

UNITY BANCORP INC /NJ/  
Form 10-Q  
May 03, 2018

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_ to \_\_\_\_.

Commission File Number 1-12431

Unity Bancorp, Inc.  
(Exact name of registrant as specified in its charter)

New Jersey 22-3282551  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

64 Old Highway 22, Clinton, NJ 08809  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (908) 730-7630

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934, as amended, 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act):  
Large accelerated filer Accelerated filer Nonaccelerated filer Smaller reporting company Emerging Growth Company

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act:

Yes No

The number of shares outstanding of each of the registrant's classes of common equity stock, as of April 30, 2018  
common stock, no par value: 10,709,121 shares outstanding.

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## PART I CONSOLIDATED FINANCIAL INFORMATION

## ITEM 1 Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

| (In thousands)   | March 31,<br>2018 | December 31,<br>2017 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Cash and due from banks  | \$ 17,044         | \$ 23,701            |
| Federal funds sold, interest-bearing deposits and repos  | 99,243            | 126,553              |
| Cash and cash equivalents  | 116,287           | 150,254              |
| Securities:  |                   |                      |
| Securities available for sale (amortized cost of \$51,445 and \$52,763 in 2018 and 2017, respectively) | 50,162            | 52,287               |
| Securities held to maturity (fair value of \$16,155 and \$16,346 in 2018 and 2017, respectively)       | 16,168            | 16,307               |
| Equity securities (amortized cost of \$1,262 in 2018 and 2017)   | 1,191             | 1,206                |
| Total securities   | 67,521            | 69,800               |
| Loans:   |                   |                      |
| SBA loans held for sale  | 21,579            | 22,810               |
| SBA loans held for investment  | 42,734            | 43,999               |
| SBA 504 loans  | 21,565            | 21,871               |
| Commercial loans   | 615,119           | 606,994              |
| Residential mortgage loans   | 380,857           | 365,145              |
| Consumer loans   | 113,256           | 109,855              |
| Total loans  | 1,195,110         | 1,170,674            |
| Allowance for loan losses  | (14,196 )         | (13,556 )            |
| Net loans  | 1,180,914         | 1,157,118            |
| Premises and equipment, net  | 23,405            | 23,470               |
| Bank owned life insurance ("BOLI")   | 24,398            | 24,227               |
| Deferred tax assets  | 4,059             | 4,017                |
| Federal Home Loan Bank ("FHLB") stock  | 9,308             | 12,863               |
| Accrued interest receivable  | 5,898             | 5,447                |
| Other real estate owned ("OREO")   | 56                | 426                  |
| Goodwill   | 1,516             | 1,516                |
| Prepaid expenses and other assets  | 6,540             | 6,358                |
| Total assets   | \$ 1,439,902      | \$ 1,455,496         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                   |                      |
| <b>Liabilities:</b>  |                   |                      |
| <b>Deposits:</b>   |                   |                      |
| Noninterest-bearing demand   | \$ 265,346        | \$ 256,119           |
| Interest-bearing demand  | 162,848           | 164,997              |
| Savings  | 408,255           | 396,557              |
| Time, under \$100,000  | 175,271           | 133,881              |
| Time, \$100,000 to \$250,000   | 83,358            | 71,480               |
| Time, \$250,000 and over   | 22,436            | 20,103               |
| Total deposits   | 1,117,514         | 1,043,137            |
| Borrowed funds   | 181,000           | 275,000              |
| Subordinated debentures  | 10,310            | 10,310               |

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|  |             |             |
|--|-------------|-------------|
| Accrued interest payable                   | 410         | 436         |
| Accrued expenses and other liabilities     | 7,564       | 8,508       |
| Total liabilities                          | 1,316,798   | 1,337,391   |
| Commitments and contingencies              |             |             |
| Shareholders' equity:                      |             |             |
| Common stock                               | 87,361      | 86,782      |
| Retained earnings                          | 35,713      | 31,117      |
| Accumulated other comprehensive income     | 30          | 206         |
| Total shareholders' equity                 | 123,104     | 118,105     |
| Total liabilities and shareholders' equity | \$1,439,902 | \$1,455,496 |
| Issued and outstanding common shares       | 10,709      | 10,615      |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

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Unity Bancorp, Inc.  
Consolidated Statements of Income  
(Unaudited)

| (In thousands, except per share amounts)                | For the three<br>months ended<br>March 31, |        |
|---|--|--------|
|   | 2018                                       | 2017   |
| <b>INTEREST INCOME</b>                                  |  |        |
| Federal funds sold, interest-bearing deposits and repos | \$205                                      | \$129  |
| FHLB stock  | 134  | 93     |
| Securities:   |  |        |
| Taxable   | 492  | 491    |
| Tax-exempt  | 31   | 44     |
| Total securities  | 523  | 535    |
| Loans:  |  |        |
| SBA loans   | 1,183                                      | 854    |
| SBA 504 loans   | 274  | 301    |
| Commercial loans  | 7,452                                      | 6,166  |
| Residential mortgage loans                              | 4,340                                      | 3,384  |
| Consumer loans  | 1,529                                      | 1,132  |
| Total loans   | 14,778                                     | 11,837 |
| Total interest income                                   | 15,640                                     | 12,594 |
| <b>INTEREST EXPENSE</b>                                 |  |        |
| Interest-bearing demand deposits                        | 224  | 153    |
| Savings deposits  | 776  | 583    |
| Time deposits   | 1,000                                      | 804    |
| Borrowed funds and subordinated debentures              | 768  | 664    |
| Total interest expense                                  | 2,768                                      | 2,204  |
| Net interest income                                     | 12,872                                     | 10,390 |
| Provision for loan losses                               | 500  | 250    |
| Net interest income after provision for loan losses     | 12,372                                     | 10,140 |
| <b>NONINTEREST INCOME</b>                               |  |        |
| Branch fee income                                       | 330  | 331    |
| Service and loan fee income                             | 564  | 512    |
| Gain on sale of SBA loans held for sale, net            | 547  | 485    |
| Gain on sale of mortgage loans, net                     | 424  | 532    |
| BOLI income   | 171  | 88     |
| Net security losses                                     | (15)                                       | —      |
| Other income  | 265  | 256    |
| Total noninterest income                                | 2,286                                      | 2,204  |
| <b>NONINTEREST EXPENSE</b>                              |  |        |
| Compensation and benefits                               | 4,834                                      | 4,095  |
| Occupancy   | 690  | 600    |
| Processing and communications                           | 689  | 604    |
| Furniture and equipment                                 | 536  | 511    |
| Professional services                                   | 251  | 226    |
| Loan collection and OREO expenses                       | 6  | 341    |
| Other loan expenses                                     | 33   | 83     |
| Deposit insurance                                       | 186  | 76     |

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|  |         |         |
|--|---------|---------|
| Advertising  | 319     | 236     |
| Director fees  | 162     | 197     |
| Other expenses                                       | 488     | 471     |
| Total noninterest expense                            | 8,194   | 7,440   |
| Income before provision for income taxes             | 6,464   | 4,904   |
| Provision for income taxes                           | 1,235   | 1,712   |
| Net income   | \$5,229 | \$3,192 |
| <br>   |         |         |
| Net income per common share - Basic                  | \$0.49  | \$0.30  |
| Net income per common share - Diluted                | \$0.48  | \$0.30  |
| <br>   |         |         |
| Weighted average common shares outstanding - Basic   | 10,678  | 10,509  |
| Weighted average common shares outstanding - Diluted | 10,853  | 10,705  |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.



Unity Bancorp, Inc.  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)

| (In thousands)  | For the three months ended |                              |                   |                   |                              |                   |
|---|----------------------------|------------------------------|-------------------|-------------------|------------------------------|-------------------|
|   | March 31, 2018             |                              |                   | March 31, 2017    |                              |                   |
|   | Before tax amount          | Income tax expense (benefit) | Net of tax amount | Before tax amount | Income tax expense (benefit) | Net of tax amount |
| Net income  | \$6,464                    | \$ 1,235                     | \$5,229           | \$4,904           | \$ 1,712                     | \$3,192           |
| Other comprehensive (loss) income   |                            |                              |                   |                   |                              |                   |
| Investment securities available for sale:   |                            |                              |                   |                   |                              |                   |
| Unrealized holding losses on securities arising during the period                 | (807 )                     | (226 )                       | (581 )            | (144 )            | (58 )                        | (86 )             |
| Less: reclassification adjustment for losses on securities included in net income | —                          | —                            | —                 | —                 | —                            | —                 |
| Total unrealized losses on securities available for sale                          | (807 )                     | (226 )                       | (581 )            | (144 )            | (58 )                        | (86 )             |
| Adjustments related to defined benefit plan:                                      |                            |                              |                   |                   |                              |                   |
| Amortization of prior service cost  | 21                         | 155                          | (134 )            | 21                | 9                            | 12                |
| Total adjustments related to defined benefit plan                                 | 21                         | 155                          | (134 )            | 21                | 9                            | 12                |
| Net unrealized gains from cash flow hedges:                                       |                            |                              |                   |                   |                              |                   |
| Unrealized holding gains on cash flow hedges arising during the period            | 583                        | 34                           | 549               | 81                | 33                           | 48                |
| Total unrealized gains on cash flow hedges  | 583                        | 34                           | 549               | 81                | 33                           | 48                |
| Total other comprehensive loss  | (203 )                     | (37 )                        | (166 )            | (42 )             | (16 )                        | (26 )             |
| Total comprehensive income  | \$6,261                    | \$ 1,198                     | \$5,063           | \$4,862           | \$ 1,696                     | \$3,166           |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Consolidated Statements of Changes in Shareholders' Equity  
For the three months ended March 31, 2018 and 2017  
(Unaudited)

| (In thousands)  | Common stock |          | Retained earnings | Accumulated other           | Total shareholders' equity |
|---|--------------|----------|-------------------|-----------------------------|----------------------------|
|   | Shares       | Amount   |                   | comprehensive income (loss) |                            |
| Balance, December 31, 2017                                  | 10,615       | \$86,782 | \$31,117          | \$ 206                      | \$ 118,105                 |
| Net income  | —            | —        | 5,229             | —                           | 5,229                      |
| Other comprehensive loss, net of tax                        | —            | —        | —                 | (166 )                      | (166 )                     |
| Dividends on common stock (\$0.06 per share)                | —            | 25       | (643 )            | —                           | (618 )                     |
| Common stock issued and related tax effects (1)             | 94           | 554      | —                 | —                           | 554                        |
| Retained earnings impact due to adoption of ASU 2016-01 (2) |              |          | (56 )             | 56                          | —                          |
| Tax rate adjustment to AOCI (3)                             |              |          | 66                | (66 )                       | —                          |
| Balance, March 31, 2018                                     | 10,709       | \$87,361 | \$35,713          | \$ 30                       | \$ 123,104                 |

| (In thousands)                                  | Common stock |          | Retained earnings | Accumulated other    | Total shareholders' equity |
|---|--------------|----------|-------------------|----------------------|----------------------------|
|   | Shares       | Amount   |                   | comprehensive (loss) |                            |
| Balance, December 31, 2016                      | 10,477       | \$85,383 | \$20,748          | \$ 160               | \$ 106,291                 |
| Net income                                      | —            | —        | 3,192             | —                    | 3,192                      |
| Other comprehensive loss, net of tax            | —            | —        | —                 | (26 )                | (26 )                      |
| Dividends on common stock (\$0.05 per share)    | —            | 33       | (526 )            | —                    | (493 )                     |
| Common stock issued and related tax effects (1) | 58           | 341      | —                 | —                    | 341                        |
| Balance, March 31, 2017                         | 10,535       | \$85,757 | \$23,414          | \$ 134               | \$ 109,305                 |

(1) Includes the issuance of common stock under employee benefit plans, which includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

(2) As a result of ASU 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities", the Company reclassified \$56 thousand of gains (losses) on available for sale equity securities sitting in accumulated other comprehensive income to retained earnings.

(3) As a result of ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income", the Company reclassified \$66 thousand from accumulated other comprehensive income to retained earnings.

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.  
Consolidated Statements of Cash Flows  
(Unaudited)

| (In thousands)  | For the three months<br>ended March 31, |            |
|---|---|------------|
|   | 2018                                    | 2017       |
| <b>OPERATING ACTIVITIES:</b>  |   |            |
| Net income  | \$5,229                                 | \$3,192    |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |            |
| Provision for loan losses   | 500                                     | 250        |
| Net amortization of purchase premiums and discounts on securities                 | 53                                      | 73         |
| Depreciation and amortization   | 379                                     | 249        |
| Deferred income tax expense (benefit)   | 36                                      | (5 )       |
| Stock compensation expense  | 265                                     | 212        |
| Loss on sale of OREO  | —                                       | 253        |
| Gain on sale of mortgage loans held for sale, net                                 | (356 )                                  | (454 )     |
| Gain on sale of SBA loans held for sale, net                                      | (547 )                                  | (485 )     |
| Origination of mortgage loans held for sale                                       | (20,132 )                               | (25,654 )  |
| Origination of SBA loans held for sale  | (3,507 )                                | (2,451 )   |
| Proceeds from sale of mortgage loans held for sale, net                           | 20,488                                  | 26,108     |
| Proceeds from sale of SBA loans held for sale, net                                | 6,322                                   | 6,511      |
| BOLI income   | (171 )                                  | (88 )      |
| Net change in other assets and liabilities  | (952 )                                  | (905 )     |
| Net cash provided by operating activities   | 7,607                                   | 6,806      |
| <b>INVESTING ACTIVITIES</b>   |   |            |
| Purchases of securities available for sale  | —                                       | (15,495 )  |
| Purchases of FHLB stock, at cost  | (13,838 )                               | (225 )     |
| Maturities and principal payments on securities held to maturity                  | 132                                     | 192        |
| Maturities and principal payments on securities available for sale                | 1,272                                   | 3,611      |
| Proceeds from redemption of FHLB stock  | 17,393                                  | 270        |
| Proceeds from sale of OREO  | 426                                     | 21         |
| Net increase in loans   | (26,674 )                               | (31,283 )  |
| Purchases of premises and equipment   | (309 )                                  | (210 )     |
| Net cash used in investing activities   | (21,598 )                               | (43,119 )  |
| <b>FINANCING ACTIVITIES</b>   |   |            |
| Net increase in deposits  | 74,377                                  | 34,980     |
| Proceeds from new borrowings  | 121,000                                 | 35,000     |
| Repayments of borrowings  | (215,000 )                              | (36,000 )  |
| Proceeds from exercise of stock options   | 290                                     | 135        |
| Dividends on common stock   | (643 )                                  | (493 )     |
| Net cash (used in) provided by financing activities                               | (19,976 )                               | 33,622     |
| Decrease in cash and cash equivalents   | (33,967 )                               | (2,691 )   |
| Cash and cash equivalents, beginning of period                                    | 150,254                                 | 105,895    |
| Cash and cash equivalents, end of period  | \$ 116,287                              | \$ 103,204 |

Unity Bancorp, Inc.  
 Consolidated Statements of Cash Flows (Continued)  
 (Unaudited)

| (In thousands)  | For the three<br>months ended<br>March 31, |         |
|---|--|---------|
|   | 2018                                       | 2017    |
| <b>SUPPLEMENTAL DISCLOSURES</b>                         |  |         |
| Cash:   |  |         |
| Interest paid   | \$2,794                                    | \$2,229 |
| Income taxes paid                                       | \$1,461                                    | \$1,877 |
| Noncash investing activities:                           |  |         |
| Transfer of SBA loans held for sale to held to maturity | \$—  | \$13    |
| Capitalization of servicing rights                      | \$241                                      | \$176   |
| Transfer of loans to OREO                               | \$106                                      | \$396   |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.  
Notes to the Consolidated Financial Statements (Unaudited)  
March 31, 2018

#### NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and OREO properties. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings or shareholders' equity. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. Amounts requiring the use of significant estimates include the allowance for loan losses, valuation of deferred tax and servicing assets, the carrying value of loans held for sale and other real estate owned, the valuation of securities and the determination of other-than-temporary impairment for securities and fair value disclosures. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the Consolidated Financial Statements included in this Quarterly Report on Form 10-Q were available to be issued.

The interim unaudited Consolidated Financial Statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC") and consist of normal recurring adjustments necessary for the fair presentation of interim results. The results of operations for the three months ended March 31, 2018 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by U.S. generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

#### Other-Than-Temporary Impairment

The Company has a process in place to identify securities that could potentially incur credit impairment that is other-than-temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. This evaluation considers relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other-than-temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity securities, our ability and intent to

hold the security for a forecasted period of time that allows for the recovery in value.

Management assesses its intent to sell or whether it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired with no intent to sell and no requirement to sell prior to recovery of its amortized cost basis, the amount of the impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income. For debt securities where management has the intent to sell, the amount of the impairment is reflected in earnings as realized losses.

The present value of expected future cash flows is determined using the best estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds and structural support, including subordination and guarantees. The corporate bond cash flow estimates are derived from scenario-based outcomes of expected corporate restructurings or the disposition of assets using bond specific facts and circumstances including timing, security interests and loss severity.

#### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### Loans

##### Loans Held for Sale

Loans held for sale represent the guaranteed portion of Small Business Administration (“SBA”) loans and are reflected at the lower of aggregate cost or market value. The Company originates loans to customers under an SBA program that historically has provided for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale. When sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income. All criteria for sale accounting must be met in order for the loan sales to occur; see details under the “Transfers of Financial Assets” heading above.

Servicing assets represent the estimated fair value of retained servicing rights, net of servicing costs, at the time loans are sold. Servicing assets are amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on stratifying the underlying financial assets by date of origination and term. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment, if temporary, would be reported as a valuation allowance.

Serviced loans sold to others are not included in the accompanying Consolidated Balance Sheets. Income and fees collected for loan servicing are credited to noninterest income when earned, net of amortization on the related servicing assets.

##### Loans Held to Maturity

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and deferred loan origination fees and costs. In accordance with the level yield method, loan origination fees, net of direct loan origination costs, are deferred and recognized over the estimated life of the related loans as an adjustment to the loan yield. Interest is credited to operations primarily based upon the principal balance outstanding.

Loans are reported as past due when either interest or principal is unpaid in the following circumstances: fixed payment loans when the borrower is in arrears for two or more monthly payments; open end credit for two or more billing cycles; and single payment notes if interest or principal remains unpaid for 30 days or more.

Nonperforming loans consist of loans that are not accruing interest as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt (nonaccrual loans). When a loan is classified as nonaccrual, interest accruals are discontinued and all past due interest previously recognized as income is reversed and charged against current period earnings. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans may be returned to an accrual status when the ability to collect is reasonably assured and when the loan is brought current as to principal and interest.



Loans are charged off when collection is sufficiently questionable and when the Company can no longer justify maintaining the loan as an asset on the balance sheet. Loans qualify for charge-off when, after thorough analysis, all possible sources of repayment are insufficient. These include: 1) potential future cash flows, 2) value of collateral, and/or 3) strength of co-makers and guarantors. All unsecured loans are charged off upon the establishment of the loan's nonaccrual status. Additionally, all loans classified as a loss or that portion of the loan classified as a loss is charged off. All loan charge-offs are approved by the Board of Directors.

Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above.

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all TDRs and nonperforming loans individually evaluated for impairment. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for all other loans. Impairment of a loan is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or as a practical expedient, based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral-dependent. If the value of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge to the provision for loan losses.

For additional information on loans, see Note 8 to the Consolidated Financial Statements and the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.

#### Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

The allowance for loan losses is maintained at a level management considers adequate to provide for probable loan losses as of the balance sheet date. The allowance is increased by provisions charged to expense and is reduced by net charge-offs.

The level of the allowance is based on management's evaluation of probable losses in the loan portfolio, after consideration of prevailing economic conditions in the Company's market area, the volume and composition of the loan portfolio, and historical loan loss experience. The allowance for loan losses consists of specific reserves for individually impaired credits and TDRs, reserves for nonimpaired loans based on historical loss factors and reserves based on general economic factors and other qualitative risk factors such as changes in delinquency trends, industry concentrations or local/national economic trends. This risk assessment process is performed at least quarterly, and, as adjustments become necessary, they are realized in the periods in which they become known.

