UNITY BANCORP INC /NJ/
Form 10-Q
August 07, 2018

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

FORM 10-Q

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

For the quarterly period ended June 30, 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

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 July 31, 2018 common stock, no par value: 10,736,071 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)	June 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$26,784	$23,701
Federal funds sold, interest-bearing deposits and repos	112,491	126,553
Cash and cash equivalents	139,275	150,254
Securities:		
Securities available for sale (amortized cost of $50,133 and $52,763 in 2018 and 2017, respectively)	48,707	52,287
Securities held to maturity (fair value of $15,614 and $16,346 in 2018 and 2017, respectively)	15,777	16,307
Equity securities (amortized cost of $1,262 in 2018 and 2017)	1,198	1,206
Total securities	65,682	69,800
Loans:		
SBA loans held for sale	14,889	22,810
SBA loans held for investment	41,351	43,999
Commercial loans	673,480	628,865
Residential mortgage loans	398,383	365,145
Consumer loans	118,408	109,855
Total loans	1,246,511	1,170,674
Allowance for loan losses	(14,634)	(13,556)
Net loans	1,231,877	1,157,118
Premises and equipment, net	23,493	23,470
Bank owned life insurance ("BOLI")	24,573	24,227
Deferred tax assets	4,438	4,017
Federal Home Loan Bank ("FHLB") stock	11,245	12,863
Accrued interest receivable	6,027	5,447
Other real estate owned ("OREO")	56	426
Goodwill	1,516	1,516
Prepaid expenses and other assets	5,938	6,358
Total assets	$1,514,120	$1,455,496
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Noninterest-bearing demand	$250,500	$256,119
Interest-bearing demand	160,327	164,997
Savings	398,694	396,557
Time, under $100,000	190,282	133,881
Time, $100,000 to $250,000	108,854	71,480
Time, $250,000 and over	37,742	20,103
Total deposits	1,146,399	1,043,137
Borrowed funds	220,000	275,000
Subordinated debentures	10,310	10,310
Accrued interest payable	509	436

Accrued expenses and other liabilities	8,761	8,508
Total liabilities	1,385,979	1,337,391
Shareholders' equity:		
Common stock	87,755	86,782
Retained earnings	40,386	31,117
Accumulated other comprehensive income	—	206
Total shareholders' equity	128,141	118,105
Total liabilities and shareholders' equity	$ 1,514,120	$ 1,455,496
Issued and outstanding common shares	10,731	10,615

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

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

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands, except per share amounts)	2018	2017	2018	2017
INTEREST INCOME				
Federal funds sold, interest-bearing deposits and repos	$171	$203	$376	$332
FHLB stock	123	73	257	166
Securities:				
Taxable	484	538	976	1,030
Tax-exempt	30	44	61	88
Total securities	514	582	1,037	1,118
Loans:				
SBA loans	1,131	886	2,314	1,739
Commercial loans	8,209	6,882	15,934	13,350
Residential mortgage loans	4,522	3,584	8,863	6,967
Consumer loans	1,699	1,267	3,228	2,400
Total loans	15,561	12,619	30,339	24,456
Total interest income	16,369	13,477	32,009	26,072
INTEREST EXPENSE				
Interest-bearing demand deposits	259	161	483	314
Savings deposits	943	678	1,719	1,261
Time deposits	1,303	814	2,302	1,618
Borrowed funds and subordinated debentures	720	674	1,489	1,338
Total interest expense	3,225	2,327	5,993	4,531
Net interest income	13,144	11,150	26,016	21,541
Provision for loan losses	550	400	1,050	650
Net interest income after provision for loan losses	12,594	10,750	24,966	20,891
NONINTEREST INCOME				
Branch fee income	419	344	750	675
Service and loan fee income	411	512	976	1,024
Gain on sale of SBA loans held for sale, net	582	479	1,130	963
Gain on sale of mortgage loans, net	421	264	845	796
BOLI income	175	89	346	178
Net security gains (losses)	7	16	(9)	16
Other income	297	317	560	573
Total noninterest income	2,312	2,021	4,598	4,225
NONINTEREST EXPENSE				
Compensation and benefits	4,736	4,299	9,570	8,394
Occupancy	693	590	1,383	1,190
Processing and communications	674	632	1,363	1,236
Furniture and equipment	610	513	1,146	1,024
Professional services	161	251	412	477
Loan collection and OREO expenses	6	38	11	379
Other loan expenses	53	18	86	102
Deposit insurance	216	144	402	220
Advertising	362	323	681	560

Director fees	165	149	327	346
Other expenses	482	464	970	934
Total noninterest expense	8,158	7,421	16,351	14,862
Income before provision for income taxes	6,748	5,350	13,213	10,254
Provision for income taxes	1,351	1,906	2,586	3,618
Net income	$5,397	$3,444	$10,627	$6,636
Net income per common share - Basic	$0.50	$0.33	$0.99	$0.63
Net income per common share - Diluted	$0.49	$0.32	$0.98	$0.62
Weighted average common shares outstanding - Basic	10,717	10,546	10,698	10,528
Weighted average common shares outstanding - Diluted	10,915	10,735	10,897	10,720

