

MIDDLEFIELD BANC CORP

Form 10-K

March 24, 2008

**Table of Contents**

**United States SECURITIES AND EXCHANGE COMMISSION  
Washington , D.C. 20549  
FORM 10-K**

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of  
1934 for the fiscal year ended: December 31, 2007  
Commission File Number: 33-23094  
Middlefield Banc Corp.  
(Exact name of registrant as specified in its charter)**

Ohio

34-1585111

**( State or other jurisdiction  
of incorporation or organization)**

**( IRS Employer  
Identification No.)**

15985 East High Street, Middlefield, Ohio 44062-0035  
(440) 632-1666

**( Address, including zip code, and telephone number,  
including area code, of registrant s principal executive offices )**

**Securities registered pursuant to section 12(b) of the Act : none**

**Securities registered pursuant to section 12(g) of the Act : common stock, without par value**

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting  
company

(Do not check if a smaller reporting company)

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

The aggregate market value on June 30, 2007 of common stock held by non-affiliates of the registrant was approximately \$63.6 million. As of March 21, 2008, there were 1,707,015 shares of common stock issued and outstanding.

**Documents Incorporated by Reference**

Portions of the registrant s definitive proxy statements for the 2008 Annual Meeting of Shareholders are incorporated by reference in Part III of this report. Portions of the Annual Report to Shareholders for the year ended December 31, 2007 are incorporated by reference into Part I and Part II of this report.



## Table of Contents

		<b>Page</b>
<b>Part I</b>		
	<u>Item 1</u> <u>Business</u>	2
	<u>Item 1A</u> <u>Risk Factors</u>	15
	<u>Item 2</u> <u>Properties</u>	17
	<u>Item 3</u> <u>Legal Proceedings</u>	18
	<u>Item 4</u> <u>Submission of Matters to a Vote of Security Holders</u>	18
 <b><u>Part II</u></b>		
	<u>Item 5</u> <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	18
	<u>Item 6</u> <u>Selected Financial Data</u>	19
	<u>Item 7</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
	<u>Item 7A</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	19
	<u>Item 8</u> <u>Financial Statements and Supplementary Data</u>	19
	<u>Item 9</u> <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	19
	<u>Item 9a(T)</u> <u>Controls and Procedures</u>	19
	<u>Item 9b</u> <u>Other Information</u>	19
 <b><u>Part III</u></b>		
	<u>Item 10</u> <u>Directors and Executive Officers of the Registrant</u>	19
	<u>Item 11</u> <u>Executive Compensation</u>	19
	<u>Item 12</u> <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	20
	<u>Item 13</u> <u>Certain Relationships and Related Transactions</u>	20
	<u>Item 14</u> <u>Principal Accountant Fees and Services</u>	20
 <b><u>Part IV</u></b>		

<u>Item 15</u>	<u>Exhibits, Financial Statement Schedules</u>	20
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<u>Signatures</u>		25
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EX-13

EX-21

EX-23

EX-31.1

EX-31.2

EX-32

**Table of Contents**

**Item 1 Business**

***Middlefield Banc Corp.*** Incorporated in 1988 under the Ohio General Corporation Law, Middlefield Banc Corp. ( Company ) is a two-bank holding company registered under the Bank Holding Company Act of 1956. The Company's two subsidiaries are:

1. The Middlefield Banking Company ( MBC ), an Ohio-chartered commercial bank that began operations in 1901. MBC engages in a general commercial banking business in northeastern Ohio. The principal executive office is located at 15985 East High Street, Middlefield, Ohio 44062-0035, and its telephone number is (440) 632-1666.
2. Emerald Bank ( EB ), an Ohio-chartered commercial bank headquartered in Dublin, Ohio. EB engages in a general commercial banking business in central Ohio. The principal executive office is located at 6215 Perimeter Drive, Dublin Ohio 43017, and its telephone number is (614) 793-4631.

***The Middlefield Banking Company.*** MBC was chartered under Ohio law in 1901. The Company became the holding company for MBC in 1988. MBC offers its customers a broad range of banking services, including checking, savings, and negotiable order of withdrawal (NOW) accounts; money market accounts; time certificates of deposit, commercial loans, real estate loans, and various types of consumer loans; safe deposit facilities, and travelers' checks. MBC offers online banking and bill payment services to individuals and online cash management services to business customers through its website at [www.middlefieldbank.com](http://www.middlefieldbank.com).

Engaged in a general commercial banking business in northeastern Ohio, MBC offers commercial banking services principally to small and medium-sized businesses, professionals and small business owners, and retail customers. MBC has developed and continues to monitor and update a marketing program to attract and retain consumer accounts, and to offer banking services and facilities compatible with the needs of its customers.

MBC's loan products include operational and working capital loans; loans to finance capital purchases; term business loans; residential construction loans; selected guaranteed or subsidized loan programs for small businesses; professional loans; residential mortgage and commercial mortgage loans, and consumer installment loans to purchase automobiles, boats, and for home improvement and other personal expenditures. Although the bank makes agricultural loans, it currently has no significant agricultural loans.

***Emerald Bank.*** The Company acquired Emerald Bank on April 19, 2007 for a combination of cash and stock. Emerald Bank operates as a separate commercial bank subsidiary of Middlefield, offering essentially the same range of products and services in central Ohio as MBC does in northeastern Ohio.

***Market Area.*** MBC's market area consists principally of Geauga, Portage, Trumbull, and Ashtabula Counties. Benefiting from the area's proximity both to Cleveland and Warren, population and income levels have maintained steady growth over the years. EB's sole office is located in Dublin in Franklin County, serving the central Ohio market.

***Competition.*** The banking industry has been changing for many reasons, including continued consolidation within the banking industry, legislative and regulatory changes, and advances in technology. To deliver banking products and services more effectively and efficiently, banking institutions are opening in-store branches, installing more automated teller machines (ATMs) and investing in technology to permit telephone, personal computer, and internet banking. While all banks are experiencing the effects of the changing competitive and technological environment, the manner in which banks choose to compete is increasing the gap between large national and super-regional banks, on one hand, and community banks on the other. Large institutions are committed to becoming national or regional brand names, providing a broad selection of products at low cost and with advanced technology, while community banks provide most of the same products but with a commitment to personal service and with local ties to the customers and communities they serve. The Company seeks to take competitive advantage of its local orientation and community banking profile. It competes for loans principally through responsiveness to customers and its ability to communicate effectively with them and understand and address their needs. The Company competes for deposits principally by offering customers personal attention, a variety of banking services, attractive rates, and strategically located banking facilities. The Company seeks to provide high quality banking service to professionals and small and mid-sized businesses, as well as individuals, emphasizing quick and flexible responses to customer demands.

***Forward-looking Statements.*** This document contains forward-looking statements (as defined in the Private Securities Litigation Reform Act of 1995) about The Company and subsidiaries. Information incorporated in this

document by reference, future filings by the Company on Form 10-Q and Form 8-K, and future oral and written statements by the Company and its management may also contain forward-looking statements. Forward-looking statements include statements about anticipated operating and financial performance, such as loan originations, operating efficiencies, loan sales, charge-offs and loan loss provisions, growth opportunities, interest rates, and deposit growth. Words such as may, could, should, would, believe, anticipate, estimate, expect, intend, pro similar expressions are intended to identify these forward-looking statements.