Although management attempts to maintain the allowance at a level deemed adequate to provide for probable losses, future additions to the allowance may be necessary based upon certain factors including changes in market conditions and underlying collateral values. In addition, various regulatory agencies periodically review the adequacy of the Company's allowance for loan losses. These agencies may require the Company to make additional provisions based on their judgments about information available to them at the time of their examination.

The Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the allowance are made through other

expenses and applied to the allowance which is maintained in other liabilities.

For additional information on the allowance for loan losses and unfunded loan commitments, see Note 9 to the Consolidated Financial Statements and the sections titled "Asset Quality" and "Allowance for Loan Losses and Reserve for Unfunded Loan Commitments" under Item 2. Management's Discussion and Analysis.

## Income Taxes

The Company accounts for income taxes according to the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions. Tax positions that meet the more likely than not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits would be recognized in income tax expense on the income statement.

### NOTE 2. Litigation

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business. In the best judgment of management, based upon consultation with counsel, the consolidated financial position and results of operations of the Company will not be affected materially by the final outcome of any pending legal proceedings or other contingent liabilities and commitments.

### NOTE 3. Net Income per Share

Basic net income per common share is calculated as net income divided by the weighted average common shares outstanding during the reporting period.

Diluted net income per common share is computed similarly to that of basic net income per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options, were issued during the reporting period utilizing the Treasury stock method.

The following is a reconciliation of the calculation of basic and diluted income per share:

|  |  |
|--|--|
|  | For the three<br>months ended<br>March 31, |
| (In thousands, except per share amounts) | 2018    2017                               |

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|   |         |         |
|---|---------|---------|
| Net income  | \$5,229 | \$3,192 |
| Weighted average common shares outstanding - Basic  | 10,678  | 10,509  |
| Plus: Potential dilutive common stock equivalents   | 175     | 196     |
| Weighted average common shares outstanding - Diluted  | 10,853  | 10,705  |
| Net income per common share - Basic   | \$0.49  | \$0.30  |
| Net income per common share - Diluted   | 0.48    | 0.30    |
| Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive | 84      | 56      |

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NOTE 4. Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes.

On December 22, 2017, the "Tax Cuts and Jobs Act" (TCJA) was signed into law, lowering the corporate tax rate from 35 percent to 21 percent. This provided significant tax benefits in 2018 by lowering the effective tax rate.

For the quarter ended March 31, 2018, the Company reported income tax expense of \$1.2 million for an effective tax rate of 19.1 percent, compared to an income tax expense of \$1.7 million and an effective tax rate of 34.9 percent for the prior year's quarter. The Company did not recognize or accrue any interest or penalties related to income taxes during the three months ended March 31, 2018 or 2017. The Company did not have an accrual for uncertain tax positions as of March 31, 2018 or December 31, 2017, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2013 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive (Loss) Income

The following tables show the changes in other comprehensive income (loss) for the three months ended March 31, 2018 and 2017, net of tax:

|  | For the three months ended March 31, 2018 |   |  |   |
|--|---|---|--|---|
| (In thousands)   | Net unrealized losses on securities       | Adjustments related to defined benefit plan | Net unrealized gains from cash flow hedges | Accumulated other comprehensive income (loss) |
| Balance, beginning of period   | \$ (335)                                  | \$ (341)                                    | \$ 882                                     | \$ 206  |
| Other comprehensive (loss) income before reclassifications                   | (581)                                     | —   | 549  | (32)  |
| Less amounts reclassified from accumulated other comprehensive (loss) income | —   | 134   | —  | 134   |
| Period change  | (581)                                     | (134)                                       | 549  | (166)   |
| Balance, end of period   | \$ (916)                                  | \$ (475)                                    | \$ 1,431                                   | \$ 40   |

  

|   | For the three months ended March 31, 2017 |   |  |   |
|---|---|---|--|---|
| (In thousands)  | Net unrealized losses on securities       | Adjustments related to defined benefit plan | Net unrealized gains from cash flow hedges | Accumulated other comprehensive income (loss) |
| Balance, beginning of period  | \$ (161)                                  | \$ (391)                                    | \$ 712                                     | \$ 160  |
| Other comprehensive (loss) income before reclassifications          | (86)                                      | —   | 48   | (38)  |
| Less amounts reclassified from accumulated other comprehensive loss | —   | (12)  | —  | (12)  |
| Period change   | (86)                                      | 12  | 48   | (26)  |
| Balance, end of period  | \$ (247)                                  | \$ (379)                                    | \$ 760                                     | \$ 134  |



## NOTE 6. Fair Value

### Fair Value Measurement

The Company follows FASB ASC Topic 820, “Fair Value Measurement and Disclosures,” which requires additional disclosures about the Company’s assets and liabilities that are measured at fair value. Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and/or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company utilizes techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed as follows:

#### Level 1 Inputs

Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain U.S. Treasury, U.S. Government and sponsored entity agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

#### Level 2 Inputs

Quoted prices for similar assets or liabilities in active markets.

Quoted prices for identical or similar assets or liabilities in inactive markets.

Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (i.e., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or “market corroborated inputs.”

Generally, this includes U.S. Government and sponsored entity mortgage-backed securities, corporate debt securities and derivative contracts.

#### Level 3 Inputs

Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.

These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

### Fair Value on a Recurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis:

#### Securities Available for Sale

The fair value of available for sale ("AFS") securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of March 31, 2018, the fair value of the Company's AFS securities portfolio was \$50.2 million. Approximately 60 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of \$30.1 million at March 31, 2018. Approximately \$29.6 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States.



All of the Company's AFS securities were classified as Level 2 assets at March 31, 2018. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

#### Equity Securities

The fair value of equity securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of March 31, 2018, the fair value of the Company's equity securities portfolio was \$1.2 million.

All of the Company's equity securities were classified as Level 2 assets at March 31, 2018. The valuation of security securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information.

There were no changes in the inputs or methodologies used to determine fair value during the period ended March 31, 2018, as compared to the periods ended December 31, 2017 and March 31, 2017.

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The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of March 31, 2018 and December 31, 2017:

|  |   | Fair Value Measurements at March 31, 2018                      |   |   |   |
|--|---|--|---|---|---|
|  |   | Using  |   |   |   |
| (In thousands)                         | Assets/Liabilities Measured at Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |   |
| Measured on a recurring basis:         |   |  |   |   |   |
| Assets:                                |   |  |   |   |   |
| Securities available for sale:         |   |  |   |   |   |
| U.S. Government sponsored entities     | \$5,616                                   | \$   | —\$ 5,616                                     | \$  | — |
| State and political subdivisions       | 4,945                                     | —  | 4,945   | —   |   |
| Residential mortgage-backed securities | 30,150                                    | —  | 30,150  | —   |   |
| Corporate and other securities         | 9,451                                     | —  | 9,451   | —   |   |
| Total securities available for sale    | \$50,162                                  | \$   | —\$ 50,162                                    | \$  | — |
| Equity securities                      | 1,191                                     | —  | 1,191   | —   |   |
| Total equity securities                | \$1,191                                   | \$   | —1,191  | \$  | — |
| Interest rate swap agreements          | 1,991                                     | —  | 1,991   | —   |   |
| Total swap agreements                  | \$1,991                                   | \$   | —1,991  | \$  | — |

|   |   | Fair value Measurements at December 31, 2017 Using             |   |   |   |
|---|---|--|---|---|---|
|   |   | Using  |   |   |   |
| (In thousands)                          | Assets/Liabilities Measured at Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |   |
| Measured on a recurring basis:          |   |  |   |   |   |
| Assets:                                 |   |  |   |   |   |
| Securities available for sale:          |   |  |   |   |   |
| U.S. Government sponsored entities      | \$5,691                                   | \$   | —\$ 5,691                                     | \$  | — |
| State and political subdivisions        | 5,192                                     | —  | 5,192   | —   |   |
| Residential mortgage-backed securities  | 31,878                                    | —  | 31,878  | —   |   |
| Corporate and other securities          | 10,732                                    | —  | 10,732  | —   |   |
| Total securities available for sale (1) | \$53,493                                  | \$   | —\$ 53,493                                    | \$  | — |
| Interest rate swap agreements           | 1,407                                     | —  | 1,407   | —   |   |
| Total swap agreements                   | \$1,407                                   | \$   | —\$ 1,407                                     | \$  | — |

(1) Securities available for sale at December 31, 2017, include equity securities of \$1.2 million.

Fair Value on a Nonrecurring Basis

Certain assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis:

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## Appraisal Policy

All appraisals must be performed in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). Appraisals are certified to the Company and performed by appraisers on the Company's approved list of appraisers. Evaluations are completed by a person independent of Company management. The content of the appraisal depends on the complexity of the property. Appraisals are completed on a "retail value" and an "as is value."

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over \$100,000 and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount ranges from 10 to 25 percent and is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral's location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. After receiving the third party results, the Company will discount the value 8 to 10 percent for selling and closing costs.

## OREO

The fair value of OREO is determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

## Impaired Collateral-Dependent Loans

The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. Partially charged-off loans are measured for impairment based upon an appraisal for collateral-dependent loans. When an updated appraisal is received for a nonperforming loan, the value on the appraisal is discounted in the manner discussed above. If there is a deficiency in the value after the Company applies these discounts, management applies a specific reserve and the loan remains in nonaccrual status. The receipt of an updated appraisal would not qualify as a reason to put a loan back into accruing status. The Company removes loans from nonaccrual status generally when the borrower makes nine months of contractual payments and demonstrates the ability to service the debt going forward. Charge-offs are determined based upon the loss that management believes the Company will incur after evaluating collateral for impairment based upon the valuation methods described above and the ability of the borrower to pay any deficiency.

The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At March 31, 2018, the valuation allowance for impaired loans was \$405 thousand, an increase of \$73 thousand from \$332 thousand at December 31, 2017.

The following tables present the assets and liabilities subject to fair value adjustments (impairment) on a non-recurring basis carried on the balance sheet by caption and by level within the hierarchy (as described above):

| (In thousands)                      | Fair Value Measurements at March 31, 2018 Using                |   |   |       | Net Provision (Credit) During Period |
|-------------------------------------|--|---|---|-------|--------------------------------------|
|                                     | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |       |                                      |
| Measured on a non-recurring basis:  |  |   |   |       |                                      |
| Financial assets:                   |  |   |   |       |                                      |
| OREO                                | \$56   | \$ —  | \$ —                                      | \$ 56 | \$ (175 )                            |
| Impaired collateral-dependent loans | 2,344  | —   | —   | 2,344 | (73 )                                |

| (In thousands)                      | Fair Value Measurements at December 31, 2017 Using             |   |   |        | Net Provision (Credit) During Period |
|-------------------------------------|--|---|---|--------|--------------------------------------|
|                                     | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |        |                                      |
| Financial assets:                   |  |   |   |        |                                      |
| OREO                                | \$426  | \$ —  | \$ —                                      | \$ 426 | \$ (299 )                            |
| Impaired collateral-dependent loans | 1,126  | —   | —   | 1,126  | (52 )                                |

#### Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of March 31, 2018 and December 31, 2017 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

#### Cash and Cash Equivalents

For these short-term instruments, the carrying value is a reasonable estimate of fair value.

#### Securities

The fair value of securities is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

#### SBA Loans Held for Sale

The fair value of SBA loans held for sale is estimated by using a market approach that includes significant other observable inputs.

#### Loans

The fair value of loans is estimated by discounting the future cash flows using current market rates that reflect the interest rate risk inherent in the loan, except for previously discussed impaired loans.

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#### FHLB Stock

Federal Home Loan Bank stock is carried at cost. Carrying value approximates fair value based on the redemption provisions of the issues.

#### Servicing Assets

Servicing assets do not trade in an active, open market with readily observable prices. The Company estimates the fair value of servicing assets using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds.

#### Accrued Interest

The carrying amounts of accrued interest approximate fair value.

#### OREO

The fair value of OREO is determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

#### Deposit Liabilities

The fair value of demand deposits and savings accounts is the amount payable on demand at the reporting date (i.e. carrying value). The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using current market rates.

#### Borrowed Funds and Subordinated Debentures

The fair value of borrowings is estimated by discounting the projected future cash flows using current market rates.

#### Standby Letters of Credit

At March 31, 2018, the Bank had standby letters of credit outstanding of \$4.4 million, compared to \$5.6 million at December 31, 2017. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company's financial instruments presented as of March 31, 2018 and December 31, 2017:

| (In thousands)                              | Fair value level | March 31, 2018  |                      | December 31, 2017 |                      |
|---|------------------|-----------------|----------------------|-------------------|----------------------|
|   |                  | Carrying amount | Estimated fair value | Carrying amount   | Estimated fair value |
| Financial assets:                           |                  |                 |                      |                   |                      |
| Cash and cash equivalents                   | Level 1          | \$116,287       | \$116,287            | \$150,254         | \$150,254            |
| Securities (1)                              | Level 2          | 67,521          | 67,508               | 69,800            | 69,839               |
| SBA loans held for sale                     | Level 2          | 21,579          | 24,226               | 22,810            | 25,568               |
| Loans, net of allowance for loan losses (2) | Level 2          | 1,159,335       | 1,153,545            | 1,134,308         | 1,133,739            |
| FHLB stock                                  | Level 2          | 9,308           | 9,308                | 12,863            | 12,863               |
| Servicing assets                            | Level 3          | 1,924           | 1,924                | 1,800             | 1,800                |
| Accrued interest receivable                 | Level 2          | 5,898           | 5,898                | 5,447             | 5,447                |
| OREO  | Level 3          | 56              | 56                   | 426               | 426                  |
| Financial liabilities:                      |                  |                 |                      |                   |                      |
| Deposits                                    | Level 2          | 1,117,514       | 1,114,210            | 1,043,137         | 1,041,111            |
| Borrowed funds and subordinated debentures  | Level 2          | 191,310         | 189,463              | 285,310           | 284,117              |
| Accrued interest payable                    | Level 2          | 410             | 410                  | 436               | 436                  |

Includes held to maturity ("HTM") corporate securities that are considered Level 3. These securities had book values (1) of \$3.7 million at March 31, 2018 and December 31, 2017, and market values of \$3.5 million at March 31, 2018 and December 31, 2017.

(2) Includes collateral-dependent impaired loans that are considered Level 3 and reported separately in the tables under the "Fair Value on a Nonrecurring Basis" heading. Collateral-dependent impaired loans, net of specific reserves totaled \$2.3 million and \$1.1 million at March 31, 2018 and December 31, 2017, respectively.



## NOTE 7. Securities

This table provides the major components of securities available for sale ("AFS") and held to maturity ("HTM") at amortized cost and estimated fair value at March 31, 2018 and December 31, 2017:

| (In thousands)                         | March 31, 2018 |                        |                         | December 31, 2017    |                |                        |                         |                      |
|--|----------------|------------------------|-------------------------|----------------------|----------------|------------------------|-------------------------|----------------------|
|  | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| Available for sale:                    |                |                        |                         |                      |                |                        |                         |                      |
| U.S. Government sponsored entities     | \$5,763        | \$ —                   | \$(147)                 | \$5,616              | \$5,765        | \$ —                   | \$(74)                  | \$5,691              |
| State and political subdivisions       | 5,111          | 3                      | (169)                   | 4,945                | 5,227          | 21                     | (56)                    | 5,192                |
| Residential mortgage-backed securities | 30,913         | 106                    | (869)                   | 30,150               | 32,111         | 153                    | (386)                   | 31,878               |
| Corporate and other securities         | 9,658          | 7                      | (214)                   | 9,451                | 9,660          | 9                      | (143)                   | 9,526                |
| Total securities available for sale    | \$51,445       | \$ 116                 | \$(1,399)               | \$50,162             | \$52,763       | \$ 183                 | \$(659)                 | \$52,287             |
| Held to maturity:                      |                |                        |                         |                      |                |                        |                         |                      |
| U.S. Government sponsored entities     | \$3,026        | \$ —                   | \$(108)                 | \$2,918              | \$3,026        | \$ —                   | \$(93)                  | \$2,933              |
| State and political subdivisions       | 1,113          | 120                    | —                       | 1,233                | 1,113          | 144                    | —                       | 1,257                |
| Residential mortgage-backed securities | 3,850          | 25                     | (53)                    | 3,822                | 3,958          | 59                     | (18)                    | 3,999                |
| Commercial mortgage-backed securities  | 3,656          | —                      | (146)                   | 3,510                | 3,685          | —                      | (142)                   | 3,543                |
| Corporate and other securities         | 4,523          | 149                    | —                       | 4,672                | 4,525          | 89                     | —                       | 4,614                |
| Total securities held to maturity      | \$16,168       | \$ 294                 | \$(307)                 | \$16,155             | \$16,307       | \$ 292                 | \$(253)                 | \$16,346             |
| Equity securities:                     |                |                        |                         |                      |                |                        |                         |                      |
| Total equity securities                | \$1,262        | \$ 16                  | \$(87)                  | \$1,191              | \$1,262        | \$ 15                  | \$(71)                  | \$1,206              |

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at March 31, 2018 is distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls.

|  | Within one year |        | After one through five years |        | After five through ten years |        | After ten years |        | Total carrying value |        |
|--|-----------------|--------|------------------------------|--------|------------------------------|--------|-----------------|--------|----------------------|--------|
| (In thousands, except percentages)     | Amount          | Yield  | Amount                       | Yield  | Amount                       | Yield  | Amount          | Yield  | Amount               | Yield  |
| Available for sale at fair value:      |                 |        |                              |        |                              |        |                 |        |                      |        |
| U.S. Government sponsored entities     | \$—             | — %    | \$3,662                      | 1.61 % | \$1,954                      | 2.17 % | \$—             | — %    | \$5,616              | 1.80 % |
| State and political subdivisions       | 796             | 3.89   | 363                          | 2.41   | 1,697                        | 2.41   | 2,089           | 2.69   | 4,945                | 2.77   |
| Residential mortgage-backed securities | 334             | 3.03   | 12,999                       | 2.59   | 14,415                       | 2.89   | 2,402           | 2.87   | 30,150               | 2.76   |
| Corporate and other securities         | —               | —      | 5,649                        | 4.39   | 2,897                        | 3.60   | 905             | 2.90   | 9,451                | 4.01   |
| Total securities available for sale    | \$1,130         | 3.64 % | \$22,673                     | 2.87 % | \$20,963                     | 2.88 % | \$5,396         | 2.81 % | \$50,162             | 2.89 % |
| Held to maturity at cost:              |                 |        |                              |        |                              |        |                 |        |                      |        |
| U.S. Government sponsored entities     | \$—             | — %    | \$—                          | — %    | \$3,026                      | 1.98 % | \$—             | — %    | \$3,026              | 1.98 % |
| State and political subdivisions       | 162             | 1.49   | 493                          | 5.07   | —                            | —      | 458             | 5.84   | 1,113                | 4.86   |
| Residential mortgage-backed securities | 29              | 3.22   | 1,200                        | 2.87   | 434                          | 3.29   | 2,187           | 3.79   | 3,850                | 3.45   |
| Commercial mortgage-backed securities  | —               | —      | —                            | —      | 1,642                        | 2.48   | 2,014           | 2.99   | 3,656                | 2.76   |
| Corporate and other securities         | —               | —      | 4,523                        | 5.73   | —                            | —      | —               | —      | 4,523                | 5.73   |
| Total securities held to maturity      | \$191           | 1.75 % | \$6,216                      | 5.13 % | \$5,102                      | 2.25 % | \$4,659         | 3.65 % | \$16,168             | 3.75 % |
| Equity Securities at fair value:       |                 |        |                              |        |                              |        |                 |        |                      |        |
| Total equity securities                | \$—             | — %    | \$—                          | — %    | \$—                          | — %    | \$1,191         | 1.69 % | \$1,191              | 1.69 % |

