief Executive Officer

risk profile in the consolidated portfolio remains unchanged relative to our prudent expectations.

Net charged-off loans were once again negligible at just .03% of total loans. All critical credit quality metrics improved from year-end 2022, with non-performing 3.63% of capital, classified 20.02% of capital, and criticized 34.02% of capital loans at manageable levels and conservatively positioned by industry benchmark standards. Our total Allowance for Credit Loss (ACL) at year-end was 1.16% of total loans and includes assessment of risk associated with unfunded commitments. While we have not experienced credit quality deterioration, we remain watchful in measuring the impact of high inflation on consumers and higher interest rates on borrowers' ability to meet repayment obligations.

Your "One Merchants" Focused Team

A year ago in my annual report letter, I wrote *the core business battleground in 2023 will be on the deposit front* and that proved to be the case, magnified in part by industry disruption detailed above. The deposit franchise for Merchants is diversified, sticky and strong, but we were not immune from depositors seeking higher-yield alternatives for excess cash. Total deposits were down 3.7% for the year, with most of the runoff occurring in the first two quarters. Protection of the deposit franchise is bolstered by the fact we continue to onboard far more new deposit accounts than we close. Our philosophy to continue to fund loan growth with core deposits vs. wholesale funding remains uncompromised, and our entire team of bankers is focused on deposit gathering as the most critical business priority for the year ahead.

I have repeatedly suggested our ability to optimize earnings performance through changing market cycles can largely be attributed to our business line diversification. Diverse revenue production from the Merchants Bank Equipment Finance division helped offset the impact of interest margin compression on earnings. Total equipment finance origination activity in 2023 was $165.5 million, a division record. The loan/lease portfolio is diverse across many industry segments, short in duration and affords the Company with yield opportunities not available in some of our traditional commercial lending market segments.

The accelerating growth of the Trust division of our wealth management practice is also worthy of note. Since 2018, we have more than doubled the number of client relationships in Trust with growth in Assets Under Management to $553 million. Total gross revenue for 2023 increased 15.9% to $2.75 million. There is a strong new business pipeline suggesting potential for more growth for this line of business in the year ahead.

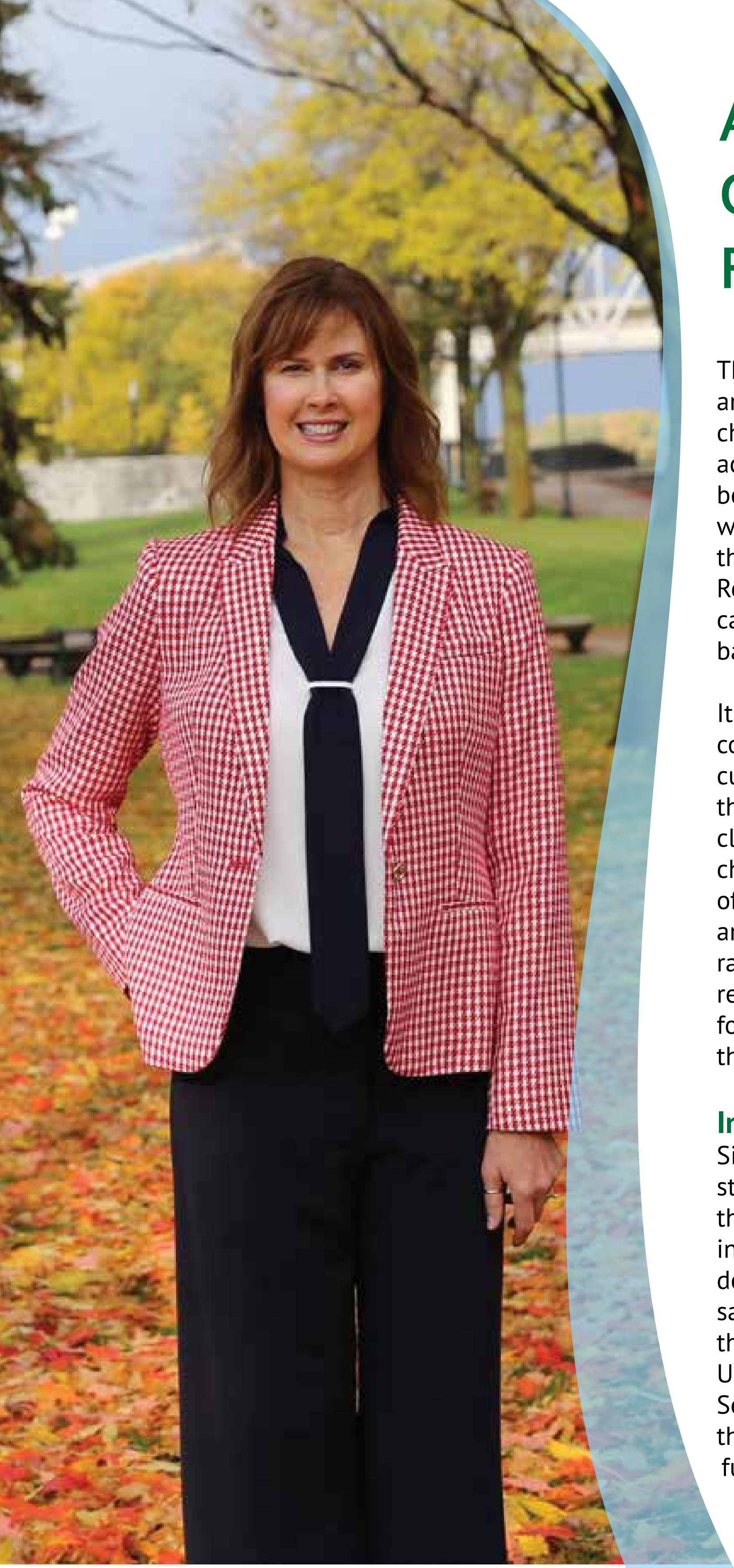
While 2023 was not a record-earnings year for Merchants, I am extraordinarily proud of our team and bullish about our future. It was a hard year. Reality suggests that 2024 could be even more challenging as we begin the year with tight interest margins that will undoubtedly continue to get squeezed. My confidence and optimism are buoyed by what our ***One Merchants Team*** has consistently accomplished from one volatile market environment to another over the course of the past four years.

Community Bank Proud

In my 34 years with the Company, we have never focused with greater intentionality on our mission as a community bank to help our customers and communities achieve financial hopes and dreams. Industry events during the first half of the year absolutely increased the challenges and pressures associated with community banking. Deposits flowed to large money center banks perceived to be too big for the government to allow to fail. Those banks serve a real purpose in the national and global economy but are not positioned to provide access to capital in communities like the ones we have the privilege to serve. Your loyalty and investment in this Company are essential to the economic vitality of main streets and neighborhoods in the 19 communities Merchants calls home.

In addition to the return on your investment in the form of tangible book value growth of the Company, you have my promise that our team remains laser focused on three clearly-defined pillars of our Strategic Plan: delivering exceptional customer experiences that differentiate Merchants in a crowded marketplace; an unparalleled commitment to teamwork that shows up not just in the workplace but also in the form of tremendous community connections as showcased in this Annual Report; and, driving business growth and earnings optimization at the level you expect and deserve – even when times are toughest. Thank you for the trust and confidence you continue to place in our team and its ability to fulfill these commitments.

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



Sue Savat

Senior Vice President &
Chief Financial Officer

A Letter From Our Chief Financial Officer

The basics of community banking - taking in deposits and using those dollars to make loans - has not changed for a very long time but managing that activity in the past four years was different than ever before. The industry came through the pandemic very well, however, the run-away inflation in early 2023 and the responding 525 basis point increase in the Federal Reserve funds interest rate since the start of 2022 caused banks to face new challenges in performing the basic services of banking.

It was challenging to retain deposits when customers could get Treasury bonds paying over 5% and borrowing customers were shocked with loan rates higher than they had been in almost 25 years. We could no longer cling to the ways of the past or be afraid to face the changes head on. This required changes for nearly all of our team members to focus on deposit retention and growth, manage potential loan risks due to rapid rate increases and do more with less to ensure we remain strong and safe. Once again, I am so grateful for every team member who stepped up and accepted the change and pushed us forward.

Income Statement Highlights

Since the balance sheet drives much of the income statement, we must cover a few of the key changes in the balance sheet from year to year. With strong growth in loan balances in the first part of the year and the decline in deposits with the failure of three banks, we saw excess federal funds decrease by 97.6%. We took the opportunity in the market to sell $30 million of U.S. Treasuries and $30 million of Mortgage-backed Securities at lower yields with minimal loss. Due to those changes and the drop in excess Federal Reserve funds, investment income was down 10.2% from the previous year and 34.9% from plan. Between loan balances up 15.0% and loan yields up 10.9%, we saw loan interest income increase $23.6 million or 32.0%. Total revenue increased $21.7 million or 18.3% from 2022 and was only $1.5 million (or 1.0%) below plan.

We anticipated mortgage volume to be light in 2023 due to higher rates, low inventory and continued strong housing prices. Mortgage volume was down 33.5% from 2022 and was only 83.2% of our budget. Mortgage revenue from production and servicing activities was down 15.2% from last year.

As we were planning for 2023, we knew we would need to get aggressive on deposit rates to be competitive and retain deposits to the best of our ability. We budgeted a 224.4% increase in interest expense and our actual interest expense was a 277.7% increase. That was a $23.1 million increase year-over-year.

Diligence with expenses found our employee expense 4.7% below plan and down 0.7% from the prior year. Occupancy expenses were also kept in check. Due to previous year commitments to critical customer technology tools and an 8% inflation adjuster on many of the contracts with our core system provider, our computer-related expenses increased $920,000 or 10.9%. Expenses related to loans and deposits increased just over $1 million or 31.7%. The largest increases were in credit card expenses, mortgage loan expenses and ATM/debit card expenses. The ATM/debit card expense increase was matched by the ATM/debit card income in the income section.

Net income of $25,502,129 was 4.6% below plan and 16.18% below last year. This was a return on average assets of 1.02% and a return on ending equity of 9.66%. Our net interest margin was 3.42% at year-end compared to 3.62% at the end of 2022. Due to the rapid increase in interest expense, the efficiency ratio finished the year at 67.70%.

Capital Strength

Since the pandemic, your Board and management have been focused on growing tangible capital. We are pleased that our tangible capital equity grew from 6.85% at the end of 2021 to 8.75% at year-end 2023. All other capital ratios have continued to be strong throughout the ups and downs of the past four years. With the significant increase in interest rates, one of our trust preferred securities (a debt instrument that could be included in Tier 1 capital) was becoming quite expensive with the total rate over 9%. The Board and the Federal Reserve approved our request for redemption of $13 million of the securities. We anticipate this will save us net interest expense of approximately $400,000 in the next year.

Deposits/Liquidity

You have heard us say that our deposits are the raw material with which we can make loans and support our local businesses and residents. During the pandemic, the influx of deposits was much greater than the loan demand at that time. 2022 and 2023 saw a rapid change in deposit balances. Some was due to customers using the excess funds in their daily lives with the end of stimulus or reinvesting in their business, some was customers, out of fear, moving deposits to large banks, as Greg indicated in his letter, and some were people suddenly aware of high-rate opportunities outside of the banking system. When we saw a more than 7% decline in balances by mid-year 2023, we identified that about 63% was due to municipalities moving to other state offered funds. We are pleased that our deposits balances have stabilized and even grew 4% from the end of the second quarter through November. We did see a decline in December primarily due to year-end bonus payments and loan paydowns by large businesses. We typically see those be replenished in the beginning of the year.