**Table of Contents**

Forward-looking statements are necessarily subject to many risks and uncertainties. A number of things could cause actual results to differ materially from those indicated by the forward-looking statements. These include the factors we discuss immediately below, those addressed under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations, other factors discussed elsewhere in this document or identified in our filings with the Securities and Exchange Commission, and those presented elsewhere by our management from time to time. Many of the risks and uncertainties are beyond our control. The following factors could cause our operating and financial performance to differ materially from the plans, objectives, assumptions, expectations, estimates, and intentions expressed in forward-looking statements:

the strength of the United States economy in general and the strength of the local economies in which we conduct our operations; general economic conditions, either nationally or regionally, may be less favorable than we expect, resulting in a deterioration in the credit quality of our loan assets, among other things

the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest-rate policies of the Federal Reserve Board

inflation, interest rate, market, and monetary fluctuations

the development and acceptance of new products and services of the Company and subsidiaries and the perceived overall value of these products and services by users, including the features, pricing, and quality compared to competitors' products and services

the willingness of users to substitute our products and services for those of competitors

the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities, and insurance)

changes in consumer spending and saving habits

Forward-looking statements are based on our beliefs, plans, objectives, goals, assumptions, expectations, estimates, and intentions as of the date the statements are made. Investors should exercise caution because the Company cannot give any assurance that its beliefs, plans, objectives, goals, assumptions, expectations, estimates, and intentions will be realized. The Company disclaims any obligation to update or revise any forward-looking statements based on the occurrence of future events, the receipt of new information, or otherwise.

**Lending** *Loan Portfolio Composition and Activity*. The Company makes residential mortgage and commercial mortgage loans, home equity loans, secured and unsecured consumer installment loans, commercial and industrial loans, and real estate construction loans for owner-occupied and rental properties. The Company's loan policy aspires to a loan composition mix consisting of approximately 60% to 70% residential real estate loans, 35% to 40% commercial loans, consumer loans of 5% to 15%, and credit card accounts of up to 5%.

Although Ohio bank law imposes no material restrictions on the kinds of loans the Company may make, real estate-based lending has historically been the bank's primary focus. For prudential reasons, the bank avoids lending on the security of real estate located in regions with which the bank is not familiar, and as a consequence almost all of the bank's real-estate secured loans are secured by real property in northeastern Ohio. Ohio bank law does restrict the amount of loans an Ohio-chartered bank such as the banks may make, however, providing generally that loans and extensions of credit to any one borrower may not exceed 15% of capital. An additional margin of 10% of capital is allowed for loans fully secured by readily marketable collateral. This 15% legal lending limit has not been a material restriction on the banks' lending. The banks can accommodate loan volumes exceeding the legal lending limit by selling loan participations to other banks. The subsidiaries' internal policy is to maintain its credit exposure to any one borrower at less than \$3.0 million, which is comfortably within the range of the bank's legal lending limit. As of December 31, 2007, the Company's 15%-of-capital limit on loans to a single borrower was approximately \$5.2 million.



The Company offers specialized loans for business and commercial customers, including equipment and inventory financing, real estate construction loans and Small Business Administration loans for qualified businesses. A substantial portion of the bank's commercial loans are designated as real estate loans for regulatory reporting purposes because they are secured by mortgages on real property. Loans of that type may be made for purpose of financing commercial activities, such as accounts receivable, equipment purchases and leasing, but they are secured by real estate to provide the bank with an extra measure of security. Although these loans might be secured in whole or in part by real estate, they are treated in the discussions to follow as commercial and industrial loans. The Company's consumer installment loans include secured and unsecured loans to individual borrowers for a variety of purposes, including personal, home improvements, revolving credit lines, autos, boats, and recreational vehicles.

**Table of Contents**

The following table shows the composition of the loan portfolio in dollar amounts and in percentages at December 31, 2007, 2006, 2005, 2004 and 2003, along with a reconciliation to loans receivable, net.

	Loan Portfolio Composition at December 31,									
	2007		2006		2005		2004		2003	
(Dollars in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
<b>Type of loan:</b>										
<b>Commercial and industrial</b>	\$ 67,010	21.65	\$ 68,496	27.49	\$ 65,252	27.88%	\$ 52,148	24.18%	\$ 42,063	21.81%
<b>Real estate construction</b>	6,704	2.17	2,458	0.99	2,725	1.16	3,144	1.46	3,434	1.78
<b>Mortgage:</b>										
<b>Residential</b>	193,514	62.53	162,917	65.38	151,866	64.88	147,425	68.36	134,007	69.48
<b>Commercial</b>	36,818	11.90	9,949	3.99	8,208	3.51	7,027	3.26	7,866	4.08
<b>Consumer installment</b>	5,400	1.75	5,371	2.16	6,004	2.57	5,909	2.74	5,510	2.85
<b>Total loans</b>	<b>309,446</b>	<b>100</b>	<b>249,191</b>	<b>100</b>	<b>234,055</b>	<b>100%</b>	<b>215,653</b>	<b>100%</b>	<b>192,880</b>	<b>100%</b>
<b>Less:</b>										
<b>Allowance for loan losses</b>	3,299		2,849		2,841		2,623		2,521	
<b>Net loans</b>	<b>\$ 306,147</b>		<b>\$ 246,342</b>		<b>\$ 231,214</b>		<b>\$ 213,030</b>		<b>\$ 190,359</b>	
<b>Net loans as a percent of total assets</b>	<b>89.82%</b>		<b>56.73%</b>		<b>74.29%</b>		<b>73.15%</b>		<b>72.55%</b>	

The following table presents maturity information for the loan portfolio at December 31, 2007. The table does not include prepayments or scheduled principal repayments. All loans are shown as maturing based on contractual maturities.

	Loan Portfolio Maturity at December 31, 2007					
	Commercial and Industrial	Real Estate Construction	Mortgage Residential	Mortgage Commercial	Consumer Installment	Total
(Dollars in thousands)						
Amount due:						
In one year or less	\$ 21,230	\$ 3,338	\$ 59,598	\$ 4,353	\$ 1,346	\$ 89,865
After one year through five years	28,680	1,259	108,556	21,367	3,777	163,639
After five years	17,100	2,107	25,360	11,098	277	55,942
<b>Total amount due</b>	<b>\$ 67,010</b>	<b>\$ 6,704</b>	<b>\$ 193,514</b>	<b>\$ 36,818</b>	<b>\$ 5,400</b>	<b>\$ 309,446</b>

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Loans due on demand and overdrafts are included in the amount due in one year or less. The Company has no loans without a stated schedule of repayment or a stated maturity.

The following table shows the dollar amount of all loans due after December 31, 2007 that have pre-determined interest rates and the dollar amount of all loans due after December 31, 2007 that have floating or adjustable rates.

(Dollars in thousands)	Fixed Rate	Adjustable Rate	Total
Commercial and industrial	\$ 27,819	\$ 39,191	\$ 67,010
Real estate construction	2,618	4,086	6,704
Mortgage:			
Residential	51,323	142,191	193,514
Commercial	14,764	22,054	36,818
Consumer installment	5,059	341	5,400
	\$ 101,583	\$ 207,863	\$ 309,446

**Table of Contents**

***Residential Mortgage Loans.*** A significant portion of the Company's lending consists of origination of conventional loans secured by 1-4 family real estate located in Franklin, Geauga, Portage, Trumbull, and Ashtabula Counties. These loans approximated \$194 million or 62.5% of the Company's total loan portfolio at December 31, 2007.