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 Comprehensive Income
(Unaudited)

(In thousands)	For the three months ended June 30, 2018			June 30, 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	$6,748	$1,351	$5,397	$5,350	$1,906	$3,444
Other comprehensive (loss) income						
Investment securities available for sale:						
Unrealized holding (losses) gains on securities arising during the period	(136)	(63)	(73)	409	163	246
Less: reclassification adjustment for gains on securities included in net income	7	1	6	16	5	11
Total unrealized (losses) gains on securities available for sale	(143)	(64)	(79)	393	158	235
Adjustments related to defined benefit plan:						
Amortization of prior service cost	21	6	15	21	8	13
Total adjustments related to defined benefit plan	21	6	15	21	8	13
Net unrealized gains (losses) from cash flow hedges:						
Unrealized holding gains (losses) on cash flow hedges arising during the period	82	23	59	(312)	(128)	(184)
Total unrealized gains (losses) on cash flow hedges	82	23	59	(312)	(128)	(184)
Total other comprehensive (loss) income	(40)	(35)	(5)	102	38	64
Total comprehensive income	$6,708	$1,316	$5,392	$5,452	$1,944	$3,508

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

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

	For the six months ended					
	June 30, 2018			June 30, 2017		
(In thousands)	Before tax amount	Income tax expense (benefit)	Net of tax amount	Before tax amount	Income tax expense (benefit)	Net of tax amount
Net income	$13,213	$2,586	$10,627	$10,254	$3,618	$6,636
Other comprehensive (loss) income						
Investment securities available for sale:						
Unrealized holding (losses) gains on securities arising during the period	(943)	(289)	(654)	265	105	160
Less: reclassification adjustment for gains on securities included in net income	7	1	6	16	5	11
Total unrealized (losses) gains on securities available for sale	(950)	(290)	(660)	249	100	149
Adjustments related to defined benefit plan:						
Amortization of prior service cost	42	161	(119)	42	17	25
Total adjustments related to defined benefit plan	42	161	(119)	42	17	25
Net unrealized gains (losses) from cash flow hedges:						
Unrealized holding gains (losses) on cash flow hedges arising during the period	665	57	608	(231)	(95)	(136)
Total unrealized gains (losses) on cash flow hedges	665	57	608	(231)	(95)	(136)
Total other comprehensive (loss) income	(243)	(72)	(171)	60	22	38
Total comprehensive income	$12,970	$2,514	$10,456	$10,314	$3,640	$6,674

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

Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2018 and 2017
(Unaudited)

(In thousands)	Common stock Shares	Common stock Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
Balance, December 31, 2017	10,615	$86,782	$31,117	$ 206	$ 118,105
Net income			10,627		10,627
Other comprehensive loss, net of tax				(171)	(171)
Dividends on common stock ($0.13 per share)		53	(1,393)		(1,340)
Common stock issued and related tax effects (1)	116	920			920
Balance, Retained earnings impact due to adoption of ASU 2016-01 (2)			(40)	40	—
Tax rate adjustment to AOCI (3)			75	(75)	—
Balance, June 30, 2018	10,731	$87,755	$40,386	$ —	$ 128,141

(In thousands)	Common stock Shares	Common stock Amount	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance, December 31, 2016	10,477	$85,383	$20,748	$ 160	$ 106,291
Net income			6,636		6,636
Other comprehensive income, net of tax				38	38
Dividends on common stock ($0.11 per share)		74	(1,247)		(1,173)
Common stock issued and related tax effects (1)	90	655			655
Balance, June 30, 2017	10,567	$86,112	$26,137	$ 198	$ 112,447

(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 reclassed $40 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 reclassed $75 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 six months ended June 30, 2018	2017
OPERATING ACTIVITIES:		
Net income	$10,627	$6,636
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,050	650
Net amortization of purchase premiums and discounts on securities	108	137
Depreciation and amortization	895	797
Deferred income tax benefit	(543)	(82)
Net security gains	—	(16)
Stock compensation expense	528	390
(Gain) loss on sale of OREO	(13)	253
Valuation writedowns on OREO	—	50
Gain on sale of mortgage loans held for sale, net	(682)	(841)
Gain on sale of SBA loans held for sale, net	(1,130)	(963)
Origination of mortgage loans held for sale	(26,501)	(42,348)
Origination of SBA loans held for sale	(4,424)	(9,867)
Proceeds from sale of mortgage loans held for sale, net	27,183	43,189
Proceeds from sale of SBA loans held for sale, net	13,516	12,304
BOLI income	(346)	(178)
Net change in other assets and liabilities	1,123	604
Net cash provided by operating activities	21,391	10,715
INVESTING ACTIVITIES		
Purchases of securities available for sale	—	(25,720)
Purchases of FHLB stock, at cost	(32,155)	(2,009)
Maturities and principal payments on securities held to maturity	514	711
Maturities and principal payments on securities available for sale	2,538	8,840
Proceeds from sales of securities held to maturity	—	2,777
Proceeds from redemption of FHLB stock	33,773	945
Proceeds from sale of OREO	439	546
Net increase in loans	(84,020)	(75,776)
Purchases of premises and equipment	(773)	(451)
Net cash used in investing activities	(79,684)	(90,137)
FINANCING ACTIVITIES		
Net increase in deposits	103,262	58,244
Proceeds from new borrowings	190,000	77,000
Repayments of borrowings	(245,000)	(56,000)
Proceeds from exercise of stock options	392	271
Dividends on common stock	(1,340)	(1,173)
Net cash provided by financing activities	47,314	78,342
Decrease in cash and cash equivalents	(10,979)	(1,080)
Cash and cash equivalents, beginning of period	150,254	105,895
Cash and cash equivalents, end of period	$139,275	$104,815