The fair value of securities with unrealized losses by length of time that the individual securities have been in a continuous unrealized loss position at March 31, 2018 and December 31, 2017 are as follows:

|  | March 31, 2018                  |                      |                       |                      |                 |                      |                 |  |
|--|---------------------------------|----------------------|-----------------------|----------------------|-----------------|----------------------|-----------------|--|
|  | Less than 12 months             |                      | 12 months and greater |                      | Total           |                      |                 |  |
| (In thousands, except number in a loss position) | Total number in a loss position | Estimated fair value | Unrealized loss       | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss |  |
| Available for sale:                              |                                 |                      |                       |                      |                 |                      |                 |  |
| U.S. Government sponsored entities               | 5                               | \$3,678              | \$(91)                | \$1,938              | \$(56)          | \$5,616              | \$(147)         |  |
| State and political subdivisions                 | 5                               | 2,153                | (73)                  | 1,633                | (96)            | 3,786                | (169)           |  |
| Residential mortgage-backed securities           | 23                              | 21,231               | (619)                 | 3,811                | (250)           | 25,042               | (869)           |  |
| Corporate and other securities                   | 4                               | 4,055                | (116)                 | 1,888                | (98)            | 5,943                | (214)           |  |
| Total temporarily impaired securities            | 37                              | \$31,117             | \$(899)               | \$9,270              | \$(500)         | \$40,387             | \$(1,399)       |  |
| Held to maturity:                                |                                 |                      |                       |                      |                 |                      |                 |  |
| U.S. Government sponsored entities               | 2                               | \$—                  | \$—                   | \$2,917              | \$(108)         | \$2,917              | \$(108)         |  |

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|  |    |         |        |   |         |         |   |         |         |   |
|--|----|---------|--------|---|---------|---------|---|---------|---------|---|
| Residential mortgage-backed securities | 8  | 1,945   | (12    | ) | 913     | (41     | ) | 2,858   | (53     | ) |
| Commercial mortgage-backed securities  | 2  | —       | —      |   | 3,510   | (146    | ) | 3,510   | (146    | ) |
| Total temporarily impaired securities  | 12 | \$1,945 | \$ (12 | ) | \$7,340 | \$ (295 | ) | \$9,285 | \$ (307 | ) |
| Equity Securities:                     |    |         |        |   |         |         |   |         |         |   |
| Total temporarily impaired securities  | 2  | \$—     | \$ —   |   | \$913   | \$ (87  | ) | \$913   | \$ (87  | ) |

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| (In thousands, except number in a loss position) | December 31, 2017               |                      |                 |                       |                 |                      |                 |
|--|---------------------------------|----------------------|-----------------|-----------------------|-----------------|----------------------|-----------------|
|  | Less than 12 months             |                      |                 | 12 months and greater |                 | Total                |                 |
|  | Total number in a loss position | Estimated fair value | Unrealized loss | Estimated fair value  | Unrealized loss | Estimated fair value | Unrealized loss |
| <b>Available for sale:</b>                       |                                 |                      |                 |                       |                 |                      |                 |
| U.S. Government sponsored entities               | 5                               | \$3,732              | \$ (40 )        | \$1,958               | \$ (34 )        | \$5,690              | \$ (74 )        |
| State and political subdivisions                 | 2                               | 476                  | (6 )            | 1,792                 | (50 )           | 2,268                | (56 )           |
| Residential mortgage-backed securities           | 22                              | 20,646               | (218 )          | 4,028                 | (168 )          | 24,674               | (386 )          |
| Corporate and other securities                   | 7                               | 4,563                | (37 )           | 2,803                 | (184 )          | 7,366                | (221 )          |
| Total temporarily impaired securities            | 36                              | \$29,417             | \$ (301 )       | \$10,581              | \$ (436 )       | \$39,998             | \$ (737 )       |
| <b>Held to maturity:</b>                         |                                 |                      |                 |                       |                 |                      |                 |
| U.S. Government sponsored entities               | 2                               | \$—                  | \$ —            | \$2,933               | \$ (93 )        | \$2,933              | \$ (93 )        |
| Residential mortgage-backed securities           | 2                               | —                    | —               | 979                   | (18 )           | 979                  | (18 )           |
| Commercial mortgage-backed securities            | 2                               | —                    | —               | 3,543                 | (142 )          | 3,543                | (142 )          |
| Total temporarily impaired securities            | 6                               | \$—                  | \$ —            | \$7,455               | \$ (253 )       | \$7,455              | \$ (253 )       |

#### Unrealized Losses

The unrealized losses in each of the categories presented in the tables above are discussed in the paragraphs that follow:

**U.S. government sponsored entities and state and political subdivision securities:** The unrealized losses on investments in these types of securities were caused by the increase in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than temporarily impaired as of March 31, 2018 or December 31, 2017.

**Residential and commercial mortgage-backed securities:** The unrealized losses on investments in mortgage-backed securities were caused by increases in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The majority of contractual cash flows of these securities are guaranteed by the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of March 31, 2018 or December 31, 2017.

**Corporate and other securities:** Included in this category are corporate debt securities, investments, asset-backed securities, and trust preferred securities. The unrealized losses on corporate debt securities were due to widening credit spreads or the increase in interest rates at the long end of the Treasury curve. The Company evaluated the prospects of the issuers and forecasted a recovery period; and as a result determined it did not consider these

investments to be other-than-temporarily impaired as of March 31, 2018 or December 31, 2017. The unrealized loss on the trust preferred security was caused by an inactive trading market and changes in market credit spreads. The contractual terms do not allow the security to be settled at a price less than the par value. Because the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, which may be at maturity, the Company did not consider this security to be other-than-temporarily impaired as of March 31, 2018 or December 31, 2017.

Equity Securities: Included in this category are Community Reinvestment Act ("CRA") investments and the Company's current other equity holdings. Equity securities are defined to include (a) preferred, common and other ownership interests in entities including partnerships, joint ventures and limited liability companies and (b) rights to acquire or dispose of ownership interest in entities at fixed or determinable prices. As a result of the adoption of ASU 2016-01 in January 2018, these securities were transferred from available for sale and reclassified into equity securities on the balance sheet. These securities are measured at fair value with unrealized holding gains and losses reflected in net income. The unrealized losses on these securities were caused by decreases in the market value of the shares.

#### Realized Gains and Losses

There were no gross realized gains or losses for the three months ended March 31, 2018, or 2017.

The Company follows ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities," which aims to simplify accounting for financial instruments and to converge the guidance between U.S. GAAP and IFRS. ASU 2016-01 also includes guidance on how entities account for equity investments, present and disclose financial instruments, and measure the valuation allowance on deferred tax assets related to available-for-sale debt securities. The guidance in ASU 2016-01 requires an entity to disaggregate the net gains and losses on the equity investments recognized in the income statement during a reporting period into realized and unrealized gains and losses. As a result, equity securities are no longer carried at fair value through other comprehensive income (OCI) or by applying the cost method to those equity securities that do not have readily determinable values. Equity securities are generally required to be measured at fair value with unrealized holding gains and losses reflected in net income. The Company adopted this standard as of January 1, 2018. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three months ended March 31, 2018:

| (In thousands)   | Three months ended March 31, 2018 |
|--|-----------------------------------|
| Net losses recognized during the period on equity securities   | (15 )                             |
| Less: Net gains (losses) recognized during the period on equity securities sold during the period              | —                                 |
| Unrealized losses recognized during the reporting period on equity securities still held at the reporting date | (15 )                             |

#### Pledged Securities

Securities with a carrying value of \$3.9 million and \$20.8 million for March 31, 2018 and December 31, 2017, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law.

#### NOTE 8. Loans

The following table sets forth the classification of loans by class, including unearned fees, deferred costs and excluding the allowance for loan losses as of March 31, 2018 and December 31, 2017:

| (In thousands)                | March 31, 2018 | December 31, 2017 |
|-------------------------------|----------------|-------------------|
| SBA loans held for investment | \$42,734       | \$ 43,999         |
| SBA 504 loans                 | 21,565         | 21,871            |
| Commercial loans              |                |                   |

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|                                     |             |              |
|-------------------------------------|-------------|--------------|
| Commercial other                    | 92,903      | 82,825       |
| Commercial real estate              | 464,552     | 469,696      |
| Commercial real estate construction | 57,664      | 54,473       |
| Residential mortgage loans          | 380,857     | 365,145      |
| Consumer loans                      |             |              |
| Home equity                         | 57,856      | 55,817       |
| Consumer other                      | 55,400      | 54,038       |
| Total loans held for investment     | \$1,173,531 | \$ 1,147,864 |
| SBA loans held for sale             | 21,579      | 22,810       |
| Total loans                         | \$1,195,110 | \$ 1,170,674 |

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Loans are made to individuals as well as commercial entities. Specific loan terms vary as to interest rate, repayment, and collateral requirements based on the type of loan requested and the credit worthiness of the prospective borrower. Credit risk tends to be geographically concentrated in that a majority of the loan customers are located in the markets serviced by the Bank. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to the real estate market such as geographic location and/or property type. A description of the Company's different loan segments follows:

**SBA Loans:** SBA 7(a) loans, on which the SBA has historically provided guarantees of up to 90 percent of the principal balance, are considered a higher risk loan product for the Company than its other loan products. The guaranteed portion of the Company's SBA loans is generally sold in the secondary market with the nonguaranteed portion held in the portfolio as a loan held for investment. SBA loans are for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. Loans are guaranteed by the businesses' major owners. SBA loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided.

**SBA 504 Loans:** The SBA 504 program consists of real estate backed commercial mortgages where the Company has the first mortgage and the SBA has the second mortgage on the property. Loans will generally be guaranteed in full or for a meaningful amount by the businesses' major owners. SBA 504 loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided. Generally, the Company has a 50 percent loan to value ratio on SBA 504 program loans at origination.

**Commercial Loans:** Commercial credit is extended primarily to middle market and small business customers. Commercial loans are generally made in the Company's market place for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. Loans will generally be guaranteed in full or for a meaningful amount by the businesses' major owners. Commercial loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided.

**Residential Mortgage and Consumer Loans:** The Company originates mortgage and consumer loans including principally residential real estate and home equity lines and loans and consumer construction lines. The Company originates qualified mortgages which are generally sold in the secondary market and nonqualified mortgages which are generally held for investment. Each loan type is evaluated on debt to income, type of collateral and loan to collateral value, credit history and Company's relationship with the borrower.

Inherent in the lending function is credit risk, which is the possibility a borrower may not perform in accordance with the contractual terms of their loan. A borrower's inability to pay their obligations according to the contractual terms can create the risk of past due loans and, ultimately, credit losses, especially on collateral deficient loans. The Company minimizes its credit risk by loan diversification and adhering to credit administration policies and procedures. Due diligence on loans begins when we initiate contact regarding a loan with a borrower. Documentation, including a borrower's credit history, materials establishing the value and liquidity of potential collateral, the purpose of the loan, the source of funds for repayment of the loan, and other factors, are analyzed before a loan is submitted for approval. The loan portfolio is then subject to on-going internal reviews for credit quality which in part is derived from ongoing collection and review of borrowers' financial information, as well as independent credit reviews by an outside firm.

The Company's extension of credit is governed by the Credit Risk Policy which was established to control the quality of the Company's loans. This policy and the underlying procedures are reviewed and approved by the Board of Directors on a regular basis.



### Credit Ratings

For SBA 7(a), SBA 504 and commercial loans, management uses internally assigned risk ratings as the best indicator of credit quality. A loan's internal risk rating is updated at least annually and more frequently if circumstances warrant a change in risk rating. The Company uses a 1 through 10 loan grading system that follows regulatory accepted definitions.

Pass: Risk ratings of 1 through 6 are used for loans that are performing, as they meet, and are expected to continue to meet, all of the terms and conditions set forth in the original loan documentation, and are generally current on principal and interest payments. These performing loans are termed "Pass".

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**Special Mention:** Criticized loans are assigned a risk rating of 7 and termed “Special Mention”, as the borrowers exhibit potential credit weaknesses or downward trends deserving management’s close attention. If not checked or corrected, these trends will weaken the Bank’s collateral and position. While potentially weak, these borrowers are currently marginally acceptable and no loss of interest or principal is anticipated. As a result, special mention assets do not expose an institution to sufficient risk to warrant adverse classification. Included in “Special Mention” could be turnaround situations, such as borrowers with deteriorating trends beyond one year, borrowers in startup or deteriorating industries, or borrowers with a poor market share in an average industry. “Special Mention” loans may include an element of asset quality, financial flexibility, or below average management. Management and ownership may have limited depth or experience. Regulatory agencies have agreed on a consistent definition of “Special Mention” as an asset with potential weaknesses which, if left uncorrected, may result in deterioration of the repayment prospects for the asset or in the Bank’s credit position at some future date. This definition is intended to ensure that the “Special Mention” category is not used to identify assets that have as their sole weakness credit data exceptions or collateral documentation exceptions that are not material to the repayment of the asset.

**Substandard:** Classified loans are assigned a risk rating of an 8 or 9, depending upon the prospect for collection, and deemed “Substandard”. A risk rating of 8 is used for borrowers with well-defined weaknesses that jeopardize the orderly liquidation of debt. The loan is inadequately protected by the current paying capacity of the obligor or by the collateral pledged, if any. Normal repayment from the borrower is in jeopardy, although no loss of principal is envisioned. There is a distinct possibility that a partial loss of interest and/or principal will occur if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified “Substandard”.

A risk rating of 9 is used for borrowers that have all the weaknesses inherent in a loan with a risk rating of 8, with the added characteristic that the weaknesses make collection of debt in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Serious problems exist to the point where partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably specific pending factors that may work to strengthen the assets, the loans’ classification as estimated losses is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures; capital injection; perfecting liens on additional collateral; and refinancing plans. Partial charge-offs are likely.

**Loss:** Once a borrower is deemed incapable of repayment of unsecured debt, the risk rating becomes a 10, the loan is termed a “Loss”, and charged-off immediately. Loans to such borrowers are considered uncollectible and of such little value that continuance as active assets of the Bank is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off these basically worthless assets even though partial recovery may be affected in the future.

For residential mortgage and consumer loans, management uses performing versus nonperforming as the best indicator of credit quality. Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. These credit quality indicators are updated on an ongoing basis, as a loan is placed on nonaccrual status as soon as management believes there is sufficient doubt as to the ultimate ability to collect interest on a loan.

At March 31, 2018, the Company owned no residential consumer properties that were included in OREO in the Consolidated Balance Sheets, compared to \$166 thousand at December 31, 2017. Additionally, there were \$1.2 million of residential consumer loans in the process of foreclosure at March 31, 2018, and December 31, 2017.



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The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of March 31, 2018:

| (In thousands)                          | March 31, 2018<br>SBA, SBA 504 & Commercial loans - Internal<br>risk ratings |                    |             |           |
|---|--|--------------------|-------------|-----------|
|   | Pass   | Special<br>mention | Substandard | Total     |
| SBA loans held for investment           | \$41,172   | \$ 311             | \$ 1,251    | \$42,734  |
| SBA 504 loans                           | 20,460   | 1,012              | 93          | 21,565    |
| Commercial loans                        |  |                    |             |           |
| Commercial other                        | 92,288   | 189                | 426         | 92,903    |
| Commercial real estate                  | 459,651  | 2,935              | 1,966       | 464,552   |
| Commercial real estate construction     | 57,664   | —                  | —           | 57,664    |
| Total commercial loans                  | 609,603  | 3,124              | 2,392       | 615,119   |
| Total SBA, SBA 504 and commercial loans | \$671,235  | \$ 4,447           | \$ 3,736    | \$679,418 |

| (In thousands)                                | Residential mortgage & Consumer loans -<br>Performing/Nonperforming |               |  | Total     |
|---|---|---------------|--|-----------|
|   | Performing  | Nonperforming |  |           |
| Residential mortgage loans                    | \$ 378,905  | \$ 1,952      |  | \$380,857 |
| Consumer loans                                |   |               |  |           |
| Home equity                                   | 57,533  | 323           |  | 57,856    |
| Consumer other                                | 55,400  | —             |  | 55,400    |
| Total consumer loans                          | 112,933   | 323           |  | 113,256   |
| Total residential mortgage and consumer loans | \$ 491,838  | \$ 2,275      |  | \$494,113 |

The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of December 31, 2017:

| (In thousands)                          | December 31, 2017<br>SBA, SBA 504 & Commercial loans - Internal<br>risk ratings |                    |             |           |
|---|---|--------------------|-------------|-----------|
|   | Pass  | Special<br>mention | Substandard | Total     |
| SBA loans held for investment           | \$42,415  | \$ 373             | \$ 1,211    | \$43,999  |
| SBA 504 loans                           | 20,751  | 1,024              | 96          | 21,871    |
| Commercial loans                        |   |                    |             |           |
| Commercial other                        | 82,201  | 599                | 25          | 82,825    |
| Commercial real estate                  | 464,589   | 3,047              | 2,060       | 469,696   |
| Commercial real estate construction     | 54,473  | —                  | —           | 54,473    |
| Total commercial loans                  | 601,263   | 3,646              | 2,085       | 606,994   |
| Total SBA, SBA 504 and commercial loans | \$664,429   | \$ 5,043           | \$ 3,392    | \$672,864 |

| (In thousands)             | Residential mortgage & Consumer loans -<br>Performing/Nonperforming |               |  | Total     |
|----------------------------|---|---------------|--|-----------|
|                            | Performing  | Nonperforming |  |           |
| Residential mortgage loans | \$ 363,476  | \$ 1,669      |  | \$365,145 |
| Consumer loans             |   |               |  |           |
| Home equity                | 55,192  | 625           |  | 55,817    |
| Consumer other             | 54,038  | —             |  | 54,038    |

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|   |            |          |            |
|---|------------|----------|------------|
| Total consumer loans                          | 109,230    | 625      | 109,855    |
| Total residential mortgage and consumer loans | \$ 472,706 | \$ 2,294 | \$ 475,000 |

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## Nonperforming and Past Due Loans

Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. Loans past due 90 days or more and still accruing interest are not included in nonperforming loans and generally represent loans that are well collateralized and in a continuing process expected to result in repayment or restoration to current status. The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market.

The following tables set forth an aging analysis of past due and nonaccrual loans as of March 31, 2018 and December 31, 2017:

| (In thousands)                      | March 31, 2018               |                              |                                   | Nonaccrual<br>(1) | Total<br>past due | Current     | Total loans |
|-------------------------------------|------------------------------|------------------------------|-----------------------------------|-------------------|-------------------|-------------|-------------|
|                                     | 30-59<br>days<br>past<br>due | 60-89<br>days<br>past<br>due | 90+ days<br>and still<br>accruing |                   |                   |             |             |
| SBA loans held for investment       | \$860                        | \$—                          | \$                                | —\$ 933           | \$1,793           | \$40,941    | \$42,734    |
| SBA 504 loans                       | —                            | —                            | —                                 | —                 | —                 | 21,565      | 21,565      |
| Commercial loans                    |                              |                              |                                   |                   |                   |             |             |
| Commercial other                    | —                            | 22                           | —                                 | —                 | 22                | 92,881      | 92,903      |
| Commercial real estate              | 1,786                        | 174                          | —                                 | 1,069             | 3,029             | 461,523     | 464,552     |
| Commercial real estate construction | —                            | —                            | —                                 | —                 | —                 | 57,664      | 57,664      |
| Residential mortgage loans          | 5,837                        | 293                          | —                                 | 1,952             | 8,082             | 372,775     | 380,857     |
| Consumer loans                      |                              |                              |                                   |                   |                   |             |             |
| Home equity                         | —                            | 201                          | —                                 | 323               | 524               | 57,332      | 57,856      |
| Consumer other                      | —                            | —                            | —                                 | —                 | —                 | 55,400      | 55,400      |
| Total loans held for investment     | \$8,483                      | \$690                        | \$                                | —\$ 4,277         | \$13,450          | \$1,160,081 | \$1,173,531 |
| SBA loans held for sale             | —                            | —                            | —                                 | —                 | —                 | 21,579      | 21,579      |
| Total loans                         | \$8,483                      | \$690                        | \$                                | —\$ 4,277         | \$13,450          | \$1,181,660 | \$1,195,110 |

(1) At March 31, 2018, nonaccrual loans included \$27 thousand of loans guaranteed by the SBA.

| (In thousands)                      | December 31, 2017            |                              |                                   |          | Nonaccrual<br>(1) | Total<br>past<br>due | Current     | Total loans |
|-------------------------------------|------------------------------|------------------------------|-----------------------------------|----------|-------------------|----------------------|-------------|-------------|
|                                     | 30-59<br>days<br>past<br>due | 60-89<br>days<br>past<br>due | 90+ days<br>and still<br>accruing |          |                   |                      |             |             |
| SBA loans held for investment       | \$240                        | \$313                        | \$ —                              | \$ 632   | \$1,185           | \$42,814             | \$43,999    |             |
| SBA 504 loans                       | —                            | —                            | —                                 | —        | —                 | 21,871               | 21,871      |             |
| Commercial loans                    |                              |                              |                                   |          |                   |                      |             |             |
| Commercial other                    | 23                           | —                            | 60                                | 25       | 108               | 82,717               | 82,825      |             |
| Commercial real estate              | 558                          | 1,073                        | —                                 | 43       | 1,674             | 468,022              | 469,696     |             |
| Commercial real estate construction | —                            | —                            | —                                 | —        | —                 | 54,473               | 54,473      |             |
| Residential mortgage loans          | 1,830                        | 958                          | —                                 | 1,669    | 4,457             | 360,688              | 365,145     |             |
| Consumer loans                      |                              |                              |                                   |          |                   |                      |             |             |
| Home equity                         | 51                           | 205                          | —                                 | 625      | 881               | 54,936               | 55,817      |             |
| Consumer other                      | 3                            | —                            | —                                 | —        | 3                 | 54,035               | 54,038      |             |
| Total loans held for investment     | \$2,705                      | \$2,549                      | \$ 60                             | \$ 2,994 | \$8,308           | \$1,139,556          | \$1,147,864 |             |
| SBA loans held for sale             | —                            | —                            | —                                 | —        | —                 | 22,810               | 22,810      |             |
| Total loans                         | \$2,705                      | \$2,549                      | \$ 60                             | \$ 2,994 | \$8,308           | \$1,162,366          | \$1,170,674 |             |

(1) At December 31, 2017, nonaccrual loans included \$27 thousand of loans guaranteed by the SBA.