The Company makes loans of up to 80% of the value of the real estate and improvements securing a loan (the loan-to-value or LTV ratio) on 1-4 family real estate. The Company generally does not lend in excess of 80% of the appraised value or sales price (whichever is less) of the property unless additional collateral is obtained, thereby lowering the total LTV. The Company offers residential real estate loans with terms of up to 30 years.

Before 1996, nearly all residential mortgage loans originated by the Company were written on a balloon-note basis. During 1996, the Company began to originate fixed-rate mortgage loans for maturities up to 20 years. In late 1998, the Company began originating adjustable-rate mortgage loans and de-emphasized balloon-note mortgages. Approximately 73.5% of the portfolio of conventional mortgage loans secured by 1-4 family real estate at December 31, 2007 was adjustable rate. The Company's mortgage loans are ordinarily retained in the loan portfolio. The Company's residential mortgage loans have not been originated with loan documentation that would permit their sale to Fannie Mae and Freddie Mac.

The Company's home equity loan policy generally allows for a loan of up to 85% of a property's appraised value, less the principal balance of the outstanding first mortgage loan. The Company's home equity loans generally have terms of 10 years.

At December 31, 2007, residential mortgage loans of approximately \$3.2 million were over 90 days delinquent or non-accruing on that date, representing 1.63% of the residential mortgage loan portfolio.

***Commercial and Industrial Loans and Commercial Real Estate Loans .*** The Company's commercial loan services include

accounts receivable, inventory and working capital loans

renewable operating lines of credit

loans to finance capital equipment

term business loans

short-term notes

selected guaranteed or subsidized loan programs for small businesses

loans to professionals

commercial real estate loans

Commercial real estate loans include commercial properties occupied by the proprietor of the business conducted on the premises, and income-producing or farm properties. Although the Company makes agricultural loans, it currently does not have a significant amount of agricultural loans. The primary risk of commercial real estate loans is loss of income of the owner or occupier of the property and the inability of the market to sustain rent levels. Although commercial and commercial real estate loans generally bear somewhat more risk than single-family residential mortgage loans, commercial and commercial real estate loans tend to be higher yielding, tend to have shorter terms and commonly provide for interest-rate adjustments as prevailing rates change. Accordingly, commercial and commercial real estate loans enhance a lender's interest rate risk management and, in management's opinion, promote more rapid asset and income growth than a loan portfolio comprised strictly of residential real estate mortgage loans.

Although a risk of nonpayment exists for all loans, certain specific types of risks are associated with various kinds of loans. One of the primary risks associated with commercial loans is the possibility that the commercial borrower will not generate income sufficient to repay the loan. The Company's loan policy provides that commercial loan applications must be supported by documentation indicating that there will be cash flow sufficient for the borrower to

service the proposed loan. Financial statements or tax returns for at least three years must be submitted, and annual reviews are undertaken for loans of \$150,000 or more. The fair market value of collateral for collateralized commercial loans must exceed the Company's loan exposure. For this purpose fair market value is determined by independent appraisal or by the loan officer's estimate employing guidelines established by the loan policy. Term loans not secured by real estate generally have terms of five years or less, unless guaranteed by the U.S. Small Business Administration or other governmental agency, and terms loans secured by collateral having a useful life exceeding five years may have longer terms. The Company's loan policy allows for terms of up to 15 years for loans secured by commercial real estate, and one year for business lines of credit. The maximum loan-to-value ratio for commercial real estate loans is 75% of the appraised value or cost, whichever is less.

Real estate is commonly a material component of collateral for the Company's loans, including commercial loans. Although the expected source of repayment of these loans is generally the operations of the borrower's business or personal income, real estate collateral provides an additional measure of security. Risks associated with loans secured by real estate include fluctuating land values, changing local economic conditions, changes in tax policies, and a concentration of loans within a limited geographic area.

At December 31, 2007, commercial and commercial real estate loans totaled \$103.8million, or 33.6% of the Company's total loan portfolio. At December 31, 2007, commercial and commercial real estate loans of approximately \$1.8 million were over 90 days delinquent or non-accruing on that date, and represented 1.77% of the commercial and commercial real estate loan portfolios.

**Real Estate Construction** . The Company originates several different types of loans that it categorizes as construction loans, including

residential construction loans to borrowers who will occupy the premises upon completion of construction,

residential construction loans to builders,

commercial construction loans, and

real estate acquisition and development loans.

**Table of Contents**

Because of the complex nature of construction lending, these loans are generally recognized as having a higher degree of risk than other forms of real estate lending. The Company's fixed-rate and adjustable-rate construction loans do not provide for the same interest rate terms on the construction loan and on the permanent mortgage loan that follows completion of the construction phase of the loan. It is the norm for the Company to make residential construction loans without an existing written commitment for permanent financing. The Company's loan policy provides that the Company may make construction loans with terms of up to one year, with a maximum loan-to-value ratio for residential construction of 80%.

At December 31, 2007, real estate construction loans totaled \$6.7 million, or 2.2% of the Company's total loan portfolio. At December 31, 2007, real estate-construction loans of approximately \$643,000 were over 90 days delinquent or non-accruing on that date, and represented 9.56% of the real estate-construction loan portfolios.

**Consumer Installment Loans** . The Company's consumer installment loans include secured and unsecured loans to individual borrowers for a variety of purposes, including personal, home improvement, revolving credit lines, autos, boats, and recreational vehicles. The Company does not currently do any indirect lending. Unsecured consumer loans carry significantly higher interest rates than secured loans. The Company maintains a higher loan loss allowance for consumer loans, while maintaining strict credit guidelines when considering consumer loan applications.

According to the Company's loan policy, consumer loans secured by collateral other than real estate generally may have terms of up to five years, and unsecured consumer loans may have terms up to two and one-half years. Real estate security generally is required for consumer loans having terms exceeding five years.

At December 31, 2007, the Company had approximately \$5.4 million in its consumer installment loan portfolio, representing 1.8% of total loans. Consumer installment loans of approximately \$23,000 were over 90 days delinquent or non-accruing on that date, representing .43% of the installment loan portfolio.

**Loan Solicitation and Processing** . Loan originations are developed from a number of sources, including continuing business with depositors, other borrowers and real estate builders, solicitations by Company personnel and walk-in customers.

When a loan request is made, the Company reviews the application, credit bureau reports, property appraisals or evaluations, financial information, verifications of income, and other documentation concerning the creditworthiness of the borrower, as applicable to each loan type. The Company's underwriting guidelines are set by senior management and approved by the board. The loan policy specifies each individual officer's loan approval authority, loans exceeding an individual officer's approval authority are submitted to a committee consisting of loan officers, which has authority to approve loans up to \$500,000. The full board acts as a loan committee for loans exceeding that amount.

**Income from Lending Activities** . The Company earns interest and fee income from its lending activities. Net of origination costs, loan origination fees are amortized over the life of a loan. The Company also receives loan fees related to existing loans, including late charges. Income from loan origination and commitment fees and discounts varies with the volume and type of loans and commitments made and with competitive and economic conditions. Note 1 to the Consolidated Financial Statements included herein contains a discussion of the manner in which loan fees and income are recognized for financial reporting purposes.

**Nonperforming Loans** . Late charges on residential mortgages and consumer loans are assessed if a payment is not received by the due date plus a grace period. When an advanced stage of delinquency appears on a single-family loan and if repayment cannot be expected within a reasonable time or a repayment agreement is not entered into, a required notice of foreclosure or repossession proceedings may be prepared by the Company's attorney and delivered to the borrower so that foreclosure proceedings may be initiated promptly, if necessary. The Company also collects late charges on commercial loans.

