

**UNIVERSITY BANCORP, INC.
AND SUBSIDIARIES**

AUDITED CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016 and 2015

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

| | Page |
|---|-------------|
| Independent Auditor's Report | 1 |
| Consolidated Financial Statements | |
| Consolidated Balance Sheets | 3 |
| Consolidated Statements of Operations and Comprehensive Income | 5 |
| Consolidated Statements of Equity | 7 |
| Consolidated Statements of Cash Flows | 8 |
| Notes to Consolidated Financial Statements | 10 |

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Stockholders
University Bancorp, Inc. and Subsidiaries

We have audited the accompanying consolidated financial statements of University Bancorp, Inc. and Subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations and comprehensive income, equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

To the Board of Directors and Stockholders
University Bancorp, Inc. and Subsidiaries
Page Two

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of University Bancorp, Inc. and Subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

UHY LLP

Farmington Hills, Michigan
March 29, 2017

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | December 31, | |
|---|-----------------------|-----------------------|
| | 2016 | 2015 |
| ASSETS | | |
| Cash and due from banks | \$ 42,424,211 | \$ 59,738,893 |
| Restricted cash | 1,006,312 | 1,002,307 |
| Investment securities available-for-sale, at fair value | 2,039,365 | 2,438,803 |
| Federal Home Loan Bank stock, at cost | 637,000 | 637,000 |
| Loans and financings held for sale or assignment, at fair value | 56,496,574 | 42,666,107 |
| Loans and financings, net | 65,677,980 | 55,686,036 |
| Premises and equipment, net | 5,370,574 | 4,854,364 |
| Mortgage and financing servicing rights, at fair value | 11,069,440 | 9,379,862 |
| Real estate owned, net | 39,454 | 301,840 |
| Accounts receivable | 1,648,978 | 1,257,584 |
| Accrued interest and financing income receivable | 212,753 | 177,401 |
| Prepaid expenses | 935,022 | 983,009 |
| Derivatives, at fair value | 1,438,577 | 959,862 |
| Goodwill | 356,310 | 356,310 |
| Customer relationships, net | 213,428 | 284,571 |
| Investor remittances receivable | 906,667 | 546,644 |
| Deferred income taxes | 455,191 | 1,158,111 |
| Other assets | 12,340 | 30,208 |
| | \$ 190,940,176 | \$ 182,458,912 |
| Total assets | \$ 190,940,176 | \$ 182,458,912 |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (Continued)

| | December 31, | |
|--|-----------------------|----------------|
| | 2016 | 2015 |
| LIABILITIES AND EQUITY | | |
| LIABILITIES | | |
| Deposits: | | |
| Demand - non-interest bearing | \$ 135,219,886 | \$ 131,835,236 |
| Demand - interest bearing and profit sharing | 15,399,611 | 16,566,706 |
| Savings | 478,470 | 436,324 |
| Time | 3,043,355 | 3,417,774 |
| Total deposits | 154,141,322 | 152,256,040 |
| Derivatives, at fair value | - | 58,111 |
| Accounts payable | 1,178,900 | 807,958 |
| Accrued interest and profit sharing payable | 3,976 | 7,318 |
| Allowance for loan and financing recourse | 205,617 | 217,553 |
| Escrow, mortgage and financing insurance liabilities | 337,596 | 257,002 |
| Liability to fund closed but undisbursed loans and financings | 979,034 | 1,600,925 |
| Investor remittances payable | 1,063,446 | 1,330,595 |
| Participatory note payable | 2,352,767 | - |
| Earn-out liability | 430,012 | 430,012 |
| Contingent legal liabilities | - | 977,840 |
| Federal income tax payable | 461,956 | 17,808 |
| Deferred income taxes | 5,515,648 | 4,670,948 |
| Accrued expenses and other liabilities | 3,483,918 | 2,497,529 |
| Total liabilities | 170,154,192 | 165,129,639 |
| EQUITY | | |
| University Bancorp, Inc. stockholders' equity: | | |
| Common stock, \$.01 par value per share; 6,000,000 shares authorized, 5,100,899 shares issued as of December 31, 2016 and 2015 | 51,009 | 51,009 |
| Additional paid-in capital | 7,548,685 | 7,548,685 |
| Retained earnings | 10,463,713 | 7,204,249 |
| Accumulated other comprehensive income | 12,428 | 17,475 |
| Equity attributable to stockholders of University Bancorp, Inc. | 18,075,835 | 14,821,418 |
| Noncontrolling interest | 2,710,149 | 2,507,855 |
| Total equity | 20,785,984 | 17,329,273 |
| Total liabilities and equity | \$ 190,940,176 | \$ 182,458,912 |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND
COMPREHENSIVE INCOME

| | <u>Years ended December 31,</u> | |
|--|---------------------------------|-------------------|
| | <u>2016</u> | <u>2015</u> |
| Interest and financing income: | | |
| Interest and fees on loans and financing income | \$ 5,333,569 | \$ 4,583,564 |
| Interest on securities: | | |
| U.S. Government agencies | 63,671 | 50,743 |
| Other securities | 27,073 | 30,915 |
| Interest on federal funds and other | <u>241,701</u> | <u>147,823</u> |
| Total interest and financing income | <u>5,666,014</u> | <u>4,813,045</u> |
| Interest and profit sharing expense: | | |
| Interest and profit sharing on deposits: | | |
| Demand deposits | 20,069 | 21,955 |
| Savings deposits | 453 | 349 |
| Time deposits | 61,347 | 59,001 |
| Participatory note payable | 77,830 | - |
| Other | <u>-</u> | <u>5,395</u> |
| Total interest and profit sharing expense | <u>159,699</u> | <u>86,700</u> |
| Net interest and financing income | 5,506,315 | 4,726,345 |
| Provision for loan and financing losses | <u>6,534</u> | <u>(314,131)</u> |
| Net interest and financing income after provision for loan and financing losses | <u>5,499,781</u> | <u>5,040,476</u> |
| Other income (loss): | | |
| Loan and financing servicing and sub-servicing fees | 10,597,587 | 9,930,774 |
| Origination and other fees | 7,181,712 | 7,017,767 |
| Gain on sale of mortgage loans, net, and fee income for assignment of financings | 25,176,856 | 20,703,586 |
| Insurance & investment agency fee income | 774,800 | 735,790 |
| Deposit service charges and fees | 26,459 | 10,876 |
| Change in fair value of mortgage and financing servicing rights due to: | | |
| Pay-offs and pay-downs | (654,373) | (1,146,491) |
| Changes in estimates | (513,015) | (563,480) |
| Change in fair value of loans and financings held for sale or assignment, interest and financing rate locks, and forward commitments | 2,547,560 | 1,988,921 |
| Other income | <u>144,549</u> | <u>153,637</u> |
| Total other income, net | <u>45,282,135</u> | <u>38,831,380</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND
COMPREHENSIVE INCOME (Continued)

| | Years ended December 31, | |
|---|---------------------------------|----------------------------|
| | 2016 | 2015 |
| Other expenses: | | |
| Compensation and benefits | \$ 32,701,943 | \$ 27,646,858 |
| Occupancy | 1,887,093 | 1,665,021 |
| Data processing and equipment expense | 1,976,240 | 2,088,268 |
| Legal and audit | 1,265,987 | 1,401,142 |
| Consulting fees | 489,137 | 547,582 |
| Mortgage banking | 1,725,214 | 1,477,937 |
| Advertising | 866,201 | 831,233 |
| Membership and training | 485,280 | 343,020 |
| Travel and entertainment | 825,281 | 678,943 |
| Supplies and postage | 1,043,819 | 1,092,580 |
| Insurance | 433,226 | 415,793 |
| Real estate expense | 64,893 | 41,531 |
| Director related expenses | 243,600 | 191,588 |
| FDIC assessments | 79,992 | 60,702 |
| Contingent legal expense | 264,525 | 129,840 |
| Amortization of customer relationships | 71,143 | 71,143 |
| Other operating expenses | 228,083 | 227,920 |
| | <u>44,651,657</u> | <u>38,911,101</u> |
| Total other expenses | | |
| | <u>44,651,657</u> | <u>38,911,101</u> |
| Income before income taxes | 6,130,259 | 4,960,755 |
| Income tax expense | 2,121,768 | 1,711,575 |
| | <u>6,130,259</u> | <u>4,960,755</u> |
| | <u>2,121,768</u> | <u>1,711,575</u> |
| Net income | <u>\$ 4,008,491</u> | <u>\$ 3,249,180</u> |
| COMPREHENSIVE INCOME | | |
| Net income | \$ 4,008,491 | \$ 3,249,180 |
| Net unrealized loss on securities available-for-sale | <u>(5,047)</u> | <u>(5,636)</u> |
| COMPREHENSIVE INCOME | <u>\$ 4,003,444</u> | <u>\$ 3,243,544</u> |
| Net income and comprehensive income attributable to the noncontrolling interests | <u>\$ 202,294</u> | <u>\$ 109,963</u> |
| Net income attributable to common stockholders of University Bancorp, Inc. | <u>\$ 3,806,197</u> | <u>\$ 3,139,217</u> |
| Comprehensive income attributable to common stockholders of University Bancorp, Inc. | <u>\$ 3,801,150</u> | <u>\$ 3,133,581</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EQUITY

| | University Bancorp, Inc. Stockholders' | | | | | | | | |
|--|--|------------------|----------------------------------|---------------------|-------------|----------------------|--|---------------------------------|----------------------|
| | Common Stock \$.01 Par value | | Additional Paid-in Capital | Treasury Stock | | Retained Earnings | Accumulated Other Compre- hensive Income | Non- controlling Interest | Total |
| | Number of Shares | Par Value | | Number of Shares | Cost | | | | |
| Balance at January 1, 2015 | 4,782,782 | \$ 47,828 | \$ 6,313,650 | (31,522) | \$ (93,192) | \$ 4,065,032 | \$ 23,111 | \$ 4,562,639 | \$ 14,919,068 |
| Exercise of stock options | 17,041 | 170 | 76,609 | 31,522 | 93,192 | - | - | - | 169,971 |
| Excess tax benefit from exercise of stock options | - | - | 53,000 | - | - | - | - | - | 53,000 |
| Issuance of common stock to ESOP | 9,215 | 92 | - | - | - | - | - | - | 92 |
| Issuance of common stock to acquire noncontrolling interest | 309,361 | 3,094 | 1,210,251 | - | - | - | - | (2,164,747) | (951,402) |
| Repurchase and cancellation of common stock | (17,500) | (175) | (104,825) | - | - | - | - | - | (105,000) |
| Net unrealized loss on securities available-for-sale | - | - | - | - | - | - | (5,636) | - | (5,636) |
| Net income | - | - | - | - | - | 3,139,217 | - | 109,963 | 3,249,180 |
| Balance at December 31, 2015 | 5,100,899 | 51,009 | 7,548,685 | - | - | 7,204,249 | 17,475 | 2,507,855 | 17,329,273 |
| Dividends | - | - | - | - | - | (546,733) | - | - | (546,733) |
| Net unrealized loss on securities available-for-sale | - | - | - | - | - | - | (5,047) | - | (5,047) |
| Net income | - | - | - | - | - | 3,806,197 | - | 202,294 | 4,008,491 |
| Balance at December 31, 2016 | <u>5,100,899</u> | <u>\$ 51,009</u> | <u>\$ 7,548,685</u> | <u>-</u> | <u>\$ -</u> | <u>\$ 10,463,713</u> | <u>\$ 12,428</u> | <u>\$ 2,710,149</u> | <u>\$ 20,785,984</u> |