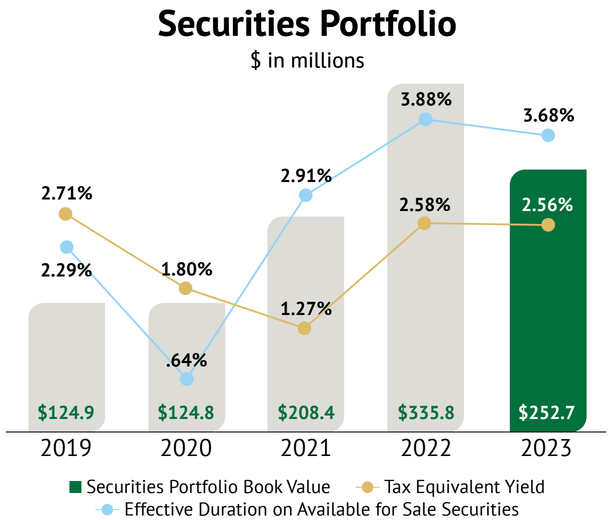
While it was hard for us to watch the decline of our share price this year, since we historically have not seen the volatility others in the market experienced, we also know that this year was the most dramatic direct focus on bank stocks due to the bank failures. We are pleased that it has started to recover and also that while we did see a 18.4% decline in our value, the KBW bank indexes were down nearly 14%. We are bullish on our future and our increase of 11.1% in our annual dividend reflects our confidence. We also fully believe in the future of community banking, as it remains the lifeblood of our communities.

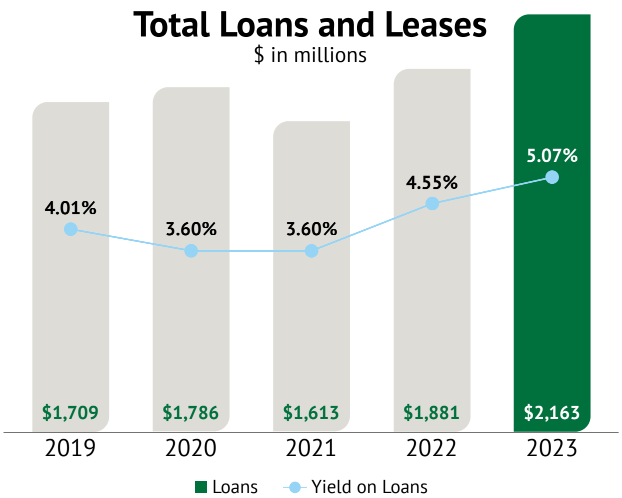
Thank you for your support of community banking and Merchants Financial Group. We will continue to focus on our diversification, being advisors to our customers, working together as a team and ensuring our legacy continues far into the future.

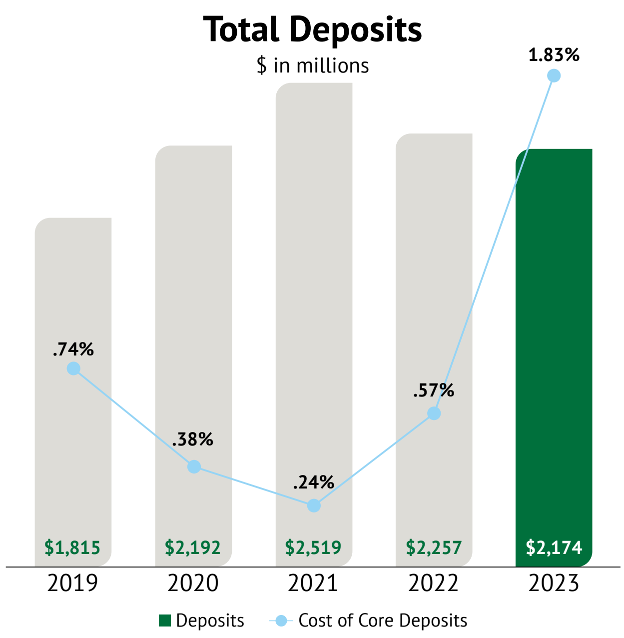
Susan M Savat

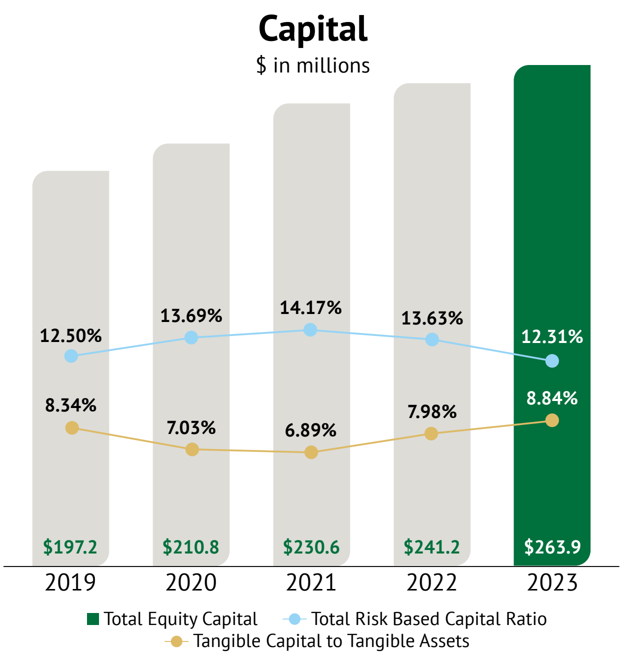
Susan M. Savat
Senior Vice President & Chief Financial Officer
Merchants Financial Group, Inc.

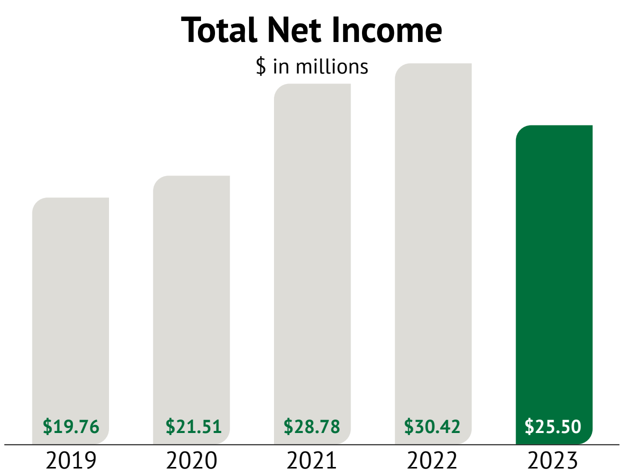
2023 Financial Charts











Consolidated Financials

Condensed Consolidated
Statement of Condition

Assets	12/31/23	12/31/22
Cash and Cash Equivalents	$ 39,055,718	$ 227,190,992
Investments	239,936,189	312,200,627
Loans and Leases, Net	2,131,665,132	1,851,957,842
Banking Houses, Furniture and Fixtures	25,728,081	26,388,272
Other Assets	163,968,895	162,634,785
Total	2,600,354,015	2,580,372,518

Liabilities & Equity		
Deposits	$ 2,174,408,649	$ 2,257,301,154
Federal Funds Purchased	94,690,563	-
Other Liabilities	67,318,613	81,912,018
Equity	263,936,190	241,159,346
Total	2,600,354,015	2,580,372,518

Condensed Consolidated
Statement of Income

Income	12/31/23	12/31/22
Interest Income	$ 114,499,201	$ 94,271,379
Interest Expense	31,434,909	8,323,695
Net Interest Income	83,064,292	85,947,684
Other Operating Income	29,300,621	27,986,487
Other Operating Expense	78,392,784	72,939,704
Income Before Taxes	33,972,129	40,994,467
Income Taxes	8,470,000	10,570,000
Net Income	$ 25,502,129	$ 30,424,467
Earnings Per Share*	$ 3.23	$ 3.85
Book Value Per Share*	$ 33.38	$ 30.55
Shares Outstanding	8,178,741	8,178,741

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

Executive Leadership Team

Merchants' strong reputation as a community banking leader is a reflection of the strength of an extraordinary team of people and unwavering commitment to fulfilling our mission, both driven by the Company's Executive Leadership Team. With Board oversight, we focus on objectives that align with our core values and three strategic pillars defined in our long-range plan: Consistently deliver exceptional customer experiences; embrace teamwork and responsibility as "One Merchants;" and deliver the revenue growth and earnings optimization necessary for long-term relevance in an intensely-competitive industry so we may earn the opportunity to fulfill the hopes and dreams of our customers and communities for years to come.

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

- In banking since 1989
- Joined Merchants in 1989

Cat Breet
Chief Human Resource Officer

- In human resources since 1997
- Joined Merchants in 2022

Andrew Guzzo
Chief Banking Officer & President (Winona)

- In banking since 2006
- Joined Merchants in 2017

Cindy Harrison
Chief Credit Officer

- In banking since 1992
- Joined Merchants in 1992

Erick Maki
Regional President, South Region

- In banking since 2001
- Joined Merchants in 2022

Dan Massett
Regional President, North Region

- In banking since 1991
- Joined Merchants in 2014

Sue Savat
Chief Financial Officer

- In banking since 1992
- Joined Merchants in 2000 (also from 1992-1995)

Dave Schlauderaff
President, Merchants Bank Equipment Finance

- In equipment finance since 1998
- Joined Merchants in 2022

Stephen Swenson
Chief Information Officer

- In information technology since 1984
- Joined Merchants in 2020

Sharing Our Story

The story of Merchants Bank is truly the story of the customers we work with day in and day out. As community bankers, we are grateful for the opportunity to help write the stories of our customers every single day. It's our privilege to share these stories from a few of our customers about how we've worked together to realize hopes and dreams, find places to call home, build and strengthen businesses and keep nonprofits thriving.

Home Dreams Come True

With a competitive housing market, limited home inventory and rising mortgage rates, buying a home in 2023 was daunting for some. As first-time homebuyers, Kendall Ritter shares how she and her husband, Joseph, relied on the expertise of Mortgage Lender, Nicole Williamson, to guide them through the process and secure their dream home.

Nicole Williamson
Mortgage Lender
Lanesboro

"We had been searching for a home for over a year and I had myself convinced that we'd never find what we were looking for. My husband and I had a specific vision of our future home, and it was difficult to find.

Kendall and Joseph Ritter

As we continued to search, we worked through the mortgage pre-approval process with Nicole. After seeing the loan scenarios in black and white, I started to feel more hopeful because it showed us that the home we were envisioning was something we could truly afford. It made a huge difference to me. Shortly after that, the perfect house came on the market - it was exactly what we were looking for! Between the quick work of our realtor and Nicole, we were able to put in an offer the same day it was listed. Thankfully our offer was accepted, and we now own our dream home.

Nicole and the mortgage team at Merchants made the entire mortgage process seamless. I've always heard that buying a home can be super stressful, but I didn't feel that one bit. Those people should have chosen Nicole and Merchants Bank."

A Place for Family Memories

After starting a family, owning a family cabin was Sophie Rupp and her partner Harrison's dream. Working with Mortgage Lender, Robb Nelson, they found the perfect cabin and turned it into a peaceful retreat before the birth of their second daughter, Lorelei.