When the Company acquires real estate through foreclosure, voluntary deed, or similar means, it is classified as other real estate owned until it is sold. When property is acquired in this manner, it is recorded at the lower of cost (the unpaid principal balance at the date of acquisition) or fair value. Any subsequent write-down is charged to expense. All costs incurred from the date of acquisition to maintain the property are expensed. Other real estate owned is appraised during the foreclosure process, before acquisition. Losses are recognized for the amount by which the book value of the related mortgage loan exceeds the estimated net realizable value of the property.

The Company undertakes regular review of the loan portfolio to assess its risks, particularly the risks associated with the commercial loan portfolio. This includes annual review of every commercial loan representing credit

exposure of \$150,000 or more. An independent firm performs semi-annual loan reviews for the Company.

**Classified Assets** . FDIC regulations governing classification of assets require nonmember commercial banks including the Company to classify their own assets and to establish appropriate general and specific allowances for losses, subject to FDIC review. The regulations are designed to encourage management to evaluate assets on a case-by-case basis, discouraging automatic classifications. Under this classification system, problem assets of insured institutions are classified as substandard, doubtful, or loss. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses make collection of principal in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not expose the Company to risk sufficient to warrant classification in one of the above categories, but that possess some weakness, are required to be designated special mention by management.

**Table of Contents**

When an insured institution classifies assets as either substandard or doubtful, it may establish allowances for loan losses in an amount deemed prudent by management. When an insured institution classifies assets as loss, it is required either to establish an allowance for losses equal to 100% of that portion of the assets so classified or to charge off that amount. An FDIC-insured institution's determination about classification of its assets and the amount of its allowances is subject to review by the FDIC, which may order the establishment of additional loss allowances. Management also employs an independent third party to semi-annually review and validate the internal loan review process and loan classifications. As of December 31, 2007, 2006, 2005, 2004 and 2003 classified assets were as follows:

		Classified Assets at December 31,									
		2007		2006		2005		2004		2003	
		Percent		Percent		Percent		Percent		Percent	
		of		of		of		of		of	
		total		total		total		total		total	
(Dollars in thousands)	Amount	loans	Amount	loans	Amount	loans	Amount	loans	Amount	loans	
Classified loans:											
Special mention	\$ 5,302	1.71%	\$ 7,394	2.97%	\$ 6,567	2.81%	\$ 4,094	1.90%	\$ 2,876	1.49%	
Substandard	1,029	0.33%	1,515	0.61%	2,020	0.86%	3,097	1.44%	1,920	1.00%	
Doubtful	835	0.27%				0.00%	163	0.08%	199	0.10%	
Loss											
Total amount due	\$ 7,166	2.31%	\$ 8,909	3.58%	\$ 8,587	3.67%	\$ 7,354	3.42%	\$ 4,995	3.41%	

**Investments.** Investment securities provide a return on residual funds after lending activities. Investments may be in federal funds sold, corporate securities, U.S. Government and agency obligations, state and local government obligations and government-guaranteed, mortgage-backed securities. The Company generally does not invest in securities that are rated less than investment grade by a nationally recognized statistical rating organization. Ohio bank law prescribes the kinds of investments an Ohio-chartered bank may make. Permitted investments include local, state, and federal government securities, mortgage-backed securities, and securities of federal government agencies. An Ohio-chartered bank also may invest up to 10% of its assets in corporate debt and equity securities, or a higher percentage in certain circumstances. Similar to the legal lending limit on loans to any one borrower, Ohio bank law also limits to 15% of capital the amount an Ohio-chartered bank may invest in the securities of any one issuer, other than local, state, and federal government and federal government agency issuers and mortgage-backed securities issuers. These Ohio bank law provisions have not been a material constraint upon the bank's investment activities.

All securities-related activity is reported to the Company's board of directors. General changes in investment strategy are required to be reviewed and approved by the board. Senior management can purchase and sell securities in accordance with the Company's stated investment policy.

Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold a security until maturity or on a long-term basis, the security is classified as held-to-maturity and is reflected on the balance sheet at historical cost. Securities to be held for indefinite periods and not intended to be held to maturity or on a long-term basis are classified as available-for-sale. Available-for-sale securities are reflected on the balance sheet at their market value.



**Table of Contents**

The following table sets forth the amortized cost and fair value of the Company's investment portfolio at the dates indicated.

**Investment Portfolio Amortized Cost and Fair Value at December 31,****2007****2006****2005****Gross Gross****Gross Gross****Gross Gross**

**Amortized unrealized realized Fair Amortized unrealized realized Fair Amortized unrealized realized Fair**  
**cost gains losses value cost gains losses value cost gains losses value**

(Dollars in thousands)

**Available for Sale:**

U.S. Government

agency securities	\$ 7,873	\$ 55	\$ (1)	\$ 7,927	\$ 7,253	\$ 2	\$ (110)	\$ 7,145	\$ 7,261	\$ 10	\$ (112)	\$ 7,159
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Obligations of states

and political

subdivisions:

Taxable	749		(7)	742	748		(21)	727	748		(23)	725
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Tax-exempt

	47,263	188	(522)	46,929	38,182	140	(354)	37,968	28,231	98	(331)	27,998
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Corporate securities

Mortgage-backed securities	29,219	162	(335)	29,046	16,959		(490)	16,469	22,229	16	(640)	21,605
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Equity securities

	944	396	(16)	1,324	694	48	(3)	739	444	1	(45)	400
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<b>Total</b>	<b>\$ 86,048</b>	<b>\$ 801</b>	<b>\$ (881)</b>	<b>\$ 85,968</b>	<b>\$ 63,836</b>	<b>\$ 190</b>	<b>\$ (978)</b>	<b>\$ 63,048</b>	<b>\$ 58,913</b>	<b>\$ 125</b>	<b>\$ (1,151)</b>	<b>\$ 57,887</b>
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**Held to Maturity:**

Obligations of states

and political

subdivisions:

	\$	\$	\$	\$	\$ 126	\$ 8	\$	\$ 134	\$ 221	\$ 12	\$	\$ 233
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<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$ 126</b>	<b>\$ 8</b>	<b>\$</b>	<b>\$ 134</b>	<b>\$ 221</b>	<b>\$ 12</b>	<b>\$</b>	<b>\$ 233</b>
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**Total Investment**

<b>Securities</b>	<b>\$ 86,048</b>	<b>\$ 801</b>	<b>\$ (881)</b>	<b>\$ 85,968</b>	<b>\$ 63,962</b>	<b>\$ 198</b>	<b>\$ (978)</b>	<b>\$ 63,182</b>	<b>\$ 59,134</b>	<b>\$ 137</b>	<b>\$ (1,151)</b>	<b>\$ 58,120</b>
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The contractual maturity of investment securities at December 31, 2007 is shown below.