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

(In thousands)	For the six months ended June 30, 2018	2017
SUPPLEMENTAL DISCLOSURES		
Cash:		
Interest paid	$5,920	$4,551
Income taxes paid	2,111	3,277
Noncash investing activities:		
Transfer of SBA loans held for sale to held to maturity	—	13
Capitalization of servicing rights	426	146
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)
June 30, 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 and six months ended June 30, 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 months ended June 30,		For the six months ended June 30,	
(In thousands, except per share amounts)	2018	2017	2018	2017

Net income	$5,397	$3,444	$10,627	$6,636
Weighted average common shares outstanding - Basic	10,717	10,546	10,698	10,528
Plus: Potential dilutive common stock equivalents	198	189	199	192
Weighted average common shares outstanding - Diluted	10,915	10,735	10,897	10,720
Net income per common share - Basic	$0.50	$0.33	$0.99	$0.63
Net income per common share - Diluted	0.49	0.32	0.98	0.62
Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive	$112	$77	$99	$66

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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.

On July 1, 2018, New Jersey's Assembly Bill 4202 was signed into law. The new Bill, effective January 1, 2018, imposed a temporary surtax on corporations earning New Jersey allocated income in excess of $1 million at a rate of 2.5% for tax years beginning on or after January 1, 2018, through December 31, 2019, and at 1.5% for tax years beginning on or after January 1, 2020, through December 31, 2021. In addition, effective for periods on or after January 1, 2019, New Jersey is adopting mandatory unitary combined reporting for its Corporation Business Tax.

For the quarter ended June 30, 2018, the Company reported income tax expense of $1.4 million for an effective tax rate of 20.0 percent, compared to an income tax expense of $1.9 million and an effective tax rate of 35.6 percent for the prior year’s quarter. For the six months ended June 30, 2018, the Company reported income tax expense of $2.6 million for an effective tax rate of 19.6 percent, compared to an income tax expense of $3.6 million and an effective tax rate of 35.3 percent for the six months ended June 30, 2017. The Company did not recognize or accrue any interest or penalties related to income taxes during the three or six months ended June 30, 2018 or 2017. The Company did not have an accrual for uncertain tax positions as of June 30, 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 Income (Loss)

The following tables show the changes in other comprehensive income (loss) for the three and six months ended June 30, 2018 and 2017, net of tax:

(In thousands)	For the three months ended June 30, 2018			
	Net unrealized (losses) gains on securities	Adjustments related to defined benefit plan	Net unrealized gains from cash flow hedges	Accumulated other comprehensive income (loss)
Balance, beginning of period	$(916)	$ (475)	$ 1,431	$ 40
Other comprehensive (loss) income before reclassification	(73)	—	59	(14)
Less amounts reclassified from accumulated other comprehensive income (loss)	6	(15)	—	(9)
Period change	(79)	15	59	(5)
Balance, end of period (1)	$(995)	$ (460)	$ 1,490	$ 35

(1) AOCI does not reflect the net reclassification of $35 thousand 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" & ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income".

(In thousands)	For the three months ended June 30, 2017			
	Net unrealized (losses) gains on securities	Adjustments related to defined benefit plan	Net unrealized gains (losses) from cash flow hedges	Accumulated other comprehensive income (loss)
Balance, beginning of period	$(247)	$ (379)	$ 760	$ 134
Other comprehensive income (loss) before reclassification	246	—	(184)	62
Less amounts reclassified from accumulated other comprehensive income (loss)	11	(13)	—	(2)
Period change	235	13	(184)	64
Balance, end of period	$(12)	$ (366)	$ 576	$ 198

(In thousands)	For the six months ended June 30, 2018			
	Net unrealized (losses) gains 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 reclassification	(654)	—	608	(46)
Less amounts reclassified from accumulated other comprehensive income	6	119	—	125

Period change	(660)	(119)	608	(171)
Balance, end of period (1)	$(995)	$ (460)	$ 1,490	$ 35

(1) AOCI does not reflect the net reclassification of $35 thousand 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" & ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income".

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(In thousands)	For the six months ended June 30, 2017 Net unrealized (losses) gains on securities	Adjustments related to defined benefit plan	Net unrealized gains (losses) from cash flow hedges	Accumulated other comprehensive income (loss)
Balance, beginning of period	$(161)	$ (391)	$ 712	$ 160
Other comprehensive income (loss) before reclassification	160	—	(136)	24
Less amounts reclassified from accumulated other comprehensive income (loss)	11	(25)	—	(14)
Period change	149	25	(136)	38
Balance, end of period	$(12)	$ (366)	$ 576	$ 198

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.