Robb Nelson
Mortgage Lender
Northfield

Sophie Rupp and Harrison Wagenseil

We had been looking for a cabin for a few years when Harrison stumbled upon a unique property for sale in Northern Wisconsin. It was December and when we went to go look at it we fell in love with it immediately, even in the middle of winter.

With the competitive market, it was important to us to put in an offer as soon as possible. I appreciated that Robb worked quickly through the mortgage process and was accommodating to some extra documentation requests from the sellers. He was a joy to work with and made us an absolute priority. In this day and age, I feel like that's rare.

We closed in March and spent the next two months furiously getting the cabin ready before our daughter was born in May. Our goal was to make the space beautiful for not only our family, but for other families to rent as a vacation home.

When Lorelei was born, our family spent every weekend that month at the cabin creating special memories. After that, the cabin was rented all summer and it was rewarding to see our hard work pay off (even though we missed being there ourselves)! We're looking forward to enjoying winter weekends up North as a family, building fires in the amazing fireplace and rediscovering our love for cold weather activities. And of course, spending time there in the warmer months, too, if there's room between renters! Thank you, Robb, and the team at Merchants for playing a big part in helping us achieve our dream of owning a family cabin.

Mission-Driven Work

As told by Sue Mackert, PossAbilities

The relationship between community banks and local nonprofits is special. When two mission-driven organizations work together, like Merchants and PossAbilities, it's the individuals in the community that benefit the most. Sue Mackert, Executive Director, shares their journey to financial growth and greater community impact.

Sue with Jarett Jones, Rochester President, and Masood Dehnavifar, Trust Department Manager.

At PossAbilities, we provide day and employment services for people with disabilities so they can contribute to and connect with the community. A few years ago, we navigated a difficult financial situation that needed support from a bank. Not just any bank, but one that embraced our mission and understood the intricacies of finance in a complex nonprofit organization. I started looking for a bank that demonstrated its support for community banking and for individuals with disabilities.

I chose Merchants because there was a sense of community and a welcoming environment. Jarett Jones and the team listened to our needs and challenges. They took time to learn about our business. The relationship we built enabled us to develop a mutually beneficial plan to reduce overhead debt, eliminate unmanageable debt, establish reserve accounts, and better focus on our most important asset – our employees. We've come a long way in the past few years. We both know this organization needs to be here for the community and having Merchants' financial advisors supporting what we do means a lot.

Our relationship has grown to include full services from the Trust Department. They handle our employee retirement plan, advise us on how best to invest funds and manage day-to-day accounts. My human resources and finance staff are impressed with the professionals at Merchants. As Executive Director, their satisfaction is important to me.

With our banking in good hands, PossAbilities is well positioned to meet the needs of the growing disabilities community of southeast Minnesota. Innovation and inclusion are at the heart of our mission and I credit our partnership with Merchants for helping us get to a place where I can fully concentrate on our mission. It's rewarding to look back and see how far both of our organizations have come. Together, anything is possible.

Growing Small Business

As told by Mike Jensen, Gauthier Industries

Providing the financing for businesses to grow and meet new goals is just one way Merchants Bank contributes to local economies. As Mike Jensen, President of Gauthier Industries, a precision stampings and metal fabricator, explains the company has found positive impacts to their bottom line through a Merchants partnership.

Mike with Jarett Jones, Rochester President.

"We first had the opportunity to work with Merchants on Paycheck Protection Program loans during the pandemic and I could tell immediately that our relationship was going to be different from what I was used to at a big bank. The smaller, community atmosphere and customer service that goes along with that is a major difference maker for us as a business.

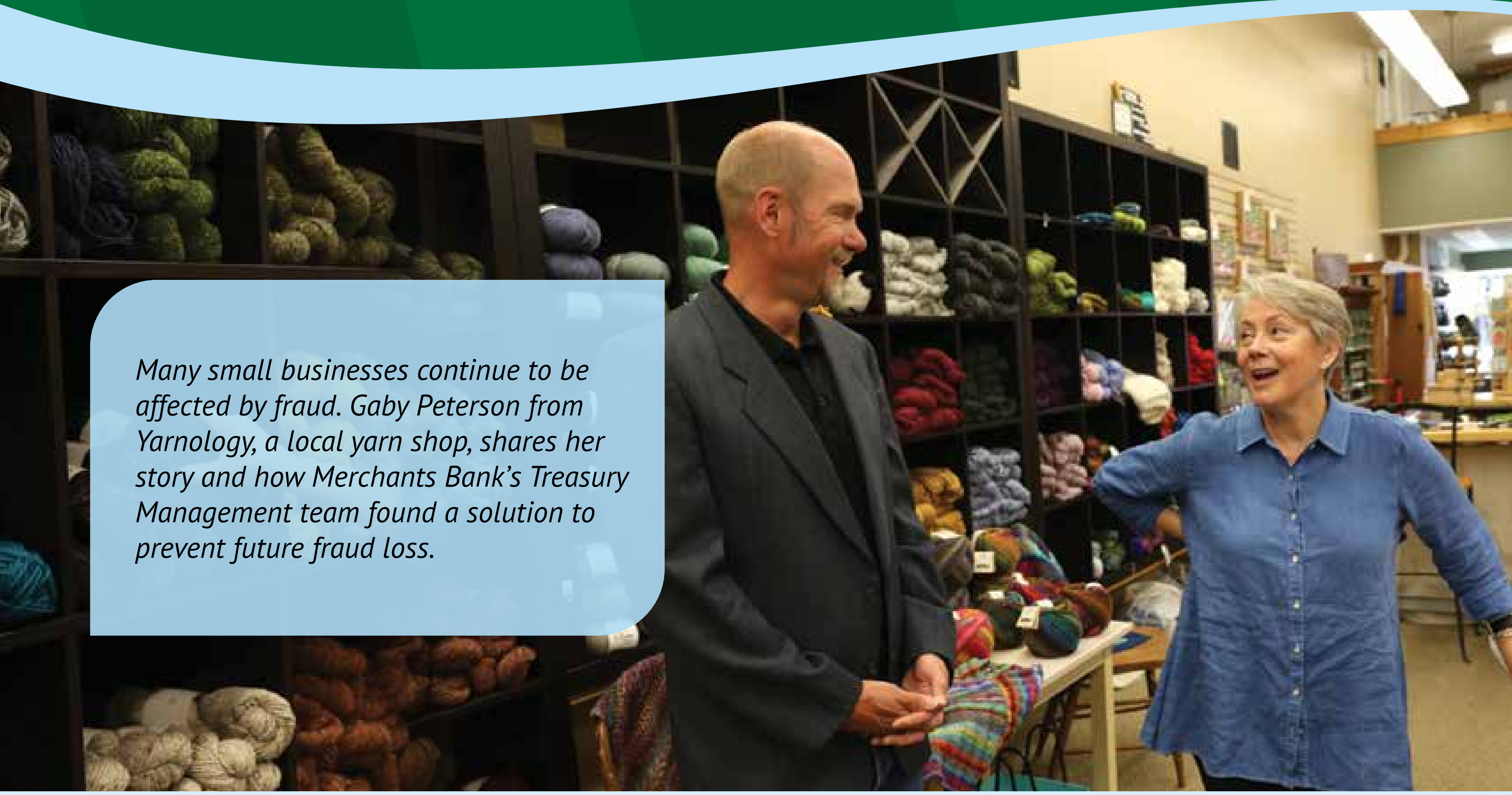
I really appreciate working with Jarett Jones, our Commercial Banker, and Nick Benz in Treasury Management. There is clear communication on all the products and services available and how we can take advantage of the best options for our business. Jarett and Nick have provided multiple ways to pay our vendors and introduced us to security features to keep our account information secure and prevent fraud.

Jarett and I are closely in touch on business happenings, and he knows our goal is to grow. He provides fair loan rates and terms and is mindful of the bank rate environment. As we look at future purchases or expenses, Jarett continues to share creative financing options. Purchasing a new piece of equipment, like a laser, can have a huge impact on efficiency and give us a competitive advantage. We can cut material three times faster and expand our customer base by providing more flexibility and cutting thicker materials. Ultimately the equipment investment will provide higher revenue and profits, along with additional production capacity.

We are in business to be profitable, and our solid banking relationship with Merchants helps us achieve that goal. I would encourage Merchants to keep doing what they do best, be a key player in the success of business customers. At Gauthier Industries, we are grateful for it and look forward to a great future."

Peace of Mind with Fraud Protection

As told by Gaby Peterson, Yarnology



Many small businesses continue to be affected by fraud. Gaby Peterson from Yarnology, a local yarn shop, shares her story and how Merchants Bank's Treasury Management team found a solution to prevent future fraud loss.

Gaby with Lucas Stangl, Treasury Management Consultant.

"When I was reviewing account statements, I spotted transactions from companies that Yarnology does not do business with, and the dollar amounts were large and varying. That was a red flag for me.

I got in touch with my bankers at Merchants who helped me assess the situation. They were my guardian angels. I was frazzled and their calm, positive demeanors were what I needed in that moment. They knew that the best person to help me would be Lucas Stangl, in the Treasury Management area.

He got to work researching the transactions and looking for a solution. Eventually he set up ACH Blocks to stop the current fraudulent transactions and prevent future ones from automatically posting to the Yarnology checking accounts.

ACH Blocks has been very easy to use. Every morning, with my coffee nearby and cat in my lap, I sign into our online banking account and review incoming automatic payment requests. I decide what goes through and what is blocked. It's just part of my daily routine now and I have peace of mind knowing we are in control.

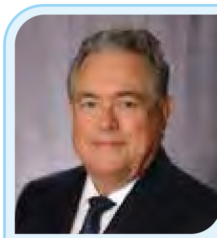
No business owner wants to have to take this step, but fraud is a reality most of us will have to address at some point. Merchants has been so supportive throughout this process. We couldn't ask for a better banking partner."

Merchants Bank Local Leadership

Our unique leadership structure encourages strong community partnerships with leaders who understand and serve the needs of their local market.

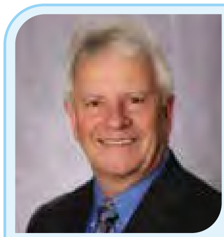
Larry Bodin
President, La Crescent and Onalaska

- In banking since 1986
- Joined Merchants in 2020



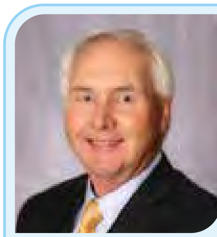
Jon Dahl
President, Cannon Falls and Hampton

- In banking since 1983
- Joined Merchants in 2020



Bruce Goblirsch
President, Cottage Grove and Hastings

- In banking since 1986
- Joined Merchants in 2002

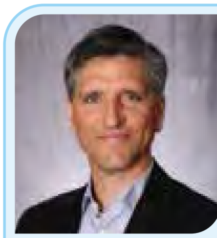


Ken Graner
President, Lanesboro, Rushford and St. Charles

- In banking since 1981
- Joined Merchants in 2009

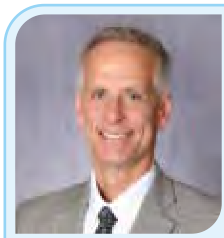
Andrew Guzzo
Chief Banking Officer & President (Winona)

- In banking since 2006
- Joined Merchants in 2017



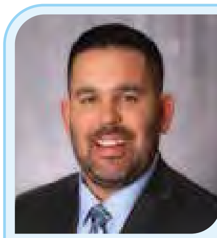
Jarett Jones
President, Rochester

- In banking since 1999
- Joined Merchants in 2020



Kirk Muhlenbruck
President, Northfield

- In banking since 1988
- Joined Merchants in 2021



Tom Pasch
President, Red Wing

- In banking since 2009
- Joined Merchants in 2021

Dave Schlauderaff
President, Merchants Bank Equipment Finance

- In equipment finance since 1998
- Joined Merchants in 2022

Matt Schuldt
President, Caledonia and Spring Grove

- In banking since 2009
- Joined Merchants in 2014

Seth Sundeen
President, Eau Claire

- In banking since 2003
- Joined Merchants in 2023

Dan Vlasak
President, Apple Valley, Lakeville and Rosemount

- In banking since 1989
- Joined Merchants in 2009

Community Commitment in Action

We're proud to serve our communities and share photos from volunteer efforts and events in 2023.

