

MACATAWA BANK CORP  
Form 10-Q  
July 27, 2017

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

FORM 10-Q

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

For the quarterly period ended June 30, 2017

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: 000-25927

MACATAWA BANK CORPORATION  
(Exact name of registrant as specified in its charter)

Michigan 38-3391345  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

10753 Macatawa Drive, Holland, Michigan 49424  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444

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Indicate by checkmark 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 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging Growth Company

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:  
33,938,486 shares of the Company's Common Stock (no par value) were outstanding as of July 27, 2017.

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Forward-Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Macatawa Bank Corporation. Forward-looking statements are identifiable by words or phrases such as "outlook", "plan" or "strategy"; that an event or trend "may", "should", "will", "is likely", or is "probable" to occur or "continue", has "begun" or "is scheduled" or that the Company or its management "anticipates", "believes", "estimates", "plans", "forecasts", "intends", "predicts", "projects", "expects" a particular result, or is "committed", "confident", "optimistic" or has an "opinion" that an event will occur, or other words or phrases such as "ongoing", "future", "signs", "efforts", "tend", "exploring", "appearing", "until", "near term", "concentrate", "focus", "starting", "initiative," "trend" and variations of such words and similar expressions. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, future levels of earning assets, statements related to stabilization of our loan portfolio, trends in credit quality metrics, future capital levels and capital needs, including the impact of Basel III, real estate valuation, future levels of repossessed and foreclosed properties and nonperforming assets, future levels of losses and costs associated with the administration and disposition of repossessed and foreclosed properties and nonperforming assets, future levels of loan charge-offs, future levels of other real estate owned, future levels of provisions for loan losses and reserve recoveries, the rate of asset dispositions, future dividends, future growth and funding sources, future cost of funds, future liquidity levels, future profitability levels, future FDIC assessment levels, future net interest margin levels, building and improving our investment portfolio, diversifying our credit risk, the effects on earnings of changes in interest rates, future economic conditions, future effects of new or changed accounting standards, future loss recoveries, future balances of short-term investments, future loan demand and loan growth, future levels of mortgage banking revenue and the future level of other revenue sources. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including deferred tax assets) and other real estate owned, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment) involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Our ability to sell other real estate owned at its carrying value or at all, successfully implement new programs and initiatives, increase efficiencies, maintain our current levels of deposits and other sources of funding, maintain liquidity, respond to declines in collateral values and credit quality, increase loan volume, originate high quality loans, maintain or improve mortgage banking income, realize the benefit of our deferred tax assets, continue payment of dividends and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Macatawa Bank Corporation, specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. Macatawa Bank Corporation does not undertake to update forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2016. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

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## Part I Financial Information

## Item 1.

## MACATAWA BANK CORPORATION

## CONSOLIDATED BALANCE SHEETS

As of June 30, 2017 (unaudited) and December 31, 2016

(Dollars in thousands, except per share data)

	June 30, 2017	December 31, 2016
<b>ASSETS</b>		
Cash and due from banks	\$31,165	\$ 27,690
Federal funds sold and other short-term investments	114,104	62,129
Cash and cash equivalents	145,269	89,819
Securities available for sale, at fair value	184,761	184,433
Securities held to maturity (fair value 2017 - \$69,816 and 2016 - \$69,849)	68,818	69,378
Federal Home Loan Bank (FHLB) stock	11,558	11,558
Loans held for sale, at fair value	3,184	2,181
Total loans	1,251,355	1,280,812
Allowance for loan losses	(16,570 )	(16,962 )
Net loans	1,234,785	1,263,850
Premises and equipment – net	48,626	50,026
Accrued interest receivable	4,084	4,092
Bank-owned life insurance	39,781	39,274
Other real estate owned - net	7,097	12,253
Net deferred tax asset	5,869	8,863
Other assets	5,231	5,286
Total assets	\$1,759,063	\$ 1,741,013
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest-bearing	\$481,769	\$ 501,478
Interest-bearing	978,221	947,246
Total deposits	1,459,990	1,448,724
Other borrowed funds	82,785	84,173
Long-term debt	41,238	41,238
Accrued expenses and other liabilities	4,875	4,639
Total liabilities	1,588,888	1,578,774
Commitments and contingent liabilities	---	---
Shareholders' equity		
Common stock, no par value, 200,000,000 shares authorized; 33,938,486 and 33,940,788 shares issued and outstanding at June 30, 2017 and December 31, 2016	216,959	216,731
Retained deficit	(46,491 )	(53,008 )
Accumulated other comprehensive income (loss)	(293 )	(1,484 )
Total shareholders' equity	170,175	162,239
Total liabilities and shareholders' equity	\$1,759,063	\$ 1,741,013

See accompanying notes to consolidated financial statements.