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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 June 30, 2018, the fair value of the Company's AFS securities portfolio was $48.7 million. Approximately 59 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $28.9 million at June 30, 2018. Approximately $28.3 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 June 30, 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 June 30, 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 June 30, 2018. The valuation of 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 June 30, 2018, as compared to the periods ended December 31, 2017 and June 30, 2017.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017:

	Fair Value Measurements at June 30, 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	$5,598	$ —	$ 5,598	$ —
State and political subdivisions	4,822	—	4,822	—
Residential mortgage-backed securities	28,853	—	28,853	—
Corporate and other securities	9,434	—	9,434	—
Total securities available for sale	$48,707	$ —	$ 48,707	$ —
Equity securities	1,198	—	1,198	—
Total equity securities	$1,198	$ —	$ 1,198	$ —
Interest rate swap agreements	2,073	—	2,073	—
Total swap agreements	$2,073	$ —	$ 2,073	$ —

	Fair Value Measurements at December 31, 2017 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:

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 thousand 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 June 30, 2018, the valuation allowance for impaired loans was $586 thousand, an increase of $254 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):

	Fair Value Measurements at June 30, 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)	Net Provision (Credit) During Period
Measured on a non-recurring basis:					
Financial assets:					
OREO	$56	$ —	$ —	$ 56	$ (175)
Impaired collateral-dependent loans	3,534	—	—	3,534	(254)

	Fair Value Measurements at December 31, 2017 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)	Net Provision (Credit) During Period
Measured on a non-recurring basis:					
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 June 30, 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.

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 June 30, 2018, the Bank had standby letters of credit outstanding of $5.5 million, as 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 June 30, 2018 and December 31, 2017:

(In thousands)	Fair value level	June 30, 2018 Carrying amount	June 30, 2018 Estimated fair value	December 31, 2017 Carrying amount	December 31, 2017 Estimated fair value
Financial assets:					
Cash and cash equivalents	Level 1	$139,275	$139,275	$150,254	$150,254
Securities (1)	Level 2	65,682	65,519	69,800	69,839
SBA loans held for sale	Level 2	14,889	16,368	22,810	25,568
Loans, net of allowance for loan losses (2)	Level 2	1,216,988	1,208,298	1,134,308	1,133,739
FHLB stock	Level 2	11,245	11,245	12,863	12,863
Servicing assets	Level 3	1,985	1,985	1,800	1,800
Accrued interest receivable	Level 2	6,027	6,027	5,447	5,447
OREO	Level 3	56	56	426	426
Financial liabilities:					
Deposits	Level 2	1,146,399	1,142,797	1,043,137	1,041,111
Borrowed funds and subordinated debentures	Level 2	230,310	228,267	285,310	284,117
Accrued interest payable	Level 2	509	509	436	436

(1) Includes held to maturity ("HTM") corporate securities that are considered Level 3. These securities had book values of $3.6 million and $3.7 million at June 30, 2018 and December 31, 2017, respectively, with market values of $3.4 million and $3.5 million.

(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 $3.5 thousand and $1.1 million at June 30, 2018 and December 31, 2017, respectively.

NOTE 7. Securities

This table provides the major components of AFS, HTM and Equity securities at amortized cost and estimated fair value at June 30, 2018 and December 31, 2017:

	June 30, 2018				December 31, 2017			
(In thousands)	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	$5,761	$ —	$ (163)	$ 5,598	$5,765	$ —	$ (74)	$ 5,691
State and political subdivisions	5,001	1	(180)	4,822	5,227	21	(56)	5,192
Residential mortgage-backed securities	29,715	79	(941)	28,853	32,111	153	(386)	31,878
Corporate and other securities	9,656	19	(241)	9,434	9,660	9	(143)	9,526
Total securities available for sale	$50,133	$ 99	$ (1,525)	$ 48,707	$52,763	$ 183	$ (659)	$ 52,287
Held to maturity:								
U.S. Government sponsored entities	$2,789	$ —	$ (112)	$ 2,677	$3,026	$ —	$ (93)	$ 2,933
State and political subdivisions	1,113	109	—	1,222	1,113	144	—	1,257
Residential mortgage-backed securities	3,727	19	(68)	3,678	3,958	59	(18)	3,999
Commercial mortgage-backed securities	3,628	—	(188)	3,440	3,685	—	(142)	3,543
Corporate and other securities	4,520	77	—	4,597	4,525	89	—	4,614
Total securities held to maturity	$15,777	$ 205	$ (368)	$ 15,614	$16,307	$ 292	$ (253)	$ 16,346
Equity securities:								
Total equity securities	$1,262	$ 30	$ (94)	$ 1,198	$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 June 30, 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	$—	— %	$3,653	1.61%	$1,945	2.17%	$—	— %	$5,598	1.80%
State and political subdivisions	796	3.89	359	2.41	1,695	2.41	1,972	2.69	4,822	2.77
Residential mortgage-backed securities	237	3.11	11,565	2.75	15,383	2.81	1,668	2.68	28,853	2.78
Corporate and other securities	—	—	5,637	4.20	3,797	3.93	—	—	9,434	4.09
Total securities available for sale	$1,033	3.71%	$21,214	2.93%	$22,820	2.91%	$3,640	2.69%	$48,707	2.92%
Held to maturity at cost:										
U.S. Government sponsored entities	$—	— %	$—	— %	$2,789	1.98%	$—	— %	$2,789	1.98%
State and political subdivisions	162	1.48	494	5.07	—	—	457	5.84	1,113	4.86
Residential mortgage-backed securities	1	4.23	1,156	3.09	800	3.09	1,770	3.77	3,727	3.41
Commercial mortgage-backed securities	—	—	—	—	1,624	2.48	2,004	2.98	3,628	2.76
Corporate and other securities	—	—	4,520	5.73	—	—	—	—	4,520	5.73
Total securities held to maturity	$163	1.50%	$6,170	5.18%	$5,213	2.31%	$4,231	3.62%	$15,777	3.77%
Equity securities at fair value:										
Total equity securities	$—	— %	$—	— %	$—	— %	$1,198	2.04%	$1,198	2.04%