	One year or less		More than one to five years		More than five to ten years		More than ten years		Total investment securities and mortgage-backed securities		Fair Value
	Amortized cost	Average yield	Amortized cost	Average yield	Amortized cost	Average yield	Amortized cost	Average yield	Amortized cost	Average yield	
U.S. Government agency securities	\$		\$ 3,103	4.70	\$ 2,994	4.70	\$ 1,775	5.92	\$ 7,873	4.98	\$ 7,927

Obligations of  
states and  
political  
subdivisions:

Taxable	250	3.20	499	4.15					749	3.83	742
Tax-exempt	4,049	4.00	6,542	3.89	10,100	4.26	26,572	4.32	47,263	4.22	46,929
Mortgage-backed securities			137	5.18	1,220	4.47	27,863	5.13	29,219	5.10	29,046
Equity Securities	944								944		1,324
<b>Total</b>	<b>\$ 5,243</b>	<b>3.24%</b>	<b>\$ 10,281</b>	<b>4.16%</b>	<b>\$ 14,314</b>	<b>4.37%</b>	<b>\$ 56,210</b>	<b>4.77%</b>	<b>\$ 86,048</b>	<b>4.54%</b>	<b>\$ 85,968</b>

Expected maturities of investment securities could differ from contractual maturities because the borrower, or issuer, could have the right to call or prepay obligations with or without call or prepayment penalties. The average yields in the above table are not calculated on a tax equivalent basis.

As of December 31, 2007, the Company also held 17,310 shares of \$100 par value Federal Home Loan Bank of Cincinnati stock, which is a restricted security. FHLB stock represents an equity interest in the FHLB, but it does not have a readily determinable market value. The stock can be sold at its par value only, and only to the FHLB or to another member institution. Member institutions are required to maintain a minimum stock investment in the FHLB, based on total assets, total mortgages, and total mortgage-backed securities. The Company's minimum investment in FHLB stock at December 31, 2007 was approximately \$1,731,000.

**Sources of Funds** *Deposit Accounts*. Deposit accounts are a major source of funds for the Company. The Company offers a number of deposit products to attract both commercial and regular consumer checking and savings customers, including regular and money market savings accounts, NOW accounts, and a variety of fixed-maturity, fixed-rate certificates with maturities ranging from seven days to 60 months. These accounts earn interest at rates established by management based on competitive market factors and management's desire to increase certain types or maturities of deposit liabilities. The Company also provides travelers' checks, official checks, money orders, ATM services, and IRA accounts.

**Table of Contents**

The following table shows the amount of time deposits of \$100,000 or more as of December 31, 2007, including certificates of deposit, by time remaining until maturity.

	Maturity of Time Deposits of \$100,000 or more at December 31, 2007	
	Amount	Percent of Total
Within three months	\$ 8,431,158	16.53%
Beyond three but within six months	8,615,730	16.89
Beyond six but within twelve months	15,291,877	29.97
Beyond one year	18,677,293	36.61
Total	\$ 51,016,058	100.00

*Borrowings*. Deposits and repayment of loan principal are the Company's primary sources of funds for lending activities and other general business purposes. However, when the supply of lendable funds or funds available for general business purposes cannot satisfy the demand for loans or general business purposes, the Company can obtain funds from the FHLB of Cincinnati. Interest and principal are payable monthly, and the line of credit is secured by a blanket pledge collateral agreement. At December 31, 2007, the Company had \$24.2 million of FHLB borrowings outstanding. The Company also has access to credit through the Federal Reserve Bank of Cleveland and other funding sources.

The outstanding balances and related information about short-term borrowings, which includes securities sold under agreements to repurchase are summarized as follows:

	2007	2006	2005
Balance at year-end	\$1,510,607	\$1,609,738	6,710,914
Average balance outstanding	2,383,902	3,281,340	1,844,018
Maximum month-end balance	5,768,057	8,245,406	6,710,914
Weighted-average rate at year-end	2.96%	4.35%	4.38%
Weighted-average rate during the year	3.89%	5.10%	5.63%

**Personnel.**

As of December 31, 2007 the Company had 91 full-time equivalent employees. None of the employees is represented by a collective bargaining group. Management considers its relations with employees to be excellent.

**Supervision and Regulation**

The following discussion of bank supervision and regulation is qualified in its entirety by reference to the statutory and regulatory provisions discussed. Changes in applicable law or in the policies of various regulatory authorities could affect materially the business and prospects of the Company.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956. As such, the Company is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System, acting primarily through the Federal Reserve Bank of Cleveland. Middlefield is required to file annual reports and other information with the Federal Reserve. Both subsidiaries are Ohio-chartered commercial banks. As a state-chartered, nonmember banks, the banks are primarily regulated by the FDIC and by the Ohio Division of Financial Institutions.

The Company and the banks are subject to federal banking laws, and the Company is subject also to Ohio bank law. These federal and state laws are intended to protect depositors, not stockholders. Federal and state laws

applicable to holding companies and their financial institution subsidiaries regulate the range of permissible business activities, investments, reserves against deposits, capital levels, lending activities and practices, the nature and amount of collateral for loans, establishment of branches, mergers, dividends, and a variety of other important matters. The Company is subject to detailed, complex, and sometimes overlapping federal and state statutes and regulations affecting routine banking operations. These statutes and regulations include but are not limited to state usury and consumer credit laws, the Truth-in-Lending Act and Regulation Z, the Equal Credit Opportunity Act and Regulation B, the Fair Credit Reporting Act, the Truth in Savings Act, and the Community Reinvestment Act. The Company must comply with Federal Reserve Board regulations requiring depository institutions to maintain reserves against their transaction accounts (principally NOW and regular checking accounts). Because required reserves are commonly maintained in the form of vault cash or in a noninterest-bearing account (or pass-through account) at a Federal Reserve Bank, the effect of the reserve requirement is to reduce an institution's earning assets.

The Federal Deposit Insurance Corporation Improvement Act of 1991 expanded significantly the authority of federal agencies to regulate the activities of federally chartered and state-chartered financial institutions and their holding companies. The Federal Reserve Board and the FDIC have extensive authority to prevent and to remedy unsafe and unsound practices and violations of applicable laws and regulations by institutions and holding companies. The agencies may assess civil money penalties, issue cease-and-desist or removal orders, seek injunctions, and publicly disclose those actions. In addition, the Ohio Division of Financial Institutions possesses enforcement powers to address violations of Ohio banking law by Ohio-chartered banks.

**Table of Contents**

**Regulation of Bank Holding Companies** *Bank and Bank Holding Company Acquisitions* . The Bank Holding Company Act requires every bank holding company to obtain approval of the Federal Reserve before directly or indirectly acquiring ownership or control of any voting shares of another bank or bank holding company, if after the acquisition the acquiring company would own or control more than 5% of the shares of the other bank or bank holding company (unless the acquiring company already owns or controls a majority of the shares),

acquiring all or substantially all of the assets of another bank, or

merging or consolidating with another bank holding company.

The Federal Reserve will not approve an acquisition, merger, or consolidation that would have a substantially anticompetitive result, unless the anticompetitive effects of the proposed transaction are clearly outweighed by a greater public interest in satisfying the convenience and needs of the community to be served. The Federal Reserve also considers capital adequacy and other financial and managerial factors in its review of acquisitions and mergers.

Additionally, the Bank Holding Company Act, the Change in Bank Control Act and the Federal Reserve Board's Regulation Y require advance approval of the Federal Reserve to acquire control of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of a class of voting securities of the bank holding company. If the holding company has securities registered under Section 12 of the Securities Exchange Act of 1934, as Middlefield does, or if no other person owns a greater percentage of the class of voting securities, control is rebuttably presumed to exist if a person acquires 10% or more, but less than 25%, of any class of voting securities. Approval of the Ohio Division of Financial Institutions is also necessary to acquire control of an Ohio-chartered bank.