See notes to consolidated financial statements.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | <u>Years ended December 31,</u> | |
|--|---------------------------------|------------------|
| | <u>2016</u> | <u>2015</u> |
| OPERATING ACTIVITIES | | |
| Net income | \$ 4,008,491 | \$ 3,249,180 |
| Adjustments to reconcile net income to net cash flows from operating activities: | | |
| Depreciation and amortization | 1,001,606 | 994,446 |
| Change in fair value of mortgage and financing servicing rights | 1,167,388 | 1,709,971 |
| Change in fair value of loans and financings held for sale or assignment, interest and financing rate locks, and forward commitments | (2,547,560) | (1,988,921) |
| Deferred income tax expense | 1,547,620 | 1,352,609 |
| Provision for loan and financing losses | 6,534 | (314,131) |
| Net gain on sale of mortgage loans and fee income for assignment of financings | (25,176,856) | (20,703,586) |
| Net gain on sale of other real estate owned | 447 | (100,155) |
| Net amortization on investment securities | 2,630 | 855 |
| Write down of real estate owned | 31,546 | - |
| Originations of mortgage loans and financings | (834,550,051) | (669,483,879) |
| Proceeds from mortgage loan sales and assignment of financings | 844,416,381 | 686,281,280 |
| Preferred dividends recorded as interest expense | - | 5,273 |
| Net change in: | | |
| Various other assets | (727,694) | (639,187) |
| Various other liabilities | 633,742 | 923,618 |
| Net cash provided by (used in) operating activities | <u>(10,185,776)</u> | <u>1,287,373</u> |
| INVESTING ACTIVITIES | | |
| Purchase of securities available-for-sale | - | (1,237,773) |
| Proceeds from maturities of securities available-for-sale | 391,761 | 46,643 |
| Proceeds from redemption of Federal Home Loan Bank stock | - | 235,300 |
| Proceeds from sale of real estate owned | 230,393 | 455,262 |
| Loans and financings (granted) and repayments, net | (9,998,478) | (5,001,268) |
| Purchases of premises and equipment | (1,443,898) | (1,437,299) |
| Payment of contingent earn-out liability | - | (74,129) |
| Redemptions of certificates of deposit, net | - | 6,250,000 |
| Net cash used in investing activities | <u>(10,820,222)</u> | <u>(763,264)</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

| | Years ended December 31, | |
|--|---------------------------------|-----------------------------|
| | 2016 | 2015 |
| FINANCING ACTIVITIES | | |
| Net change in deposits | \$ 1,885,282 | \$ 57,682,931 |
| Exercise of stock options | - | 169,971 |
| Repurchase of common stock | - | (105,000) |
| Redemption of preferred stock | - | (350,000) |
| Payment of dividends | (546,733) | (26,049) |
| Acquisition of noncontrolling interest | - | (521,390) |
| Net proceeds from issuance of participatory note | <u>2,352,767</u> | <u>-</u> |
| Net cash provided by financing activities | <u>3,691,316</u> | <u>56,850,463</u> |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | (17,314,682) | 57,374,572 |
| Cash and Cash Equivalents, Beginning of Year | 59,738,893 | 2,364,321 |
| Cash and Cash Equivalents, End of Year | <u>\$ 42,424,211</u> | <u>\$ 59,738,893</u> |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid during the year for interest | <u>\$ 163,041</u> | <u>\$ 78,803</u> |
| Net cash paid during the year for income taxes | <u>\$ 130,000</u> | <u>\$ -</u> |
| SUPPLEMENTAL DISCLOSURE OF NON-CASH TRANSACTIONS: | | |
| Mortgage loans and financings converted to real estate owned | <u>\$ -</u> | <u>\$ 301,840</u> |
| Reduction in accrued compensation through issuance of common stock to ESOP | <u>\$ -</u> | <u>\$ 92</u> |
| Issuance of common stock to acquire noncontrolling interest | <u>\$ -</u> | <u>\$ 2,611,007</u> |
| Earn-out liability to acquire noncontrolling interest | <u>\$ -</u> | <u>\$ 430,012</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principles of Consolidation

The consolidated financial statements of University Bancorp, Inc. (the “Parent”) include the operations of its wholly-owned subsidiary, University Bank (the “Bank”), the Bank’s wholly owned subsidiaries, Ann Arbor Insurance Centre, Inc. (“AAIC”), Hoover, LLC (“Hoover”), University Lending Group, LLC (“ULG”) and Midwest Loan Solutions, Inc. (“Midwest”), and the Bank’s 80% owned subsidiary, University Islamic Financial Corporation (“UIF”). During 2015, the Bank purchased the 20% noncontrolling interest of Midwest, and Midwest became a wholly-owned subsidiary of the Bank. These consolidated financial statements also include the operations of Hoover’s wholly owned subsidiary, Tuomy, LLC, as well as the operations of AAIC’s wholly owned subsidiary, 2621 Carpenter Road, LLC. The accounts are maintained on an accrual basis in accordance with generally accepted accounting principles and predominant practices within the banking and mortgage banking industries. All significant intercompany balances and transactions have been eliminated in preparing the consolidated financial statements. University Bancorp, Inc. and Subsidiaries are herein referred to as the “Company”.

The Parent is a bank holding company. The Bank, which is located in Michigan, is a full service community bank, which offers all customary banking services, including the acceptance of checking, savings and time deposits. The Bank also makes commercial, real estate, personal, home improvement, automotive and other installment, credit card and consumer loans, and provides fee based services such as foreign currency exchange. The Bank’s customer base is primarily located in the Ann Arbor, Michigan metropolitan statistical area.

The Bank’s loan portfolio is concentrated in Ann Arbor and Washtenaw County, Michigan. While the loan portfolio is diversified, the customers’ ability to honor their debts is partially dependent on the local economy. The Ann Arbor area is primarily dependent on the education, healthcare, services, and manufacturing (automotive and other) industries. Most real estate loans are secured by residential or commercial real estate and business assets secure most business loans. Generally, installment loans are secured by various items of personal property.

AAIC is engaged in the sale of insurance products including life, health, property and casualty, and investment products such as annuities. AAIC is located in the building owned by 2621 Carpenter Road, LLC in Ann Arbor, MI.

Hoover owns the Bank’s headquarters facility. Tuomy owns commercial land with a drive through ATM and a rental building.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Nature of Operations and Principles of Consolidation (Continued)

ULG commenced operations in April 2008 and is headquartered in Clinton Township, Michigan. ULG operates in seventeen retail branches throughout Michigan, Indiana, Florida, Alabama and Texas. ULG is engaged in the business of marketing, originating, processing, closing and selling retail mortgage loans. ULG is also engaged in the business of servicing mortgage loans as servicing rights are retained on selective loans that are sold.

Midwest is engaged in the business of servicing and sub-servicing residential mortgage loans. Midwest began operations in 1992 and was acquired by University Bank in December 1995. Midwest is based in Houghton, Michigan, and is also engaged in the business of marketing, originating, processing, closing and selling retail mortgage loans. Effective January 1, 2016, Midwest changed its name from Midwest Loan Services, Inc. to Midwest Loan Solutions, Inc. Effective July 1, 2016, Midwest's servicing and sub-servicing operations were transferred to the Bank. Midwest continues to service and sub-service GNMA loans.

UIF is a faith-based banking firm and was formed in December 2005. UIF is based in Southfield, Michigan. Its current products, which comply with federal and state law, as well as religious precepts, are deposits (as agent for the Bank) that are insured by the Federal Deposit Insurance Corporation (the "FDIC"), home financings (as agent for the Bank and Federal Home Loan Mortgage Corporation ("Freddie Mac")), and home financings and commercial real estate financings (as principal for its own account). These products are offered to service the large number of Muslim, Hindu, Jewish, and Christian customers who have an ethical aversion to paying or receiving interest.

There are two distinct financing products offered using redeemable lease and installment sale contracts.

Under the redeemable lease method, a single-asset trust or an LLC is established by or on behalf of the originator (Bank/UIF), as settlor, naming a special purpose entity as the trustee or manager. The trust or LLC is subject to the terms of the written indenture designed for this specific purpose which is used generically for all financings in the redeemable lease program. The funds necessary to acquire the real property are deposited into the trust or LLC by the originator, as settlor, and used to fund the purchase of the property. The trust or LLC then enters into a combination lease/contract-for-deed agreement with the lessee/purchaser. The settlor is the initial beneficiary of the trust or LLC, but the beneficial interest in the payment stream arising from the trust or LLC is assignable to third parties. The power to remove and appoint trustees or managers is granted to the beneficiary and the beneficiary has the power to direct the trustee or manager with respect to foreclosure of the property. These rights are assignable with the payment stream.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Nature of Operations and Principles of Consolidation (Continued)

The terms of the lease and contract-for-deed agreements, in combination, result in a payment stream and cost of the real property that are functionally equivalent to secured real estate lending for both the lessee/purchaser and the Company. The lease payment under the lease agreement is similar to an interest payment under a conventional mortgage. The contract-for-deed payments resemble a principal payment under a conventional mortgage.