Twin Cities-Metro CDC | Hastings

Feed My People | Eau Claire

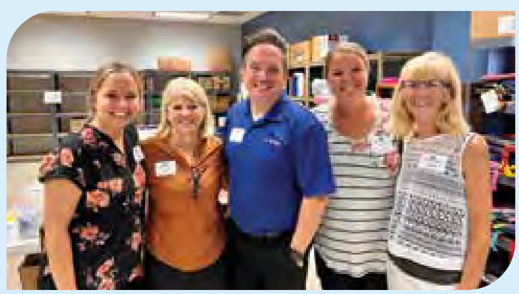
Feed My Starving Children | Edina

Night of PossAbilites Fundraiser | Rochester

10 Days of Giving | Winona

Prairie Heights Housing Development | Eau Claire

Operation Joy | Northfield



School Supply Drive | Hastings

Rotary Lights | Onalaska

Habitat for Humanity | Edina

Home Delivered Meals | Winona

Habitat for Humanity | St. Charles

Toys for Kids | Winona

Merchants Financial Group Board of Directors

Richard T. Lommen, Jr.
Chair of the Board
President & Owner

Courtesy Corporation

Ann E. Merchlewitz
Vice Chair of the Board
Senior Vice President & General Counsel

Saint Mary's University of Minnesota

Michael F. Cichanowski
Founder & Chief Executive Officer

Wenonah Canoe, Inc.

Gregory M. Evans
President & Chief Executive Officer

Merchants Financial Group, Inc. and
Merchants Bank, NA

Molly K. Jungbauer, CPA
Chief Executive Officer

Hollstadt Consulting, Inc.

John H. Killen
President

WinCraft, a Fanatics brand

Bradley J. Peterson
Chairman

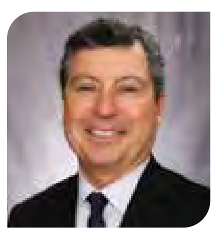
Mississippi Welders Supply Co., Inc.

James A. Rogers III
Chief Business Development Officer
Senior Administrator, Generative AI

Mayo Clinic

Bruce E. Ryan
President

Ryan Windows & Siding, Inc.



James A. Trenda, CPA
President

CP Advisors, LLC

Merchants Bank Charter Board of Directors

Richard T. Lommen, Jr.
Chair of the Board
President & Owner
Courtesy Corporation

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

Richard J. Falck
Owner, Falck Financial Services LLC
President, RJF, Inc.

John H. Killen
President
WinCraft, a Fanatics brand

James A. Rogers III
Chief Business Development Officer
Senior Administrator, Generative AI
Mayo Clinic

Jennifer R. Sawyer
Founder & Partner
Rebound Partners

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

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

Molly K. Jungbauer, CPA
Chief Executive Officer
Hollstadt Consulting, Inc.

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 Advisory Boards

North Region/Cannon Falls Area

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Retired Owner
Althoff Hardware

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Farmer & Real Estate Broker
Anderson Realty, LLC

Lisa M. Lundell
Real Estate Broker/ Owner
Cannon Realty

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Owner
Peterson Turkey Hatchery, Inc.

Mark A. Poss
Director
Big Fish Ventures

Brenda A. Stelter
Owner
Anchor Promotions, Apparel & Signage

North Region/Northfield

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Director - Business Development
Professional Risk Managers' International Association

Matthew T. Christensen
VP/Risk & Insurance Advisor
USI

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Owner, Falck Financial Services LLC
President, RJF, Inc.

Chris J. Kennelly
Real Estate Developer & Entrepreneur
REVocity
NCC Builders
G&H Management

Jennifer R. Sawyer
Founder & Partner
Rebound Partners

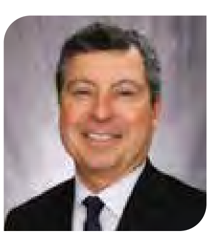
Kristin L. Yahnke
Attorney & Partner
Schmitz Ophaug, LLP

North Region/Twin Cities Area

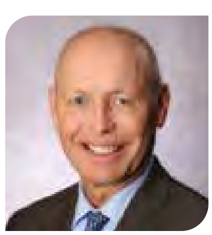
Ben E. Gathje
Owner/Operator
Culver's of Cottage Grove

Peggy P. Johnson
Community Relations Director
Dakota Electric Association

Molly K. Jungbauer, CPA
Chief Executive Officer
Hollstadt Consulting, Inc.



James A. Trenda
President
CP Advisors, LLC

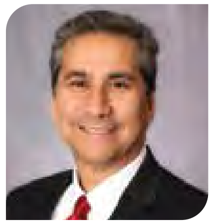


Richard H. Welshons
Twin Cities Manager
The Title Team/ DCA Title

Merchants Bank Advisory Boards

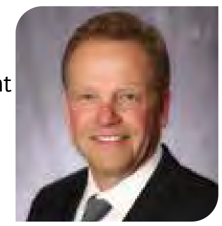
South Region/La Crosse Market Area

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



Derek S. Cortez, Ph.D.
Chief Executive Officer
Chileda, Inc.

Stephen D. Loehr
Retired Vice President
of Government &
Industry Relations
Kwik Trip, Inc.



Brian D. Wieser
Owner/Vice President
Wieser Brothers General
Contractor, Inc.

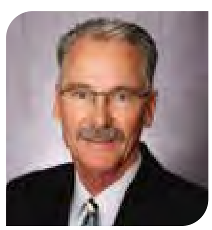
South Region/Rochester

John C. Beatty
Attorney
Dunlap & Seeger, PA

Aaron J. Benike
Vice President
of Operations
Benike Construction

Joselyn A. Raymundo
Former Founder/CEO
Rochester Home
Infusion

James A. Rogers III
Chief Business
Development Officer
Senior Administrator,
Generative AI
Mayo Clinic

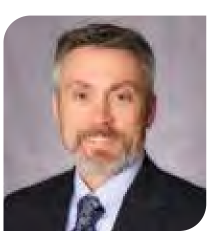


Bruce E. Ryan
President
Ryan Windows
& Siding, Inc.

South Region/Rural Market Area

Adam P. Augedahl
President
Winona Controls, Inc.

John D. Diersen
Owner & Farmer
Minnigan Hills Farm



Creighton M. Horihan
Owner
Horihan Companies

Joel B. Nelson
Farmer & Owner
Lanesboro Sales Commission
Decorah Sales Commission

Consolidated Financial Report

December 31, 2023
Merchants Financial Group, Inc. and Subsidiaries

CONTENTS

Merchants
Financial Group

102 East Third Street • Winona, MN 55987
(507) 457-1100 • www.merchantsbank.com

RSM

RSM US LLP

Independent Auditor's Report

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

Report on the Audit of the Financial Statements

Opinion

We have audited the consolidated financial statements of Merchants Financial Group, Inc. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2023 and 2022, 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).

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2023 and 2022, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with auditing standards generally accepted in the United States of America (GAAS), the Company's internal control over financial reporting as of December 31, 2023, 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 12, 2024, expressed an unmodified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

We conducted our audits in accordance with GAAS. Our responsibilities under those standards are further described in the '"Auditor's Responsibilities for the Audit of the Financial Statements'" section of our report. We are required to be independent of the Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Emphasis of Matter

As discussed in Note 1 to the financial statements, the Company has changed its method of accounting for measurement of credit losses on financial instruments in 2023 due to the adoption of Accounting Standards Update 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. Our opinion is not modified with respect to this matter.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for 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.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern within one year after the date the financial statements are issued or available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements
Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.

- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.

- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Other Information Included in the Annual Report
Management is responsible for the other information included in the annual report. The other information comprises the information included in the annual report but does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

RSM US LLP

Sioux Falls, South Dakota
February 12, 2024

Merchants Financial Group, Inc. and Subsidiary

Consolidated Balance Sheets
December 31, 2023 and 2022
(In Thousands, Except Share Information)

Assets	**2023**	2022
Cash and cash equivalents (Note 2)	**$ 39,056**	$ 227,191
Federal funds sold	**-**	277
Available-for-sale securities (Notes 3 and 10)	**202,215**	275,131
Held-to-maturity securities (Notes 3 and 10)	**37,721**	37,070
Loans held for sale (Note 4)	**1,929**	6,202
Loans and direct financing leases, net (Notes 5, 10, 14 and 16)	**2,131,665**	1,851,958
Operating lease assets, net (Note 6)	**20,365**	21,558
Premises and equipment, net (Note 7)	**25,728**	26,388
Investment in restricted stock	**9,430**	7,163
Other real estate and other personal property owned (Note 8)	**1,005**	806
Accrued interest receivable and other assets	**20,165**	15,331
Cash value of life insurance	**59,753**	58,197
Mortgage servicing rights, net (Note 4)	**15,339**	16,638
Goodwill (Note 1)	**35,665**	35,665
Intangibles (Note 1)	**317**	797
Total assets	**$ 2,600,353**	$ 2,580,372
Liabilities and Stockholders' Equity		
Liabilities		
Deposits (Note 9):		
Noninterest-bearing	**$ 482,293**	$ 635,853
Interest-bearing	**1,692,116**	1,621,448
Total deposits	**2,174,409**	2,257,301
Federal funds purchased	**94,690**	-
Repurchase agreements (Note 10)	**15,064**	12,019
Notes payable (Note 11)	**7,262**	12,120
Subordinated debentures (Note 12)	**28,351**	41,254
Deferred taxes (Note 13)	**1,617**	3,233
Accrued interest payable and other liabilities (Note 13)	**15,024**	13,286
Total liabilities	**2,336,417**	2,339,213
Commitments, Contingencies and Credit Risk (Note 14)		
Stockholders' Equity (Note 17)		
Common stock, par value $0.025 per share; 25,000,000 shares authorized; shares issued: 8,178,741 in 2023 and 2022	**68**	68
Additional paid-in capital	**10,274**	10,255
Retained earnings	**273,170**	254,087
Accumulated other comprehensive gain (Note 3)	**(12,598)**	(14,899)
Unearned ESOP shares (Note 15)	**(6,978)**	(8,352)
Total stockholders' equity	**263,936**	241,159
Total liabilities and stockholders' equity	**$ 2,600,353**	$ 2,580,372

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Income
Years Ended December 31, 2023 and 2022
(In Thousands, Except Per Share Information)