#### Impaired Loans

The Company has defined impaired loans to be all nonperforming loans individually evaluated for impairment and TDRs. Management considers a loan impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract. Impairment is evaluated on an individual basis for SBA, SBA 504, and commercial loans.

The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of March 31, 2018:

| (In thousands)                                 | March 31, 2018           |                     |                   |
|--|--------------------------|---------------------|-------------------|
|  | Unpaid principal balance | Recorded investment | Specific reserves |
| With no related allowance:                     |                          |                     |                   |
| SBA loans held for investment (1)              | \$439                    | \$ 357              | \$ —              |
| Commercial loans                               |                          |                     |                   |
| Commercial real estate                         | 1,069                    | 1,069               | —                 |
| Total commercial loans                         | 1,069                    | 1,069               | —                 |
| Total impaired loans with no related allowance | 1,508                    | 1,426               | —                 |
| With an allowance:                             |                          |                     |                   |
| SBA loans held for investment (1)              | 638                      | 549                 | 279               |
| Commercial loans                               |                          |                     |                   |
| Commercial real estate                         | 774                      | 774                 | 126               |
| Total commercial loans                         | 774                      | 774                 | 126               |
| Total impaired loans with a related allowance  | 1,412                    | 1,323               | 405               |
| Total individually evaluated impaired loans:   |                          |                     |                   |
| SBA loans held for investment (1)              | 1,077                    | 906                 | 279               |
| Commercial loans                               |                          |                     |                   |
| Commercial real estate                         | 1,843                    | 1,843               | 126               |
| Total commercial loans                         | 1,843                    | 1,843               | 126               |
| Total individually evaluated impaired loans    | \$2,920                  | \$ 2,749            | \$ 405            |

(1) Balances are reduced by amount guaranteed by the SBA of \$27 thousand at March 31, 2018.



The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of December 31, 2017:

| (In thousands)                                 | December 31, 2017        |                     |                   |
|--|--------------------------|---------------------|-------------------|
|  | Unpaid principal balance | Recorded investment | Specific reserves |
| With no related allowance:                     |                          |                     |                   |
| SBA loans held for investment (1)              | \$ 135                   | \$ 52               | \$ —              |
| SBA 504 loans                                  | —                        | —                   | —                 |
| Commercial loans                               |                          |                     |                   |
| Commercial other                               | 25                       | 25                  | —                 |
| Commercial real estate                         | 43                       | 43                  | —                 |
| Total commercial loans                         | 68                       | 68                  | —                 |
| Total impaired loans with no related allowance | 203                      | 120                 | —                 |
| With an allowance:                             |                          |                     |                   |
| SBA loans held for investment (1)              | 748                      | 553                 | 194               |
| Commercial loans                               |                          |                     |                   |
| Commercial other                               | —                        | —                   | —                 |
| Commercial real estate                         | 786                      | 786                 | 138               |
| Total commercial loans                         | 786                      | 786                 | 138               |
| Total impaired loans with a related allowance  | 1,534                    | 1,339               | 332               |
| Total individually evaluated impaired loans:   |                          |                     |                   |
| SBA loans held for investment (1)              | 883                      | 605                 | 194               |
| SBA 504 loans                                  | —                        | —                   | —                 |
| Commercial loans                               |                          |                     |                   |
| Commercial other                               | 25                       | 25                  | —                 |
| Commercial real estate                         | 829                      | 829                 | 138               |
| Total commercial loans                         | 854                      | 854                 | 138               |
| Total individually evaluated impaired loans    | \$ 1,737                 | \$ 1,459            | \$ 332            |

(1) Balances are reduced by amount guaranteed by the SBA of \$27 thousand at December 31, 2017.

Impaired loans increased \$1.2 million at March 31, 2018 compared to December 31, 2017. The increase in impaired loans was primarily due to the downgrade of one commercial loan totaling \$1.1 million and one SBA loan totaling \$307 thousand. Both loans were put on to nonaccrual in the first quarter of 2018.

The following table presents the average recorded investments in impaired loans and the related amount of interest recognized during the time period in which the loans were impaired for the three months ended March 31, 2018 and 2017. The average balances are calculated based on the month-end balances of impaired loans. When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal under the cost recovery method, and therefore no interest income is recognized. The interest income recognized on impaired loans noted below represents primarily accruing TDRs and nominal amounts of income recognized on a cash basis for well-collateralized impaired loans.

| (In thousands)                    | For the three months ended March 31, |  |                             |  |
|-----------------------------------|--------------------------------------|--|-----------------------------|--|
|                                   | 2018                                 |  | 2017                        |  |
|                                   | Average recorded investment          | Interest income recognized on impaired loans | Average recorded investment | Interest income recognized on impaired loans |
| SBA loans held for investment (1) | \$658                                | \$ (2 )                                      | \$998                       | \$ (6 )                                      |
| SBA 504 loans                     | —                                    | —  | 329                         | —  |
| Commercial loans                  |                                      |  |                             |  |
| Commercial other                  | —                                    | —  | 25                          | —  |
| Commercial real estate            | 1,495                                | 15   | 1,133                       | 22   |
| Total                             | \$2,153                              | \$ 13  | \$2,485                     | \$ 16  |

(1) Balances are reduced by the average amount guaranteed by the SBA of \$30 thousand and \$248 thousand for the three months ended March 31, 2018 and 2017, respectively.

#### TDRs

The Company's loan portfolio also includes certain loans that have been modified as TDRs. TDRs occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider, unless it results in a delay in payment that is insignificant. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. When the Company modifies a loan, management evaluates for any possible impairment using either the discounted cash flows method, where the value of the modified loan is based on the present value of expected cash flows, discounted at the contractual interest rate of the original loan agreement, or by using the fair value of the collateral less selling costs if the loan is collateral-dependent. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through an allowance estimate or charge-off to the allowance. This process is used, regardless of loan type, and for loans modified as TDRs that subsequently default on their modified terms.

The Company had one performing TDR with a balance of \$774 thousand and \$786 thousand as of March 31, 2018 and December 31, 2017, respectively, which was included in the impaired loan numbers as of such dates. At March 31, 2018 and December 31, 2017, there were specific reserves of \$126 thousand and \$138 thousand, respectively, on the performing TDR. The loan remains in accrual status since it continues to perform in accordance with the restructured terms.

To date, the Company's TDRs consisted of interest rate reductions, interest only periods, principal balance reductions, and maturity extensions. There were no loans modified during the three months ended March 31, 2018 and 2017 that were deemed to be TDRs. There were no loans modified as a TDR within the previous 12 months that subsequently defaulted at some point during the three months ended March 31, 2018. In this case, the subsequent default is defined as 90 days past due or transferred to nonaccrual status.

NOTE 9. Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

Allowance for Loan Losses

The Company has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. At a minimum, the adequacy of the allowance for loan losses is reviewed by management on a quarterly basis. For purposes of determining the allowance for loan losses, the Company has segmented the loans in its portfolio by loan type. Loans are segmented into the following pools: SBA 7(a), SBA 504, commercial, residential mortgages, and consumer loans. Certain portfolio segments are further broken down into classes based on the associated risks within those segments and the type of collateral underlying each loan. Commercial loans are divided into the following four classes: commercial real estate, commercial real estate construction, unsecured business line of credit and commercial other. Consumer loans are divided into two classes as follows: Home equity and other.

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The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. The same standard methodology is used, regardless of loan type. Specific reserves are made to individual impaired loans and TDRs (see Note 1 for additional information on this term). The general reserve is set based upon a representative average historical net charge-off rate adjusted for the following environmental factors: delinquency and impairment trends, charge-off and recovery trends, changes in the volume of restructured loans, volume and loan term trends, changes in risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes. Within the five-year historical net charge-off rate, the Company weights the past three years more heavily as it believes it is more indicative of future charge-offs. All of the environmental factors are ranked and assigned a basis points value based on the following scale: low, low moderate, moderate, high moderate and high risk. Each environmental factor is evaluated separately for each class of loans and risk weighted based on its individual characteristics.

For SBA 7(a), SBA 504 and commercial loans, the estimate of loss based on pools of loans with similar characteristics is made through the use of a standardized loan grading system that is applied on an individual loan level and updated on a continuous basis. The loan grading system incorporates reviews of the financial performance of the borrower, including cash flow, debt-service coverage ratio, earnings power, debt level and equity position, in conjunction with an assessment of the borrower's industry and future prospects. It also incorporates analysis of the type of collateral and the relative loan to value ratio.

For residential mortgage and consumer loans, the estimate of loss is based on pools of loans with similar characteristics. Factors such as credit score, delinquency status and type of collateral are evaluated. Factors are updated frequently to capture the recent behavioral characteristics of the subject portfolios, as well as any changes in loss mitigation or credit origination strategies, and adjustments to the reserve factors are made as needed.

According to the Company's policy, a loss ("charge-off") is to be recognized and charged to the allowance for loan losses as soon as a loan is recognized as uncollectable. All credits which are 90 days past due must be analyzed for the Company's ability to collect on the credit. Once a loss is known to exist, the charge-off approval process is immediately expedited. This charge-off policy is followed for all loan types.

The allocated allowance is the total of identified specific and general reserves by loan category. The allocation is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of the portfolio. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in methodologies for estimating allocated and general reserves in the portfolio.

The following tables detail the activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2018 and 2017:

| (In thousands)   | For the three months ended March 31, 2018 |         |            |             |          |             | Total     |
|--|---|---------|------------|-------------|----------|-------------|-----------|
|  | SBA held for investment                   | SBA 504 | Commercial | Residential | Consumer | Unallocated |           |
| Balance, beginning of period                             | \$1,471                                   | \$430   | \$ 7,395   | \$ 3,130    | \$ 1,130 | \$ —        | —\$13,556 |
| Charge-offs  | (81 )                                     | —       | —          | —           | (6 )     | —           | (87 )     |
| Recoveries   | 64  | —       | 16         | 13          | 134      | —           | 227       |
| Net (charge-offs) recoveries                             | (17 )                                     | —       | 16         | 13          | 128      | —           | 140       |
| Provision for (credit to) loan losses charged to expense | 50  | (100 )  | 398        | 287         | (135 )   | —           | 500       |
| Balance, end of period                                   | \$1,504                                   | \$330   | \$ 7,809   | \$ 3,430    | \$ 1,123 | \$ —        | —\$14,196 |



| (In thousands)   | For the three months ended March 31, 2017 |         |            |             |          |             | Total    |
|--|---|---------|------------|-------------|----------|-------------|----------|
|  | SBA held for investment                   | SBA 504 | Commercial | Residential | Consumer | Unallocated |          |
| Balance, beginning of period                             | \$1,576                                   | \$573   | \$ 6,729   | \$ 2,593    | \$ 925   | \$ 183      | \$12,579 |
| Charge-offs  | (109)                                     | —       | (76)       | —           | (66)     | —           | (251)    |
| Recoveries   | 37  | —       | 53         | 12          | 1        | —           | 103      |
| Net (charge-offs) recoveries                             | (72)                                      | —       | (23)       | 12          | (65)     | —           | (148)    |
| Provision for (credit to) loan losses charged to expense | 149                                       | 27      | (173)      | 264         | 166      | (183)       | 250      |
| Balance, end of period                                   | \$1,653                                   | \$600   | \$ 6,533   | \$ 2,869    | \$ 1,026 | \$ —        | \$12,681 |

The following tables present loans and their related allowance for loan losses, by portfolio segment, as of March 31, 2018 and December 31, 2017:

| (In thousands)                            | March 31, 2018          |          |            |             |            |             | Total        |
|---|-------------------------|----------|------------|-------------|------------|-------------|--------------|
|   | SBA held for investment | SBA 504  | Commercial | Residential | Consumer   | Unallocated |              |
| Allowance for loan losses ending balance: |                         |          |            |             |            |             |              |
| Individually evaluated for impairment     | \$279                   | \$—      | \$ 126     | \$—         | \$—        | \$          | —\$405       |
| Collectively evaluated for impairment     | 1,225                   | 330      | 7,683      | 3,430       | 1,123      | —           | 13,791       |
| Total                                     | \$1,504                 | \$330    | \$ 7,809   | \$ 3,430    | \$ 1,123   | \$          | —\$14,196    |
| Loan ending balances:                     |                         |          |            |             |            |             |              |
| Individually evaluated for impairment     | \$906                   | \$—      | \$ 1,843   | \$—         | \$—        | \$          | —\$2,749     |
| Collectively evaluated for impairment     | 41,828                  | 21,565   | 613,276    | 380,857     | 113,256    | —           | 1,170,782    |
| Total                                     | \$42,734                | \$21,565 | \$ 615,119 | \$ 380,857  | \$ 113,256 | \$          | —\$1,173,531 |

| (In thousands)                            | December 31, 2017       |          |            |             |            |             | Total        |
|---|-------------------------|----------|------------|-------------|------------|-------------|--------------|
|   | SBA held for investment | SBA 504  | Commercial | Residential | Consumer   | Unallocated |              |
| Allowance for loan losses ending balance: |                         |          |            |             |            |             |              |
| Individually evaluated for impairment     | \$194                   | \$—      | \$ 138     | \$—         | \$—        | \$          | —\$332       |
| Collectively evaluated for impairment     | 1,277                   | 430      | 7,257      | 3,130       | 1,130      | —           | 13,224       |
| Total                                     | \$1,471                 | \$430    | \$ 7,395   | \$ 3,130    | \$ 1,130   | \$          | —\$13,556    |
| Loan ending balances:                     |                         |          |            |             |            |             |              |
| Individually evaluated for impairment     | \$605                   | \$—      | \$ 854     | \$—         | \$—        | \$          | —\$1,459     |
| Collectively evaluated for impairment     | 43,394                  | 21,871   | 606,140    | 365,145     | 109,855    | —           | 1,146,405    |
| Total                                     | \$43,999                | \$21,871 | \$ 606,994 | \$ 365,145  | \$ 109,855 | \$          | —\$1,147,864 |

#### Changes in Methodology

The Company did not make any changes to its allowance for loan losses methodology in the current period.



## Reserve for Unfunded Loan Commitments

In addition to the allowance for loan losses, the Company maintains a reserve for unfunded loan commitments at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the reserve are made through other expense and applied to the reserve which is classified as other liabilities. At March 31, 2018, a \$286 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a \$292 thousand commitment reserve at December 31, 2017, due to a larger loan portfolio requiring a larger general reserve.

## NOTE 10. New Accounting Pronouncements

ASU 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU 2014-09 replaced almost all existing revenue recognition guidance in current U.S. GAAP. The Company’s main source of revenue is comprised of net interest income on interest earning assets and liabilities and non-interest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. As such, the Company does not expect the guidance to have a material impact on its financial statements.

Under current U.S. GAAP, when full consideration is not expected and financing is required by the buyer to purchase the property, there are very prescriptive requirements in determining when foreclosed real estate property sold by an institution should be derecognized and a gain or loss be recognized. The new guidance that will be applied to these sales is more principles based. For example, as it pertains to the criteria for determining how a contract should be accounted for under the new guidance, judgment will need to be exercised in evaluating if: (a) a commitment on the buyer’s part exists, (b) collection is probable in circumstances where the initial investment is minimal and (c) the buyer has obtained control of the asset, including the significant risks and rewards of the ownership. If there is no commitment on the buyer’s part, collection is not probable or the buyer has not obtained control of the asset, then a gain cannot be recognized under the new guidance. The initial investment requirement for the buyer along with the various methods for profit recognition are no longer applicable when the new guidance goes into effect. The Company will revise its current policy on the recognition and measurement of gain on sale of other real estate owned to be consistent with the new guidance, but does not expect the new guidance to have a significant impact on the consolidated financial statements of the Company when adopted.

For deposit-related fees, considering the straightforward nature of the arrangements with the Company’s deposits customers, the Company does not expect the recognition and measurement outcomes of deposit-related fees to be significant differently under the new guidance compared to current U.S. GAAP.

ASU 2014-09 was to be effective for interim and annual periods beginning after December 15, 2016 and was to be applied on either a modified retrospective or full retrospective basis. In August 2015, the FASB issued ASU 2015-14 which defers the original effective date for all entities by one year. Public business entities should apply the guidance in ASU 2015-14 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company has applied this change and the impact of the adoption of ASU 2014-09 on its consolidated financial statements was immaterial.

ASU 2016-01, “Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This eliminates the available for sale classification of accounting for equity securities and adjusts the fair value disclosures for financial instruments carried at amortized cost such that the disclosed fair values represent an exit price as opposed to an entry price. This update requires that equity securities be carried at fair value on the balance sheet and any periodic changes in value will be adjusted through the income



statement. A practical expedient is provided for equity securities without a readily determinable fair value, such that these securities can be carried at cost less any impairment. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company has adopted this standard as of January 1, 2018. As of March 31, 2018, \$15 thousand in unrealized losses on equity securities were reclassified to net income.

ASU 2016-02, "Leases (Topic 842)". ASU 2016-02 was issued in three parts: (a) Section A, "Leases: Amendments to the FASB Accounting Standards Codification®," (b) Section B, "Conforming Amendments Related to Leases: Amendments to the FASB Accounting Standards Codification®," and (c) Section C, "Background Information and Basis for Conclusions." While both lessees and lessors are affected by the new guidance, the effects on lessees are much more significant. The update states that a lessee should recognize the assets and liabilities that arise from all leases with a term greater than 12 months. The core principle requires the lessee to recognize a liability to make lease payments and a "right-of-use" asset. The accounting applied by the lessor is relatively unchanged as the majority of operating leases should remain classified as operating leases and the income from them recognized, generally, on a straight-line basis over the lease term. The standards update also requires expanded qualitative and quantitative disclosures. For public business entities, ASC 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018. ASC 2016-02 mandates a modified retrospective transition for all entities. In January 2018, FASB issued ASU 2018-01, "Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842." ASU 2018-01 was issued to facilitate the implementation of ASU 2016-02. ASU 2018-01 would give entities the option to apply ASC 842 as of the effective date, rather than as of the beginning of the earliest period presented. Under this additional optional transition method, a cumulative-effect adjustment would be recognized in the opening balance of retained earnings in the period of adoption. Lessors would be able to apply a practical expedient under which they could elect, by class of underlying assets, to not separate nonlease components from the related lease components and account for the components as a single lease component if the timing and pattern of revenue recognition for the lease and nonlease components are the same, and the combined single lease component is classified as an operating lease. The effective date and transition requirements for the amendment are the same as the effective date and transition requirements in ASU 2016-02. The Company is currently evaluating the impact of the adoption of ASC 2016-02 and ASU 2018-01 on its consolidated financial statements. As of March 31, 2018, the Company had minimum noncancelable net operating lease payments of \$1.7 million that are being evaluated. The implementation team is working on gathering all key lease data elements to meet the requirements of the new guidance.

ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." ASU 2016-13 was issued to replace the incurred loss impairment methodology in current GAAP with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. Financial assets measured at amortized cost will be presented at the net amount expected to be collected by using an allowance for credit losses. Purchased credit impaired loans will receive an allowance account at the acquisition date that represents a component of the purchase price allocation. Credit losses relating to available-for-sale debt securities will be recorded through an allowance for credit losses, with such allowance limited to the amount by which fair value is below amortized cost. For public business entities, ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019. The Company is currently evaluating the impact of the adoption of ASU 2016-13 on its consolidated financial statements.

ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 was issued to address diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, Statement of Cash Flows, and other Topics. This update addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments in this update provide guidance on the following eight specific cash flow issues:

- Debt Prepayment or Debt Extinguishment Costs
- Settlement of Zero-Coupon Debt Instruments or Other Debt Instruments with Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing
- Contingent Consideration Payments Made after a Business Combination
- Proceeds from the Settlement of Insurance Claims
- Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, include Bank-Owned Life Insurance Policies

Distributions Received from Equity Method Investees

- Beneficial Interest in Securitization Transactions

Separately Identifiable Cash Flows and Application of the Predominance Principle

The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company has applied this change and the impact of the adoption of ASU 2016-15 on its consolidated financial statements was immaterial.

ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." ASU 2016-18 was issued to address divergence in the way restricted cash is classified and presented. The amendments in the update require that a statement of cash flows explain the change during a reporting period in the total of cash, cash equivalents, and amounts generally described as restricted cash and restricted cash equivalents. The amendments in this update apply to entities that have restricted cash or restricted cash equivalents and are required to present a statement of cash flows under Topic 230. The amendment says that transfers between cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are not part of the entity's operating, investing, and financing activities. For public business entities, ASU 2016-18 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company has applied this change and the impact of the adoption of ASU 2016-18 on its consolidated financial statements was immaterial.

ASU 2017-04, "Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." ASU 2017-04 was issued in an effort to simplify accounting in a new standard. The amendments in this update require that an entity perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. The amendment states that an entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, but the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. For public business entities, ASU 2017-04 is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performing on testing dates after January 1, 2017. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements since the fair values of our reporting units were not lower than their respective carrying amounts at the time of our goodwill impairment analysis for 2017.

ASU 2017-07, "Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost" ASU 2017-07 was issued to provide guidance on the presentation of defined benefit costs in the income statement. The amendments in this update requires that an entity report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The amendment states that other components of net benefit cost be separate from the service cost component in the income statement. For public business entities, ASU 2017-07 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. ASU 2017-07 is not expected to have a significant impact on the presentation of the Company's consolidated financial statements.

ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities." ASU 2017-08 was issued to enhance the accounting for the amortization of premiums for purchased callable debt securities. This amendment requires that the amortization premium be shortened to the earliest call date. For public business entities, ASU 2017-08 is effective for fiscal years after December 15, 2018, and interim periods within those fiscal years. The Company has applied this change and the impact of the adoption of ASU 2017-08 on its consolidated financial statements was immaterial.

ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 was issued to ease the burden associated with assessing hedge effectiveness and to promote better financial statement alignment of the recognition and presentation of the effects of the hedging instrument and the hedged item. This guidance requires entities to present the earnings effect of the hedging instrument in the same income statement line item with the earnings effect on the hedged item. For public business entities, ASU 2017-12 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. ASU 2017-12 is not expected to have a significant impact on the consolidated financial statements.

ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." ASU 2018-02 allows a reclassification from accumulated other comprehensive income (loss) ("AOCI") to retained earnings for the stranded tax effects caused by the

revaluation of deferred taxes resulting from the newly enacted corporate tax rate in the Tax Cuts and Jobs Act. The ASU is effective in years beginning after December 15, 2018, but permits early adoption in a period for which financial statements have not yet been issued. The Company has elected to early adopt the ASU as of January 1, 2018. The adoption of the guidance resulted in a \$66 thousand cumulative-effect adjustment that increased retained earnings and decreased AOCI in the first quarter of 2018.

## NOTE 11. Derivative Financial Instruments and Hedging Activities

## Derivative Financial Instruments

The Company has derivative financial instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instrument, is reflected on the Company's balance sheet as other assets or other liabilities.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to any derivative agreement. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations. The Company deals only with primary dealers.

Derivative instruments are generally either negotiated OTC contracts or standardized contracts executed on a recognized exchange. Negotiated OTC derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

## Risk Management Policies – Hedging Instruments

The primary focus of the Company's asset/liability management program is to monitor the sensitivity of the Company's net portfolio value and net income under varying interest rate scenarios to take steps to control its risks. On a quarterly basis, the Company evaluates the effectiveness of entering into any derivative agreement by measuring the cost of such an agreement in relation to the reduction in net portfolio value and net income volatility within an assumed range of interest rates.

## Interest Rate Risk Management – Cash Flow Hedging Instruments

The Company has variable rate debt as a source of funds for use in the Company's lending and investment activities and for other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore hedges its variable-rate interest payments. To meet this objective, management enters into interest rate swap agreements whereby the Company receives variable interest rate payments and makes fixed interest rate payments during the contract period.

During the three months ended March 31, 2018, the Company received variable rate London Interbank Offered Rate ("LIBOR") payments from and paid fixed rates in accordance with its interest rate swap agreements. A summary of the Company's outstanding interest rate swap agreements used to hedge variable rate debt at March 31, 2018 and 2017, respectively is as follows:

| (In thousands, except percentages and years) | For the three months<br>ended March 31, |          |   |  |
|--|---|----------|---|--|
|  | 2018                                    | 2017     |   |  |
| Notional amount                              | \$60,000                                | \$60,000 |   |  |
| Weighted average pay rate                    | 1.26                                    | % 1.26   | % |  |
| Weighted average receive rate                | 1.39                                    | % 0.97   | % |  |

|   |       |      |
|---|-------|------|
| Weighted average maturity in years              | 2.74  | 3.61 |
| Unrealized gain relating to interest rate swaps | \$583 | \$81 |

At March 31, 2018 and 2017, the unrealized gain relating to interest rate swaps was recorded as a derivative asset. Changes in the fair value of the interest rate swaps designated as hedging instruments of the variability of cash flows associated with long-term debt are reported in other comprehensive income.

## NOTE 12. Employee Benefit Plans

## Stock Option Plans

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. Transactions under the Company's stock option plans for the three months ended March 31, 2018 are summarized in the following table:

|                                  | Shares    | Weighted average exercise price | Weighted average remaining contractual life in years | Aggregate intrinsic value |
|----------------------------------|-----------|---------------------------------|--|---------------------------|
| Outstanding at December 31, 2017 | 504,573   | \$ 8.31                         | 5.7  | \$5,772,843               |
| Options granted                  | 114,500   | 20.24                           |  |                           |
| Options exercised                | (55,007 ) | 5.28                            |  |                           |
| Options forfeited                | (4,433 )  | 12.57                           |  |                           |
| Options expired                  | —         | —                               |  |                           |
| Outstanding at March 31, 2018    | 559,633   | \$ 11.01                        | 6.7  | \$6,148,159               |
| Exercisable at March 31, 2018    | 357,672   | \$ 7.52                         | 5.3  | \$5,179,996               |

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of March 31, 2018, 2,462,585 shares have been reserved for issuance upon the exercise of options, 559,633 option grants are outstanding, and 1,630,647 option grants have been exercised, forfeited or expired, leaving 272,305 shares available for grant.

The fair values of the options granted during the three months ended March 31, 2018 and 2017 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

|  | For the three months ended March 31, |          |
|--|--------------------------------------|----------|
|  | 2018                                 | 2017     |
| Number of options granted              | 114,500                              | 47,100   |
| Weighted average exercise price        | \$20.24                              | \$ 16.37 |
| Weighted average fair value of options | \$5.97                               | \$ 4.64  |
| Expected life in years (1)             | 6.34977168056M26D                    |          |
| Expected volatility (2)                | 26.40 %                              | 28.12 %  |
| Risk-free interest rate (3)            | 2.48 %                               | 2.18 %   |
| Dividend yield (4)                     | 1.14 %                               | 1.15 %   |

(1) The expected life of the options was estimated based on historical employee behavior and represents the period of time that options granted are expected to be outstanding.

(2) The expected volatility of the Company's stock price was based on the historical volatility over the period commensurate with the expected life of the options.

(3) The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant.

(4) The expected dividend yield is the projected annual yield based on the grant date stock price.

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options. The following table presents information about options exercised during the three months ended March 31, 2018 and 2017:



|  | For the three<br>months ended<br>March 31, |           |
|--|--|-----------|
|  | 2018                                       | 2017      |
| Number of options exercised                | 55,007                                     | 17,064    |
| Total intrinsic value of options exercised | \$825,653                                  | \$147,690 |
| Cash received from options exercised       | \$290,357                                  | \$134,955 |
| Tax deduction realized from options        | \$232,091                                  | \$60,331  |

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The following table summarizes information about stock options outstanding and exercisable at March 31, 2018:

| Range of exercise prices | Options outstanding |                  |                                       | Weighted average exercise price | Options exercisable |                                 |
|--------------------------|---------------------|------------------|---------------------------------------|---------------------------------|---------------------|---------------------------------|
|                          | Options outstanding | Weighted average | remaining contractual life (in years) |                                 | Options exercisable | Weighted average exercise price |
| \$0.00 - 4.00            | 39,600              | 1.0              |                                       | \$ 3.55                         | 39,600              | \$ 3.55                         |
| 4.01 - 8.00              | 177,100             | 4.5              |                                       | 6.16                            | 177,100             | 6.16                            |
| 8.01 - 12.00             | 154,367             | 7.5              |                                       | 9.41                            | 116,963             | 9.24                            |
| 12.01 - 16.00            | 44,066              | 8.7              |                                       | 14.96                           | 14,007              | 14.93                           |
| 16.01 - 20.00            | 104,500             | 9.5              |                                       | 18.89                           | 10,002              | 16.75                           |
| 20.01 - 24.00            | 40,000              | 10.0             |                                       | 21.15                           | —                   | —                               |
| Total                    | 559,633             | 6.7              |                                       | \$ 11.01                        | 357,672             | \$ 7.52                         |

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options and the related income tax benefit for the three months ended March 31, 2018 and 2017 are detailed in the following table:

|                      | For the three months ended March 31, |          |
|----------------------|--------------------------------------|----------|
|                      | 2018                                 | 2017     |
| Compensation expense | \$123,460                            | \$69,817 |
| Income tax benefit   | \$34,705                             | \$28,520 |

As of March 31, 2018, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately \$945 thousand. That cost is expected to be recognized over a weighted average period of 2.4 years.

#### Restricted Stock Awards

Restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. The following table summarizes nonvested restricted stock activity for the three months ended March 31, 2018:

|   | Shares    | Average grant date fair value |
|---|-----------|-------------------------------|
| Nonvested restricted stock at December 31, 2017 | 94,003    | \$ 12.53                      |
| Granted   | 38,300    | 20.64                         |
| Cancelled                                       | —         | —                             |
| Vested  | (28,866 ) | 11.34                         |
| Nonvested restricted stock at March 31, 2018    | 103,437   | \$ 15.86                      |

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into

salary expense on a straight line basis over the vesting period. As of March 31, 2018, 518,157 shares of restricted stock were reserved for issuance, of which 73,104 shares are available for grant.

Restricted stock awards granted during the three months ended March 31, 2018 and 2017 were as follows:

|                               | For the three<br>months ended<br>March 31, |          |
|-------------------------------|--|----------|
|                               | 2018                                       | 2017     |
| Number of shares granted      | 38,300                                     | 38,400   |
| Average grant date fair value | \$ 20.64                                   | \$ 16.36 |

Compensation expense related to restricted stock for the three months ended March 31, 2018 and 2017 is detailed in the following table:

|                      | For the three<br>months ended<br>March 31, |            |
|----------------------|--|------------|
|                      | 2018                                       | 2017       |
| Compensation expense | \$ 141,297                                 | \$ 141,804 |
| Income tax benefit   | \$ 39,719                                  | \$ 57,927  |

As of March 31, 2018, there was approximately \$1.5 million of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 3.1 years.

#### 401(k) Savings Plan

The Bank has a 401(k) savings plan covering substantially all employees. Under the Plan, an employee can contribute up to 80 percent of their salary on a tax deferred basis. The Bank may also make discretionary contributions to the Plan. The Bank contributed \$136 thousand and \$119 thousand to the Plan during the three months ended March 31, 2018 and 2017, respectively.

#### Deferred Fee Plan

The Company has a deferred fee plan for Directors and executive management. Directors of the Company have the option to elect to defer up to 100 percent of their respective retainer and Board of Director fees, and each member of executive management has the option to elect to defer up to 100 percent of their year end cash bonuses. Director and executive deferred fees totaled \$250 thousand and \$120 thousand during the three months ended March 31, 2018 and 2017, respectively. The interest paid on the deferred balances totaled \$15 thousand and \$10 thousand during the three months ended March 31, 2018 and 2017, respectively. The fees distributed on the deferred balances totaled \$3 thousand in 2018. No fees were distributed in 2017.

#### Benefit Plans

In addition to the 401(k) savings plan which covers substantially all employees, in 2015 the Company established an unfunded supplemental defined benefit plan to provide additional retirement benefits for the President and Chief Executive Officer ("CEO") and certain key executives.

On June 4, 2015, the Company approved the Supplemental Executive Retirement Plan ("SERP") pursuant to which the President and CEO is entitled to receive certain supplemental nonqualified retirement benefits. On November 21, 2016 the Company approved a change in calculation of the Retirement Benefit payable under the Plan so that the Retirement Benefit shall be an amount equal to forty percent (40%) of the average of Executive's base salary for the thirty-six (36) months immediately preceding executive's separation from service after age 66, adjusted annually thereafter by two 2 percent. The total benefit is to be made payable in fifteen annual installments. The future payments are estimated to total \$3.4 million. A discount rate of 4.00% was used to calculate the present value of the benefit obligation.

The President and CEO commenced vesting in this retirement benefit on January 1, 2014, and vests an additional 3 percent each year until fully vested on January 1, 2024. In the event that the President and CEO's separation from service from the company were to occur prior to full vesting, the President and CEO would be entitled to and shall be paid the vested portion of the retirement benefit calculated as of the date of separation from service. Notwithstanding the foregoing, upon a Change in Control, and provided that within 6 months following the Change in Control the President and CEO is involuntarily terminated for reasons other than "cause" or the President and CEO resigns for "good reason," as such is defined in the SERP, or the President and CEO voluntarily terminates his employment after being

offered continued employment in a position that is not a “Comparable Position,” as such is also defined in the SERP, the President and CEO shall become one hundred percent 100% vested in the full retirement benefit.

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No contributions or payments have been made during the three months ended March 31, 2018. The following table summarizes the components of the net periodic pension cost of the defined benefit plan recognized during the three months ended March 31, 2018 and 2017:

|                                    | For the<br>three<br>months<br>ended<br>March 31, |       |
|------------------------------------|--|-------|
| (In thousands)                     | 2018   | 2017  |
| Service cost                       | \$ 112   | \$ 16 |
| Interest cost                      | 13   | 10    |
| Amortization of prior service cost | 21   | 21    |
| Net periodic benefit cost          | \$ 146   | \$ 47 |

The following table summarizes the changes in benefit obligations of the defined benefit plan during the three months ended March 31, 2018 and 2017:

|                                       | For the three<br>months ended<br>March 31, |          |
|---------------------------------------|--|----------|
| (In thousands)                        | 2018                                       | 2017     |
| Benefit obligation, beginning of year | \$ 1,187                                   | \$ 1,023 |
| Service cost                          | 112  | 16       |
| Interest cost                         | 13   | 10       |
| Benefit obligation, end of period     | \$ 1,312                                   | \$ 1,049 |

On October 22, 2015, the Company entered into an Executive Incentive Retirement Plan (the "Plan") with certain key executive officers. The Plan has an effective date of January 1, 2015.

The Plan is an unfunded, nonqualified deferred compensation plan. For any Plan Year, a guaranteed annual Deferral Award percentage of seven and one half percent (7.5%) of the participant's annual base salary will be credited to each Participant's Deferred Benefit Account. A discretionary annual Deferral Award equal to seven and one half percent (7.5%) of the participant's annual base salary may be credited to the Participant's account in addition to the guaranteed Deferral Award, if the Bank exceeds the benchmarks set forth in the Annual Executive Bonus Matrix. The total Deferral Award shall never exceed fifteen percent (15%) of the participant's base salary for any given Plan Year.

Each Participant shall be one hundred percent 100% vested in all Deferral Awards as of the date they are awarded. As of March 31, 2018, the Company had total year to date expenses of \$21 thousand related to the Plan. The Plan is reflected on the Company's balance sheet as accrued expenses.

Certain members of management are also enrolled in a split-dollar life insurance plan with a post retirement death benefit of \$250 thousand. Total expenses related to this plan were \$1 thousand for the three months ended March 31, 2018 and 2017.

### 13. Regulatory Capital

A significant measure of the strength of a financial institution is its capital base. Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for common stock, qualifying preferred stock and certain qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, subject to limitations, certain qualifying long-term debt, preferred stock and hybrid instruments, which do not qualify for tier 1 capital. The Parent Company and its subsidiary Bank are subject to various regulatory capital requirements administered by banking regulators. Quantitative measures of capital adequacy include the leverage ratio (tier 1 capital as a percentage of tangible assets), tier 1 risk-based capital ratio (tier 1 capital as a percent of risk-weighted assets), total risk-based capital ratio (total risk-based capital as a percent of total risk-weighted assets), and common equity tier 1 capital ratio.

Minimum capital levels are regulated by risk-based capital adequacy guidelines, which require the Company and the Bank to maintain certain capital as a percentage of assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-weighted assets). Failure to meet minimum capital requirements can initiate certain mandatory and possibly discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action applicable to banks, the Company and the Bank must meet specific capital guidelines. Prompt corrective action provisions are not applicable to bank holding companies.

In September 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, adopted Basel III, which constitutes a set of capital reform measures designed to strengthen the regulation, supervision and risk management of banking organizations worldwide. In order to implement Basel III and certain additional capital changes required by the Dodd-Frank Act, the FDIC approved, as an interim final rule in July 2013, the regulatory capital requirements substantially similar to final rules issued by the Board of Governors of the Federal Reserve System ("Federal Reserve") for U.S. state nonmember banks and the Office of the Comptroller of the Currency for national banks.

The interim final rule includes new risk-based capital and leverage ratios that will be phased-in from 2015 to 2019 for most state nonmember banks. The rule includes a new common equity Tier 1 capital ("CET1") to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets, which is in addition to the Tier 1 and Total risk-based capital requirements. The interim final rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and requires a minimum leverage ratio of 4.0%. The required minimum ratio of total capital to risk-weighted assets will remain 8.0%. The new risk-based capital requirements (except for the capital conservation buffer) became effective for the Company and the Bank on January 1, 2015.

The new rules also include a one-time opportunity to opt-out of the changes to treatment of accumulated other comprehensive income ("AOCI") components. By making the election to opt-out, the institution may continue treating AOCI items in a manner consistent with risk-based capital rules in place prior to January 2015. The Bank and the Company have made the election to opt out of the treatment of AOCI on the appropriate March 31, 2015 filings.