*Nonbanking Activities* . With some exceptions, the Bank Holding Company Act has for many years also prohibited a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve non-bank activities that, by statute or by Federal Reserve Board regulation or order, are held to be closely related to the business of banking or of managing or controlling banks. In making its determination that a particular activity is closely related to the business of banking, the Federal Reserve considers whether the performance of the activities by a bank holding company can be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency in resources that will outweigh the risks of possible adverse effects such as decreased or unfair competition, conflicts of interest, or unsound banking practices. Some of the activities determined by Federal Reserve Board regulation to be closely related to the business of banking are: making or servicing loans or leases; engaging in insurance and discount brokerage activities; owning thrift institutions; performing data processing services; acting as a fiduciary or investment or financial advisor; and making investments in corporations or projects designed primarily to promote community welfare.

*Financial Holding Companies* . On November 12, 1999 the Gramm-Leach-Bliley Act became law, repealing much of the 1933 Glass-Steagall Act's separation of the commercial and investment banking industries. The Gramm-Leach-Bliley Act expands the range of nonbanking activities a bank holding company may engage in, while preserving existing authority for bank holding companies to engage in activities that are closely related to banking. The new legislation creates a new category of holding company called a financial holding company. Financial holding companies may engage in any activity that is

financial in nature or incidental to that financial activity, or

complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Activities that are financial in nature include

acting as principal, agent, or broker for insurance,

underwriting, dealing in, or making a market in securities, and

providing financial and investment advice.

The Federal Reserve Board and the Secretary of the Treasury have authority to decide that other activities are also financial in nature or incidental to financial activity, taking into account changes in technology, changes in the banking marketplace, competition for banking services, and so on. The Company is engaged solely in activities that were permissible for a bank holding company before enactment of the Gramm-Leach-Bliley Act. Although the Company has become a financial holding company, the Company has no immediate plans to use the expanded authority to engage in activities other than those in which it is currently engaged. Federal Reserve Board rules require that all of the depository institution subsidiaries of a financial holding company be and remain well capitalized and well managed. If all depository institution subsidiaries of a financial holding company do not remain well capitalized and well managed, the financial holding company must enter into an agreement acceptable to the Federal Reserve Board, undertaking to comply with all capital and management requirements within 180 days. In the meantime the financial holding company may not use its expanded authority to engage in nonbanking activities without Federal Reserve Board approval and the Federal Reserve may impose other limitations on the holding company's or affiliates activities. If a financial holding company fails to restore the well-capitalized and well-managed status of a depository institution subsidiary, the Federal Reserve may order divestiture of the subsidiary.

**Table of Contents**

*Holding Company Capital and Source of Strength .* The Federal Reserve considers the adequacy of a bank holding company's capital on essentially the same risk-adjusted basis as capital adequacy is determined by the FDIC at the bank subsidiary level. In general, bank holding companies are required to maintain a minimum ratio of total capital to risk-weighted assets of 8% and Tier 1 capital—consisting principally of stockholders' equity—of at least 4%. Bank holding companies are also subject to a leverage ratio requirement. The minimum required leverage ratio for the very highest rated companies is 3%, but as a practical matter the minimum required leverage ratio for most bank holding companies is 4% or higher. It is also Federal Reserve Board policy that bank holding companies serve as a source of strength for their subsidiary banking institutions.

Under Bank Holding Company Act section 5(e), the Federal Reserve Board may require a bank holding company to terminate any activity or relinquish control of a nonbank subsidiary if the Federal Reserve Board determines that the activity or control constitutes a serious risk to the financial safety, soundness or stability of a subsidiary bank. And with the Federal Deposit Insurance Corporation Improvement Act of 1991's addition of the prompt corrective action provisions to the Federal Deposit Insurance Act, section 38(f)(2)(I) of the Federal Deposit Insurance Act now provides that a federal bank regulatory authority may require a bank holding company to divest itself of an undercapitalized bank subsidiary if the agency determines that divestiture will improve the bank's financial condition and prospects.

*Liability of Commonly Controlled Institutions .* Adding subsection (e) to section 5 of the Federal Deposit Insurance Act, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 allows the FDIC to demand from one institution payment for losses incurred or to be incurred by the FDIC because of the default of another institution or because of assistance provided by the FDIC to the other institution in danger of default, if the institutions are commonly controlled.

**Federal Deposit Insurance .** The FDIC insures deposits of banks, savings banks, and savings associations, and it safeguards the safety and soundness of the banking industry. Two separate insurance funds are maintained and administered by the FDIC. In general, bank deposits are insured through the Bank Insurance Fund. Deposits in savings associations are insured through the Savings Association Insurance Fund.

As an FDIC member institution, deposits in the bank are insured to a maximum of \$100,000 per depositor. The banks are required to pay semiannual deposit insurance premium assessments to the FDIC. In general terms, each institution is assessed insurance premiums according to how much risk to the insurance fund the institution represents. Well-capitalized institutions with few supervisory concerns are assessed lower premiums than other institutions. The premium range is currently from \$0.00 for the highest-rated institutions to \$0.27 per \$100 of domestic deposits.

The FDIC may terminate the deposit insurance of any insured depository institution if the FDIC determines that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order, or any condition imposed in writing by, or written agreement with, the FDIC. The FDIC also may suspend deposit insurance temporarily during the hearing process for a permanent termination of insurance if the institution has no tangible capital.

**Interstate Banking and Branching .** In 1994 the Riegle-Neal Interstate Banking and Branching Efficiency Act eased restrictions on interstate banking. The Riegle-Neal Act allows the Federal Reserve to approve an application by an adequately capitalized and adequately managed bank holding company to acquire a bank located in a state other than the acquiring company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve acquisition of a bank that has not been in existence for the minimum time period (up to five years) specified by the statutory law of the acquired, or target, bank's state. The Riegle-Neal Act also prohibits the Federal Reserve from approving an application if the applicant (and its depository institution affiliates) controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. The Riegle-Neal Act does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank or bank holding company if the limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% statewide concentration limit contained in the Riegle-Neal Act.

Branching between states may be accomplished by merging commonly controlled banks located in different states into one legal entity. Branching may also be accomplished by establishing *de novo* branches or acquiring branches in

another state. Under section 24(j) of the Federal Deposit Insurance Act, a branch of a bank operating out-of-state in a host state is subject to the law of the host state regarding community reinvestment, fair lending, consumer protection, and establishment of branches. The Riegle-Neal Act authorizes the FDIC to approve interstate branching *de novo* by state-chartered banks solely in states that specifically allow it. Ohio bank law allows *de novo* branching in Ohio by an out-of-state bank. The FDIC has adopted regulations under the Riegle-Neal Act to prohibit an out-of-state bank from using the new interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to ensure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to satisfy the credit needs of the communities served by the out-of-state bank.



**Table of Contents**

**Capital Risk-Based Capital Requirements** . The Federal Reserve Board and the FDIC employ similar risk-based capital guidelines in their examination and regulation of bank holding companies and financial institutions. If capital falls below the minimum levels established by the guidelines, the bank holding company or bank may be denied approval to acquire or establish additional banks or non-bank businesses or to open new facilities. Failure to satisfy capital guidelines could subject a banking institution to a variety of enforcement actions by federal bank regulatory authorities, including the termination of deposit insurance by the FDIC and a prohibition on the acceptance of brokered deposits.