	2023	2022
Interest income:		
Loans	$ 100,203	$ 77,706
Securities	7,072	5,545
Direct financing leases	1,673	2,512
Other	5,550	8,508
	114,498	94,271
Interest expense:		
Deposits	27,776	6,101
Notes payable, federal funds purchased and repurchase agreements	941	382
Subordinated debentures	2,719	1,841
	31,436	8,324
Net interest income	83,062	85,947
Credit loss expense (benefits) under CECL (Note 5)	1,380	(2,276)
Net interest income after credit loss expense (benefits) under CECL	81,682	88,223
Noninterest income:		
Trust department	2,746	2,368
Service charges and other fees	7,018	5,476
Loan servicing fees	6,998	7,216
Net gain on sale of available-for-sale securities (Note 3)	(134)	-
Net gain on sale of loans	2,142	3,389
Net gain (loss) on sale of other real estate and other personal property owned including writedowns (Note 8)	(8)	(161)
Other	10,539	9,699
	29,301	27,987
Noninterest expenses:		
Salaries and employee benefits (Note 15)	42,034	42,326
Occupancy	18,148	16,834
Net loss on disposal of premises and equipment	-	15
Mortgage servicing rights (Note 4)	3,053	3,379
Other	13,776	12,662
	77,011	75,216
Income before income taxes	33,972	40,994
Provision for income taxes (Note 13)	8,470	10,570
Net income	$ 25,502	$ 30,424
Earnings per common share (Note 1)	$ 3.23	$ 3.85

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income
Years Ended December 31, 2023 and 2022
(In Thousands)

	2023	2022
Net income	**$ 25,502**	$ 30,424
Other comprehensive income, net of reclassification adjustments and income tax effect:		
Change in unrealized gains on securities	**2,464**	(15,495)
Unrealized gain (loss) on interest rate swap	**(163)**	1,387
Total other comprehensive income (loss)	**2,301**	(14,108)
Comprehensive income	**$ 27,803**	$ 16,316

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2023 and 2022
(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, 2021	$ 68	$ 10,135	$ 228,632	$ (791)	$ (7,405)	$ 230,639
Net income	-	-	30,424	-	-	30,424
Other comprehensive income (Note 3)	-	-	-	(14,108)	-	(14,108)
ESOP shares purchased	-	-	-	-	(2,410)	(2,410)
ESOP shares released for allocation (Note 15)	-	120	-	-	1,463	- 1,583
Cash dividends declared ($1.50 per share)	-	-	(4,969)	-	-	(4,969)
Balance, December 31, 2022	$ 68	$ 10,255	$ 254,087	$ (14,899)	$ (8,352)	$ 241,159
Net income	-	-	25,502	-	-	25,502
Other comprehensive income (Note 3)	-	-	-	2,301	-	2,301
ESOP shares released for allocation (Note 15)	-	19	-	-	1,374	1,393
Cash dividends declared ($2.65 per share)	-	-	(5,535)	-	-	(5,535)
Change in accounting principle (Note 1)	-	-	(884)	-	-	(884)
Balance, December 31, 2023	**$ 68**	**$ 10,274**	**$ 273,170**	**$ (12,598)**	**$ (6,978)**	**$ 263,936**

See Notes to Consolidated Financial Statements.

Merchants Financial Group, Inc. and Subsidiary

Consolidated Statements of Cash Flows
Years Ended December 31, 2023 and 2022
(In Thousands)

	2023	2022
Cash Flows From Operating Activities		
Net income	**$ 25,502**	$ 30,424
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization and accretion of bond premiums and discounts	**41**	372
Credit loss expense (benefits) (Note 5)	**1,380**	(2,276)
Net gain on sale of loans	**(2,142)**	(3,389)
Net change in fair value of loans held for sale	**74**	(37)
Proceeds from sales of loans held for sale	**160,387**	312,125
Originations and purchases of loans held for sale	**(155,313)**	(293,286)
Net loss on sale of available-for-sale securities	**134**	-
Mortgage servicing rights (Note 4)	**3,053**	3,379
Depreciation expense	**6,497**	5,896
Net charge-offs/write-downs of OREO (Note 8)	**8**	161
Loss on disposal of fixed assets	**-**	15
Deferred income taxes (Note 13)	**(2,572)**	5,874
Release of shares to ESOP	**1,393**	1,583
Increase in cash value of life insurance	**(1,556)**	(1,361)
Other	**(2,778)**	(2,662)
Net cash provided by operating activities	**34,108**	56,818
Cash Flows From Investing Activities		
Cash flows from securities (Note 18)	**75,509**	(129,994)
Purchases of restricted stock	**(2,267)**	(283)
Net decrease in federal funds sold	**277**	136
Net increase in loans and direct financing leases	**(282,318)**	(270,523)
Purchases of operating lease assets	**(3,726)**	(8,325)
Purchases of premises and equipment	**(918)**	(456)
Purchases of life insurance	**-**	(7,850)
Purchases of mortgage servicing rights	**(487)**	(1,310)
Proceeds from sales of equipment	**-**	40
Proceeds from sales of OREO and foreclosed assets	**140**	272
Net cash used in investing activities	**(213,790)**	(418,293)
Cash Flows From Financing Activities		
Net decrease in deposits	**(82,892)**	(261,262)
Net increase in federal funds purchased	**94,690**	-
Net increase in short-term borrowings (Note 10)	**3,045**	10,319
Repayment of long-term borrowings	**(4,858)**	(2,420)
Redemption of TRUPS	**(12,903)**	-
ESOP shares purchased	**-**	(2,410)
Cash dividends paid	**(5,535)**	(4,969)
Net cash used in financing activities	**(8,453)**	(260,742)
Decrease in cash and cash equivalents	**(188,135)**	(622,217)
Cash and Cash Equivalents		
Beginning	**227,191**	849,408
Ending	**$ 39,056**	$ 227,191

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 (the Bank). The Bank 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. The Bank provides retail, commercial loan and deposit services principally to customers within a 50-mile radius of its locations. The Bank has a leasing division, Merchants Bank Equipment Finance, which operates in the Minneapolis–St. Paul, Minnesota metropolitan area.

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 credit 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 $353,792 and $283,251 as of December 31, 2023 and 2022, 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.

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.

(In Thousands, Except Share Information)

Note 1. Basis of Presentation (Continued)

Securities: On January 1, 2023, the Company adopted ASU 2016-13 Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, as amended, which replaces the incurred loss methodology with an expected loss methodology that is referred to as the current expected credit loss (CECL) methodology. The measurement of expected credit losses under the CECL methodology is applicable to financial assets measured at amortized cost, including held-to-maturity debt securities. The Company's held-to-maturities debt securities are primarily issued by U.S. government-sponsored agencies and entities. These securities are implicitly guaranteed by the U.S. government and are consistently highly rated by major rating agencies with very little risk to default. There was $0 recorded for credit losses on held-to-maturity debt securities as of December 31, 2023.

Past due information for securities held-to-maturity as of December 31, 2023 supports the Company's conclusion to not record any credit loss for the held-to-maturity securities portfolio:

	Current	30-59 Days Past Due	60-89 Days Past Due	Past Due 90 Days or More	Total Past Due	Total
GSE residential mortgage-backed securities	$ 22,732	$ -	$ -	$ -	$ -	$ 22,732
GSE collateralized residential mortgage obligations	9,909	-	-	-	-	9,909
Obligations of states and political subdivisions	416	-	-	-	-	416
GSE commercial mortgage-backed securities	1,033	-	-	-	-	1,033
Total past due	$ 34,090	$ -	$ -	$ -	$ -	$ 34,090

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.

As of December 31, 2023, the fair value of our available-for-sale securities portfolio was approximately $202. Factors beyond the Company's control can significantly influence the fair value of securities in the portfolio and can cause potential adverse changes to the fair value of these securities. Additional factors include, but are not limited to, rating agency downgrades of the securities, defaults by the issuer or individual mortgagors with respect to the underlying securities, and instability in the credit markets. Any of the foregoing factors could result in the recognition of a loss through earnings. Because of changing economic and market conditions affecting interest rates, the financial condition of issuers of the securities and the performance of the underlying collateral, we may recognize realized and/or unrealized losses in future periods, which could have an adverse effect on our financial condition and results of operations.

Note 1. Basis of Presentation (Continued)

As of December 31, 2023, the Company had $18 in net unrealized losses in the debt securities available for sale portfolio and $3 million in net unrealized losses in the held to maturity debt securities portfolio. If the Company is forced to liquidate any of those investments prior to maturity, including because of a lack of liquidity, it would recognize as a charge to earnings the losses attributable to those securities. The securities portfolio has an average duration of 3.6 years, and the Company would expect a decrease in realized losses if interest rates fall in 2024.

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 credit losses.

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.

Note 1. Basis of Presentation (Continued)

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 modification. 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 modification 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 modification 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: On January 1, 2023, the Company adopted ASU 2016-13 Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, as amended, which replaces the incurred loss methodology with an expected loss methodology that is referred to as the current expected credit loss (CECL) methodology. The measurement of expected credit losses under the CECL methodology is applicable to financial assets measured at amortized cost, including loan receivables and held-to-maturity debt securities. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor in accordance with Topic 842 on leases.

The Company adopted ASC 326 using the modified retrospective method for all financial assets measured at amortized cost, net investments in leases and off-balance sheet (OBS) credit exposures. Results for reporting periods beginning after January 1, 2023 are presented under ASC 326 while prior period amounts continue to be reported in accordance with previously applicable Generally Accepted Accounting Principles (GAAP). The Company recorded a net decrease to retained earnings of $884 as of January 1, 2023 for the cumulative effect of adopting ASC 326. The transition adjustment includes an impact due to adjusting the calculation to forecast the loss over the life of the loan or lease to comply with currently applicable GAAP standard versus at a specific point in time under previously applicable GAAP.

The allowance for loan and lease losses is established through a provision for credit 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. Management estimates the allowance balance using relevant available information, from both internal and external sources, past events, current conditions, and reasonable and supportable forecasts. This evaluation also takes into consideration differences in current loan-specific risk characteristics such as differences in underwriting standards, portfolio mix, delinquency level, or term as well as for changes in environmental and economic conditions, such as changes in unemployment rates, property values, or other relevant factors.

Note 1. Basis of Presentation (Continued)

The Company estimates the allowance for credit losses based on the underlying assets' amortized cost basis, which is the amount at which the financing receivable is originated or acquired, adjusted for collection of cash and charge-offs, as well as applicable accretion or amortization of premium, discount, and net deferred fees or costs. In the event that collection of principal becomes uncertain, the Company has policies in place to reverse accrued interest in a timely manner. Therefore, the Company has made a policy election to exclude accrued interest from the measurement of allowance for credit losses.

Financial instruments include off-balance sheet credit losses, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for off-balance sheet loan commitments is represented by the contractual amount of those instruments. Such financial instruments are recorded when they are funded.

The Company recognizes a liability for off-balance sheet credit losses through a charge to credit loss expense for off-balance sheet credit losses, which is included in credit loss expense in the Company's consolidated statements of income, unless the commitments to extend credit are unconditionally cancellable, such as credit cards. The liability for off-balance sheet credit losses is estimated by loan segment at each balance sheet date under the current expected credit loss model using the same methodologies as portfolio loans, taking into consideration the likelihood that funding will occur, and is included in other liabilities on the Company's consolidated balance sheets. The balance of this liability as of December 31, 2023 was $3,115.

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.