The redeemable lease arrangement is treated as financing rather than leasing in accordance with U.S. generally accepted accounting principles (“GAAP”). A lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset by the lessee and as a financing by the lessor.

Under lease accounting standards of the Accounting Standards Codification (“ASC”), a lease would generally be accounted for as a financing if:

1. The underlying property is transferred to the lessee at the end of the lease, or
2. The lease contains a bargain purchase that is reasonably assured of being exercised, and
3. It is reasonably certain that the lease payments will be collected, and
4. No uncertainties surround the amount of un-reimbursable costs yet to be incurred by the lessor under the lease.

Accordingly, the Company’s accounting for this product is essentially the same as a conventional mortgage product. To reflect the legal substance of the redeemable lease transactions, the Company uses the balance sheet account title “Loans and financings” instead of a typical title of “Loans”. In the consolidated statements of operations and comprehensive income, “Interest and fees on loans” is modified to state “Interest and fees on loans and financing income”.

The second form of home financing uses the installment sale method. As agent for the Bank, UIF buys a property selected by a customer and then resells it to the customer, at a selling price higher than the purchase price. The difference between UIF’s purchase price and the selling price is the profit that the ultimate holder of the installment contract will accrete into income over the life of the contract. After the contract is executed by UIF and the customer, the contract is assigned to the Bank, and then assigned to the Freddie Mac. Freddie Mac then reimburses the Bank for the outlay of cash to purchase the property and pays the Bank a fee for origination. The cash, origination fees, and servicing rights are retained by UIF under an installment sale agreement between UIF and the Bank. The customer pays Freddie Mac for the property that was purchased on an installment basis, per an agreed repayment schedule.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Nature of Operations and Principles of Consolidation (Continued)

The Company records these contracts at fair value for the short period of time that they are held before assignment to Freddie Mac. The installment contracts are assigned with servicing retained. Thus, the value of the installment contract and value of the servicing is determined to calculate the fair value and any gain or loss on the assignment of the underlying installment contract. See Note 23 for additional discussion of the determination of fair value.

On the liability side of the balance sheet, UIF (as agent for the Bank) also offers FDIC-insured deposits that use a method of profit sharing. These deposits are specifically invested in investments that do not involve interest such as, but not limited to, transactions structured using the redeemable lease and installment sale methods. Savings, money markets, and certificates of deposits pay out earnings that are derived specifically from the revenues from these investments net of certain expenses. In compliance with the FDIC definition of a deposit, balances in these accounts, like all deposit accounts, are FDIC insured. The sharing of earnings paid out to the depositors holding these accounts can fluctuate to as low as zero percent with the net earnings of the redeemable lease portfolio and other investments compliant.

The earnings paid to the depositors by the Bank are accounted for as an expense. This expense is analogous to interest expense paid on deposits in conventional financing. To reflect the legal substance of the profit sharing deposits, the Company uses the balance sheet account title "Demand deposits – interest bearing and profit sharing" instead of the typical title of "Demand deposits – interest bearing". In the consolidated statements of operations and comprehensive income, "Interest on deposits" is modified to state "Interest and profit sharing on deposits".

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions based upon available information. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of Estimates (Continued)

The significant estimates incorporated into these consolidated financial statements, which are more susceptible to change in the near term, include the value of mortgage and financing servicing rights, the allowance for loan and financing losses, the identification and valuation of impaired loans and financings, the valuation of real estate owned, impairment analysis of goodwill and other intangible assets, the valuation allowance for deferred tax assets, the fair value of loans and financings held for sale or assignment, and the fair value of derivative instruments such as mortgage interest and financing rate locks and forward commitments, recourse liabilities related to loans sold and financings assigned and loans and financings held for sale or assignment, the valuation of stock options and related stock based-compensation, the fair value of the contingent earn-out liabilities, the amount of contingent liabilities, and the determination and the fair value of other financial instruments.

Cash Flow Reporting

For purposes of the consolidated statements of cash flows, cash and cash equivalents is defined to include the cash on hand, interest bearing deposits in other institutions, federal funds sold and other investments with an original maturity of three months or less. Net cash flows are reported for customer loans and financings, deposit transactions, and interest bearing deposits with other banks.

Securities

Securities are classified as available-for-sale at the date of purchase. Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income or loss. Available-for-sale securities are written down to fair value through a charge to earnings when a decline in fair value is not temporary. Interest income includes amortization of purchase premium or discount. Other securities such as Federal Home Loan Bank stock are carried at cost.

Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank (the "FHLB"), the Bank is required to invest in FHLB stock, which is carried at cost since there is no readily available market value. When redeemed, the Bank receives an amount equal to the par value of the stock. Dividends paid on the FHLB stock are subject to economic events, regulatory actions, and other factors.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans and Financings

Loans and financings are reported at the principal balance outstanding, net of unearned interest or financing income, deferred loan or financing fees and costs, and an allowance for loan and financing losses. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Financing income is calculated monthly and includes amortization of net deferred financing fees and costs over the term of the financing. Interest or financing income is not reported when full loan repayment is in doubt, typically when payments are past due over ninety days. Payments received on such loans and financings are reported as principal reductions, unless all interest or financing income and principal payments in arrears are paid in full.

Allowance for Loan and Financing Losses

The allowance for loan and financing losses is a valuation allowance for probable credit losses, increased by the provision for loan and financing losses and recoveries and decreased by charge-offs. Management estimates the balance required based on past loss experience, known and inherent risks in the portfolio, information about specific borrower situations, and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans or financings, but the entire allowance is available for any loan or financing that, in management's judgment, should be charged-off.

Loan or financing impairment is reported when full payment under the loan or financing terms is not expected. Impairment is evaluated in total for smaller-balance loans and financings of similar nature such as residential, consumer, and credit card, and on an individual loan or financing basis for other loans or financings. If a loan or financing is impaired, a portion of the allowance is allocated so that the loan or financing is reported, net, at the present value of estimated future cash flows using the loan's or financing's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans or financings are evaluated for impairment when payments are delayed, typically ninety days or more, or when it is probable that all principal and interest or profit sharing amounts will not be collected according to the original terms of the loan or financing. When collection becomes remote, loans or financings are charged off.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is computed primarily on the straight-line method over the assets' estimated useful lives which range from three to thirty-nine years. In the case of a leasehold improvement, the life will be the lesser of the term of the lease and the estimated useful life.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Mortgage Banking Activities

The Company's mortgage banking activities consist of retail and servicing operations. Loans and financings held for sale are sold or assigned with selective loans or financings having their servicing or financing rights retained, and others are sold or assigned on a servicing released basis. The Company elected to record loans and financings held for sale at fair value. Loans and financings are sold or assigned without recourse, except in certain events as defined in the related documents.

An allowance was booked for potential recourse liabilities related to loans and financings sold or assigned, and loans and financings held for sale or assignment, in the amount of \$205,617 and \$217,553 as of December 31, 2016 and 2015, respectively.

Mortgage and financing servicing rights ("MSRs") represent both purchased rights and the allocated value of servicing rights retained on loans or financings originated and sold or assigned. Loan and financing servicing and sub-servicing fees are contractually based and are recognized monthly as earned over the life of the loans or financings.

The Company accounts for its MSRs in accordance with the applicable standards under the ASC which requires that MSRs be initially recognized at their fair value and by providing the option to either: (1) carry MSRs at fair value with changes in fair value recognized in earnings; or (2) continue recognizing periodic amortization expense and assess the MSRs for impairment. This option may be applied by class of servicing assets or liabilities. The Company has identified MSRs relating to loans and financings as a class of servicing rights and has elected to apply fair value accounting to these assets.

Real Estate Owned

Real estate properties acquired in collection of a loan or financing are recorded at fair value upon foreclosure, establishing a new cost basis. Any reduction to fair value from the carrying value of the related loan or financing is accounted for as a loan or financing loss. After foreclosure, management periodically performs valuations to ensure real estate is carried at the lower of cost or fair value, less estimated costs to sell. Expenses, gains and losses on disposition, and decreases in the fair value are reported in other expenses.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivative Instruments

The Company enters into interest and financing rate lock commitments (“IRLCs”) in connection with its mortgage banking activities to fund residential mortgage loans and financings at specified times in the future. IRLCs that relate to the origination of mortgage loans and financings that will be held for sale or assignment are considered derivative instruments under the ASC. As such, these IRLCs are recorded at fair value (see Note 23) with changes in fair value recorded in earnings.

Outstanding IRLCs expose the Company to the risk that the price of the loans or financings underlying the commitments might decline from inception of the rate lock to the funding of the loan or financing. To protect against this risk, the Company utilizes forward loan and financing sales commitments to economically hedge the risk of potential changes in the value of the loans and financings that would result from the commitments. These forward commitments are valued at fair value (see Note 23) with net changes in fair value recorded in earnings. The Company documents its risk management strategy and hedge effectiveness at the inception of and during the term of the IRLCs and forward sales commitments within the portfolio.

Goodwill

Goodwill is the excess costs of acquired businesses over the fair value amounts assigned to identifiable assets acquired and liabilities assumed. The Company has elected not to amortize goodwill, but rather, review goodwill for impairment annually or whenever events and circumstances have occurred that indicate a potential impairment.

When performing an impairment test, entities are provided with the option of first performing a qualitative assessment on none, some or all of its reporting units to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If after completing a qualitative analysis, it is determined that it is more likely than not that the fair value of a reporting unit is less than its carrying value, a quantitative analysis is required.

Under a quantitative analysis, management first compares the fair value of a reporting unit to the carrying value of the reporting unit’s net assets at the measurement date. If the carrying value of the reporting unit exceeds the fair value, the second step of the quantitative analysis must be performed. The second step of the quantitative analysis requires an allocation of the estimated fair value of the reporting unit to all assets and liabilities as if the reporting unit had been acquired at the measurement date. The carrying value of goodwill is then compared to the implied value of goodwill and any excess of carrying value over implied value is recognized as goodwill impairment.

The Company’s evaluations of goodwill completed during 2016 and 2015 resulted in no impairment losses.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Long-Lived Assets

Management periodically reviews the potential impairment of long-lived assets to assess recoverability. If a long-lived asset is deemed to be impaired, the write-down is recorded as a periodic expense. There was no impairment recorded during 2016 or 2015.