The following table summarizes the Company's and the Bank's regulatory capital ratios at March 31, 2018 and December 31, 2017, as well as the minimum regulatory capital ratios required for the Bank to be deemed "well-capitalized."

|                                 | At March 31,<br>2018 |         | Required for<br>capital<br>adequacy purposes<br>effective |                        | To be<br>well-capitalized<br>under prompt<br>corrective action<br>regulations |   |
|---------------------------------|----------------------|---------|---|------------------------|---|---|
|                                 | Company              | Bank    | January<br>1, 2018  | January<br>1, 2019     | Bank  |   |
| Leverage ratio                  | 9.46 %               | 9.12 %  | 4.000 %   | 4.00 %                 | 5.00  | % |
| CET1                            | 11.14 %              | 11.60 % | 6.375 % <sup>(1)</sup>                                    | 7.00 % <sup>(2)</sup>  | 6.50  | % |
| Tier I risk-based capital ratio | 12.07 %              | 11.60 % | 7.875 % <sup>(1)</sup>                                    | 8.50 % <sup>(2)</sup>  | 8.00  | % |
| Total risk-based capital ratio  | 13.24 %              | 12.81 % | 9.875 % <sup>(1)</sup>                                    | 10.50 % <sup>(2)</sup> | 10.00   | % |

(1) Includes 1.875% capital conservation buffer.

(2) Includes 2.5% capital conservation buffer.

|  | At December 31,<br>2017 | Required for<br>capital | To be<br>well-capitalized |
|--|-------------------------|-------------------------|---------------------------|
|--|-------------------------|-------------------------|---------------------------|

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|                                 | adequacy purposes<br>effective |         | under prompt<br>corrective action<br>regulations |                        |         |
|---------------------------------|--------------------------------|---------|--|------------------------|---------|
|                                 | Company                        | Bank    | January<br>1, 2017                               | January<br>1, 2019     | Bank    |
| Leverage ratio                  | 9.37 %                         | 9.03 %  | 4.00%  | 4.00 %                 | 5.00 %  |
| CET1                            | 10.81 %                        | 11.33 % | 5.750 % <sup>(3)</sup>                           | 7.00 % <sup>(4)</sup>  | 6.50 %  |
| Tier I risk-based capital ratio | 11.75 %                        | 11.33 % | 7.250 % <sup>(3)</sup>                           | 8.50 % <sup>(4)</sup>  | 8.00 %  |
| Total risk-based capital ratio  | 12.87 %                        | 12.50 % | 9.250 % <sup>(3)</sup>                           | 10.50 % <sup>(4)</sup> | 10.00 % |

(3) Includes 1.25% capital conservation buffer.

(4) Includes 2.5% capital conservation buffer.

## ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2017 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain “forward looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as “believe”, “expect”, “anticipate”, “should”, “planned”, “estimated” “potential”. Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, in addition to those items contained in the Company’s Annual Report on Form 10-K under Item IA-Risk Factors, as updated by our subsequent Quarterly Reports on Form 10-Q, the following: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc.’s interest rate spread or other income anticipated from operations and investments.

### Overview

Unity Bancorp, Inc. (the “Parent Company”) is a bank holding company incorporated in New Jersey and registered under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the “Bank” or, when consolidated with the Parent Company, the “Company”) is chartered by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through the internet and its eighteen branch offices located in Bergen, Hunterdon, Middlesex, Somerset, Union and Warren counties in New Jersey, and Northampton County in Pennsylvania as well as a loan production office in Bergen County, New Jersey. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, SBA and other commercial credits. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and OREO properties.

The Company has two other wholly-owned subsidiaries: Unity (NJ) Statutory Trust II and Unity Risk Management, Inc. On July 24, 2006, the Trust issued \$10.0 million of trust preferred securities to investors. These floating rate securities are treated as subordinated debentures on the Company’s financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes, subject to certain limitations. Unity Risk Management, Inc. is the Company's captive insurance company that insures risks to the Bank not covered by the traditional commercial insurance market. The Company does not consolidate the accounts and related activity of Unity (NJ) Statutory Trust II, but it does consolidate the accounts of Unity Risk Management, Inc.



## Earnings Summary

Net income totaled \$5.2 million, or \$0.48 per diluted share for the quarter ended March 31, 2018, compared to \$3.2 million, or \$0.30 per diluted share for the same period a year ago. Return on average assets and average common equity for the quarter were 1.53% and 17.69%, respectively, compared to 1.07 % and 12.02% for the same period a year ago.

First quarter highlights include:

Net interest income increased 23.9% compared to the prior year's quarter due to strong loan growth and the increase in interest rate environment.

Net interest margin equaled 3.99% this quarter compared to 3.70% in the prior years' quarter. Higher yields on our earning assets such as loans offset the rising costs of deposits.

Noninterest income increased 3.7% compared to the prior year's quarter due to increased loan payoff fees, gains on the sales of SBA loans and bank owned life insurance ("BOLI") income.

Noninterest expense increased 10.1% compared to the prior year's quarter due to growth of our retail branch and lending networks.

The effective tax rate declined to 19.1% as a result of the "Tax Cuts and Jobs Act," which was enacted December 22, 2017 and lowered the corporate tax rate.

Residential mortgage, consumer and commercial loans increased 4.3%, 3.1% and 1.3%, respectively, while total loans increased 2.1% since year end 2017.

Time, noninterest-bearing demand and savings deposits rose 24.7%, 3.6% and 2.9%, respectively, while total deposits increased 7.1% since year-end 2017.

The Company's quarterly performance ratios may be found in the table below.

|   | For the three<br>months ended<br>March 31, |         |
|---|--|---------|
|   | 2018                                       | 2017    |
| Net income per common share - Basic (1)   | \$0.49                                     | \$0.30  |
| Net income per common share - Diluted (2) | \$0.48                                     | \$0.30  |
| Return on average assets                  | 1.53 %                                     | 1.07 %  |
| Return on average equity (3)              | 17.69 %                                    | 12.02 % |
| Efficiency ratio (4)                      | 54.00 %                                    | 59.08 % |

(1) Defined as net income divided by weighted average shares outstanding.

(2) Defined as net income divided by the sum of the weighted average shares and the potential dilutive impact of the exercise of outstanding options.

(3) Defined as net income divided by average shareholders' equity.

(4) Defined as noninterest expense divided by the sum of the net interest income plus noninterest income less any gains or losses on securities.

## Net Interest Income

The primary source of the Company's operating income is net interest income, which is the difference between interest and dividends earned on earning assets and fees earned on loans, and interest paid on interest-bearing liabilities. Earning assets include loans to individuals and businesses, investment securities, interest-earning deposits and federal funds sold. Interest-bearing liabilities include interest-bearing demand, savings and time deposits, FHLB advances and other borrowings. Net interest income is determined by the difference between the yields earned on earning assets and the rates paid on interest-bearing liabilities ("net interest spread") and the relative amounts of earning assets and interest-bearing liabilities. The Company's net interest spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand, deposit flows and general levels of nonperforming

assets.

During the quarter ended March 31, 2018, tax-equivalent net interest income amounted to \$12.9 million, an increase of \$2.5 million or 23.7 percent when compared to the same period in 2017. The net interest margin increased 29 basis points to 3.99 percent for the quarter ended March 31, 2018, compared to 3.70 percent for the same period in 2017. The net interest spread was 3.73 percent for the first quarter of 2018, a 27 basis point increase compared to the same period in 2017. This was due to strong loan growth, the rising interest rate environment and a stable cost of funds.

During the quarter ended March 31, 2018, tax-equivalent interest income was \$15.6 million, an increase of \$3.0 million or 24.0 percent when compared to the same period in the prior year. This increase was mainly driven by the increase in the balance of average loans, partially offset by a decrease in the balance of average securities, federal funds sold, interest-bearing deposits and repos.

Of the \$3.0 million net increase in interest income on a tax-equivalent basis, \$2.4 million of the increase was due to increased average earning assets, and \$678 thousand was due to increased yields on the earning assets.

The average volume of interest-earning assets increased \$166.0 million to \$1.3 billion for the first quarter of 2018 compared to \$1.1 billion for the same period in 2017. This was due primarily to a \$194.8 million increase in average loans, primarily commercial, residential mortgage and consumer loans, partially offset by a \$29.0 million decrease in federal funds sold, interest-bearing deposits and repos and a \$1.8 million decrease in investment securities.

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The yield on total interest-earning assets increased 37 basis points to 4.85 percent for the three months ended March 31, 2018 when compared to the same period in 2017. The yield on the loan portfolio increased 21 basis points to 5.07 percent.

Total interest expense was \$2.8 million for the three months ended March 31, 2018, an increase of \$564 thousand or 25.6 percent compared to the same period in 2017. This increase was driven by the increased rate and volume of interest-bearing deposits and the increased volume of borrowed funds and subordinated debentures, partially offset by the decreased rate on the borrowed funds and subordinated debentures compared to a year ago:

Of the \$564 thousand increase in interest expense, \$278 thousand was due to increased rates on interest-bearing deposits, \$204 thousand was due to an increase in the volume of borrowed funds and subordinated debentures and \$182 thousand was due to an increase in the volume of interest-bearing deposits, partially offset by \$100 thousand due to reduced rates paid on borrowed funds and subordinated debentures.

Interest-bearing liabilities averaged \$1.0 billion for the first quarter of 2018, an increase of \$122.4 million or 13.9 percent compared to the prior year's quarter. The increase in interest-bearing liabilities was due to an increase in interest-bearing deposits and borrowed funds and subordinated debentures.

The average cost of total interest-bearing liabilities increased 10 basis points to 1.12 percent. While the cost of interest-bearing deposits increased 14 basis points to 0.97 percent for the first quarter of 2018, the cost of borrowed funds and subordinated debentures decreased 29 basis points to 1.86 percent due to the use of derivative instruments to hedge interest risk. The increase in the cost of deposits was primarily driven by a promotional savings and time product.

The following table reflects the components of net interest income, setting forth for the periods presented herein: (1) average assets, liabilities and shareholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) net interest spread, and (5) net interest income/margin on average earning assets. Rates/Yields are computed on a fully tax-equivalent basis, assuming a federal income tax rate of 21 percent in 2018 and 35 percent in 2017.

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Consolidated Average Balance Sheets

(Dollar amounts in thousands, interest amounts and interest rates/yields on a fully tax-equivalent basis)

|   | For the three months ended |          |            |                 |          |            |
|---|----------------------------|----------|------------|-----------------|----------|------------|
|   | March 31, 2018             |          |            | March 31, 2017  |          |            |
|   | Average Balance            | Interest | Rate/Yield | Average Balance | Interest | Rate/Yield |
| <b>ASSETS</b>   |                            |          |            |                 |          |            |
| Interest-earning assets:                                |                            |          |            |                 |          |            |
| Federal funds sold, interest-bearing deposits and repos | \$48,936                   | \$205    | 1.70       | %\$77,943       | \$129    | 0.67 %     |
| FHLB stock  | 7,799                      | 134      | 6.97       | 5,776           | 93       | 6.53       |
| Securities:   |                            |          |            |                 |          |            |
| Taxable   | 63,393                     | 492      | 3.15       | 64,148          | 491      | 3.10       |
| Tax-exempt  | 5,349                      | 38       | 2.88       | 6,443           | 67       | 4.22       |
| Total securities (A)                                    | 68,742                     | 530      | 3.13       | 70,591          | 558      | 3.21       |
| Loans:  |                            |          |            |                 |          |            |
| SBA loans   | 68,376                     | 1,183    | 7.02       | 57,960          | 854      | 5.98       |
| SBA 504 loans   | 21,689                     | 274      | 5.12       | 26,050          | 301      | 4.69       |
| Commercial loans  | 610,720                    | 7,452    | 4.95       | 512,543         | 6,166    | 4.88       |
| Residential mortgage loans                              | 371,061                    | 4,340    | 4.74       | 297,203         | 3,384    | 4.62       |
| Consumer loans  | 110,947                    | 1,529    | 5.59       | 94,217          | 1,132    | 4.87       |
| Total loans (B)   | 1,182,793                  | 14,778   | 5.07       | 987,973         | 11,837   | 4.86       |
| Total interest-earning assets                           | \$1,308,270                | \$15,647 | 4.85       | %\$1,142,283    | \$12,617 | 4.48 %     |
| Noninterest-earning assets:                             |                            |          |            |                 |          |            |
| Cash and due from banks                                 | 23,244                     |          |            | 23,578          |          |            |
| Allowance for loan losses                               | (13,949 )                  |          |            | (12,785 )       |          |            |
| Other assets  | 65,686                     |          |            | 55,493          |          |            |
| Total noninterest-earning assets                        | 74,981                     |          |            | 66,286          |          |            |
| Total assets  | \$1,383,251                |          |            | \$1,208,569     |          |            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>             |                            |          |            |                 |          |            |
| Interest-bearing liabilities:                           |                            |          |            |                 |          |            |
| Total interest-bearing demand deposits                  | \$178,385                  | \$224    | 0.51       | %\$152,392      | \$153    | 0.41 %     |
| Total savings deposits                                  | 403,222                    | 776      | 0.78       | 378,439         | 583      | 0.62       |
| Total time deposits                                     | 252,000                    | 1,000    | 1.61       | 222,307         | 804      | 1.47       |
| Total interest-bearing deposits                         | 833,607                    | 2,000    | 0.97       | 753,138         | 1,540    | 0.83       |
| Borrowed funds and subordinated debentures              | 167,458                    | 768      | 1.86       | 125,499         | 664      | 2.15       |
| Total interest-bearing liabilities                      | \$1,001,065                | \$2,768  | 1.12       | %\$878,637      | \$2,204  | 1.02 %     |
| Noninterest-bearing liabilities:                        |                            |          |            |                 |          |            |
| Noninterest-bearing demand deposits                     | 252,128                    |          |            | 215,405         |          |            |
| Other liabilities                                       | 10,165                     |          |            | 6,792           |          |            |
| Total noninterest-bearing liabilities                   | 262,293                    |          |            | 222,197         |          |            |
| Total shareholders' equity                              | 119,893                    |          |            | 107,735         |          |            |
| Total liabilities and shareholders' equity              | \$1,383,251                |          |            | \$1,208,569     |          |            |
| Net interest spread                                     |                            |          |            |                 |          |            |
|   |                            | \$12,879 | 3.73 %     |                 | \$10,413 | 3.46 %     |
| Tax-equivalent basis adjustment                         |                            |          |            |                 |          |            |
|   |                            | (7 )     |            |                 | (23 )    |            |
| Net interest income                                     |                            |          |            |                 |          |            |
|   |                            | \$12,872 |            |                 | \$10,390 |            |

|                     |      |   |      |   |
|---------------------|------|---|------|---|
| Net interest margin | 3.99 | % | 3.70 | % |
|---------------------|------|---|------|---|

Yields related to securities exempt from federal and state income taxes are stated on a fully tax-equivalent (A) basis. They are reduced by the nondeductible portion of interest expense, assuming a federal tax rate of 21 percent in 2018 and 35 percent in 2017, as well as all applicable state rates.

(B) The loan averages are stated net of unearned income, and the averages include loans on which the accrual of interest has been discontinued.

The rate volume table below presents an analysis of the impact on interest income and expense resulting from changes in average volume and rates over the periods presented. Changes that are not due to volume or rate variances have been allocated proportionally to both, based on their relative absolute values. Amounts have been computed on a tax-equivalent basis, assuming a federal income tax rate of 21 percent in 2018 and 35 percent in 2017.

| (In thousands on a tax-equivalent basis)                | For the three months<br>ended March 31, 2018<br>versus March 31, 2017<br>Increase (decrease) due<br>to change in: |        |         |
|---|---|--------|---------|
|   | Volume  | Rate   | Net     |
| Interest income:  |   |        |         |
| Federal funds sold, interest-bearing deposits and repos | \$(62 )   | \$138  | \$76    |
| FHLB stock  | 35  | 6      | 41      |
| Securities  | (16 )   | (12 )  | (28 )   |
| Loans   | 2,395   | 546    | 2,941   |
| Total interest income                                   | \$2,352   | \$678  | \$3,030 |
| Interest expense:                                       |   |        |         |
| Demand deposits   | \$29  | \$42   | \$71    |
| Savings deposits  | 39  | 154    | 193     |
| Time deposits   | 114   | 82     | 196     |
| Total interest-bearing deposits                         | 182   | 278    | 460     |
| Borrowed funds and subordinated debentures              | 204   | (100 ) | 104     |
| Total interest expense                                  | 386   | 178    | 564     |
| Net interest income - fully tax-equivalent              | \$1,966   | \$500  | \$2,466 |
| Decrease in tax-equivalent adjustment                   |   |        | 16      |
| Net interest income                                     |   |        | \$2,482 |

#### Provision for Loan Losses

The provision for loan losses totaled \$500 thousand for the three months ended March 31, 2018, compared to \$250 thousand for the three months ended March 31, 2017. Each period's loan loss provision is the result of management's analysis of the loan portfolio and reflects changes in the size and composition of the portfolio, the level of net charge-offs, delinquencies, current economic conditions and other internal and external factors impacting the risk within the loan portfolio. Additional information may be found under the captions "Financial Condition - Asset Quality" and "Financial Condition - Allowance for Loan Losses and Reserve for Unfunded Loan Commitments." The current provision is considered appropriate under management's assessment of the adequacy of the allowance for loan losses.

#### Noninterest Income

The following table shows the components of noninterest income for the three months ended March 31, 2018 and 2017:

| (In thousands)              | For the three<br>months ended<br>March 31, |       |
|-----------------------------|--|-------|
|                             | 2018                                       | 2017  |
| Branch fee income           | \$330                                      | \$331 |
| Service and loan fee income | 564  | 512   |

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|  |         |         |
|--|---------|---------|
| Gain on sale of SBA loans held for sale, net | 547     | 485     |
| Gain on sale of mortgage loans, net          | 424     | 532     |
| BOLI income                                  | 171     | 88      |
| Net security losses                          | (15 )   | —       |
| Other income                                 | 265     | 256     |
| Total noninterest income                     | \$2,286 | \$2,204 |

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For the three months ended March 31, 2018, noninterest income increased \$82 thousand to \$2.3 million, compared to the same period last year. Quarterly noninterest income increased primarily due to higher service and loan fee income, gains on the sale of SBA loans and bank owned life insurance ("BOLI") income.

Changes in our noninterest income for the three months ended March 31, 2018 vs. 2017 reflect:

Branch fee income remained relatively flat for the three months ended March 31, 2018 when compared to the same period in the prior year.

Service and loan fee income increased primarily due to higher loan payoff fees.

SBA loan sales during the first quarter of 2018 totaled \$5.8 million with a net gain of \$547 thousand, compared to \$6.0 million in sales with a net gain of \$485 thousand in the prior year's quarter.

During the quarter, \$20.1 million in residential mortgage loans were sold at a gain of \$424 thousand, compared to \$25.7 million in loans sold at a gain of \$532 thousand during the prior year's quarter. Residential mortgage loans are sold as a tool to manage liquidity needs within the bank.

Bank owned life insurance ("BOLI") income increased \$83 thousand for the three months ended March 31, 2018 when compared to the same period in the prior year primarily due to the purchase of a \$10.0 million Separate Account BOLI policy.

There were no gains on the sale of securities for the three months ended March 31, 2018 or 2017. Due to the adoption of ASU 2016-01 in January of 2018, there was a \$15 thousand adjustment to net income in the first quarter of 2018 resulting from unrealized losses on equity securities.

Other income increased in the quarterly period primarily due to increased service charges on Visa check cards.

#### Noninterest Expense

The following table presents a breakdown of noninterest expense for the three months ended March 31, 2018 and 2017:

| (In thousands)                    | For the three months ended |         |
|-----------------------------------|----------------------------|---------|
|                                   | 2018                       | 2017    |
| Compensation and benefits         | \$4,834                    | \$4,095 |
| Occupancy                         | 690                        | 600     |
| Processing and communications     | 689                        | 604     |
| Furniture and equipment           | 536                        | 511     |
| Professional services             | 251                        | 226     |
| Loan collection and OREO expenses | 6                          | 341     |
| Other loan expenses               | 33                         | 83      |
| Deposit insurance                 | 186                        | 76      |
| Advertising                       | 319                        | 236     |
| Director fees                     | 162                        | 197     |
| Other expenses                    | 488                        | 471     |
| Total noninterest expense         | \$8,194                    | \$7,440 |

Noninterest expense increased \$754 thousand to \$8.2 million for the three months ended March 31, 2018.