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 June 30, 2018 and December 31, 2017 are as follows:

	June 30, 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	$1,720	$ (32)	$3,878	$ (131)	$5,598	$ (163)
State and political subdivisions	6	2,513	(72)	1,513	(108)	4,026	(180)
Residential mortgage-backed securities	28	13,576	(345)	13,339	(596)	26,915	(941)
Corporate and other securities	5	3,129	(40)	3,786	(201)	6,915	(241)
Total temporarily impaired securities	44	$20,938	$ (489)	$22,516	$ (1,036)	$43,454	$ (1,525)
Held to maturity:							
U.S. Government sponsored entities	2	$—	$ —	$2,677	$ (112)	$2,677	$ (112)

Residential mortgage-backed securities	8	2,550	(26)	873	(42)	$3,423	(68)
Commercial mortgage-backed securities	2	—	—	3,439	(188)	3,439	(188)
Total temporarily impaired securities	12	$2,550	$ (26)	$6,989	$ (342)	$9,539	$ (368)
Equity securities:							
Total temporarily impaired securities	2	$—	$ —	$906	$ (94)	$906	$ (94)

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	December 31, 2017						
		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	$3,732	$ (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	(30)	2,803	(184)	7,366	(214)
Total temporarily impaired securities	36	$29,417	$ (294)	$10,581	$ (436)	$39,998	$ (730)
Held to maturity:							
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 June 30, 2018. There was no impairment on these securities at 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 FNMA, GNMA, and the 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 June 30, 2018 or December 31, 2017.

Corporate and other securities: Included in this category are corporate debt securities, Community Reinvestment Act (“CRA”) 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

and the unrealized losses on CRA investments were caused by decreases in the market value of underlying bonds and rate changes. 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 June 30, 2018 or December 31, 2017. The contractual terms do not allow the securities to be settled at a price less than the par value. Because the Company does not intend to sell the securities and it is not more likely than not that the Company will be required to sell the securities before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired as of June 30, 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 transfered 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

Gross realized gains on securities for the three and six months ended June 30, 2018 and 2017 are detailed in the table below:

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands)	2018	2017	2018	2017
Available for sale:				
Realized gains	$—	$74	$—	$74
Realized losses	—	(58)	—	(58)
Total securities available for sale	—	16	—	16
Held to maturity:				
Realized gains	—	—	—	—
Realized losses	—	—	—	—
Total securities held to maturity	—	—	—	—
Net gains on sales of securities	$—	$16	$—	$16

The net realized gains are included in noninterest income in the Consolidated Statements of Income as net security gains. There were no gross realized gains for the three and six months ended June 30, 2018. There was a gross realized gain of $16 thousand for the three and six months ended June 30, 2017.

For the three and six months ended June 30, 2017, the net gains are attributed to the sale of three residential mortgage-backed securities with a total book value of $1.2 million and resulting gains of $71 thousand, and the call of two asset-backed securities with a total book value of $3.5 million and resulting gains of $3 thousand, partially offset by the sale of two residential mortgage-backed securities with a book value of $1.6 million which resulted in a loss of $58 thousand.

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 and six months ended June 30, 2018:

(In thousands)	Three months ended June 30, 2018	Six months ended June 30, 2018
Net gains (losses) recognized during the period on equity securities	7	(9)
Less: Net gains (losses) recognized during the period on equity securities sold during the period	—	—
Unrealized gains (losses) recognized during the reporting period on equity securities still held at the reporting date	7	(9)

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Pledged Securities

Securities with a carrying value of $3.8 million and $20.8 million for June 30, 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 June 30, 2018 and December 31, 2017:

(In thousands)	June 30, 2018	December 31, 2017
SBA loans held for investment	$41,351	$ 43,999
Commercial loans		
SBA 504 loans	23,927	21,871
Commercial other	96,759	82,825
Commercial real estate	479,530	469,696
Commercial real estate construction	73,264	54,473
Residential mortgage loans	398,383	365,145
Consumer loans		
Home equity	60,974	55,817
Consumer other	57,434	54,038
Total loans held for investment	$1,231,622	$ 1,147,864
SBA loans held for sale	14,889	22,810
Total loans	$1,246,511	$ 1,170,674

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.