Income Taxes

Deferred income tax assets and liabilities are recorded for estimated future tax consequences attributable to the differences between the financial carrying amounts of existing assets and liabilities and their respective tax bases. Deferred income taxes are to be computed on the liability method and deferred tax assets are recognized only when realization is certain. Deferred income tax assets and liabilities are measured using the tax rate in effect for the year in which those temporary differences are expected to turn around. If necessary, a valuation allowance is booked to reduce net deferred tax assets to a net amount that is more likely than not to be realized.

The ASC standards regarding accounting for uncertainty in income taxes clarifies the accounting for income taxes by prescribing the minimum recognition threshold an income tax position is required to meet before being recognized in the financial statements and applies to all income tax positions. Each income tax position is assessed using a two-step process. A determination is first made as to whether it is more likely than not that the income tax position will be sustained, based upon technical merits, upon examination by the taxing authorities. If the income tax position is expected to meet the more likely than not criteria, the benefit recorded in the financial statements equals the largest amount that is greater than 50% likely to be realized upon its ultimate settlement. At December 31, 2016 and 2015, there was no accrual for uncertain tax positions.

The Company's major state tax expense is in the state of Michigan. Under Michigan tax law, the Company is subject to a franchise tax. It is management's policy to include the franchise tax in other operating expenses. The Michigan statute calls for a "joint and severally liable" unitary tax on entities which are commonly controlled and have inter-company "flow of value" transactions. Hence, the Company pays this tax on a consolidated basis just as it pays its federal tax on a consolidated basis.

The Parent and the Bank have a tax sharing agreement with some of its subsidiaries in which the subsidiaries record their share of federal and state taxes in accordance with the tax sharing agreements.

Subsequent Events

The Company has performed a review of events subsequent to December 31, 2016 through March 29, 2017, the date the consolidated financial statements were available to be issued.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 2 – RESTRICTIONS ON CASH AND AMOUNTS DUE FROM BANKS

The Bank is required to maintain average balances on hand or with the Federal Reserve Bank. At December 31, 2016 and 2015, this reserve requirement amounted to \$4,636,000 and \$4,003,000, respectively.

In accordance with a seller and servicer agreement with Freddie Mac, UIF is required to maintain a pledged collateral deposit of \$1,000,000. The balance maintained in the restricted account totaled \$1,006,312 and \$1,002,307 at December 31, 2016 and 2015, respectively. This cash balance is shown as restricted cash in the consolidated balance sheets.

NOTE 3 – INVESTMENT SECURITIES - AVAILABLE-FOR-SALE

The following is a summary of the amortized cost, gross unrealized gains, gross unrealized losses, and fair value of securities available-for-sale.

Securities available-for-sale at December 31, 2016 consists of the following:

| | Amortized Cost | Unrealized Gain | Fair Value |
|--|---------------------|--------------------|---------------------|
| U.S. agency mortgage-backed securities | <u>\$ 2,026,937</u> | <u>\$ 12,428</u> | <u>\$ 2,039,365</u> |

Securities available-for-sale at December 31, 2015 consists of the following:

| | Amortized Cost | Unrealized Gain | Fair Value |
|--|---------------------|--------------------|---------------------|
| U.S. agency mortgage-backed securities | <u>\$ 2,421,328</u> | <u>\$ 17,475</u> | <u>\$ 2,438,803</u> |

At December 31, 2016 and 2015, the fair value of available-for-sale securities pledged to secure certain borrowings was \$2,039,365 and \$2,483,803, respectively. The balance of these borrowings at both December 31, 2016 and 2015 was \$-0-.

Actual maturities may differ from contractual maturities because issuers and borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Proceeds from pay downs of mortgage-backed securities amounted to \$391,761 and \$46,643 for the years ended December 31, 2016 and 2015, respectively.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 4 – LOANS AND FINANCINGS, NET

Major classifications of loans and financings are as follows:

| | December 31, | |
|---|----------------------|----------------------|
| | 2016 | 2015 |
| Commercial | \$ 3,177,783 | \$ 1,837,939 |
| Commercial real estate | 41,351,003 | 33,482,901 |
| Residential real estate | 21,290,435 | 20,492,242 |
| Installment | 189,130 | 139,385 |
| Credit cards | 92,331 | 138,246 |
| | <u>66,100,682</u> | <u>56,090,713</u> |
| Gross loans and financings | | |
| Allowance for loan and financing losses | <u>(422,702)</u> | <u>(404,677)</u> |
| Net loans and financings | <u>\$ 65,677,980</u> | <u>\$ 55,686,036</u> |

Changes in the allowance for loan and financing losses were as follows:

| | December 31, | |
|---------------------------------|-------------------|-------------------|
| | 2016 | 2015 |
| Balance, beginning of year | \$ 404,677 | \$ 665,080 |
| Provision charged to operations | 6,534 | (314,131) |
| Recoveries | 15,142 | 53,728 |
| Charge-offs | <u>(3,651)</u> | <u>-</u> |
| Balance, end of year | <u>\$ 422,702</u> | <u>\$ 404,677</u> |

Information regarding impaired loans and financings is as follows:

| | December 31, | |
|---|--------------|------------|
| | 2016 | 2015 |
| Impaired loans and financings: | | |
| Loans and financings with no allowance allocated | \$ 454,083 | \$ 458,222 |
| Loans and financings with allowance allocated | \$ - | \$ 5,127 |
| Amount of allowance for loan and financing losses allocated | \$ - | \$ 4,080 |
| Impaired loans and financings: | | |
| Average balance during the year | \$ 665,904 | \$ 579,828 |
| Interest and financing income recognized thereon | \$ 51,412 | \$ 33,251 |
| Cash basis interest and financing income recognized | \$ 49,403 | \$ 30,077 |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 4 – LOANS AND FINANCINGS, NET (Continued)

The following tables present informative data by class of loan and financing regarding their age and interest or financing income accrual status at December 31, 2016 and 2015 (in thousands):

| December 31, 2016 | Current | Past Due | | | Total Past Due | Total Loans and Financings |
|-------------------------|------------------|-------------|-------------|-------------|----------------|----------------------------|
| | | 30-59 Days | 60-89 Days | ≥ 90 Days | | |
| Commercial | \$ 3,178 | \$ - | \$ - | \$ - | \$ - | \$ 3,178 |
| Commercial real estate | 41,351 | - | - | - | - | 41,351 |
| Consumer | 189 | - | - | - | - | 189 |
| Credit card | 92 | - | - | - | - | 92 |
| Residential real estate | 21,291 | - | - | - | - | 21,291 |
| Total | \$ 66,101 | \$ - | \$ - | \$ - | \$ - | \$ 66,101 |

| December 31, 2015 | Current | Past Due | | | Total Past Due | Total Loans and Financings |
|-------------------------|------------------|---------------|-------------|---------------|----------------|----------------------------|
| | | 30-59 Days | 60-89 Days | ≥ 90 Days | | |
| Commercial | \$ 1,838 | \$ - | \$ - | \$ - | \$ - | \$ 1,838 |
| Commercial real estate | 33,483 | - | - | - | - | 33,483 |
| Consumer | 139 | - | - | - | - | 139 |
| Credit card | 138 | - | - | - | - | 138 |
| Residential real estate | 20,035 | 156 | - | 302 | 458 | 20,493 |
| Total | \$ 55,633 | \$ 156 | \$ - | \$ 302 | \$ 458 | \$ 56,091 |

| December 31, 2016 | Accrual Status | |
|-------------------------|---|--|
| | Total Loans and Financings on Nonaccrual Status | Loans and Financings Past Due ≥ 90 Days and Still Accruing |
| Commercial | \$ - | \$ - |
| Commercial real estate | - | - |
| Consumer | - | - |
| Credit card | - | - |
| Residential real estate | - | - |
| Total | \$ - | \$ - |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 4 – LOANS AND FINANCINGS, NET (Continued)

| | Accrual Status | |
|-------------------------|--|--|
| | Total Loans and Financings on Nonaccrual Status | Loans and Financings Past Due ≥ 90 Days and Still Accruing |
| December 31, 2015 | | |
| Commercial | \$ - | \$ - |
| Commercial real estate | - | - |
| Consumer | - | - |
| Credit card | - | - |
| Residential real estate | 302 | - |
| Total | \$ 302 | \$ - |

NOTE 5 – MORTGAGE BANKING ACTIVITIES

Midwest provides sub-servicing of real estate mortgage loans for several financial institutions. The unpaid principal balance of these loans was approximately \$18.0 billion and \$17.0 billion as of December 31, 2016 and 2015, respectively. The value of these mortgage servicing rights are not included in the accompanying consolidated financial statements.

University Bank, Midwest, UIF and ULG sell residential mortgage loans and financings to the secondary market with servicing rights retained for selective loans and financings. These loans and financings are owned by other institutions and are not included in the Company's consolidated balance sheets, but the MSRs are included in the accompanying consolidated financial statements. Such mortgage loans and financings have been sold or assigned predominately without recourse or with limited recourse. The unpaid principal balance of these loans and financings was \$1.2 billion and \$1.1 billion at December 31, 2016 and 2015, respectively.

Custodial escrow balances maintained in connection with these loans and financings were \$330 million and \$249 million, of which \$214 million and \$201 million were held at other banks and were not included in the accompanying consolidated financial statements at December 31, 2016 and 2015, respectively.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 5 – MORTGAGE BANKING ACTIVITIES (Continued)

The following summarizes the activity relating to MSR's:

| | December 31, | |
|------------------------------|----------------------|---------------------|
| | 2016 | 2015 |
| Balance, January 1 | \$ 9,379,862 | \$ 7,900,842 |
| Amount capitalized | 2,856,966 | 3,188,991 |
| Change in fair value due to: | | |
| Pay-offs and pay-downs | (654,373) | (1,146,491) |
| Changes in estimates | (513,015) | (563,480) |
| Balance, December 31 | <u>\$ 11,069,440</u> | <u>\$ 9,379,862</u> |

The Company enters into IRLCs in connection with its mortgage banking activities to fund residential mortgage loans and financings at specified times in the future. As of December 31, 2016 and 2015, IRLCs amounted to \$55.5 million and \$40.0 million, respectively, of which management estimated \$47.1 million and \$34.4 million, respectively, to eventually close and be funded. These IRLCs were recorded in assets in the consolidated balance sheets at a fair value of \$1,271,023 and \$959,862 as of December 31, 2016 and 2015, respectively.