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## MACATAWA BANK CORPORATION

## CONSOLIDATED STATEMENTS OF INCOME

Three and Six Month Periods Ended June 30, 2017 and 2016

(unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Interest income				
Loans, including fees	\$ 12,540	\$ 11,634	\$ 24,996	\$ 23,390
Securities				
Taxable	646	565	1,285	1,115
Tax-exempt	546	441	1,084	874
FHLB Stock	121	122	244	246
Federal funds sold and other short-term investments	189	111	281	256
Total interest income	14,042	12,873	27,890	25,881
Interest expense				
Deposits	557	439	1,038	902
Other borrowings	358	458	740	900
Long-term debt	422	368	824	733
Total interest expense	1,337	1,265	2,602	2,535
Net interest income	12,705	11,608	25,288	23,346
Provision for loan losses	(500 )	(750 )	(1,000 )	(850 )
Net interest income after provision for loan losses	13,205	12,358	26,288	24,196
Noninterest income				
Service charges and fees	1,110	1,112	2,170	2,159
Net gains on mortgage loans	476	572	904	1,060
Trust fees	833	788	1,611	1,496
ATM and debit card fees	1,338	1,257	2,539	2,443
Gain on sales of securities	---	10	3	99
Bank owned life insurance ("BOLI") income	243	158	481	602
Other	478	639	1,001	1,285
Total noninterest income	4,478	4,536	8,709	9,144
Noninterest expense				
Salaries and benefits	6,153	6,168	12,152	12,355
Occupancy of premises	991	901	2,017	1,883
Furniture and equipment	750	839	1,482	1,704
Legal and professional	197	188	422	347
Marketing and promotion	225	275	453	550
Data processing	731	688	1,413	1,347
FDIC assessment	134	220	270	472
Interchange and other card expense	324	308	637	594
Bond and D&O Insurance	118	131	234	263
Net losses (gains) on repossessed and foreclosed properties	(300 )	258	(385 )	294
Administration and disposition of problem assets	142	202	322	577
Other	1,327	1,292	2,662	2,635

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Total noninterest expenses	10,792	11,470	21,679	23,021
Income before income tax	6,891	5,424	13,318	10,319
Income tax expense	2,129	1,679	4,095	3,079
Net income	\$ 4,762	\$ 3,745	\$ 9,223	\$ 7,240
Basic earnings per common share	\$ 0.14	\$ 0.11	\$ 0.27	\$ 0.21
Diluted earnings per common share	\$ 0.14	\$ 0.11	\$ 0.27	\$ 0.21
Cash dividends per common share	\$ 0.04	\$ 0.03	\$ 0.08	\$ 0.06

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See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Three and Six Month Periods Ended June 30, 2017 and 2016

(unaudited)

(Dollars in thousands)

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	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Net income	\$ 4,762	\$ 3,745	\$ 9,223	\$ 7,240
Other comprehensive income:				
Unrealized gains (losses):				
Net change in unrealized gains (losses) on securities available for sale	772	590	1,835	1,654
Tax effect	(270 )	(206 )	(642 )	(579 )
Net change in unrealized gains (losses) on securities available for sale, net of tax	502	384	1,193	1,075
Less: reclassification adjustments:				
Reclassification for gains included in net income	---	10	3	99
Tax effect	---	(3 )	(1 )	(35 )
Reclassification for gains included in net income, net of tax	---	7	2	64
Other comprehensive income (loss), net of tax	502	377	1,191	1,011
Comprehensive income	\$ 5,264	\$ 4,122	\$ 10,414	\$ 8,251

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See accompanying notes to consolidated financial statements.

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## MACATAWA BANK CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Six Month Periods Ended June 30, 2017 and 2016

(unaudited)

(Dollars in thousands, except per share data)

	Common Stock	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, January 1, 2016	\$216,540	\$(64,910)	\$ 347	\$ 151,977
Net income for the six months ended June 30, 2016	---	7,240	---	7,240
Cash dividends at \$.06 per share	---	(2,025 )	---	(2,025 )
Repurchase of 2,824 shares for taxes withheld on vested restricted stock	(19 )	---	---	(19 )
Net change in unrealized gain on securities available for sale, net of tax	---	---	1,011	1,011
Stock compensation expense	278	---	---	278
Balance, June 30, 2016	\$216,799	\$(59,695)	\$ 1,358	\$ 158,462
Balance, January 1, 2017	\$216,731	\$(53,008)	\$ (1,484 )	\$ 162,239
Net income for the six months ended June 30, 2017	---	9,223	---	9,223
Cash dividends at \$.08 per share	---	(2,706 )	---	(2,706 )
Net change in unrealized loss on securities available for sale, net of tax	---	---	1,191	1,191
Stock compensation expense	228	---	---	228
Balance, June 30, 2017	\$216,959	\$(46,491)	\$ (293 )	\$ 170,175