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. 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. Commercial 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.

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) 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”.

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 June 30, 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 $3.0 million of residential consumer loans in the process of foreclosure at June 30, 2018, compared to $1.2 million at December 31, 2017.

The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of June 30, 2018:

	June 30, 2018 SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans held for investment	$39,215	$ 564	$ 1,572	$41,351
Commercial loans				
SBA 504 loans	22,838	—	1,089	23,927
Commercial other	96,121	187	451	96,759
Commercial real estate	474,481	2,115	2,934	479,530
Commercial real estate construction	73,264	—	—	73,264
Total commercial loans	666,704	2,302	4,474	673,480
Total SBA, SBA 504 and commercial loans	$705,919	$ 2,866	$ 6,046	$714,831

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans	$ 396,723	$ 1,660	$398,383
Consumer loans			
Home equity	60,907	67	60,974
Consumer other	57,434	—	57,434
Total consumer loans	118,341	67	118,408
Total residential mortgage and consumer loans	$ 515,064	$ 1,727	$516,791

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:

	December 31, 2017			
	SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans held for investment	$42,415	$ 373	$ 1,211	$43,999
Commercial loans				
SBA 504 loans	20,751	1,024	96	21,871
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	622,014	4,670	2,181	628,865
Total SBA, SBA 504 and commercial loans	$664,429	$ 5,043	$ 3,392	$672,864

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans	$ 363,476	$ 1,669	$365,145
Consumer loans			
Home equity	55,192	625	55,817
Consumer other	54,038	—	54,038
Total consumer loans	109,230	625	109,855
Total residential mortgage and consumer loans	$ 472,706	$ 2,294	$475,000

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 improved state of the economy has resulted in a substantial reduction in nonperforming loans and loan delinquencies. 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 June 30, 2018 and December 31, 2017:

	June 30, 2018						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$60	$—	$ —	$ 1,420	$1,480	$39,871	$41,351
Commercial loans							
SBA 504 loans	—	—	—	—	—	23,927	23,927
Commercial other	39	—	—	19	58	96,701	96,759
Commercial real estate	312	—	—	2,043	2,355	477,175	479,530
Commercial real estate construction	—	—	—	—	—	73,264	73,264
Residential mortgage loans	3,749	1,839	286	1,660	7,534	390,849	398,383
Consumer loans							
Home equity	101	198	—	67	366	60,608	60,974
Consumer other	—	—	—	—	—	57,434	57,434
Total loans held for investment	$4,261	$2,037	$ 286	$ 5,209	$11,793	$1,219,829	$1,231,622
SBA loans held for sale	—	—	—	—	—	14,889	14,889
Total loans	$4,261	$2,037	$ 286	$ 5,209	$11,793	$1,234,718	$1,246,511

(1) At June 30, 2018, nonaccrual loans included $129 thousand of loans guaranteed by the SBA.

	December 31, 2017						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$240	$313	$ —	$ 632	$1,185	$42,814	$43,999
Commercial loans							
SBA 504 loans	—	—	—	—	—	21,871	21,871
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 June 30, 2018:

(In thousands)	June 30, 2018 Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$331	$ 304	$ —
Commercial loans			
Commercial real estate	2,042	2,042	—
Total commercial loans	2,042	2,042	—
Total impaired loans with no related allowance	2,373	2,346	—
With an allowance:			
SBA loans held for investment (1)	1,078	989	448
Commercial loans			
Commercial other	19	19	19
Commercial real estate	767	767	119
Total commercial loans	786	786	138
Total impaired loans with a related allowance	1,864	1,775	586
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	1,409	1,292	448
Commercial loans			
Commercial other	19	19	19
Commercial real estate	2,809	2,809	119
Total commercial loans	2,828	2,828	138
Total individually evaluated impaired loans	$4,237	$ 4,120	$ 586

(1) Balances are reduced by amount guaranteed by the SBA of $129 thousand at June 30, 2018.

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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:

	December 31, 2017		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$135	$ 52	$ —
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 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
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 $2.5 million at June 30, 2018 compared to December 31, 2017. The increase in impaired loans was primarily due to the downgrade of three commercial loans totaling $2.0 million and two SBA loans totaling $579 thousand, all of which were put on to nonaccrual in 2018.

The following tables present 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 and six months ended June 30, 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 nominal amounts of income recognized on a cash basis for well-collateralized impaired loans.

	For the three months ended June 30,			
	2018		2017	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans held for investment (1)	$1,076	$ —	$989	$ 22
Commercial loans				
Commercial other	19	—	25	—
Commercial real estate	2,551	10	921	—
Total	$3,646	$ 10	$1,935	$ 22

(1) Balances are reduced by the average amount guaranteed by the SBA of $95 thousand and $54 thousand for the three months ended June 30, 2018 and 2017, respectively.