The Company also utilizes forward loan and financing sales commitments in order to economically hedge the risk of potential changes in the value of the loans and financings that would result from the IRLCs. Forward sales commitments to fund loans and financings at specified rates amounted to \$62.5 million and \$55.9 million as of December 31, 2016 and 2015, respectively. These IRLCs were recorded in assets in the consolidated balance sheet at a fair value of \$167,554 as of December 31, 2016, and in liabilities in the consolidated balance sheet at a fair value of \$58,111 as of December 31, 2015.

The net change in fair value of the IRLCs and the related forward loan and financing sales commitments held at December 31, 2016 and 2015 resulted in gains of \$536,826 and \$7,989, respectively, which has been recognized in the other income section in the consolidated statements of operations. These gains and losses are due principally to the inclusion of day one gains associated with the adoption of fair value accounting as discussed in Note 23. Prior to companies being permitted to adopt fair value accounting, the recognition of such day one gains was prohibited and these gains were not recognized until realized through the sale or assignment of the related loans and financings.

Market interest rate conditions can quickly affect the fair value of MSRs, IRLCs, and forward loan and financing sales commitments in a positive or negative fashion, as long-term interest rates rise and fall. See Note 23 for further discussion of management's assumptions used in determination of fair value of these assets and liabilities.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 6 – PREMISES AND EQUIPMENT, NET

Premises and equipment consist of the following:

| | December 31, | |
|--|---------------------|---------------------|
| | 2016 | 2015 |
| Land | \$ 562,500 | \$ 562,500 |
| Buildings and improvements | 3,443,610 | 3,325,815 |
| Furniture, fixtures, equipment and software | 6,132,617 | 4,908,446 |
| Construction in process | 157,526 | 59,071 |
| | <u>10,296,253</u> | <u>8,855,832</u> |
| Less accumulated depreciation and amortization | <u>(4,925,679)</u> | <u>(4,001,468)</u> |
| Premises and equipment, net | <u>\$ 5,370,574</u> | <u>\$ 4,854,364</u> |

Depreciation and amortization expense related to premises and equipment amounted to \$930,463 and \$923,303 for the years ended December 31, 2016 and 2015, respectively.

Midwest, UIF, and ULG each lease office space for their respective operations. ULG and UIF also lease office space for their retail branches. All of the retail branch lease agreements are short-term in nature, with some being month-to-month, and some allowing the Company to break the lease with both a termination notice ranging from thirty days to six months, and a fee. The Company leases various other facilities and office equipment at varying rates on a month-to-month basis. Total rent expense for all operating leases was approximately \$956,000 and \$902,000 in 2016 and 2015, respectively.

The following table summarizes the future minimum payments under the contractual obligations of the Company as of December 31, 2016:

| Years ending December 31, | Amount |
|---------------------------|------------|
| 2017 | \$ 741,474 |
| 2018 | 587,028 |
| 2019 | 520,348 |
| 2020 | 457,297 |
| 2021 | 411,160 |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 7 – GOODWILL

The following table summarizes goodwill by reporting unit:

| | December 31, | |
|---------|-------------------|-------------------|
| | 2016 | 2015 |
| Midwest | \$ 103,914 | \$ 103,914 |
| AAIC | 252,396 | 252,396 |
| | <u>\$ 356,310</u> | <u>\$ 356,310</u> |

NOTE 8 – CUSTOMER RELATIONSHIPS, NET

During 2012, the Company acquired customer relationships of \$498,000 as part of the acquisition of AAIC and 2621 Carpenter Road, LLC. These customer relationships are being amortized on a straight-line basis over their estimated economic lives, which were determined to be seven years. Amortization expense amounted to \$71,143 for each of the years ended December 31, 2016 and 2015. Amortization expense related to these customer relationships is expected to be approximately \$71,143 in each of the next three years.

NOTE 9 – TIME DEPOSITS

Time deposit liabilities issued in denominations of \$100,000 or more were \$2,088,074 and \$2,108,380 at December 31, 2016 and 2015, respectively.

At December 31, 2016, stated maturities of time deposits were:

| Years ending December 31, | Amount |
|---------------------------|---------------------|
| 2017 | \$ 1,394,958 |
| 2018 | 365,803 |
| 2019 | 364,586 |
| 2020 | 61,768 |
| 2021 and thereafter | 856,240 |
| | <u>\$ 3,043,355</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 10 – DEFERRED COMPENSATION

ULG has a deferred compensation agreement (the “Agreement”) with one of its key employees that provides this employee with a phantom interest in the net income of ULG based on years of service. The deemed value of the phantom interest at any point in time is the net income of ULG since September 1, 2011, less 34%, multiplied by 12.4975%, less \$250,000. This phantom interest vests over three years, but is fully vested upon a change in control, death or disability of the employee, or the dissolution or liquidation of ULG, as defined in the Agreement. Since December 31, 2014, the phantom interest has been fully vested.

In addition, the employee is entitled to earn \$250,000 vested over time with 50% vesting after 5 years, and 10% vesting in each of the 5 years thereafter. Any accrued benefit to the employee is to be distributed upon retirement, death, or disability of the employee, or upon termination of the employee without cause. As of December 31, 2016, special distributions events occurred in which the employee was paid the following amounts of the accrued liability:

| Years ended December 31, | Amount |
|--------------------------|-------------------|
| 2013 | \$ 65,000 |
| 2014 | 165,000 |
| 2015 | - |
| 2016 | 140,000 |
| | <u>\$ 370,000</u> |

In relation to the Agreement, the Company recognized compensation expense of \$252,993 and \$279,469 during the years ended December 31, 2016 and 2015, respectively, and recorded accrued deferred compensation of \$523,435 and \$410,442 as of December 31, 2016 and 2015, respectively. Accrued deferred compensation is included in “Accrued expenses and other liabilities” in the consolidated balance sheets.

NOTE 11 – INCOME TAXES

Income tax expense is summarized as follows:

| | December 31, | |
|--------------------|---------------------|---------------------|
| | 2016 | 2015 |
| Current | \$ 574,148 | \$ 358,966 |
| Deferred | 1,547,620 | 1,352,609 |
| Income tax expense | <u>\$ 2,121,768</u> | <u>\$ 1,711,575</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 11 – INCOME TAXES (Continued)

The effective tax rate differs from the statutory income tax rate as a result of permanent differences in accounting for certain income and expense items for financial and tax reporting purposes.

Significant components of the Company's deferred income tax assets and liabilities consist of the following:

| | December 31, | |
|---|-----------------------|-------------------------------|
| | <u>2016</u> | <u>2015</u> |
| Deferred income tax assets: | | |
| Tax credit carry-forward | \$ 400,825 | \$ 815,411 |
| Contingent legal liability | - | 288,320 |
| Other | <u>54,366</u> | <u>54,380</u> |
| Deferred tax asset | <u>455,191</u> | <u>1,158,111</u> |
| Deferred income tax liabilities: | | |
| Mortgage servicing rights | 3,763,609 | 3,189,153 |
| Derivatives and LHFS | 1,172,766 | 980,112 |
| Premises and equipment | 500,437 | 400,495 |
| Customer relationships | 72,566 | 96,754 |
| Allowance for loan and financing losses and recourse liabilities | <u>6,270</u> | <u>4,434</u> |
| Deferred tax liability | <u>5,515,648</u> | <u>4,670,948</u> |
| Net deferred tax asset (liability) | <u>\$ (5,060,457)</u> | <u>\$ (3,512,837)</u> |
| Unused Credits: | | |
| | <u>Amount</u> | <u>Date of expiration</u> |
| Low income housing credits | \$ 299,243 | Starting 2020 |
| Minimum tax credits | \$ 101,582 | N/A |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 12 – PREFERRED STOCK SUBJECT TO MANDATORY REDEMPTION

As of December 31, 2016 and 2015, the Company had 500,000 shares of preferred stock authorized with a \$.001 par value per share. As of December 31, 2016 and 2015 there were no preferred shares issued and outstanding. During the year ended December 31, 2015, the Company redeemed the 35,000 remaining outstanding preferred shares for \$350,000. Preferred shares have a \$10 per share liquidation value and accrue dividends at an annual rate of 9%. Additional shares of preferred stock are typically issued semi-annually for unpaid accrued dividends. However, the Board did not approve any paid-in-kind dividends during 2015.

During 2015, the Company declared preferred dividends of \$5,273. Generally accepted accounting principles require these dividends to be reflected as interest expense. As a result, they have been included in other interest in the consolidated statement of operations and comprehensive income. All unpaid preferred dividends were paid when the remaining outstanding 35,000 preferred shares were redeemed in 2015.

NOTE 13 – STOCK OPTIONS

In 1995, the Company adopted a stock option and stock award plan (the “1995 Stock Plan”), which provides for the grant of incentive stock options, as defined in Section 422(b) of the Internal Revenue Code of 1986, as amended, as well as the grant of non-qualified stock options and other stock awards. The Plan provides for the grant, to officers, directors and key employees of the Company, and independent contractors providing services to the Company, of options to purchase common stock and other awards of common stock.

The exercise price of options granted under the Plan shall be determined by the Board of Directors, or a compensation committee thereof. Options shall expire on the date specified by the Board of Directors or such committee, but not more than 10 years from the date of grant (or five years from the date of grant for incentive stock options if the grantee owned 10% of the Company’s voting stock at the date of grant). The 1995 Stock Plan terminated on November 15, 2006; however, all outstanding options under the Plan remain outstanding until expiration, exercise or forfeiture. Options continue to be granted to directors of the Company in lieu of board fees paid in cash, outside of the 1995 Stock Plan.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 13 – STOCK OPTIONS (Continued)

The following tables summarize the activity relating to options to purchase the Company's common stock:

| | Number of Options | Weighted Average Exercise Price |
|----------------------------------|-------------------------|--|
| | <u> </u> | <u> </u> |
| Outstanding at January 1, 2015 | 155,563 | \$ 2.59 |
| Granted | - | - |
| Exercised | (48,563) | 3.50 |
| Expired or forfeited | <u>-</u> | <u>-</u> |
| Outstanding at December 31, 2015 | 107,000 | 2.17 |
| Granted | - | - |
| Exercised | - | - |
| Expired or forfeited | <u>-</u> | <u>-</u> |
| Outstanding at December 31, 2016 | <u>107,000</u> | <u>\$ 2.17</u> |

At December 31, 2016:

| | |
|--|-----------------|
| Number of options immediately exercisable | 107,000 |
| Weighted average exercise price of immediately exercisable options | \$2.17 |
| Range of exercise price of options outstanding | \$1.80 - \$7.49 |
| Weighted average remaining life of options outstanding | 0.2 years |

During 2016 and 2015, the Company received cash of \$-0- and \$169,971, respectively, related to the exercise of options. As of the exercise date, the intrinsic value of the options exercised in 2015 was approximately \$189,000.