In the calculation of risk-based capital, assets and off-balance sheet items are assigned to broad risk categories, each with an assigned weighting (0%, 20%, 50% and 100%). Most loans are assigned to the 100% risk category, except for first mortgage loans fully secured by residential property, which carry a 50% rating. Most investment securities are assigned to the 20% category, except for municipal or state revenue bonds, which have a 50% risk-weight, and direct obligations of or obligations guaranteed by the United States Treasury or United States Government agencies, which have a 0% risk-weight. Off-balance sheet items are also taken into account in the calculation of risk-based capital, with each class of off-balance sheet item being converted to a balance sheet equivalent according to established conversion factors. From these computations, the total of risk-weighted assets is derived. Risk-based capital ratios therefore state capital as a percentage of total risk-weighted assets and off-balance sheet items. The ratios established by guideline are minimums only.

Current risk-based capital guidelines require bank holding companies and banks to maintain a minimum risk-based total capital ratio equal to 8% and a Tier 1 capital ratio of 4%. Intangibles other than readily marketable mortgage servicing rights are generally deducted from capital. Tier 1 capital includes stockholders' equity, qualifying perpetual preferred stock (within limits and subject to conditions, particularly if the preferred stock is cumulative preferred stock), and minority interests in equity accounts of consolidated subsidiaries, less intangibles, identified losses, investments in securities subsidiaries, and certain other assets. Tier 2 capital includes

the allowance for loan losses, up to a maximum of 1.25% of risk-weighted assets,

any qualifying perpetual preferred stock exceeding the amount includable in Tier 1 capital,

mandatory convertible securities, and

subordinated debt and intermediate term preferred stock, up to 50% of Tier 1 capital.

The FDIC also employs a market risk component in its calculation of capital requirements for nonmember banks. The market risk component could require additional capital for general or specific market risk of trading portfolios of debt and equity securities and other investments or assets. The FDIC's evaluation of an institution's capital adequacy takes account of a variety of other factors as well, including interest rate risks to which the institution is subject, the level and quality of an institution's earnings, loan and investment portfolio characteristics and risks, risks arising from the conduct of nontraditional activities, and a variety of other factors.

Accordingly, the FDIC's final supervisory judgment concerning an institution's capital adequacy could differ significantly from the conclusions that might be derived from the absolute level of an institution's risk-based capital ratios. Therefore, institutions generally are expected to maintain risk-based capital ratios that exceed the minimum ratios discussed above. This is particularly true for institutions contemplating significant expansion plans and institutions that are subject to high or inordinate levels of risk. Moreover, although the FDIC does not impose explicit capital requirements on holding companies of institutions regulated by the FDIC, the FDIC can take account of the degree of leverage and risks at the holding company level. If the FDIC determines that the holding company (or another affiliate of the institution regulated by the FDIC) has an excessive degree of leverage or is subject to inordinate risks, the FDIC may require the subsidiary institution(s) to maintain additional capital or the FDIC may impose limitations on the subsidiary institution's ability to support its weaker affiliates or holding company.

The banking agencies have also established a minimum leverage ratio of 3%, which represents Tier 1 capital as a percentage of total assets, less intangibles. However, for bank holding companies and financial institutions seeking to expand and for all but the most highly rated banks and bank holding companies, the banking agencies expect an

additional cushion of at least 100 to 200 basis points. At December 31, 2007, the Company was in compliance with all regulatory capital requirements.

*Prompt Corrective Action* . To resolve the problems of undercapitalized institutions and to prevent a recurrence of the banking crisis of the 1980s and early 1990s, the Federal Deposit Insurance Corporation Improvement Act of 1991 established a system known as prompt corrective action. Under the prompt corrective action provisions and implementing regulations, every institution is classified into one of five categories, depending on its total risk-based capital ratio, its Tier 1 risk-based capital ratio, its leverage ratio, and subjective factors. The categories are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. financial institution s operations can be significantly affected by its capital classification. For example, an institution that is not well capitalized generally is prohibited from accepting brokered deposits and offering interest rates on deposits higher than the prevailing rate in its market, and the holding company of any undercapitalized institution must guarantee, in part, aspects of the institution s capital plan. Financial institution regulatory agencies generally are required to appoint a receiver or conservator shortly after an institution enters the category of weakest capitalization. The Federal Deposit Insurance Corporation Improvement Act of 1991 also authorizes the regulatory agencies to reclassify an institution from one category into a lower category if the institution is in an unsafe or unsound condition or engaging in an unsafe or unsound practice. Undercapitalized institutions are required to take specified actions to increase their capital or otherwise decrease the risks to the federal deposit insurance funds.

**Table of Contents**

The following table illustrates the capital and prompt corrective action guidelines applicable to the Company and its subsidiaries, as well as its total risk-based capital ratio, Tier 1 capital ratio and leverage ratio as of December 31, 2007.

	2007		2006	
	Amount	Ratio	Amount	Ratio
<b>Total Capital (to Risk-Weighted Assets)</b>				
Actual	\$ 42,664,943	14.56%	\$ 41,978,838	18.05%
For Capital Adequacy Purposes	23,441,926	8.00	18,605,783	8.00
To Be Well Capitalized	29,302,408	10.00	23,257,229	10.00
<b>Tier I Capital (to Risk-Weighted Assets)</b>				
Actual	\$ 39,194,767	13.38%	\$ 39,109,743	16.82%
For Capital Adequacy Purposes	11,720,963	4.00	9,302,892	4.00
To Be Well Capitalized	17,581,445	6.00	13,954,337	6.00
<b>Tier I Capital (to Average Assets)</b>				
Actual	\$ 39,194,767	9.23%	\$ 39,109,743	11.82%
For Capital Adequacy Purposes	16,990,099	4.00	13,236,186	4.00
To Be Well Capitalized	21,237,623	5.00	16,545,233	5.00

**Limits on Dividends and Other Payments** . The Company's ability to obtain funds for the payment of dividends and for other cash requirements depends on the amount of dividends that may be paid to it by the banks. Under Ohio bank law, an Ohio-chartered bank may not pay a cash dividend if the amount of the dividend exceeds undivided profits, which is defined in Ohio bank law to mean the cumulative undistributed amount of the bank's net income. But with the approval of two thirds of the outstanding shares and approval of the superintendent of the Division of Financial Institutions, an Ohio-chartered bank may pay cash dividends from surplus. Lastly, approval of the superintendent is also required if the total of all dividends and distributions declared on the bank's shares in any year exceeds the total of the bank's net income for the year plus retained net income for the two preceding years.

State-chartered banks' ability to pay dividends may be affected by capital maintenance requirements of their primary federal bank regulatory agency as well. Moreover, regulatory authorities may prohibit banks and bank holding companies from paying dividends if payment of dividends would constitute an unsafe and unsound banking practice.

A 1985 policy statement of the Federal Reserve Board declares that a bank holding company should not pay cash dividends on common stock unless the organization's net income for the past year is sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

**Recent Legislation** . On July 30, 2002 the Sarbanes-Oxley Act of 2002 became law. The goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of corporate disclosures made under the securities laws. The proposed changes are intended to allow shareholders to monitor the performance of companies and directors more easily and efficiently.

The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the SEC under the Securities Exchange Act of 1934. The Act includes very specific additional disclosure requirements and new corporate governance rules, requires the SEC, securities exchanges, and Nasdaq to adopt extensive additional disclosure, corporate governance, and other related rules. The final scope of all of these new requirements is not yet

clear. Some of the changes are effective already, but others will become effective in the future.