Loans that do not share risk characteristics are evaluated on an individual basis. Loans evaluated individually are not also included in the collective evaluation. When management determines that foreclosure is probable expected credit losses are based on the fair value of the collateral at the reporting date, adjusted for selling costs as appropriate.

Loans are categorized into pools of loans with similar risk and loss characteristics and assessed for expected losses. These loan pools include commercial; commercial real estate; agricultural, including real estate; residential real estate; consumer; and direct financing leases.

Management estimates the allowance using relevant available information from internal and external sources, relating to past events, current conditions, and reasonable and supportable forecasts. The Company uses historical credit loss experience and benchmark data to provide a basis for expected credit losses. Qualitative adjustments to historical loss information are made for differences in current loan-specific risk characteristics such as: changes in the lending policies and procedures, including underwriting standards and collection, charge off, and recovery practices; 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 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.

(In Thousands, Except Share Information)

Note 1. Basis of Presentation (Continued)

The following table illustrates the impact of ASC 326:

	January 1, 2023		
	As Reported Under ASC 326	Pre-ASC 326 Adoption	Impact of ASC 326 Adoption
Assets:			
Loans			
Commercial	$ 3,117	$ 2,741	$ 376
Commercial real estate	16,137	16,090	47
Agricultural, including real estate	1,669	1,347	322
Residential real estate	3,350	2,515	835
Consumer	1,190	850	340
Direct financing leases	1,874	2,566	(692)
Total	$ 27,337	$ 26,109	$ 1,228
Less deferred tax liability			344
Change in accounting principle (Note 1)			$ 884

Acquired loans: The Company adopted ASC 326 using the prospective transition approach for financial assets purchased with credit deterioration (PCD) that were previously classified as purchase credit impaired (PCI) and accounted for under ASC 310-30. On January 1, 2023, there were no PCD assets in the Company's loan portfolio and there was no allowance for credit losses assigned for this purpose.

As allowed by ASC 326, the Company elected to maintain pools of loans accounted for under ASC 310-30. The Company segments the loan portfolio into pools based on the following risk characteristics: financial asset type, collateral type, loan characteristics, credit characteristics, industry of borrower and concentrations, and historical or expected credit loss. In accordance with the standard, management did not reassess whether modifications to individual acquired financial assets accounted for in pools were modifications to borrowers experiencing financial difficulty as of the date of adoption.

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, 2023 and 2022.

Note 1. Basis of Presentation (Continued)

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.

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 2023 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 2023 and applied an adjustment factor to recognize the improvement. The secondary market buyback reserve at December 31, 2023 and 2022 was $100 and $175, respectively.

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.

(In Thousands, Except Share Information)

Note 1. Basis of Presentation (Continued)

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 2023 and 2022 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. The amortization of the core deposit intangible was $479 and $697 in 2023 and 2022, respectively. Future amortization of the core deposit intangible is as follows:

Years Ending December 31,	
2024	263
2025	54
	$ 317

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 swap on trust preferred securities: 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 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. 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.

Note 1. Basis of Presentation (Continued)

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 $126 and $134 were made in 2023 and 2022, 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 7,907,292 and 7,894,867 in 2023 and 2022, respectively. Effective May 13, 2022, the Company effected a three-for-one stock split for shareholders of record as of May 5, 2022. All share amounts and per share financial data contained in these financial statements related to periods prior to this stock split have been adjusted to reflect the split.

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 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 12, 2024, the date the consolidated financial statements were available to be issued.

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 balance as of December 31, 2023 and 2022, was $3,581 and $0, 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, 2023				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Credit Loss Recognized	Fair Value
Securities available for sale:					
GSE residential mortgage-backed securities	$ 48,521	$ 311	$ (3,213)	$ -	$ 45,619
GSE collateralized residential mortgage obligations	112,704	65	(13,696)	-	99,073
Obligations of states and political subdivisions	90	-	-	-	90
US government corporations and agencies	7,616	61	(109)	-	7,568
GSE commercial mortgage-backed securities	51,994	-	(2,129)	-	49,865
Total securities available for sale	$ 220,925	$ 437	$ (19,147)	$ -	$202,215
Securities held to maturity:					
GSE residential mortgage-backed securities	$ 24,798	$ 31	$ (2,097)	$ -	$ 22,732
GSE collateralized residential mortgage obligations	11,419	-	(1,510)	-	9,909
Obligations of states and political subdivisions	405	11	-	-	416
GSE commercial mortgage-backed securities	1,099	-	(66)	-	1,033
Total securities held to maturity	$ 37,721	$ 42	$ (3,673)	$ -	$ 34,090

	December 31, 2022			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
GSE residential mortgage-backed securities	$ 82,836	$ 562	$ (3,297)	$ 80,101
GSE collateralized residential mortgage obligations	119,298	-	(16,170)	103,128
Obligations of states and political subdivisions	184	-	-	184
US government corporations and agencies	38,500	-	(751)	37,749
GSE commercial mortgage-backed securities	56,444	-	(2,475)	53,969
Total securities available for sale	$ 297,262	$ 562	$ (22,693)	$ 275,131
Securities held to maturity:				
GSE residential mortgage-backed securities	$ 23,470	$ -	$ (2,086)	$ 21,384
GSE collateralized residential mortgage obligations	13,003	-	(1,645)	11,358
Obligations of states and political subdivisions	597	-	-	597
Total securities held to maturity	$ 37,070	$ -	$ (3,731)	$ 33,339

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, 2023:

	Securities Held to Maturity		Securities Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	$ 84	$ 83	$ 23	$ 23
Due after one year through five years	141	141	67	67
Due after five years through ten years	180	192	-	-
Due after ten years	-	-	-	-
	405	416	90	90
GSE residential mortgage-backed securities	24,798	22,732	48,521	45,619
US government corporations and agencies	-	-	7,616	7,568
GSE collateralized residential mortgage obligations	11,419	9,909	112,704	99,073
GSE commercial mortgage-backed securities	1,099	1,033	51,994	49,865
	$ 37,721	$ 34,090	$ 220,925	$ 202,215

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

There were $134 in realized losses in 2023 and no realized gains or losses in 2022.

Changes in accumulated other comprehensive income related to the unrealized gain (loss) on available-for-sale securities, net of the related deferred tax effects:

	Years Ended December 31	
	2023	2022
Balance, beginning	$ (15,945)	$ (451)
Unrealized holding gain (loss) during the year	3,421	(21,505)
Deferred tax effect of unrealized gain (loss)	(957)	6,011
Balance, ending	$ (13,481)	$ (15,945)

Changes in accumulated other comprehensive income related to the unrealized gain (loss) on interest rate swap on trust preferred securities, net of the related deferred tax effects:

	2023	2022
Balance, beginning	$ 1,046	$ (340)
Unrealized gain (loss) during the year	(226)	1,924
Deferred tax effect of unrealized gain (loss)	63	(538)
Balance, ending	$ 883	$ 1,046

(In Thousands, Except Share Information)

Note 3. Securities (Continued)

Summary of accumulated other comprehensive income (loss):

	December 31 2023	December 31 2022
Available-for-sale securities	$ (13,481)	$ (15,945)
Interest rate swap on trust preferred securities (Note 19)	883	1,046
Balance, ending	$ (12,598)	$ (14,899)

The following tables summarize the Company's investments in an unrealized loss position at December 31, 2023 and 2022, that are not deemed to be other-than-temporarily impaired:

December 31, 2023	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	$ 1,410	$ (35)	$ 32,453	$ (3,178)	$ 33,863	$ (3,213)
GSE collateralized residential mortgage obligations	1,025	(52)	86,880	(13,644)	87,905	(13,696)
US government corporations and agencies	-	-	4,866	(109)	4,866	(109)
GSE commercial mortgage-backed securities	-	-	49,865	(2,129)	49,865	(2,129)
Total securities available for sale	$ 2,435	$ (87)	$ 174,064	$ (19,060)	$ 176,499	$ (19,147)
Securities held to maturity:						
GSE residential mortgage-backed securities	$ -	$ -	$ 17,192	$ (2,097)	$ 17,192	$ (2,097)
GSE collateralized residential mortgage obligations	-	-	9,909	(1,510)	9,909	(1,510)
GSE commercial mortgage-backed securities	1,033	(66)	-	-	1,033	(66)
Total securities held to maturity	$ 1,033	$ (66)	$ 27,101	$ (3,607)	$ 28,134	$ (3,673)

December 31, 2022	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	$ 41,149	$ (2,721)	$ 2,693	$ (576)	$ 43,842	$ (3,297)
GSE collateralized residential mortgage obligations	21,184	(1,694)	81,944	(14,476)	103,128	(16,170)
US government corporations and agencies	37,749	(751)	-	-	37,749	(751)
GSE commercial mortgage-backed securities	47,941	(1,335)	6,028	(1,140)	53,969	(2,475)
Total securities available for sale	$ 148,023	$ (6,501)	$ 90,665	$ (16,192)	$ 238,688	$ (22,693)
Securities held to maturity:						
GSE residential mortgage-backed securities	20,703	(1,948)	681	(138)	$ 21,384	$ (2,086)
GSE collateralized residential mortgage obligations	11,358	(1,645)	-	-	11,358	(1,645)
Total securities held to maturity	$ 32,061	$ (3,593)	$ 681	$ (138)	$ 32,742	$ (3,731)

(In Thousands, Except Share Information)

Note 3. Securities (Continued)

There were 92 and 101 securities in unrealized loss positions at December 31, 2023 and 2022, respectively. The Company believes the unrealized loss position in GSE residential and commercial 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 $147,422 and $156,268 at December 31, 2023 and 2022, 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	
	2023	2022
Loans held for sale, unpaid principal balance	$ 1,892	$ 6,239
Fair value adjustment	37	(37)
Total loans held for sale	$ 1,929	$ 6,202

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	
	2023	2022
Mortgage loan portfolios serviced for:		
FNMA	$ 1,938,089	$ 2,077,301
FHLMC	600,027	547,284
	$ 2,538,116	$ 2,624,585
Outstanding commitments at year-end:		
Commitments to fund loans	$ 7,659	$ 7,283
Commitments to sell loans	8,717	8,504

(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	
	2023	2022
Balance at beginning of year, net	$ 16,638	$ 16,251
Mortgage servicing rights capitalized:		
Loans originated	1,267	2,457
Loans purchased	487	1,309
Amortization expense	(3,053)	(3,379)
Balance at end of year, net	$ 15,339	$ 16,638

The valuation allowance at December 31, 2023 and 2022, was $210 and $1, respectively, with the impairment loss recognized in credit loss expense on the consolidated statements of income. The estimated fair value of the servicing assets aggregated $31,939 and $32,490 at December 31, 2023 and 2022, 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	
	2023	2022
Commercial	$ 450,184	$ 404,029
Commercial real estate	1,188,407	1,007,923
Agricultural, including real estate	152,175	146,104
Residential real estate	275,421	227,673
Consumer	60,529	54,231
Direct financing leases	36,712	41,457
Total loans	2,163,428	1,881,417
Less unearned income on loans and leases	3,618	3,350
Less allowance for credit losses	28,145	26,109
Loans receivable, net	$ 2,131,665	$ 1,851,958

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, 2023 and 2022, the Company had $396 and $575 of loans outstanding under this program, respectively. The Company's unearned income on loans and leases includes $8 and $12 of net deferred loan fees related to SBA PPP loans at December 31, 2023 and 2022, respectively.