In accordance with the ASC, the Company is required to recognize the compensation cost relating to share-based payment transactions in the consolidated financial statements. That cost is to be measured based on the fair value of the equity or liability instruments issued. The fair value of the Company's options was determined pursuant to the Black-Scholes model at the date of issuance. As the options vested, the Company recognized compensation expense in earnings. As there were no options granted in 2015 or 2016, there was no share-based compensation expense recognized in the consolidated statement of operations and comprehensive income. As of December 31, 2016 and 2015, all outstanding options were fully vested.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 13 – STOCK OPTIONS (Continued)

The Black-Scholes option pricing model values options based on the stock price at the grant date, expected term of the option, expected volatility of the stock, expected dividend payments and risk-free interest rate over the expected term of the option.

The Black-Scholes option valuation model was developed for estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Because option valuation models require the use of subjective assumptions, changes in these assumptions can materially affect the fair value of the options. As the Company's options do not have the characteristics of traded options, the option valuation models do not necessarily provide a reliable measure of the fair value of its options.

NOTE 14 – EMPLOYEE STOCK OWNERSHIP PLAN (“ESOP”)

The Company has a noncontributory ESOP covering all full-time employees after one year of service, after at least 1,000 hours of service, and upon reaching the age of twenty-one (“participants”). The participants' share in the Company's contribution is based on their current compensation as a percentage of the total employee compensation. Upon retirement from the Company, participants can receive distributions of their allocated shares of the Company's stock. The Company contributed -0- and 9,215 common shares to the ESOP during the years ended December 31, 2016 and 2015, respectively. Compensation expense related to the shares contributed in 2015 was accrued and expensed in years prior to 2014 when the ESOP contributions were declared. At December 31, 2016, the Company had accrued \$110,722 which is expected to be contributed to the ESOP in 2017. Compensation expense related to ESOP contributions amounted to \$110,722 and \$-0- during the years ended December 31, 2016 and 2015, respectively.

The annual contribution to the ESOP is at the discretion of the Board of Directors. Assets of the ESOP are comprised entirely of 96,029 and 98,054 shares of the Company's stock at December 31, 2016 and 2015, respectively, all of which were fully allocated. The assets of the ESOP are held in trust and were valued at \$691,409 and \$635,390 at December 31, 2016 and 2015, respectively.

Effective July 1, 2016, the 401(k) plan discussed in Note 17, and the ESOP were merged into one plan.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 15 – NONCONTROLLING INTEREST

As of December 31, 2014, the Bank owned an 80% interest in the common stock of Midwest, with the remaining 20% owned by the former CEO of Midwest. In February 2015, the Company acquired the 20% noncontrolling interest in MLS for consideration of \$3,562,409 consisting of cash of \$521,390, 309,361 shares of University Bancorp, Inc. common stock with a fair value of \$2,611,007, and an earn-out of \$430,012. The earn-out is to be paid monthly and determined by multiplying the federal funds interest rate minus 0.5%, by the monthly average MLS escrow deposits held at University Bank and the FHLB, divided by 12. At December 31, 2016 and 2015, the balance of the earn-out was \$430,012 as no amounts were required to be paid for the earn-out during 2016 or 2015. In conjunction with this agreement to acquire the MLS noncontrolling interest, in January 2015, the Company amended its articles of incorporation which increased the number of authorized common shares from 5,000,000 to 6,000,000.

Also, included in the consolidated financial statements are the results for UIF. The Bank owns 80% of the common stock of UIF. An outside investor owns the remaining 20%. At December 31, 2016 and 2015, total equity of UIF was \$13,550,745 and \$12,539,278, respectively. The noncontrolling interest at December 31, 2016 and 2015 was \$2,710,149 and \$2,507,855, respectively.

NOTE 16 – PARTICIPATORY NOTE PAYABLE

On April 5, 2016, the Bank entered into a \$2,500,000 Tier 1 Capital Participatory Note Certificate (the “Note”). In connection with issuance of the Note, the Bank and the Investor (or the “Subscriber”) entered into a Participation Agreement (the “Participation Agreement”) and a Subscription Agreement (the “Subscription Agreement”) which together constitute the “Transaction Documents”.

On April 5, 2016, the Subscriber paid the subscription price of \$2,500,000 and in exchange received the Note. The Note’s return is tied to a designated portfolio of financial assets held by UIF (the “Participation Assets”). The Bank, on a quarterly basis, calculates the change in the value of the Participation Assets, and distributes a portion thereof (less certain taxes and costs) to the Subscriber (that portion, the “Participant Profit”). If the Participant Profit for a particular period is in excess of an annual return of 5.75% (the “Expected Rate”), the Bank holds the excess in a reserve account (the “Reserve Account”). As such, the Participant Profit is effectively capped at the Expected Rate. If the Participant Profit in a particular period is below the Expected Rate, the Bank may draw on the Reserve Account to cover the difference and/or elect to cover such shortfall using its own net income and retained earnings.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 16 – PARTICIPATORY NOTE PAYABLE (Continued)

If the Bank's net income and retained earnings are insufficient to pay the Participant Profit and payments due under instruments that rank pari passu with the Note, the Bank is undercapitalized, or certain other events occur (each, a "Non-Payment Event"), or if the Bank elects not to pay the Participant Profit at its discretion (a "Non-Payment Election"), the Bank is not required to pay the Participant Profit to the Subscriber. Failure to pay such Participant Profit does not constitute an event of default under the Participation Agreement. In the event of a Non-Payment Event or a Non-Payment Election, the Bank may not pay dividends on or purchase or redeem any securities that rank junior to the Note until the Bank makes another payment of Participant Profit.

The Note has no maturity date. The Bank may, but is not at any time required to, terminate the Note by exercising a right to conduct a final constructive liquidation of the Note (a "Final Liquidation"). The Bank may only conduct a Final Liquidation (1) if certain adverse tax events occur, (2) if the Note stops being eligible as AT1 capital, or (3) beginning five years after issuance of the Note. A Final Liquidation may only be commenced if certain regulatory criteria are satisfied. In the event of the Bank's insolvency, the Note ranks senior only to the Bank's common stock and similar instruments, and ranks pari passu with other AT1 instruments. It is subordinated to all other liabilities, including depositors and general and subordinated creditors. The Note is not secured and is not guaranteed by any party.

At December 31, 2016, the Note balance totaled \$2,352,767, which is net of issuance costs. During the year ended December 31, 2016, the Company recorded interest expense related to the Note totaling \$77,830. As of December 31, 2016, this accrued interest was unpaid and is included in accounts payable in the consolidated balance sheet. As of December 31, 2016, there was no balance in the off balance sheet Reserve Account.

NOTE 17 – EMPLOYEE RETIREMENT PLAN

The Bank has a 401(K) plan (the "Plan") that allows employees of the Bank and the Bank's subsidiaries to contribute a portion of their salary pre-tax, to the allowable limit prescribed by the Internal Revenue Service. Management has discretion to make matching contributions to the Plan. All amounts have been funded or accrued at each respective balance sheet date. Matching contributions for the years ended December 31, 2016 and 2015 totaled \$239,329 and \$-0-, respectively.

Effective July 1, 2016, the 401(k) plan and the ESOP discussed in Note 14, were merged into one plan.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 18 – COMMITMENTS AND CONTINGENCIES

Commitments

The Bank 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 fund lines of credit and credit card limits. The Bank’s exposure to credit loss in the event of non-performance is equal to or less than the contractual amount of these instruments. The Bank follows the same credit policy to make such commitments as that followed by loans recorded in the consolidated financial statements.

The following is a summary of commitments:

| | December 31, | |
|---|---------------------|---------------------|
| | 2016 | 2015 |
| Unused lines of credit | \$ 3,725,719 | \$ 1,388,046 |
| Unused credit card limits | 2,628,691 | 1,438,914 |
| Unused commitments for residential construction | <u>4,908,233</u> | <u>3,542,452</u> |
| | <u>\$11,262,643</u> | <u>\$ 6,369,412</u> |

Contingencies

The Company has been party to various legal claims that have arisen from time to time in the normal course of business. Any impact of these legal claims has been reflected in the Company’s consolidated financial statements.

In December 2015, the Company recorded a contingent liability totaling \$977,840 related to a lawsuit against the Company stemming from trade secrets claims made by a competitor of UIF. In March 2015, the jury returned a verdict against UIF and awarded the competitor \$848,000. In July 2016, the court entered an amended final judgment in favor of the competitor in the amount of \$1,242,365 which was paid by the Company in August 2016. In October 2016, the court entered a full satisfaction of the judgment. In July 2016, the competitor appealed the court rulings for denial of its request for exemplary damages, reduction of its requested cost/fee awards, and enhancement of defendants’ fee award. The Company cross-appealed on all issues, asking that the judgment be reversed and that the competitor’s claims be dismissed. As of the date of this report, the appeal is in the briefing stage and the matter has not been scheduled for a hearing. As of the date of this report, it can’t be determined whether there is additional exposure to the Company beyond legal costs for these open appeals, and therefore, as of December 31, 2016, no additional contingent liability is accrued related to this case.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 18 – COMMITMENTS AND CONTINGENCIES (Continued)

Contingencies (Continued)

A competitor of ULG has filed a lawsuit against the Company relating to trade secret claims made by the competitor. As of the date of this report, the case has been scheduled for mediation. Until mediation has occurred, it is difficult to determine the amount of potential loss, if any, resulting from this claim. No amount has been accrued related to this case.

NOTE 19 – RELATED PARTY TRANSACTIONS

Available lines of credit to directors, officers and their affiliates at both December 31, 2016 and 2015 amounted to \$155,000, of which \$29,874 and \$41,177 had been borrowed against, respectively. The Company has closed and sold related party loans during the normal course of business. These loans were performing pursuant to terms at December 31, 2016 and 2015.