Changes in noninterest expense for the three months ended March 31, 2018 versus 2017 reflect:

Compensation and benefits expense, the largest component of noninterest expense, increased \$739 thousand for the three months ended March 31, 2018, when compared to 2017. Expenses have risen as we expanded our branch network, lending and support staff. This additional headcount has resulted in higher salary, commission and benefit expenses such as medical insurance, retirement and 401(k) plan benefits.



Due to expansion, occupancy expense increased \$90 thousand for the three months ended March 31, 2018. Rental and utilities expense as well as seasonal snow removal also increased compared to the same period last year.

Processing and communications expenses increased \$85 thousand for the three months ended March 31, 2018, primarily due to increased armored car expense from the addition of new branches.

Furniture and equipment expense increased \$25 thousand during the first quarter of 2018, primarily due to investment in our technology infrastructure through equipment, network and software upgrades that will improve our efficiency and help to keep our data secure.

Professional service fees increased \$25 thousand for the three months ended March 30, 2018, primarily due to higher legal expenses.

Loan collection and OREO costs decreased \$335 thousand compared to the prior year's quarter due to a loss of \$253 thousand on the sale of an OREO property in the first quarter of 2017.

Other loan expenses decreased \$50 thousand for the three months ended March 31, 2018, compared to the prior year's quarter, primarily due to a decrease in loan appraisal expenses.

Deposit insurance expense increased \$110 thousand for the three months ended March 31, 2018.

Advertising expense increased \$83 thousand compared to the prior year's quarter in support of our retail and lending staff as well as branch expansions and retail promotions.

Director fees decreased \$35 thousand for the three months ended March 31, 2018.

Other expenses increased \$17 thousand for the three months ended March 31, 2018, primarily due to higher officer and employee training expenses.

### Income Tax Expense

For the quarter ended March 31, 2018, the Company reported income tax expense of \$1.2 million for an effective tax rate of 19.1 percent, compared to income tax expense of \$1.7 million and an effective tax rate of 34.9 percent for the prior year's quarter. The decrease in the effective tax rate was due to the "Tax Cuts and Jobs Act", which lowered the corporate tax rate from 35% to 21% starting in 2018. For additional information on income taxes, see Note 4 to the Consolidated Financial Statements.

### Financial Condition at March 31, 2018

Total assets decreased \$15.6 million or 1.1 percent, to \$1.4 billion at March 31, 2018, when compared to year end 2017. This decrease was due to decreases of \$34.0 million in cash and cash equivalents and \$2.3 million in securities, partially offset by an increase of \$23.8 million in net loans.

Total deposits increased \$74.4 million, due to increases of \$55.6 million in time deposits, \$11.7 million in savings deposits and \$9.2 million in noninterest-bearing demand deposits, partially offset by a decrease of \$2.1 million in interest-bearing demand deposits. Borrowed funds decreased \$94.0 million due to a reduction in overnight borrowings.

Total shareholders' equity increased \$5.0 million over year end 2017, primarily due to earnings and an increase in common stock, partially offset by dividends paid during the three months ended March 31, 2018.

These fluctuations are discussed in further detail in the paragraphs that follow.

### Securities Portfolio

The Company's securities portfolio consists of AFS, HTM and equity investments. Management determines the appropriate security classification of AFS and HTM at the time of purchase. The investment securities portfolio is maintained for asset-liability management purposes, as well as for liquidity and earnings purposes.

AFS securities are investments carried at fair value that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk, to take advantage of market conditions that create economically attractive returns and as an additional source of earnings. AFS securities consist primarily of obligations of U.S. Government sponsored entities, obligations of state and political subdivisions, mortgage-backed securities, and corporate and other securities.

AFS securities totaled \$50.2 million at March 31, 2018, a decrease of \$2.1 million or 4.0 percent, compared to \$52.3 million at December 31, 2017. This net decrease was the result of:

\$1.3 million in principal payments and maturities,

\$806 thousand of depreciation in the market value of the portfolio. At March 31, 2018, the portfolio had a net unrealized loss of \$1.3 million compared to a net unrealized loss of \$476 thousand at December 31, 2017. These net unrealized losses are reflected net of tax in net income, and

\$46 thousand in net amortization of premiums.

The weighted average life of AFS securities, adjusted for prepayments, amounted to 6.2 years at March 31, 2018 and December 31, 2017.

Equity securities are investments carried at fair value that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk, to take advantage of market conditions that create economically attractive returns and as an additional source of earnings. Equity securities consist of Community Reinvestment Act ("CRA") investments and the Company's current other equity holdings. These securities were transferred from available for sale and reclassified into equity securities on the balance sheet as a result of the adoption of ASU 2016-01 in January 2018.

Equity securities totaled \$1.2 million as of March 31, 2018 and December 31, 2017. As of March 31, 2018, \$15 thousand in unrealized losses in equity securities were reclassified to net income.

HTM securities, which are carried at amortized cost, are investments for which there is the positive intent and ability to hold to maturity. The portfolio is comprised primarily of U.S. Government sponsored entities, obligations of state and political subdivisions, mortgage-backed securities, and corporate and other securities.

HTM securities were \$16.2 million at March 31, 2018, a decrease of \$139 thousand or 0.9 percent, from year end 2017. This decrease was the result of:

\$132 thousand in principal payments and maturities and  
\$7 thousand in net amortization of premiums.

The weighted average life of HTM securities, adjusted for prepayments, amounted to 6.0 years and 5.9 years at March 31, 2018 and December 31, 2017, respectively. As of March 31, 2018 and December 31, 2017, the fair value of HTM securities was \$16.2 million and \$16.3 million, respectively.

The average balance of taxable securities amounted to \$63.4 million for the three months ended March 31, 2018, compared to \$64.1 million for the same period in 2017. The average yield earned on taxable securities increased 5 basis points, to 3.15 percent for the three months ended March 31, 2018, from 3.10 percent for the same period in the prior year. The average balance of tax-exempt securities amounted to \$5.3 million for the three months ended March 31, 2018, compared to \$6.4 million for the same period in 2017. The average yield earned on tax-exempt securities decreased 134 basis points, to 2.88 percent for the three months ended March 31, 2018, from 4.22 percent for the same period in 2017.

Securities with a carrying value of \$3.9 million and \$20.8 million at March 31, 2018 and December 31, 2017, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law.

Approximately 81 percent of the total investment portfolio had a fixed rate of interest at March 31, 2018.

See Note 7 to the accompanying Consolidated Financial Statements for more information regarding Securities.

#### Loan Portfolio

The loan portfolio, which represents the Company's largest asset group, is a significant source of both interest and fee income. The portfolio consists of SBA, SBA 504, commercial, residential mortgage and consumer loans. Each of these segments is subject to differing levels of credit and interest rate risk.

Total loans increased \$24.4 million or 2.1 percent to \$1.2 billion at March 31, 2018, compared to year end 2017. Residential mortgage, commercial and consumer loans increased \$15.7 million, \$8.1 million, and \$3.4 million, respectively, partially offset by a decrease of \$2.5 million and \$306 thousand in SBA and SBA 504 loans, respectively.



The following table sets forth the classification of loans by major category, including unearned fees and deferred costs and excluding the allowance for loan losses as of March 31, 2018 and December 31, 2017:

| (In thousands, except percentages) | March 31, 2018 |            | December 31, 2017 |            |
|------------------------------------|----------------|------------|-------------------|------------|
|                                    | Amount         | % of total | Amount            | % of total |
| SBA loans held for investment      | \$42,734       | 3.6 %      | \$43,999          | 3.8 %      |
| SBA 504 loans                      | 21,565         | 1.8        | 21,871            | 1.9        |
| Commercial loans                   | 615,119        | 51.4       | 606,994           | 51.8       |
| Residential mortgage loans         | 380,857        | 31.9       | 365,145           | 31.2       |
| Consumer loans                     | 113,256        | 9.5        | 109,855           | 9.4        |
| Total loans held for investment    | 1,173,531      | 98.2       | 1,147,864         | 98.1       |
| SBA loans held for sale            | 21,579         | 1.8        | 22,810            | 1.9        |
| Total loans                        | \$1,195,110    | 100.0%     | \$1,170,674       | 100.0%     |

Average loans increased \$194.8 million or 19.7 percent to \$1.2 billion for the three months ended March 31, 2018 from \$988.0 million for the same period in 2017. The increase in average loans was due to increases in commercial, residential mortgages, consumer, and SBA 7(a) loans, partially offset by a decline in SBA 504 loans. The yield on the overall loan portfolio increased 21 basis points to 5.07 percent for the three months ended March 31, 2018 when compared to the same period in the prior year.

SBA 7(a) loans, on which the SBA historically has provided guarantees of up to 90 percent of the principal balance, are considered a higher risk loan product for the Company than its other loan products. These loans are made for the purposes of providing working capital or financing the purchase of equipment, inventory or commercial real estate. Generally, an SBA 7(a) loan has a deficiency in its credit profile that would not allow the borrower to qualify for a traditional commercial loan, which is why the SBA provides the guarantee. The deficiency may be a higher loan to value (“LTV”) ratio, lower debt service coverage (“DSC”) ratio or weak personal financial guarantees. In addition, many SBA 7(a) loans are for start up businesses where there is no history or financial information. Finally, many SBA borrowers do not have an ongoing and continuous banking relationship with the Bank, but merely work with the Bank on a single transaction. The guaranteed portion of the Company’s SBA loans are generally sold in the secondary market with the nonguaranteed portion held in the portfolio as a loan held for investment.

SBA 7(a) loans held for sale, carried at the lower of cost or market, amounted to \$21.6 million at March 31, 2018, a decrease of \$1.2 million from \$22.8 million at December 31, 2017. SBA 7(a) loans held to maturity amounted to \$42.7 million at March 31, 2018, a decrease of \$1.3 million from \$44.0 million at December 31, 2017. The yield on SBA loans, which are generally floating and adjust quarterly to the Prime rate, was 7.02 percent for the three months ended March 31, 2018, compared to 5.98 percent in the prior year.

The guarantee rates on SBA 7(a) loans range from 50 percent to 90 percent, with the majority of the portfolio having a guarantee rate of 75 percent at origination. The guarantee rates are determined by the SBA and can vary from year to year depending on government funding and the goals of the SBA program. The carrying value of SBA loans held for sale represents the guaranteed portion to be sold into the secondary market. The carrying value of SBA loans held to maturity represents the unguaranteed portion, which is the Company's portion of SBA loans originated, reduced by the guaranteed portion that is sold into the secondary market. Approximately \$96.6 million and \$97.5 million in SBA loans were sold but serviced by the Company at March 31, 2018 and December 31, 2017, respectively, and are not included on the Company’s balance sheet. There is no relationship or correlation between the guarantee percentages and the level of charge-offs and recoveries on the Company’s SBA 7(a) loans. Charge-offs taken on SBA 7(a) loans effect the unguaranteed portion of the loan. SBA loans are underwritten to the same credit standards irrespective of the guarantee percentage.

The SBA 504 program consists of real estate backed commercial mortgages where the Company has the first mortgage and the SBA has the second mortgage on the property. Generally, the Company has a 50 percent LTV ratio on SBA 504 program loans at origination. At March 31, 2018, SBA 504 loans totaled \$21.6 million, a decrease of \$306 thousand from \$21.9 million at December 31, 2017. The yield on SBA 504 loans increased 43 basis points to 5.12 percent for the three months ended March 31, 2018, from 4.69 percent for the same period in 2017.

Commercial loans are generally made in the Company's marketplace for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. These loans amounted to \$615.1 million at March 31, 2018, an increase of \$8.1 million from year end 2017. The yield on commercial loans was 4.95 percent for the three months ended March 31, 2018, compared to 4.88 percent for the same period in 2017.

Residential mortgage loans consist of loans secured by 1 to 4 family residential properties. These loans amounted to \$380.9 million at March 31, 2018, an increase of \$15.7 million from year end 2017. Sales of mortgage loans totaled \$20.1 million for the three months ended March 31, 2018. Approximately \$2.7 million of the loans sold were from portfolio, with the remainder consisting of new production. The yield on residential mortgages was 4.74 percent for the three months ended March 31, 2018, compared to 4.62 percent in the 2017 period. Residential mortgage loans maintained in portfolio are generally to individuals that do not qualify for conventional financing. In extending credit to this category of borrowers, the Bank considers other mitigating factors such as credit history, equity and liquid reserves of the borrower. As a result, the residential mortgage loan portfolio of the Bank includes adjustable rate mortgages with rates that exceed the rates on conventional fixed-rate mortgage loan products but which are not considered high priced mortgages.

Consumer loans consist of home equity loans, construction loans and loans for the purpose of financing the purchase of consumer goods, home improvements, and other personal needs, and are generally secured by the personal property being purchased. These loans amounted to \$113.3 million, an increase of \$3.4 million from year end 2017 primarily related to consumer construction loans. The yield on consumer loans was 5.59 percent for the three months ended March 31, 2018, compared to 4.87 percent for the same period in 2017.

There are no concentrations of loans to any borrowers or group of borrowers exceeding 10 percent of the total loan portfolio and no foreign loans in the portfolio.

In the normal course of business, the Company may originate loan products whose terms could give rise to additional credit risk. Interest-only loans, loans with high LTV or debt service ratios, construction loans with payments made from interest reserves and multiple loans supported by the same collateral (e.g. home equity loans) are examples of such products. However, these products are not material to the Company's financial position and are closely managed via credit controls that mitigate their additional inherent risk. Management does not believe that these products create a concentration of credit risk in the Company's loan portfolio. The Company does not have any option adjustable rate mortgage loans.

The majority of the Company's loans are secured by real estate. Declines in the market values of real estate in the Company's trade area impact the value of the collateral securing its loans. This could lead to greater losses in the event of defaults on loans secured by real estate. At March 31, 2018 and December 31, 2017, approximately 94 percent of the Company's loan portfolio was secured by real estate.

#### TDRs

TDRs occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. When the Company modifies a loan, management evaluates for any possible impairment using either the discounted cash flows method, where the value of the modified loan is based on the present value of expected cash flows, discounted at the contractual interest rate of the original loan agreement, or by using the fair value of the collateral less selling costs. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through an allowance estimate or charge-off to the allowance. This process is used, regardless of loan type, and for loans modified as TDRs that subsequently default on their modified terms.

At March 31, 2018, there was one loan totaling \$774 thousand that was classified as a TDR and deemed impaired, compared to one such loan totaling \$786 thousand at December 31, 2017. The TDR was a commercial real estate loan which was modified in 2017 to reduce the principal balance. The loan remains in accrual status since it continues to



perform in accordance with the restructured terms. Restructured loans that are placed in nonaccrual status may be removed after six months of contractual payments and the borrower showing the ability to service the debt going forward.

## Asset Quality

Inherent in the lending function is credit risk, which is the possibility a borrower may not perform in accordance with the contractual terms of their loan. A borrower's inability to pay their obligations according to the contractual terms can create the risk of past due loans and, ultimately, credit losses, especially on collateral deficient loans. The Company minimizes its credit risk by loan diversification and adhering to strict credit administration policies and procedures. Due diligence on loans begins when we initiate contact regarding a loan with a borrower. Documentation, including a borrower's credit history, materials establishing the value and liquidity of potential collateral, the purpose of the loan, the source of funds for repayment of the loan, and other factors, are analyzed before a loan is submitted for approval. The loan portfolio is then subject to on-going internal reviews for credit quality, as well as independent credit reviews by an outside firm.

The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. In some cases, these factors have also resulted in significant impairment to the value of loan collateral. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market.

Nonperforming assets consist of nonperforming loans and OREO. Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal, until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans past due 90 days or more and still accruing interest are not included in nonperforming loans. Loans past due 90 days or more and still accruing generally represent loans that are well collateralized and in a continuing process that are expected to result in repayment or restoration to current status.

The following table sets forth information concerning nonperforming assets and loans past due 90 days or more and still accruing interest at each of the periods presented:

| (In thousands, except percentages)                         | March 31, December 31, March 31, |          |          |
|--|----------------------------------|----------|----------|
|  | 2018                             | 2017     | 2017     |
| Nonperforming by category:                                 |                                  |          |          |
| SBA loans held for investment (1)                          | \$ 933                           | \$ 632   | \$ 1,239 |
| SBA 504 loans  | —                                | —        | 237      |
| Commercial loans   | 1,069                            | 68       | 1,499    |
| Residential mortgage loans                                 | 1,952                            | 1,669    | 2,514    |
| Consumer loans   | 323                              | 625      | 2,269    |
| Total nonperforming loans (2)                              | \$ 4,277                         | \$ 2,994 | \$ 7,758 |
| OREO   | 56                               | 426      | 1,172    |
| Total nonperforming assets                                 | \$ 4,333                         | \$ 3,420 | \$ 8,930 |
| Past due 90 days or more and still accruing interest:      |                                  |          |          |
| Commercial loans   | \$ —                             | \$ 60    | \$ —     |
| Total past due 90 days or more and still accruing interest | \$ —                             | \$ 60    | \$ —     |
| Nonperforming loans to total loans                         | 0.36                             | % 0.26   | % 0.78   |
| Nonperforming loans and TDRs to total loans (3)            | 0.42                             | 0.32     | 0.78     |
| Nonperforming assets to total loans and OREO               | 0.36                             | 0.29     | 0.89     |
| Nonperforming assets to total assets                       | 0.30                             | 0.23     | 0.73     |

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|   |      |       |      |
|---|------|-------|------|
| (1) Guaranteed SBA loans included above | \$27 | \$ 27 | \$60 |
| (2) Nonperforming TDRs included above   | —    | —     | —    |
| (3) Performing TDRs                     | 774  | 786   | —    |

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Nonperforming loans were \$4.3 million at March 31, 2018, a \$1.3 million increase from \$3.0 million at year end 2017 and a \$3.5 million decrease from \$7.8 million at March 31, 2017. Since year end 2017, nonperforming loans in the commercial, SBA, and residential loan segments increased, partially offset by a decrease in the consumer loan segment. Included in nonperforming loans at March 31, 2018 and December 31, 2017 are approximately \$27 thousand of loans guaranteed by the SBA, compared to \$60 thousand at March 31, 2017. In addition, there were \$60 thousand in loans past due 90 days or more and still accruing interest at December 31, 2017, compared to no such loans at March 31, 2018 and 2017, respectively.

OREO properties totaled \$56 thousand at March 31, 2018, a decrease of \$370 thousand from \$426 thousand at year end 2017 and a \$1.1 million decrease from \$1.2 million at March 31, 2017. During the three months ended March 31, 2018, the Company took title to one new property valued at \$106 thousand that resulted in a charge to the allowance of \$125 thousand. Two OREO properties were sold, resulting in net recoveries of \$24 thousand.

The Company also monitors potential problem loans. Potential problem loans are those loans where information about possible credit problems of borrowers causes management to have doubts as to the ability of such borrowers to comply with loan repayment terms. These loans are not included in nonperforming loans as they continue to perform. Potential problem loans totaled \$4.7 million at March 31, 2018, an increase of \$749 thousand from \$4.0 million at December 31, 2017. The increase is due to the addition of 10 loans totaling \$2.2 million, offset by the deletion of four loans totaling \$1.4 million.

See Note 8 to the accompanying Consolidated Financial Statements for more information regarding Asset Quality.

#### Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

Management reviews the level of the allowance for loan losses on a quarterly basis. The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. Specific reserves are made to individual impaired loans, which have been defined to include all nonperforming loans and TDRs. The general reserve is set based upon a representative average historical net charge-off rate adjusted for certain environmental factors such as: delinquency and impairment trends, charge-off and recovery trends, volume and loan term trends, risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes.

When calculating the five-year historical net charge-off rate, the Company weights the past three years more heavily. The Company believes using this approach is more indicative of future charge-offs. All of the environmental factors are ranked and assigned a basis points value based on the following scale: low, low moderate, moderate, high moderate, and high risk. The factors are evaluated separately for each type of loan. For example, commercial loans are broken down further into commercial and industrial loans, commercial mortgages, construction loans, etc. Each type of loan is risk weighted for each environmental factor based on its individual characteristics.