	For the six months ended June 30,			
	2018		2017	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans held for investment (1)	$867	$ (2)	$993	$ 19
Commercial loans				
SBA 504 loans	—	—	165	—
Commercial other	9	—	25	—
Commercial real estate	2,023	25	1,027	22
Total	$2,899	$ 23	$2,210	$ 41

(1) Balances are reduced by the average amount guaranteed by the SBA of $63 thousand and $151 thousand for the six months ended June 30, 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 $767 thousand and $786 thousand as of June 30, 2018, and December 31, 2017, respectively, which was included in the impaired loan numbers as of such dates. At June 30, 2018, and December 31, 2017, there were specific reserves on the performing TDR of $119 thousand and $138 thousand, respectively. 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 or six months ended June 30, 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

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some point during the three or six months ended June 30, 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), 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 five classes: commercial real estate, commercial real estate construction, unsecured business line of credit, commercial other, and SBA 504. Consumer loans are divided into two classes as follows: Home equity and other.

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) 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 June 30, 2018 and 2017:

(In thousands)	For the three months ended June 30, 2018 SBA held for investment	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$1,504	$ 8,139	$ 3,430	$ 1,123	$ —	$14,196
Charge-offs	(104)	—	—	(16)		(120)
Recoveries	3	4	—	1		8
Net (charge-offs) recoveries	(101)	4	—	(15)	—	(112)
Provision for loan losses charged to expense	234	212	63	41	—	550
Balance, end of period	$1,637	$ 8,355	$ 3,493	$ 1,149	$ —	$14,634

(In thousands)	For the three months ended June 30, 2017 SBA held for investment	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$1,653	$ 7,133	$ 2,869	$ 1,026	$ —	$12,681
Charge-offs	(150)	(120)	—	(17)		(287)
Recoveries	3	3	—	—		6
Net charge-offs	(147)	(117)	—	(17)	—	(281)
Provision for loan losses charged to expense	8	371	(53)	74	—	400
Balance, end of period	$1,514	$ 7,387	$ 2,816	$ 1,083	$ —	$12,800

The following tables detail the activity in the allowance for loan losses portfolio segment for the six months ended June 30, 2018 and 2017:

(In thousands)	For the six months ended June 30, 2018 SBA held for investment	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$1,471	$ 7,825	$ 3,130	$ 1,130	$ —	$13,556
Charge-offs	(184)	—	—	(22)		(206)
Recoveries	66	20	13	135		234
Net (charge-offs) recoveries	(118)	20	13	113	—	28
Provision for loan losses charged to expense	284	510	350	(94)	—	1,050
Balance, end of period	$1,637	$ 8,355	$ 3,493	$ 1,149	$ —	$14,634

(In thousands)	For the six months ended June 30, 2017 SBA held for investment	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$1,576	$ 7,302	$ 2,593	$ 925	$ 183	$12,579
Charge-offs	(258)	(196)	—	(83)		(537)
Recoveries	39	56	12	1		108
Net (charge-offs) recoveries	(219)	(140)	12	(82)	—	(429)
Provision for loan losses charged to expense	157	225	211	240	(183)	650
Balance, end of period	$1,514	$ 7,387	$ 2,816	$ 1,083	$ —	$12,800

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The following tables present loans and their related allowance for loan losses, by portfolio segment, as of June 30, 2018 and December 31, 2017:

	June 30, 2018				
(In thousands)	SBA held for investment	Commercial	Residential	Consumer	Total
Allowance for loan losses ending balance:					
Individually evaluated for impairment	$448	$ 138	$ —	$ —	$586
Collectively evaluated for impairment	1,189	8,217	3,493	1,149	14,048
Total	$1,637	$ 8,355	$ 3,493	$ 1,149	$14,634
Loan ending balances:					
Individually evaluated for impairment	$1,293	$ 2,828	$ —	$ —	$4,121
Collectively evaluated for impairment	40,058	670,652	398,383	118,408	1,227,501
Total	$41,351	$ 673,480	$ 398,383	$ 118,408	$1,231,622

	December 31, 2017				
(In thousands)	SBA held for investment	Commercial	Residential	Consumer	Total
Allowance for loan losses ending balance:					
Individually evaluated for impairment	$194	$ 138	$ —	$ —	$332
Collectively evaluated for impairment	1,277	7,687	3,130	1,130	13,224
Total	$1,471	$ 7,825	$ 3,130	$ 1,130	$13,556
Loan ending balances:					
Individually evaluated for impairment	$605	$ 854	$ —	$ —	$1,459
Collectively evaluated for impairment	43,394	628,011	365,145	109,855	1,146,405
Total	$43,999	$ 628,865	$ 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 June 30, 2018, a $283 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a $292 thousand commitment reserve at December 31, 2017.

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.

Under previous U.S. GAAP, when full consideration is not expected and financing is required by the buyer to purchase the property, there were 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 was 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.

For deposit-related fees, considering the straightforward nature of the arrangements with the Company’s deposits customers, the Company's recognition and measurement outcomes of deposit-related fees was not significantly different under the new guidance compared to previous 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 June 30, 2018, $9 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 June 30, 2018, the Company had minimum noncancelable net operating lease payments of $1.9 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 $75 thousand cumulative-effect adjustment that increased retained earnings and decreased AOCI in the first quarter of 2018.

ASU 2018-06, "Codification Improvements to Topic 942, Financial Services - Depository and Lending." ASU 2018-06 was issued to replace the outdated Accounting for Net Deferred Taxes Charges (Circular 202). The ASU is effective immediately upon the release of the update. The adoption of the new guidance is not expected to have a significant effect on the consolidated financial statements.