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.

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 Company's primary service area, and the equipment leased consists primarily of trucks, construction 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, 2023, 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:

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Years Ending December 31,	
2024	$ 14,124
2025	11,142
2026	5,537
2027	3,374
2028	1,415
Thereafter	1,120
Total lease payments receivable	36,712
Unearned lease residual income	(2,991)
Net investment in direct financing leases	$ 33,721

Loans receivable aging by class:

	December 31, 2023					
	Current	30–59 Days Past Due	60–89 Days Past Due	Loans Past Due 90 Days or More	Total Past Due	Total
Commercial	$ 448,113	$ 1,527	$ 210	$ 334	$ 2,071	$ 450,184
Commercial real estate	1,187,041	873	493	-	1,366	1,188,407
Agricultural, including real estate	149,963	374	57	1,781	2,212	152,175
Residential real estate	270,125	1,407	1,043	2,846	5,296	275,421
Consumer	59,944	504	7	74	585	60,529
Direct financing leases	36,396	163	-	153	316	36,712
Total loans	$ 2,151,582	$ 4,848	$ 1,810	$ 5,188	$ 11,846	$ 2,163,428
Nonperforming loans	$ 3,784	$ 480	$ 131	$ 5,187	$ 5,798	$ 9,582

	December 31, 2022					
	Current	30–59 Days Past Due	60–89 Days Past Due	Loans Past Due 90 Days or More	Total Past Due	Total
Commercial	$ 401,249	$ 2,241	$ 7	$ 532	$ 2,780	$ 404,029
Commercial real estate	1,005,263	2,540	-	120	2,660	1,007,923
Agricultural, including real estate	145,411	390	303	-	693	146,104
Residential real estate	225,032	1,770	366	505	2,641	227,673
Consumer	53,694	460	10	67	537	54,231
Direct financing leases	40,890	567	-	-	567	41,457
Total loans	$ 1,871,539	$ 7,968	$ 686	$ 1,224	$ 9,878	$ 1,881,417
Nonperforming loans	$ 5,043	$ 2,187	$ 68	$ 1,224	$ 3,479	$ 8,522

(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, 2023 and 2022, were as follows:

	Nonaccrual With No Credit Loss	Nonaccrual With Credit Loss	Loans Past Due 90 Days or More and Still Accruing
2023			
Commercial	$ 881	$ 57	$ 106
Commercial real estate	1,408	778	-
Agricultural, including real estate	-	612	1,697
Residential real estate	1,347	1,270	1,025
Consumer	48	119	48
Direct financing leases	33	-	153
Total	$ 3,717	$ 2,836	$ 3,029

2022	Nonaccrual	Loans Past Due 90 Days or More and Still Accruing
Commercial	$ 604	$ 14
Commercial real estate	4,936	66
Agricultural, including real estate	518	-
Residential real estate	1,987	154
Consumer	180	63
Direct financing leases	-	-
Total	$ 8,225	$ 297

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, 2023:

	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 428,699	$ 13,375	$ 8,110	$ -	$ 450,184
Commercial real estate	1,142,380	12,983	33,044	-	1,188,407
Agricultural, including real estate	146,139	1,773	4,263	-	152,175
Residential real estate	265,300	4,502	5,619	-	275,421
Consumer	59,842	1	686	-	60,529
Direct financing leases	35,742	-	970	-	36,712
Total	$ 2,078,102	$ 32,634	$ 52,692	$ -	$ 2,163,428

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, 2022:

	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 378,500	$ 18,107	$ 7,422	$ -	$ 404,029
Commercial real estate	920,947	30,153	56,823	-	1,007,923
Agricultural, including real estate	138,860	1,572	5,672	-	146,104
Residential real estate	221,521	2,116	4,036	-	227,673
Consumer	53,519	1	711	-	54,231
Direct financing leases	40,819	-	638	-	41,457
Total	$ 1,754,166	$ 51,949	$ 75,302	$ -	$ 1,881,417

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

Prior to implementation of ASC 326, troubled debt restructuring was a term used to describe a loan where the terms of that loan were modified when a borrower was troubled (experiencing financial difficulties, for example) and the Company granted a concession to the borrower that would not otherwise be considered. Prior to granting a concession the Company considered the borrower's past loan payment performance, credit history, the individual circumstances surrounding the troubled borrower, and the troubled borrower's plan to meet the terms of the loan in the future. Generally, short-term deferral of required payments was not considered a concession.

There were no loans modified by the Company during 2022 that were classified as a troubled debt restructuring.

There were no troubled debt restructurings modified during 2022 that subsequently defaulted.

The terms of certain loans were modified during the year ended December 31, 2023. These loans have a total recorded investment as of December 31,2023 of $4,350. The modification of these loans involved a modification of the terms of a loan to borrowers who were not experiencing financial difficulties.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without modification. This evaluation is performed under the Company's internal underwriting policy.

The change in the allowance for credit losses for the years ended December 31, 2023 and 2022, was as follows:

	Commercial	Commercial Real Estate	Agricultural	Residential Real Estate	Consumer	Direct Financing Leases	Total
Allowance for loan and lease losses:							
December 31, 2021	$ 3,253	$ 15,062	$ 2,020	$ 2,901	$ 944	$ 4,471	$ 28,651
Charge-offs	(125)	-	-	(29)	(483)	(80)	(717)
Recoveries	163	59	-	77	125	27	451
Provision for loan and lease losses	(550)	969	(673)	(434)	264	(1,852)	(2,276)
December 31, 2022	2,741	16,090	1,347	2,515	850	2,566	26,109
Impact of adopting ASC 326	376	47	322	836	340	(693)	1,228
Charge-offs	(65)	(28)	-	(26)	(898)	(1)	(1,018)
Recoveries	119	-	-	3	323	1	446
Provision for credit losses	163	762	77	198	59	121	1,380
December 31, 2023	$ 3,334	$ 16,871	$ 1,746	$ 3,526	$ 674	$ 1,994	$ 28,145

(In Thousands, Except Share Information)

Note 5. Loans and Direct Financing Leases (Continued)

The following table presents the amortized cost basis of collateral dependent loans, by the primary collateral type, which are individually evaluated to determine expected credit losses, and the related credit loss allocated to these loans:

	December 31, 2023				
	Primary Type of Collateral				
	Real Estate	Consumer	Other	Total	Credit Loss
Commercial	$ -	$ -	$ 207	$ 207	$ 82
Commercial real estate	1,808	-		1,808	446
Agricultural, including real estate	1,196	-	25	1,221	-
Residential real estate	232	-	-	232	125
Consumer	8	4,367	-	4,375	993
Total	$ 3,244	$ 4,367	$ 232	$ 7,843	$ 1,646

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, 2022, was as follows:

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
2022:			
Allowance for loan losses:			
Commercial	$ 132	$ 2,609	$ 2,741
Commercial real estate	845	15,245	16,090
Agricultural, including real estate	-	1,347	1,347
Residential real estate	32	2,483	2,515
Consumer	15	835	850
Direct financing leases	-	2,566	2,566
Total	$ 1,024	$ 25,085	$ 26,109
Loans balance:			
Commercial	$ 305	$ 403,724	$ 404,029
Commercial real estate	5,638	1,002,285	1,007,923
Agricultural, including real estate	2,002	144,102	146,104
Residential real estate	2,321	225,352	227,673
Consumer	179	54,052	54,231
Direct financing leases	-	41,457	41,457
Total	$ 10,445	$ 1,870,972	$ 1,881,417

(In Thousands, Except Share Information)

Note 6. Operating Leases

Investment in operating lease assets includes the following as of December 31, 2023 and 2022:

	Years Ended December 31	
	2023	2022
Operating lease assets	$ 32,007	$ 30,288
Less accumulated depreciation	11,642	8,730
Net investment in operating leases	$ 20,365	$ 21,558

Future minimum lease payments receivable under operating leases as of December 31, 2023, are as follows:

Years Ending December 31,	
2024	$ 5,380
2025	6,355
2026	4,923
2027	2,480
2027	930
Thereafter	194
Total lease payments receivable	$ 20,262

At December 31, 2023 and 2022, none of these operating leases were classified as nonaccrual.

Note 7. Premises and Equipment

	Useful Lives (Years)	December 31	
		2023	2022
Land and improvements	15–40	$ 7,138	$ 7,138
Buildings and improvements	10–40	36,262	35,517
Furniture and equipment	3–7	12,738	12,564
		56,138	55,219
Less accumulated depreciation		30,410	28,831
		$ 25,728	$ 26,388

(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	
	2023	2022
Balance at beginning of year	$ 806	$ 1,123
Transfers from loans	347	116
Proceeds from sales	(140)	(272)
Net charge-offs/impairments	(23)	(161)
Net gain on sales	15	-
Balance at end of year	$ 1,005	$ 806

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	
	2023	2022
Net gain on sales	$ (15)	$ -
Net charge-offs/impairments	23	161
Operating expenses, net of rental income	59	5
	$ 67	$ 166

Note 9. Deposits

	December 31	
	2023	2022
Demand deposits	$ 482,293	$ 635,853
Savings and NOW accounts	1,325,823	1,398,884
Time deposits	366,293	222,564
	$ 2,174,409	$ 2,257,301

(In Thousands, Except Share Information)

Note 9. Deposits (Continued)

The aggregate amount of time deposit accounts that exceed the FDIC insurance limit were $99,944 and $48,705 at December 31, 2023 and 2022, respectively.

At December 31, 2023, the scheduled maturities of time deposits are as follows:

Years Ending December 31,		
2024	$	325,539
2025		31,479
2026		5,074
2027		1,391
2028		2,810
	$	366,293

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, 2023 and 2022, CDARS reciprocal deposits totaled $0.

Note 10. Repurchase Agreements

	December 31	
	2023	2022
Customer repurchase agreements	$ 15,064	$ 12,019

Securities sold under agreements to repurchase are held by the Company. Customer repurchase agreements are due on demand with interest at 5.080 percent at December 31, 2023.

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 $978,369 and $761,301 at December 31, 2023 and 2022, 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 2.05 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 three-month CME TERM SOFR plus 2.25 (at December 31, 2023, the interest rate is approximately 7.84 percent).

Future annual maturities are as follows:

Years Ending December 31,	
2024	4,500
2025	-
2026	-
2027	-
2028	-
Thereafter	2,762
	$ 7,262

Note 12. Subordinated Debentures

Subordinated debentures of $12,903 were redeemed by Merchants Capital Trust I as of December 31, 2023.