The Sarbanes-Oxley Act has an impact on a wide variety of corporate governance and disclosure issues, including the composition of audit committees, certification of financial statements by the chief executive officer and the chief financial officer, forfeiture of bonuses and profits made by directors and senior officers in the 12-month period covered by restated financial statements, a prohibition on insider trading during pension plan black-out periods, disclosure of off-balance sheet transactions, a prohibition on personal loans to directors and officers (excluding Federally insured financial institutions), expedited filing requirements for stock transaction reports by officers and directors, the formation of a public accounting oversight board, auditor independence, and various increased criminal penalties for violations of securities laws.

**Table of Contents**

**Transactions with Affiliates** . Although the banks are not member banks of the Federal Reserve System, they required by the Federal Deposit Insurance Act to comply with section 23A and section 23B of the Federal Reserve Act pertaining to transactions with affiliates as if they were member banks. These statutes are intended to protect banks from abuse in financial transactions with affiliates, preventing federally insured deposits from being diverted to support the activities of unregulated entities engaged in nonbanking businesses. An affiliate of a bank includes any company or entity that controls or is under common control with the bank. Generally, section 23A and section 23B of the Federal Reserve Act

limit the extent to which a bank or its subsidiaries may lend to or engage in various other kinds of transactions with any one affiliate to an amount equal to 10% of the institution's capital and surplus, limiting the aggregate of covered transactions with all affiliates to 20% of capital and surplus,

impose restrictions on investments by a subsidiary bank in the stock or securities of its holding company,

impose restrictions on the use of a holding company's stock as collateral for loans by the subsidiary bank, and

require that affiliate transactions be on terms substantially the same, or at least as favorable to the institution or subsidiary, as those provided to a non-affiliate.

The Company's authority to extend credit to insiders—meaning executive officers, directors and greater than 10% stockholders—or to entities those persons control, is subject to section 22(g) and section 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these laws require insider loans to be made on terms substantially similar to those offered to unaffiliated individuals, place limits on the amount of loans a bank may make to insiders based in part on the Company's capital position, and require that specified approval procedures be followed. Loans to an individual insider may not exceed the legal limit on loans to any one borrower, which in general terms is 15% of capital but can be higher in some circumstances. And the aggregate of all loans to all insiders may not exceed the Company's unimpaired capital and surplus. Insider loans exceeding the greater of 5% of capital or \$25,000 must be approved in advance by a majority of the board, with any interested director not participating in the voting. Lastly, loans to executive officers are subject to special limitations. Executive officers may borrow in unlimited amounts to finance their children's education or to finance the purchase or improvement of their residence, and they may borrow no more than \$100,000 for most other purposes. Loans to executive officers exceeding \$100,000 may be allowed if the loan is fully secured by government securities or a segregated deposit account. A violation of these restrictions could result in the assessment of substantial civil monetary penalties, the imposition of a cease-and-desist order or other regulatory sanctions.

**Community Reinvestment Act** . Under the Community Reinvestment Act of 1977 and implementing regulations of the banking agencies, a financial institution has a continuing and affirmative obligation—consistent with safe and sound operation—to address the credit needs of its entire community, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, nor does it limit an institution's discretion to develop the types of products and services it believes are best suited to its particular community. The CRA requires that bank regulatory agencies conduct regular CRA examinations and provide written evaluations of institutions' CRA performance. The CRA also requires that an institution's CRA performance rating be made public. CRA performance evaluations are based on a four-tiered rating system: Outstanding, Satisfactory, Needs to Improve and Substantial Noncompliance.

Although CRA examinations occur on a regular basis, CRA performance evaluations have been used principally in the evaluation of regulatory applications submitted by an institution. CRA performance evaluations are considered in evaluating applications for such things as mergers, acquisitions, and applications to open branches. Over the 25 years that the CRA has existed, and particularly in the last decade, institutions have faced increasingly difficult regulatory obstacles and public interest group objections in connection with their regulatory applications, including institutions that have received the highest possible CRA ratings.

A bank holding company cannot elect to be a financial holding company—with the expanded securities, insurance and other powers that designation entails—unless all of the depository institutions owned by the holding company have

a CRA rating of satisfactory or better. The Gramm-Leach-Bliley Act also provides that a financial institution with total assets of \$250 million or greater will be subject to CRA examinations no more frequently than every 2 years. Following a CRA examination as of September 19, 2005, the MBC received a rating of Outstanding. Lastly, the Gramm-Leach-Bliley Act requires public disclosure of private CRA agreements entered into between banking organizations and other parties, and annual reporting by banking organizations of actions taken under the private CRA agreements. This last provision of the Gramm-Leach-Bliley Act addresses the increasingly common practice whereby a bank or holding company undertaking acquisition of another bank or holding company enters into an agreement with parties who might otherwise file with bank regulators a CRA protest of the acquisition. The details of these agreements have not been universally disclosed by acquiring institutions in the past.

**Federal Home Loan Bank.** The Federal Home Loan Bank serves as a credit source for their members. As a member of the FHLB of Cincinnati, the Company is required to maintain an investment in the capital stock of the FHLB of Cincinnati in an amount calculated by reference to its amount of loans, and or advances, from the FHLB. The Company is in compliance with this requirement, with an investment in FHLB stock of \$1,731,300 at December 31, 2007.

Each FHLB is required to establish standards of community investment or service that its members must maintain for continued access to long-term advances from the FHLB. The standards take into account a member's performance under the Community Reinvestment Act and its record of lending to first-time home buyers.

**State Banking Regulation .** As Ohio-chartered banks, the banks are subject to regular examination by the Ohio Division of Financial Institutions. State banking regulation affects the internal organization of the banks as well as their savings, lending, investment, and other activities. State banking regulation may contain limitations on an institution's activities that are in addition to limitations imposed under federal banking law. The Ohio Division of Financial Institutions may initiate supervisory measures or formal enforcement actions, and if the grounds provided by law exist it may take possession and control of an Ohio-chartered bank.

**Table of Contents**

**Monetary Policy** . The earnings of financial institutions are affected by the policies of regulatory authorities, including monetary policy of the Federal Reserve Board. An important function of the Federal Reserve System is regulation of aggregate national credit and money supply. The Federal Reserve Board accomplishes these goals with measures such as open market transactions in securities, establishment of the discount rate on bank borrowings, and changes in reserve requirements against bank deposits. These methods are used in varying combinations to influence overall growth and distribution of financial institutions' loans, investments and deposits, and they also affect interest rates charged on loans or paid on deposits. Monetary policy is influenced by many factors, including inflation, unemployment, short-term and long-term changes in the international trade balance, and fiscal policies of the United States government. Federal Reserve Board monetary policy has had a significant effect on the operating results of financial institutions in the past, and it can be expected to influence operating results in the future.

**Item 1.A Risk Factors**

*Our market is very competitive* . We face competition both in making loans and in attracting deposits. Competition is based on interest rates and other credit and service charges, the quality of services rendered, the convenience of banking facilities, the range and type of products offered and, in the case of loans to larger commercial borrowers, lending limits, among other factors. Competition for loans comes principally from commercial banks, savings banks, savings and loan associations, credit unions, mortgage banking companies, insurance companies, and other financial service companies. Our most direct competition for deposits has historically come from commercial banks, savings banks, and savings and loan associations. We face additional competition for deposits from non-depository institutions such as mutual funds, securities and brokerage firms, and insurance companies.

Competition among financial institutions and other financial service organizations is increasing with the continuing consolidation of the financial services industry. Additionally, legislative and regulatory changes could affect competition. Congress' elimination in 1994 of many restrictions on interstate branching could increase competition from large banks headquartered outside of northeastern Ohio