The Bank had demand deposits of \$226,907 and \$244,904 from directors, officers and their affiliates as of December 31, 2016 and 2015, respectively. The Bank also holds demand deposits from various employees in the normal course of business.

NOTE 20 – LINES OF CREDIT

The Bank had a line of credit available from the FHLB that lapsed in 2016 and was not renewed. The limit on this line was \$1,250,000 as of December 31, 2015. There were no advances on this line of credit as of December 31, 2015. Borrowings were secured by the pledge of specific mortgage loans held for investment along with FHLB stock and available-for-sale securities. As of December 31, 2015, the Bank had unutilized and available credit under the line of credit of \$1,250,000.

In June 2014, the Company entered into a \$1,000,000 revolving warehouse line of credit with a bank so that UIF could meet a state licensing requirement. The Company does not intend to draw on this line. Interest on this line is at the greater of the prime rate or 5%. This line is secured by financings, and matures on June 30, 2017. At both December 31, 2016 and 2015, there was no outstanding balance on this line of credit.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 21 – REGULATORY MATTERS

Dividend Restriction

Banking regulations require the maintenance of certain capital levels and limits the amount of dividends that may be paid by a bank to a holding company or by a holding company to shareholders. The Bank paid dividends to University Bancorp, Inc. totaling \$100,000 and \$973,390 during the years ended December 31, 2016 and 2015, respectively. University Bancorp, Inc. paid dividends of \$546,733 and \$-0- to common shareholders during the years ended December 31, 2016 and 2015, respectively.

Regulatory Capital Requirements

The Bank is 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 Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

The Bank is also subject to prompt corrective action capital requirement regulations set forth by the FDIC. The FDIC requires the Bank to maintain a minimum of total capital and Tier 1 capital (as defined) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average total assets (as defined). As of December 31, 2016 and 2015, respectively, the Bank met all capital adequacy requirements to which it is subject.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 21 – REGULATORY MATTERS (Continued)

The Bank's required and actual ratios and amounts of Tier 1 leverage, Tier 1 risk-weighted and total risk-weighted capital are as follows:

| | Actual | | To Be Adequately Capitalized | | To Be Well Capitalized | |
|---------------------------|---------------|--------|------------------------------|--------|------------------------|--------|
| | Amount | Ratios | Amount | Ratios | Amount | Ratios |
| As of December 31, 2016: | | | | | | |
| Total capital | | | | | | |
| (to risk-weighted assets) | \$ 16,262,000 | 16.78% | \$ 7,752,640 | 8.00% | \$ 9,690,800 | 10.00% |
| Tier 1 capital | | | | | | |
| (to risk-weighted assets) | 15,841,000 | 16.35% | 3,876,320 | 4.00% | 5,814,480 | 6.00% |
| Tier 1 capital | | | | | | |
| (to average assets) | 15,841,000 | 8.64% | 7,330,360 | 4.00% | 9,162,950 | 5.00% |
| As of December 31, 2015: | | | | | | |
| Total capital | | | | | | |
| (to risk-weighted assets) | \$ 12,497,000 | 16.71% | \$ 5,982,000 | 8.00% | \$ 7,478,000 | 10.00% |
| Tier 1 capital | | | | | | |
| (to risk-weighted assets) | 12,092,000 | 16.17% | 2,991,000 | 4.00% | 4,487,000 | 6.00% |
| Tier 1 capital | | | | | | |
| (to average assets) | 12,092,000 | 8.93% | 5,415,000 | 4.00% | 6,768,000 | 5.00% |

NOTE 22 – OTHER CAPITAL REQUIREMENTS

The Bank, Midwest, ULG, and UIF are subject to certain capital requirements in connection with seller/servicer agreements that these entities have entered into with secondary market investors. Failure to maintain minimum capital requirements could result in these entities' inability to originate and service loans for the respective investor and, therefore, could have a direct material effect on the Company's consolidated financial statements.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 22 – OTHER CAPITAL REQUIREMENTS (Continued)

The Bank's, Midwest's, ULG's, and UIF's actual capital amounts and the minimum amounts required for capital adequacy purposes, by investor, are as follows:

| | <u>Actual Capital</u> | <u>Minimum Capital</u> |
|--------------------------|---------------------------|----------------------------|
| As of December 31, 2016: | | |
| Bank | | |
| HUD | \$ 17,413,778 | \$ 1,000,000 |
| FHLMC | 17,413,778 | 3,394,568 |
| FNMA | 17,413,778 | 3,066,811 |
| Midwest | | |
| HUD | \$ 12,424,001 | \$ 1,951,335 |
| FHLMC | 12,242,001 | 2,505,850 |
| FNMA | 12,424,001 | 2,807,913 |
| GNMA | 12,424,001 | 2,973,417 |
| ULG | | |
| HUD | \$ 13,096,765 | \$ 2,500,000 |
| UIF | | |
| FHLMC | \$ 12,138,345 | \$ 3,415,217 |
| | <u>Actual Capital</u> | <u>Minimum Capital</u> |
| As of December 31, 2015: | | |
| Bank | | |
| HUD | \$ 13,551,671 | \$ 1,000,000 |
| FHLMC | 13,551,671 | 3,000,482 |
| FNMA | 13,551,671 | 2,826,050 |
| Midwest | | |
| HUD | \$ 12,343,608 | \$ 2,080,108 |
| FHLMC | 12,343,608 | 2,506,179 |
| FNMA | 12,343,608 | 2,863,693 |
| GNMA | 12,343,608 | 2,796,945 |
| ULG | | |
| HUD | \$ 10,645,178 | \$ 1,863,307 |
| UIF | | |
| FHLMC | \$ 12,180,974 | \$ 3,636,147 |

As of December 31, 2016 and 2015, the Bank, Midwest, ULG and UIF were also each required to have a minimum amount of liquid assets under certain liquidity requirements and were in compliance with these requirements.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS

The ASC standards provide a single definition of fair value, together with a framework for measuring it, and require additional disclosure about the use of fair value to measure assets and liabilities. The standards also emphasize that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under the standards, fair value measurements are disclosed by level within that hierarchy.

The fair value standards define 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.

The fair value standards require 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 future amounts, such as cash flows or earnings, to a single present 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.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

In that regard, the standards establish 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. Determining which hierarchical level an asset or liability falls within requires significant judgment. The Company's management evaluates its hierarchy disclosures.

Hierarchical levels, as defined by the standards and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities are as follows:

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: 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 for substantially the full term of the assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

Because valuation methodologies require the use of subjective assumptions, changes in these assumptions can materially affect fair value. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A description of the valuation methodologies used by the Company for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Available-for-Sale Securities

The fair value of the securities represents the amount the Company would realize upon sale of the mortgage backed securities currently in the portfolio. The Company receives current market values from The Federal Home Loan Bank on a monthly basis as part of its collateral positions. The securities are then marked to market every month based on these values. These securities are considered to be Level 2 assets in the valuation hierarchy. Net unrealized gains and losses on available-for-sale securities are included in other comprehensive income.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

Loans and Financings Held for Sale or Assignment

The Company elected to account for its loans and financings held for sale or assignment at fair value under the ASC standards that permit the Company to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value measurement option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, thus the Company may record identical financial assets and liabilities at fair value or by another measurement basis permitted under GAAP, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments.

Loans and financings held for sale or assignment are recorded at fair value based on quoted market prices, where available, or are determined by discounting cash flows using interest rates approximating the Company's current origination rates for similar loans and financings and adjusted to reflect the inherent credit risk. In most situations, these loans and financings are locked into buckets to be sold under forward loan and financing sales commitments (as discussed below), in which case the fair value of these loans and financings held for sale or assignment are approximated by the value to be received soon thereafter under the forward sales commitments. Loans and financings held for sale or assignment are considered to be Level 2 assets in the valuation hierarchy. Net changes in the fair value of the Company's loans and financings held for sale or assignment are included in earnings. The net gain on change in fair value of loans and financings held for sale or assignment at December 31, 2016 and 2015 was \$2,010,734 and \$1,980,932, respectively, which is included in the other income section in the consolidated statements of operations.

MSRs

The Company accounts for MSR at fair value in accordance with the ASC standards for servicing rights as discussed in Note 1. The fair value of MSR represents the amount that the Company would receive upon the sale of the MSR. The Company receives an independent valuation of its MSR on a quarterly basis. The fair value of MSR is determined by projecting cash flows which are then discounted to estimate an expected fair value. The fair value of MSR is impacted by a variety of factors, including prepayment assumptions, discount rates, delinquency rates, contractual specified servicing fees and underlying portfolio characteristics. Because these inputs are not transparent in market trades, MSR are considered to be Level 3 assets in the valuation hierarchy. Net changes in fair value of MSR are included in earnings.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

Derivatives – IRLCs and Forward Commitments

The Company enters into IRLCs in connection with its mortgage banking activities to fund mortgage loans and financings at specified times in the future. IRLCs that relate to the origination of mortgage loans and financings that will be held for sale or assignment are considered derivative instruments as discussed in Note 1. As such, in accordance with ASC standards for derivative instruments, these IRLCs are recorded at fair value with changes in fair value recorded in earnings.

The Company estimates the fair value of an IRLC subsequent to inception of the commitment. In estimating the fair value of an IRLC, the Company assigns a probability to the loan or financing commitment based on an expectation that it will be exercised and the loan or financing will be funded. The fair value of IRLCs, while based on interest rates observable in the market, is highly dependent on the ultimate closing of the loans or financings. These “pull-through” rates are based on ULG’s historical data and reflect an estimate of the likelihood that a commitment will ultimately result in a closed loan or financing.

Also, the fair value of these commitments is derived from the fair value of the related mortgage loans or financings, which is based on unobservable data. Because these inputs are not transparent in market trades, IRLCs are considered to be Level 3 assets or liabilities in the valuation hierarchy. Changes in the fair value of the IRLCs are recognized based on interest rate changes, changes in the probability that the commitment will be exercised, and the passage of time. Changes from the expected future cash flows related to the customer relationship or loan or financing servicing are excluded from the valuation of IRLCs.