Subordinated debentures of $23,196 are owed to Merchants Capital Trust II and bear interest at the three-month CME TERM SOFR plus 1.30 percent (at December 31, 2023, the interest rate is approximately 6.89 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 CME TERM SOFR plus 2.70 percent (at December 31, 2023, the interest rate is approximately 8.29 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	
	2023	2022
Deferred tax assets:		
Allowance for loan and lease losses	$ 7,254	$ 6,595
Deferred compensation	499	431
Other	372	-
Unrealized loss on available-for-sale securities	5,231	6,186
Total deferred tax assets	13,356	13,212
Deferred tax liabilities:		
Direct financing leases	(5,613)	(7,521)
Mortgage servicing rights	(3,142)	(3,087)
Premises and equipment	(1,488)	(1,354)
Intangibles	(4,730)	(4,437)
Unrealized gain on available-for-sale securities	-	(46)
Total deferred tax liabilities	(14,973)	(16,445)
Net deferred tax liabilities	$ (1,617)	$ (3,233)

At December 31, 2023 and 2022, 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	
	2023	2022
Current tax expense	$ 11,042	$ 4,696
Deferred tax expense (benefit)	(2,572)	5,874
	$ 8,470	$ 10,570

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	
	2023	2022
Computed “expected” tax expense	$ 7,134	$ 8,609
Increase (decrease) in income taxes resulting from:		
State income taxes, net of federal tax benefit	2,007	2,536
Tax-exempt interest income (net of disallowed expenses)	(279)	(243)
Other	(392)	(332)
	$ 8,470	$ 10,570

(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	
	2023	2022
Commitments to extend credit	$ 608,174	$ 755,053
Credit card commitments	97,011	93,006
Standby letters of credit	8,243	9,229
	$ 713,428	$ 857,288

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). There were no shares purchased by the ESOP in 2023.

During 2022, the ESOP purchased 68,850 shares of the Company's common stock at $35.00 per share. Of the 68,850 shares, 13,770 were released as of December 31, 2023 and 6,885 were released as of December 31, 2022, respectively.

During 2021, the ESOP purchased 27,180 shares of the Company's common stock at $31.33 per share. Of the 27,180 shares, 8,154 were released as of December 31, 2023 and 5,436 were released as of December 31, 2022, respectively.

During 2020, the ESOP purchased 201,189 shares of the Company's common stock at $30.00 per share. Of the 201,189 shares, 76,820 were released as of December 31, 2023 and 56,272 were released as of December 31, 2022, respectively.

During 2019, the ESOP purchased 13,950 shares of the Company's common stock at $27.20 per share. Of the 13,950 shares, 11,520 were released as of December 31, 2023 and 8,717 were released as of December 31, 2022, respectively.

During 2018, the ESOP purchased 72,729 shares of the Company's common stock at $25.15 per share. Of the 72,729 shares, 65,517 were released as of December 31, 2023 and 58,305 were released as of December 31, 2022, respectively.

During 2017, the ESOP purchased 148,206 shares of the Company's common stock at $20.07 per share. Of the 148,206 shares, 136,641 were released as of December 31, 2023 and 125,040 were released as of December 31, 2022, 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.

(In Thousands, Except Share Information)

Note 15. Employee Stock Ownership Plan (Continued)

The Company obtains an annual independent appraisal of fair value of its common shares. The appraised fair value as of December 31, 2023 and 2022, was $32.11 per share and $35.00 per share, respectively.

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 $1,981 and $2,530 for the years ended December 31, 2023 and 2022, 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 2023, 92,300 shares were purchased from participants and retained by the ESOP, and in 2022, 126,214 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, 2023, 131,178 shares of the Company's stock, with an aggregate fair market value of approximately $4,212 are held by ESOP participants who will be eligible to elect their diversification privileges under the ESOP during the year ending December 31, 2024.

Shares of the Company held by the ESOP at December 31, 2023 and 2022 are as follows:

	December 31	
	2023	2022
Allocated shares	1,231,398	1,179,630
Shares released for allocation	51,767	51,768
Unreleased (unearned) shares	219,682	271,449
Total shares held	1,502,847	1,502,847
Fair value of unreleased (unearned) shares	$ 6,734	$ 8,167

Note 15. Employee Stock Ownership Plan (Continued)

The Company restated the ESOP Plan document in January 2016 to be in compliance with Internal Revenue Service (IRS) guidance. As part of that restatement, plan language was modified such that distributions made to terminated employees should be based on the value at the subsequent year end valuation rather than the previous year end valuation date. Administrative changes were not made to comply with this change in the plan document and as such, participants terminated between January 1, 2016 and July 31, 2021 were paid at an incorrect valuation amount per share. This error was identified in the fourth quarter of 2021 and corrected distribution amounts, additional dividends that should have been paid, and estimated lost earnings per the IRS calculator have been calculated and total approximately $1,600. Former participants have been notified and were provided paperwork to direct these additional funds. Payments were made on January 29, 2022.

Note 16. Loans and Other Transactions With Related Parties

Shareholders, 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 $8,612 and $13,361 at December 31, 2023 and 2022, respectively. Total deposits with related parties were approximately $11,702 and $14,320 at December 31, 2023 and 2022, 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, 2023, 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. 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 buffers for each measure of total capital, common equity Tier 1 capital, and Tier 1 capital are captured within the ratios below.

	Actual		Minimum Capital Requirements		Well Capitalized Standard	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2023:						
Total capital (to risk-weighted assets):						
Consolidated	$ 303,141	12.31%	$ 258,569	>10.50	N/A	N/A
Merchants Bank	307,365	12.49%	258,393	>10.50	$ 246,089	>10.0%
Common equity Tier 1 capital (to risk-weighted assets):						
Consolidated	250,611	10.17%	172,495	>7.0%	160,174	>6.5%
Merchants Bank	279,220	11.35%	172,206	>7.0%	159,906	>6.5%
Tier I capital (to risk-weighted assets):						
Consolidated	278,111	11.29%	209,384	>8.50%	N/A	N/A
Merchants Bank	279,220	11.35%	209,107	>8.50%	196,807	>8.0%
Leverage ratio:						
Consolidated	278,111	11.35%	98,013	>4.0%	N/A	N/A
Merchants Bank	279,220	11.15%	100,169	>4.0%	125,211	>5.0%
As of December 31, 2022:						
Total capital (to risk-weighted assets):						
Consolidated	$ 295,894	13.63%	$ 227,945	>10.50	N/A	N/A
Merchants Bank	297,020	13.20%	236,346	>10.50	$ 225,092	>10.0%
Common equity Tier 1 capital (to risk-weighted assets):						
Consolidated	229,785	10.58%	152,032	>7.0%	141,172	>6.5%
Merchants Bank	270,910	12.04%	157,563	>7.0%	146,309	>6.5%
Tier I capital (to risk-weighted assets):						
Consolidated	269,785	12.43%	184,487	>8.50%	N/A	N/A
Merchants Bank	270,910	12.04%	191,327	>8.50%	180,072	>8.0%
Leverage ratio:						
Consolidated	269,785	9.93%	108,675	>4.0%	N/A	N/A
Merchants Bank	270,910	10.05%	107,821	>4.0%	134,776	>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	
	2023	2022
Available-for-sale securities:		
Maturities and sales	$ 92,284	$ 31,816
Purchases	(16,110)	(135,209)
Held-to-maturity securities:		
Maturities	5,469	5,713
Purchases	(6,120)	(32,314)
	$ 75,523	$ (129,994)

Supplemental disclosures of cash flow information:		
Cash payments for interest	$ 28,783	$ 7,950
Cash payments for income taxes	16,796	13,070

Supplemental schedule of noncash investing and financing activities:		
Other real estate and other personal property owned acquired in settlement of loans	$ 347	$ 116

Note 19. Interest Rate Swaps

The Company entered into an interest rate swap agreement in 2023 with a notional amount of $22.0 million. The interest rate swap contract was designated as a fair value hedging instrument with the objective of protecting against the risk of adverse interest rate movements on the cash flows of a fixed rate customer loan throughout a fifteen year period with a three year forward start date. The trade date was June 27, 2023, the effective date is June 1, 2016 and the maturity date is June 30, 2041. Under the swap, the Company will receive interest at a rate of CME TERM SOFR plus a margin of 1.555 percent and pay a fixed rate of 4.75 percent which agrees to the customer loan rate. The rate received by the Company as of December 31, 2023 was 6.93 percent.

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 CME TERM SOFR. Under the swap, the Company will pay a fixed interest rate of 3.463 percent and receive a variable interest rate of three-month CME TERM SOFR plus a margin of 1.30 percent on the notional amount, with quarterly settlements. The rate received by the Company as of December 31, 2023 was 6.89 percent.

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 $3.0 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 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 CME TERM SOFR. Under the swap, the Company will pay a fixed interest rate of 2.50% and receive a variable interest rate of one-month CME TERM SOFR plus a margin of 2.25% on the notional amount, with semi-annual settlements. The rate received by the Company as of December 31, 2023 was 7.84%.

The estimated fair value of the interest rate derivative contracts outstanding was a gain of $1,225 and $1,452 as of December 31, 2023 and 2022, respectively, and was included in other assets in the consolidated balance sheets.

The effective portion of the gain due to changes in the fair value of the derivative hedging instrument, a loss of $163 and a gain of $1,387 for the years ended December 31, 2023 and 2022, 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 was recognized during the reporting period. Therefore, changes in the fair value of the interest rate swap 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, 2023 and 2022. Cash is only disbursed or received upon exceeding contractual thresholds.

The Company was in receipt of $1,020 and zero cash as collateral related to the derivative contracts at December 31, 2023 and 2022, respectively, due to fluctuations in the market.

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

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, 2023 and 2022 are as follows:

	Years Ended December 31	
	2023	2022
Balance, beginning	$ 184	$ 413
Maturities	(94)	(219)
Change in unrealized gain/loss	-	(10)
Balance, ending	$ 90	$ 184

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 loss on the derivative instruments was $40 and $412 in 2023 and 2022, 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 on Trust Preferred Securities: The Company utilizes an interest rate swap agreement to convert one of our variable rate trust preferred securities to a fixed rate. This has been designated as a cash flow hedge. This interest rate swap is 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 swap is deemed to be a Level 2 measurement and is 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, 2023	Level 1	Level 2	Level 3
Investment securities available for sale:				
GSE residential mortgaged-backed securities	$ 45,619	$ -	$ 45,619	$ -
GSE collateralized residential mortgage obligations	99,073	-	99,073	-
Obligations of states and political subdivisions	90	-	-	90
US government corporations and agencies	7,568	-	7,568	-
GSE commercial mortgage-backed securities	49,865		49,865	
Loans held for sale	1,929	-	1,929	-
Interest rate lock commitments	77	-	77	-
Forward sale commitments	(67)	-	(67)	-
Interest rate swaps	1,225	-	1,225	-
	$ 205,379	$ -	$ 205,289	$ 90

	Fair Value Measurements at December 31, 2022	Level 1	Level 2	Level 3
Investment securities available for sale:				
GSE residential mortgaged-backed securities	$ 80,101	$ -	$ 80,101	$ -
GSE collateralized residential mortgage obligations	103,128	-	103,128	-
Obligations of states and political subdivisions	184	-	-	184
US government corporations and agencies	37,749	33,965	3,784	-
GSE commercial mortgage-backed securities	53,969	-	53,969	-
Loans held for sale	6,202	-	6,202	-
Interest rate lock commitments	27	-	27	-
Forward sale commitments	21	-	21	-
Interest rate swaps	1,452	-	1,452	-
	$ 282,833	$ 33,965	$ 248,684	$ 184

(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, 2023			
	Total	Level 1	Level 2	Level 3
Collateral-dependent loans and leases	$ 1,436	$ -	$ -	$ 1,436
Other real estate owned and other personal property owned	1,005	-	-	1,005
	$ 2,441	$ -	$ -	$ 2,441

	Fair Value at December 31, 2022			
	Total	Level 1	Level 2	Level 3
Collateral-dependent loans and leases	$ 2,700	$ -	$ -	$ 2,700
Other real estate owned and other personal property owned	806	-	-	806
	$ 3,506	$ -	$ -	$ 3,506

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