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 and six months ended June 30, 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 June 30, 2018 and 2017, respectively is as follows:

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands, except percentages and years)	2018	2017	2018	2017
Notional amount	$60,000	$60,000	$60,000	$60,000
Weighted average pay rate	1.26 %	1.26 %	1.26 %	1.26 %
Weighted average receive rate	1.94 %	1.07 %	1.58 %	0.98 %

Weighted average maturity in years	2.37	3.36	2.61	3.61
Unrealized gain (loss) relating to interest rate swaps	$82	$312	$665	$(231)

At June 30, 2018, the unrealized gain relating to interest rate swaps was recorded as a derivative asset in Other Assets on our Consolidated Balance Sheet. 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 six months ended June 30, 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	(77,607)	5.05		
Options forfeited	(7,433)	15.47		
Options expired	—	—		
Outstanding at June 30, 2018	534,033	$ 11.24	6.7	$6,146,335
Exercisable at June 30, 2018	335,072	$ 7.72	5.3	$5,035,701

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 June 30, 2018, 2,462,585 shares have been reserved for issuance upon the exercise of options, 534,033 option grants are outstanding, and 1,653,247 option grants have been exercised, forfeited or expired, leaving 275,305 shares available for grant.

The fair values of the options granted during the six months ended June 30, 2018 and 2017 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions. No options were granted during the three months ended June 30, 2018 and 2017:

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	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)	0.00	0.00	6.35	6.57
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 and six months ended June 30, 2018 and 2017:

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Number of options exercised	22,600	29,618	77,607	46,682
Total intrinsic value of options exercised	$411,738	$337,230	$1,237,391	$484,920
Cash received from options exercised	101,601	135,837	391,958	270,792
Tax deduction realized from options	$115,740	$137,758	$347,831	$198,089

The following table summarizes information about stock options outstanding and exercisable at June 30, 2018:

	Options outstanding			Options exercisable	
Range of exercise prices	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$0.00 - 4.00	28,000	0.7	$ 3.56	28,000	$ 3.56
4.01 - 8.00	166,100	4.3	6.20	166,100	6.20
8.01 - 12.00	154,367	7.3	9.41	116,963	9.24
12.01 - 16.00	44,066	8.5	14.96	14,007	14.93
16.01 - 20.00	101,500	9.3	18.86	10,002	16.75
20.01 - 24.00	40,000	9.7	21.15	—	—
Total	534,033	6.7	$ 11.24	335,072	$ 7.72

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 and six months ended June 30, 2018 and 2017 are detailed in the following table:

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Compensation expense	$118,202	$71,023	$241,662	$140,839
Income tax benefit	33,226	29,013	67,931	57,533

As of June 30, 2018, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company’s stock option plans totaled approximately $817 thousand. That cost is expected to be recognized over a weighted average period of 2.2 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 six months ended June 30, 2018:

Shares

		Average grant date fair value
Nonvested restricted stock at December 31, 2017	94,003	$ 12.53
Granted	38,300	20.64
Cancelled	(1,624)	17.00
Vested	(29,142)	11.30
Nonvested restricted stock at June 30, 2018	101,537	$ 15.87

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 June 30, 2018, 518,157 shares of restricted stock were reserved for issuance, of which 74,728 shares are available for grant.

Restricted stock awards granted during the three and six months ended June 30, 2018 and 2017 were as follows:

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	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 and six months ended June 30, 2018 and 2017 is detailed in the following table:

	For the three months ended June 30,		For the six months ended June 30,	
	2018	2017	2018	2017
Compensation expense	$ 144,839	$ 107,773	$ 286,136	$ 249,577
Income tax benefit	40,714	44,025	80,433	101,952

As of June 30, 2018, there was approximately $1.4 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 2.9 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 $176 thousand and $138 thousand during the three months ended June 30, 2018 and 2017, respectively, and $312 thousand and $257 thousand during the six months ended June 30, 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 100 percent of their year end cash bonuses. Director and executive deferred fees totaled $9 thousand and $6 thousand during the three months ended June 30, 2018 and 2017, and $260 thousand and $126 thousand during the six months ended June 30, 2018, and 2017 respectively. The interest paid on the deferred balances totaled $17 thousand and $12 thousand during the three months ended June 30, 2018 and 2017, and $32 thousand and $21 thousand during the six months ended June 30, 2018, and 2017 respectively. The fees distributed on the deferred balances totaled $3 thousand and $7 thousand during the three and six months ended June 30, 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 percent (2%). The total benefit is to be made payable in fifteen annual installments. The future payments are estimated to total $3.3 million. A discount rate of 4.00 percent 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 three percent (3%) 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.
No contributions or payments have been made during the three and six months ended June 30, 2018. The following table summarizes the components of the net periodic pension cost of the defined benefit plan recognized during the three and six months ended June 30, 2018 and 2017:

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands)	2018	2017	2018	2017
Service cost	$94	$ 35	$206	$ 51
Interest cost	18	11	31	21
Amortization of prior service cost	21	21	42	42
Net periodic benefit cost	$133	$ 67		