Outstanding IRLCs expose the Company to the risk that the price of the loans or financings underlying the commitments might decline from inception of the rate lock to the funding of the loan or financing. To protect against this risk, the Company utilizes forward loan or financing sales commitments to economically hedge the risk of potential changes in the value of the loans or financings that would result from the commitments. These forward sales commitments are considered derivative instruments as discussed in Note 1, and hence are valued at fair value with changes in fair value recorded in earnings.

The fair value of forward sales commitments is based primarily on the fluctuation of interest rates between the date on which the particular forward sales commitment was entered into and year end. Forward commitments are considered to be Level 3 assets or liabilities in the valuation hierarchy.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

Real Estate Owned

Real estate properties acquired in collection of a loan or financing are recorded at fair value upon foreclosure, establishing a new cost basis. After foreclosure, management periodically performs valuations to ensure real estate is carried at lower of cost or fair value, less estimated costs to sell. Fair value of the collateral is estimated by considering appraisals, which are updated on a periodic basis to reflect current housing market conditions.

Contingent Earn-Out

In 2012, the Company acquired 100% of the stock of AAIC and 100% of the membership interest of 2621 Carpenter Road, LLC. The contingent earn-out arrangement requires the Company to pay the seller an earn-out amount based on AAIC's retention rate of customers since acquisition. The fair value of this contingent earn-out arrangement was estimated based on actual retention of customers. As of December 31, 2016 and 2015, the fair value of the contingent earn-out liability was \$-0- as the Company made the last remaining payment of \$74,129 during 2015 under this earn-out arrangement. The Company recognized no income or expense related to the change in the fair value of this contingent earn-out arrangement for the years ended December 31, 2016 and 2015.

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of December 31, 2016 and 2015, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| | Level 1 | Level 2 | Level 3 |
|---|---------|---------------|---------------|
| December 31, 2016 | | | |
| Assets: | | | |
| Available-for-sale securities | \$ - | \$ 2,039,365 | \$ - |
| Loans and financings held for sale or assignment | \$ - | \$ 56,496,574 | \$ - |
| Mortgage and financing servicing rights | \$ - | \$ - | \$ 11,069,440 |
| Interest and financing rate lock commitments | \$ - | \$ - | \$ 1,271,023 |
| Forward sales commitments | \$ - | \$ - | \$ 167,554 |
| Liabilities: | \$ - | \$ - | \$ - |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
|--|----------------|----------------|----------------|
| December 31, 2015 | | | |
| Assets: | | | |
| Available-for-sale securities | \$ - | \$ 2,438,803 | \$ - |
| Loans and financings held for sale or assignment | \$ - | \$ 42,666,107 | \$ - |
| Mortgage and financing servicing rights | \$ - | \$ - | \$ 9,379,862 |
| Interest and financing rate lock commitments | \$ - | \$ - | \$ 959,862 |
| Liabilities: | | | |
| Forward sales commitments | \$ - | \$ - | \$ 58,111 |

The table below includes a roll forward of the fair value of assets and liabilities that are classified by the Company within Level 3 of the valuation hierarchy:

| | <u>MSRs</u> | <u>IRLCs</u> | <u>Forward Sales Commitments</u> | <u>Contingent Earn-out Liability</u> |
|---|---------------------|---------------------|----------------------------------|--------------------------------------|
| Fair value at January 1, 2015 | \$ 7,900,842 | \$ 1,065,770 | \$ (172,008) | \$ (74,129) |
| Purchases, sales, issuances, settlements, net | 3,188,991 | (1,065,770) | 172,008 | 74,129 |
| Net gains (losses) | <u>(1,709,971)</u> | <u>959,862</u> | <u>(58,111)</u> | <u>-</u> |
| Fair value December 31, 2015 | 9,379,862 | 959,862 | (58,111) | - |
| Purchases, sales, issuances, settlements, net | 2,856,966 | (959,862) | 58,111 | - |
| Net gains (losses) | <u>(1,167,388)</u> | <u>1,271,023</u> | <u>167,554</u> | <u>-</u> |
| Fair value December 31, 2016 | <u>\$11,069,440</u> | <u>\$ 1,271,023</u> | <u>\$ 167,554</u> | <u>\$ -</u> |

The following tables summarizes financial assets and liabilities measured at fair value on a nonrecurring basis:

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> |
|------------------------------|----------------|-------------------|----------------|
| Year ended December 31, 2015 | | | |
| Real estate owned | <u>\$ -</u> | <u>\$ 301,840</u> | <u>\$ -</u> |

There were no assets or liabilities measured at fair value on a nonrecurring basis during the year ended December 31, 2016.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

Other ASC standards require disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The estimated fair value approximates carrying value for cash and due from banks, certificates of deposit, Federal Home Loan Bank stock, and the participatory note payable. The methodologies for other financial assets and financial liabilities are discussed below.

Loans and Financings, Net

The fair value of fixed-rate loans and financings is estimated by discounting the future cash flows for each loan and financing category using the current rates at which similar loans or financings would be made to borrowers with similar credit ratings and for the same remaining maturities. These loans and financings are considered to be Level 2 assets in the valuation hierarchy. The fair value of adjustable-rate loans is assumed to approximate their carrying amount.

Deposits

The fair value of demand deposits and savings accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting the future cash flows using the market rates offered for similar deposits with the same remaining maturities. These time deposits are considered to be Level 2 liabilities in the valuation hierarchy.

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 23 - FAIR VALUE MEASUREMENTS (Continued)

The estimated fair values of financial instruments are as follows (in thousands):

| | December 31, | | | |
|---|--------------------|-------------------------|--------------------|-------------------------|
| | 2016 | | 2015 | |
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Significant financial assets: | | | | |
| Cash and due from banks | \$ 42,491 | \$ 42,491 | \$ 59,739 | \$ 59,739 |
| Restricted cash | 1,006 | 1,006 | 1,002 | 1,002 |
| Securities available-for-sale | 2,039 | 2,039 | 2,439 | 2,439 |
| Federal Home Loan Bank stock | 637 | 637 | 637 | 637 |
| Loans and financings held for sale or assignment | 56,497 | 56,497 | 42,666 | 42,666 |
| Loans and financings, net | 65,678 | 65,619 | 55,686 | 55,833 |
| Mortgage and financing servicing right | 11,069 | 11,069 | 9,380 | 9,380 |
| Derivatives | 1,439 | 1,439 | 960 | 960 |
| Significant financial liabilities: | | | | |
| Deposits: | | | | |
| Demand - non-interest bearing | \$ 135,220 | \$ 135,220 | \$ 131,835 | \$ 131,835 |
| Demand - interest bearing and profit sharing | 15,400 | 15,400 | 16,567 | 16,567 |
| Savings | 478 | 478 | 436 | 436 |
| Time | 3,043 | 3,137 | 3,418 | 3,579 |
| Participatory note payable | 2,353 | 2,353 | - | - |
| Derivatives | - | - | 58 | 58 |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 24 – PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

CONDENSED BALANCE SHEETS

| | December 31, | |
|--|----------------------|----------------------|
| | 2016 | 2015 |
| ASSETS | | |
| Cash and cash equivalents | \$ 15,537 | \$ 63,389 |
| Investment in University Bank | 17,909,701 | 14,192,552 |
| Accounts receivable - University Bank | 53,000 | 505,000 |
| Other assets | 98,472 | 61,575 |
| Total assets | <u>\$ 18,076,710</u> | <u>\$ 14,822,516</u> |
| LIABILITIES AND EQUITY | | |
| Accounts payable and other liabilities | \$ 875 | \$ 1,098 |
| Total equity | <u>18,075,835</u> | <u>14,821,418</u> |
| Total liabilities and equity | <u>\$ 18,076,710</u> | <u>\$ 14,822,516</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 24 – PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION
(Continued)

CONDENSED STATEMENTS OF OPERATIONS

| | <u>December 31,</u> | |
|---|---------------------|---------------------|
| | <u>2016</u> | <u>2015</u> |
| OTHER INCOME | | |
| Interest and dividend income | \$ 160 | \$ 391 |
| EXPENSES | | |
| Compensation and benefits | - | 133,429 |
| Professional fees and public listing | 29,096 | 27,255 |
| Other miscellaneous | 18,162 | 15,157 |
| Interest expense | - | 5,273 |
| Total expenses | <u>47,258</u> | <u>181,114</u> |
| Net loss before income taxes and net income of subsidiary | (47,098) | (180,723) |
| Income tax expense (benefit) | <u>(27,934)</u> | <u>(72,572)</u> |
| Net loss before net income of subsidiary | (19,164) | (108,151) |
| Net income of subsidiary | <u>3,825,361</u> | <u>3,247,368</u> |
| Net income | <u>\$ 3,806,197</u> | <u>\$ 3,139,217</u> |

UNIVERSITY BANCORP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2016 and 2015

NOTE 24 – PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION
(Continued)

CONDENSED STATEMENTS OF CASH FLOWS

| | <u>December 31,</u> | |
|--|---------------------|--------------------|
| | <u>2016</u> | <u>2015</u> |
| OPERATING ACTIVITIES | | |
| Net income | \$ 3,806,197 | \$ 3,139,217 |
| Adjustments to reconcile net income to net cash flows from operating activities: | | |
| Share-based compensation | - | - |
| Preferred dividends recorded as interest expense | - | 5,273 |
| Net change in: | | |
| Accounts receivable and other assets | 418,276 | (914,729) |
| Accounts payable and other liabilities | (231) | (4,810) |
| Net income of subsidiary | <u>(3,825,361)</u> | <u>(3,247,368)</u> |
| Net cash provided by (used in) operating activities | <u>398,881</u> | <u>(1,022,417)</u> |
| INVESTING ACTIVITIES | | |
| Dividends received from University Bank | <u>100,000</u> | <u>973,390</u> |
| FINANCING ACTIVITIES | | |
| Payment of dividends | (546,733) | - |
| Redemption of preferred stock | - | (350,000) |
| Repurchase of common stock | - | (105,000) |
| Payment of preferred dividends | - | (26,049) |
| Exercise of stock options | <u>-</u> | <u>169,971</u> |
| Net cash used in financing activities | <u>(546,733)</u> | <u>(311,078)</u> |
| NET CHANGE IN CASH | (47,852) | (360,105) |
| Cash and Cash Equivalents, Beginning of Year | <u>63,389</u> | <u>423,494</u> |
| Cash and Cash Equivalents, End of Year | <u>\$ 15,537</u> | <u>\$ 63,389</u> |