According to the Company's policy, a loss ("charge-off") is to be recognized and charged to the allowance for loan losses as soon as a loan is recognized as uncollectable. All credits which are 90 days past due must be analyzed for the Company's ability to collect on the credit. Once a loss is known to exist, the charge-off approval process is immediately expedited.

The allowance for loan losses totaled \$14.2 million at March 31, 2018 compared to \$13.6 million at December 31, 2017, and \$12.7 million at March 31, 2017, with resulting allowance to total loan ratios of 1.19 percent, 1.16 percent, and 1.27 percent, respectively. Net recoveries amounted to \$140 thousand for the three months ended March 31, 2018, compared to net charge-offs of \$148 thousand for the same period in 2017. Net charge-offs to average loan ratios are shown in the table below for each major loan category.



| (In thousands, except percentages)            | For the three months<br>ended March 31, |          |   |
|---|---|----------|---|
|   | 2018                                    | 2017     |   |
| Balance, beginning of period                  | \$13,556                                | \$12,579 |   |
| Provision for loan losses charged to expense  | 500                                     | 250      |   |
| Less: Chargeoffs                              |   |          |   |
| SBA loans held for investment                 | 81                                      | 109      |   |
| Commercial loans                              | —                                       | 76       |   |
| Consumer loans                                | 6                                       | 66       |   |
| Total chargeoffs                              | 87                                      | 251      |   |
| Add: Recoveries                               |   |          |   |
| SBA loans held for investment                 | 64                                      | 37       |   |
| Commercial loans                              | 16                                      | 53       |   |
| Residential mortgage loans                    | 13                                      | 12       |   |
| Consumer loans                                | 134                                     | 1        |   |
| Total recoveries                              | 227                                     | 103      |   |
| Net (recoveries) charge-offs                  | (140 )                                  | 148      |   |
| Balance, end of period                        | \$14,196                                | \$12,681 |   |
| Selected loan quality ratios:                 |   |          |   |
| Net chargeoffs (recoveries) to average loans: |   |          |   |
| SBA loans held for investment                 | 0.10                                    | % 0.50   | % |
| Commercial loans                              | (0.01 )                                 | 0.02     |   |
| Residential mortgage loans                    | (0.01 )                                 | (0.02 )  |   |
| Consumer loans                                | (0.47 )                                 | 0.28     |   |
| Total loans                                   | (0.05 )                                 | 0.06     |   |
| Allowance to total loans                      | 1.19                                    | 1.27     |   |
| Allowance to nonperforming loans              | 331.91                                  | % 163.46 | % |

In addition to the allowance for loan losses, the Company maintains a reserve for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the reserve are made through other expense and applied to the reserve which is maintained in other liabilities. At March 31, 2018, a \$286 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a \$292 thousand commitment reserve at December 31, 2017.

See Note 9 to the accompanying Consolidated Financial Statements for more information regarding the Allowance for Loan Losses and Reserve for Unfunded Loan Commitments.

## Deposits

Deposits, which include noninterest-bearing demand deposits, interest-bearing demand deposits, savings deposits and time deposits, are the primary source of the Company’s funds. The Company offers a variety of products designed to attract and retain customers, with primary focus on building and expanding relationships. The Company continues to focus on establishing a comprehensive relationship with business borrowers, seeking deposits as well as lending relationships.

Total deposits increased \$74.4 million to \$1.1 billion at March 31, 2018, from \$1.0 billion at December 31, 2017. This increase in deposits was due to increases of \$55.6 million in time deposits, \$11.7 million in savings deposits, and \$9.2 million in noninterest-bearing demand deposits, partially offset by a decrease of \$2.1 million in interest-bearing demand deposits. The increase in time and savings was primarily due to new promotions. The

increase in noninterest-bearing demand deposits is attributable to growth in commercial customer relationships.

The Company's deposit composition at March 31, 2018, consisted of 36.5 percent savings deposits, 25.2 percent time deposits, 23.7 percent noninterest-bearing demand deposits and 14.6 percent interest-bearing demand deposits.

## Borrowed Funds and Subordinated Debentures

Borrowed funds consist primarily of adjustable and fixed rate advances from the Federal Home Loan Bank of New York and repurchase agreements. These borrowings are used as a source of liquidity or to fund asset growth not supported by deposit generation. Residential mortgages and commercial loans collateralize the borrowings from the FHLB, while investment securities are pledged against the repurchase agreements.

Borrowed funds and subordinated debentures totaled \$191.3 million and \$285.3 million at March 31, 2018 and December 31, 2017, respectively, and are broken down in the following table:

| (In thousands)                                   | March 31, December 31, |            |
|--|------------------------|------------|
|  | 2018                   | 2017       |
| FHLB borrowings:                                 |                        |            |
| Fixed rate advances                              | \$ 40,000              | \$ 40,000  |
| Adjustable rate advances                         | 50,000                 | 50,000     |
| Overnight advances                               | 91,000                 | 170,000    |
| Other repurchase agreements                      | —                      | 15,000     |
| Subordinated debentures                          | 10,310                 | 10,310     |
| Total borrowed funds and subordinated debentures | \$ 191,310             | \$ 285,310 |

The \$94.0 million decrease in total borrowed funds and subordinated debentures was due to a \$79.0 million decrease in FHLB overnight borrowings and a \$15.0 million decrease in other repurchase agreements. The following transactions impacted borrowed funds and subordinated debentures:

A \$91.0 million FHLB overnight line of credit advance issued on March 30, 2018 was at a rate of 2.00% and was repaid on April 2, 2018.

A \$15.0 million repurchase agreement borrowing with a rate of 3.670% that matured on February 28, 2018.

A \$10.0 million ARC FHLB borrowing with a rate of 1.173% that matured on February 16, 2018. This \$10.0 million FHLB advance was renewed for an additional six months at a rate of LIBOR plus 0.105%. A swap instrument was implemented which modified the borrowing to a 5 year fixed rate borrowing at 1.208% that matures on February 16, 2021.

A \$20.0 million ARC FHLB borrowing with a rate of 1.158% that matured on January 5, 2018. This \$20.0 million FHLB advance was renewed for an additional six months at a rate of LIBOR plus 0.105%. A swap instrument was implemented which modified the borrowing to a 5 year fixed rate borrowing at 1.153% that matures on July 5, 2021.

In March 2018, the FHLB issued a \$12.0 million municipal deposit letter of credit in the name of Unity Bank naming the NJ Department of Banking and Insurance as beneficiary to secure certain municipal deposits held by the Bank.

At March 31, 2018, the Company had \$223.0 million of additional credit available at the FHLB. Pledging additional collateral in the form of 1 to 4 family residential mortgages, commercial loans and investment securities can increase the line with the FHLB.

## Interest Rate Sensitivity

The principal objectives of the asset and liability management function are to establish prudent risk management guidelines, evaluate and control the level of interest-rate risk in balance sheet accounts, determine the level of appropriate risk given the business focus, operating environment, capital, and liquidity requirements, and actively manage risk within the Board approved guidelines. The Company seeks to reduce the vulnerability of operations to changes in interest rates, and actions in this regard are taken under the guidance of the Asset/Liability Management



Committee (“ALCO”) of the Board of Directors. The ALCO reviews the maturities and re-pricing of loans, investments, deposits and borrowings, cash flow needs, current market conditions, and interest rate levels.

The Company utilizes Modified Duration of Equity and Economic Value of Portfolio Equity (“EVPE”) models to measure the impact of longer-term asset and liability mismatches beyond two years. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVPE analysis is also used to dynamically model the present value of asset and liability cash flows with rate shocks of 200 basis points. The economic value of equity is likely to be different as interest rates change. Results falling outside prescribed ranges require action by the ALCO. The Company’s variance in the economic value of equity, as a percentage of assets with rate shocks of 200 basis points at March 31, 2018, is a decline of 0.75 percent in a rising-rate environment and an increase of 0.10 percent in a falling-rate environment. The variances in the EVPE at March 31, 2018 are within the Board-approved guidelines of +/- 3.00 percent. In a falling rate environment with a rate shock of 200 basis points, benchmark interest rates are assumed to have floors of 0.00%. At December 31, 2017, the economic value of equity as a percentage of assets with rate shocks of 200 basis points was a decline of 0.81 percent in a rising-rate environment and a decrease of 0.15 percent in a falling-rate environment.

## Liquidity

### Consolidated Bank Liquidity

Liquidity measures the ability to satisfy current and future cash flow needs as they become due. A bank’s liquidity reflects its ability to meet loan demand, to accommodate possible outflows in deposits and to take advantage of interest rate opportunities in the marketplace. Our liquidity is monitored by management and the Board of Directors through a Risk Management Committee, which reviews historical funding requirements, our current liquidity position, sources and stability of funding, marketability of assets, options for attracting additional funds, and anticipated future funding needs, including the level of unfunded commitments. Our goal is to maintain sufficient asset-based liquidity to cover potential funding requirements in order to minimize our dependence on volatile and potentially unstable funding markets.

The principal sources of funds at the Bank are deposits, scheduled amortization and prepayments of investment and loan principal, sales and maturities of investment securities and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit inflows and outflows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Consolidated Statement of Cash Flows provides detail on the Company’s sources and uses of cash, as well as an indication of the Company’s ability to maintain an adequate level of liquidity. At March 31, 2018, the balance of cash and cash equivalents was \$116.3 million, a decrease of \$34.0 million from December 31, 2017. A discussion of the cash provided by and used in operating, investing and financing activities follows.

Operating activities provided \$7.6 million and \$6.8 million in net cash for the three months ended March 31, 2018 and 2017, respectively. The primary sources of funds were net income from operations and adjustments to net income, such as the proceeds from the sale of mortgage and SBA loans held for sale, partially offset by originations of mortgage and SBA loans held for sale.

Investing activities used \$21.6 million and \$43.1 million in net cash for the three months ended March 31, 2018 and 2017, respectively. Cash was primarily used to fund new loans and purchase FHLB stock, partially offset by proceeds from redemption of FHLB stock.

Securities. The Consolidated Bank’s available for sale investment portfolio amounted to \$50.2 million and \$52.3 million at March 31, 2018 and December 31, 2017, respectively. This excludes the Parent Company’s securities discussed under the heading “Parent Company Liquidity” below. Projected cash flows from securities over the next twelve months are \$6.7 million.

Loans. The SBA loans held for sale portfolio amounted to \$21.6 million and \$22.8 million at March 31, 2018 and December 31, 2017, respectively. Sales of these loans provide an additional source of liquidity for the Company. Outstanding Commitments. The Company was committed to advance approximately \$286.2 million to its borrowers as of March 31, 2018, compared to \$291.9 million at December 31, 2017. At March 31, 2018, \$209.6 million of these commitments expire within one year, compared to \$209.3 million at December 31, 2017. The Company had \$4.4 million and \$5.6 million in standby letters of credit at March 31, 2018 and December 31, 2017, respectively, which are included in the commitments amount noted above. The estimated fair value of these guarantees is not significant. The Company believes it has the necessary liquidity to honor all commitments. Many of these commitments will expire and never be funded.

Financing activities used \$20.0 million in net cash for the three months ended March 31, 2018, compared to providing \$33.6 million for the same period in the prior year, primarily due to repayments of borrowings, partially offset by proceeds from new borrowings and an increase in the Company's deposits.

**Deposits.** As of March 31, 2018, deposits included \$87.5 million of Government deposits, as compared to \$99.6 million at year end 2017. These deposits are generally short in duration and are very sensitive to price competition. The Company believes that the current level of these types of deposits is appropriate. Included in the portfolio were \$80.1 million of deposits from thirteen municipalities with account balances in excess of \$1.5 million. The withdrawal of these deposits, in whole or in part, would not create a liquidity shortfall for the Company.

**Borrowed Funds.** Total FHLB borrowings amounted to \$181.0 million and \$260.0 million as of March 31, 2018 and December 31, 2017, respectively. There were no third party repurchase agreements as of March 31, 2018 compared to a total of \$15.0 million at December 31, 2017. As a member of the Federal Home Loan Bank of New York, the Company can borrow additional funds based on the market value of collateral pledged. At March 31, 2018, pledging provided an additional \$223.0 million in borrowing potential from the FHLB. In addition, the Company can pledge additional collateral in the form of 1 to 4 family residential mortgages, commercial loans or investment securities to increase this line with the FHLB.

#### Parent Company Liquidity

The Parent Company's cash needs are funded by dividends and rental payments on corporate headquarters paid by the Bank. Other than its investment in the Bank, Unity Risk Management, Inc. and Unity Statutory Trust II, the Parent Company does not actively engage in other transactions or business. Only expenses specifically for the benefit of the Parent Company are paid using its cash, which typically includes the payment of operating expenses, cash dividends on common stock and payments on trust preferred debt.

At March 31, 2018, the Parent Company had \$1.9 million in cash and cash equivalents and \$279 thousand in investment securities valued at fair market value, compared to \$1.6 million and \$278 thousand at December 31, 2017.

#### Regulatory Capital

Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for common stock, qualifying preferred stock and certain qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, certain qualifying long-term debt, preferred stock and hybrid instruments which do not qualify as tier 1 capital. Minimum capital levels are regulated by risk-based capital adequacy guidelines, which require the Company and the Bank to maintain certain capital as a percent of assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-weighted assets). A bank is required to maintain, at a minimum, tier 1 capital as a percentage of risk-weighted assets of 4 percent and combined tier 1 and tier 2 capital as a percentage of risk-weighted assets of 8 percent. In addition, banks are required to meet a leverage capital requirement, which measures tier 1 capital against average assets. Banks which are highly rated and not experiencing significant growth are required to maintain a leverage ratio of 3 percent while all other banks are expected to maintain a leverage ratio 1 to 2 percentage points higher. Finally, the Bank is required to maintain a ratio of common equity tier 1 capital, consisting solely of common equity, to risk-weighted assets of at least 4.5%. The Company is subject to similar requirements on a consolidated basis.

The following tables summarize the Company's and the Bank's regulatory capital ratios at March 31, 2018 and December 31, 2017, as well as the minimum regulatory capital ratios required for the Bank to be deemed "well-capitalized." The Company's capital amounts and ratios reflect the capital decreases described above.

|                                 | At March 31,<br>2018 |         | Required for<br>capital<br>adequacy purposes<br>effective |                        | To be<br>well-capitalized<br>under prompt<br>corrective action<br>regulations |   |
|---------------------------------|----------------------|---------|---|------------------------|---|---|
|                                 | Company              | Bank    | January<br>1, 2018  | January<br>1, 2019     | Bank  |   |
| Leverage ratio                  | 9.46 %               | 9.12 %  | 4.000 %   | 4.00 %                 | 5.00  | % |
| CET1                            | 11.14 %              | 11.60 % | 6.375 % <sup>(1)</sup>                                    | 7.00 % <sup>(2)</sup>  | 6.50  | % |
| Tier I risk-based capital ratio | 12.07 %              | 11.60 % | 7.875 % <sup>(1)</sup>                                    | 8.50 % <sup>(2)</sup>  | 8.00  | % |
| Total risk-based capital ratio  | 13.24 %              | 12.81 % | 9.875 % <sup>(1)</sup>                                    | 10.50 % <sup>(2)</sup> | 10.00   | % |

(1) Includes 1.875% capital conservation buffer.

(2) Includes 2.5% capital conservation buffer.

|                                 | At December 31,<br>2017 |         | Required for<br>capital<br>adequacy purposes<br>effective |                        | To be<br>well-capitalized<br>under prompt<br>corrective action<br>regulations |   |
|---------------------------------|-------------------------|---------|---|------------------------|---|---|
|                                 | Company                 | Bank    | January<br>1, 2017  | January<br>1, 2019     | Bank  |   |
| Leverage ratio                  | 9.37 %                  | 9.03 %  | 4.000 %   | 4.00 %                 | 5.00  | % |
| CET1                            | 10.81 %                 | 11.33 % | 5.750 % <sup>(3)</sup>                                    | 7.00 % <sup>(4)</sup>  | 6.50  | % |
| Tier I risk-based capital ratio | 11.75 %                 | 11.33 % | 7.250 % <sup>(3)</sup>                                    | 8.50 % <sup>(4)</sup>  | 8.00  | % |
| Total risk-based capital ratio  | 12.87 %                 | 12.50 % | 9.250 % <sup>(3)</sup>                                    | 10.50 % <sup>(4)</sup> | 10.00   | % |

(3) Includes 1.25% capital conservation buffer.

(4) Includes 2.5% capital conservation buffer.

For additional information on regulatory capital, see Note 13 to the Consolidated Financial Statements.

### Shareholders' Equity

Shareholders' equity increased \$5.0 million to \$123.1 million at March 31, 2018 compared to \$118.1 million at December 31, 2017, primarily due to net income of \$5.2 million. Other items impacting shareholders' equity included \$619 thousand in dividends paid on common stock, \$554 thousand from the issuance of common stock under employee benefit plans, \$176 thousand in accumulated other comprehensive loss net of tax, and \$11 thousand in tax rate adjustments made to accumulated other comprehensive income. As a result of ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income", the Company reclassified \$66 thousand from accumulated other comprehensive income to retained earnings. As a result of ASU 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities", the Company reclassified \$56 thousand of gains (losses) on available for sale equity securities sitting in accumulated other comprehensive income as of December 31, 2017 to beginning retained earnings as of January 1, 2018. The issuance of common stock under employee benefit plans

includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

#### Repurchase Plan

On October 21, 2002, the Company authorized the repurchase of up to 10 percent of its outstanding common stock. The amount and timing of purchases is dependent upon a number of factors, including the price and availability of the Company's shares, general market conditions and competing alternate uses of funds. There were no shares repurchased during the three months ended March 31, 2018 or 2017.

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### Impact of Inflation and Changing Prices

The financial statements and notes thereto, presented elsewhere herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. The impact of inflation is reflected in the increased cost of the operations. Unlike most industrial companies, nearly all the Company's assets and liabilities are monetary. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

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ITEM 3 Quantitative and Qualitative Disclosures about Market Risk

During the three months ended March 31, 2018, there have been no significant changes in the Company's assessment of market risk as reported in Item 6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. (See Interest Rate Sensitivity in Management's Discussion and Analysis herein.)

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ITEM 4 Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures as of March 31, 2018. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that a) the Company's disclosure controls and procedures are effective for recording, processing, summarizing and reporting the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms.

No significant change in the Company's internal control over financial reporting has occurred during the quarterly b) period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's controls over financial reporting.

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PART II OTHER INFORMATION

ITEM 1 Legal Proceedings

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of the operation of the Company.

ITEM 1A Risk Factors

Information regarding this item as of March 31, 2018 appears under the heading, “Risk Factors” within the Company’s Form 10-K for the year ended December 31, 2017.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds - None

ITEM 3 Defaults upon Senior Securities - None

ITEM 4 Mine Safety Disclosures - N/A

ITEM 5 Other Information - None

ITEM 6 Exhibits

| (a)           | Description  |
|---------------|--|
| Exhibits      |  |
| Exhibit 3(ii) | By-laws of Unity Bancorp as amended. Incorporated by reference from Exhibit 3.1 of current report on Form 8-K filed February 24, 2017  |
| Exhibit 31.1  | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002  |
| Exhibit 31.2  | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002  |
| Exhibit 32.1  | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

UNITY BANCORP, INC.

Dated: May 3, 2018 /s/ Alan J. Bedner, Jr.

Alan J. Bedner, Jr.

Executive Vice President and Chief Financial Officer

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EXHIBIT INDEX

QUARTERLY REPORT ON FORM 10-Q

| Exhibit No. | Description  |
|-------------|--|
| <u>31.1</u> | Exhibit 31.1-Certification of James A. Hughes. Required by Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002  |
| <u>31.2</u> | Exhibit 31.2-Certification of Alan J. Bedner, Jr. Required by Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002   |
| <u>32.1</u> | Exhibit 32.1-Certification of James A. Hughes and Alan J. Bedner, Jr. Required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |
| 101.INS     | XBRL Instance Document   |
| 101.SCH     | XBRL Taxonomy Extension Schema Document  |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE     | XBRL Taxonomy Extension Presentation Linkbase Document   |
| 101.DEF     | XBRL Taxonomy Extension Definitions Linkbase Document  |