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

Six Month Periods Ended June 30, 2017 and 2016

(unaudited)

(Dollars in thousands)

	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Cash flows from operating activities		
Net income	\$ 9,223	\$ 7,240
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	973	1,403
Stock compensation expense	228	278
Provision for loan losses	(1,000 )	(850 )
Origination of loans for sale	(33,707 )	(37,891 )
Proceeds from sales of loans originated for sale	33,608	40,589
Net gains on mortgage loans	(904 )	(1,060 )
Gain on sales of securities	(3 )	(99 )
Write-down of other real estate	85	555
Net gain on sales of other real estate	(470 )	(260 )
Net loss on sale of premises and equipment	69	---
Deferred income tax expense	2,353	(147 )
Change in accrued interest receivable and other assets	63	(1,405 )
Earnings in bank-owned life insurance	(481 )	(602 )
Change in accrued expenses and other liabilities	236	2,182
Net cash from operating activities	10,273	9,933
Cash flows from investing activities		
Loan originations and payments, net	30,005	(13,286 )
Change in interest-bearing deposits in other financial institutions	---	20,000
Purchases of securities available for sale	(14,683 )	(43,570 )
Purchases of securities held to maturity	(3,000 )	(1,144 )
Proceeds from:		
Maturities and calls of securities	10,872	30,480
Sales of securities available for sale	5,807	9,648
Principal paydowns on securities	3,381	1,873
Sales of other real estate	5,601	3,313
Sales of premises and equipment	590	---
Death benefit from bank-owned life insurance	---	518
Additions to premises and equipment	(568 )	(501 )
Net cash from investing activities	38,005	7,331
Cash flows from financing activities		
Change in deposits	11,266	(80,434 )
Repayments and maturities of other borrowed funds	(21,388 )	(1,329 )
Proceeds from other borrowed funds	20,000	10,000
Cash dividends paid	(2,706 )	(2,025 )

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Repurchase of shares for taxes withheld on vested restricted stock	---	(19 )
Net cash from financing activities	7,172	(73,807 )
Net change in cash and cash equivalents	55,450	(56,543 )
Cash and cash equivalents at beginning of period	89,819	181,476
Cash and cash equivalents at end of period	\$ 145,269	\$ 124,933

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See accompanying notes to consolidated financial statements.

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## MACATAWA BANK CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

Six Month Periods Ended June 30, 2017 and 2016

(unaudited)

(Dollars in thousands)

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	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Supplemental cash flow information		
Interest paid	\$ 2,600	\$ 2,536
Income taxes paid	825	3,200
Supplemental noncash disclosures:		
Transfers from loans to other real estate	60	102
Security settlement	---	---

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See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of Macatawa Bank Corporation ("the Company", "our", "we") and its wholly-owned subsidiary, Macatawa Bank ("the Bank"). All significant intercompany accounts and transactions have been eliminated in consolidation.

Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The Bank operates 26 full service branch offices providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan.

The Company owns all of the common stock of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are not consolidated with the Company under accounting principles generally accepted in the United States of America.

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) believed necessary for a fair presentation have been included.

Operating results for the three and six month periods ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. For further information, refer to the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, valuation of deferred tax assets, loss contingencies, fair value of other real estate owned and fair values of financial instruments are particularly subject to change.

Allowance for Loan Losses: The allowance for loan losses (allowance) is a valuation allowance for probable incurred credit losses inherent in our loan portfolio, increased by the provision for loan losses and recoveries, and decreased by charge-offs of loans. Management believes the allowance for loan losses balance to be adequate based on known and inherent risks in the portfolio, past loan loss experience, information about specific borrower situations and estimated collateral values, economic conditions and other relevant factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Management continues its collection efforts on previously charged-off balances and applies recoveries as additions to the allowance for loan losses.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current qualitative factors. The Company maintains a loss migration analysis that tracks loan

losses and recoveries based on loan class and the loan risk grade assignment for commercial loans. At June 30, 2017, an 18 month annualized historical loss experience was used for commercial loans and a 12 month historical loss experience period was applied to residential mortgage loans and consumer loans. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, external factors and other considerations.

A loan is impaired when, based on current information and events, it is believed to be probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified and a concession has been made, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Commercial and commercial real estate loans with relationship balances exceeding \$500,000 and an internal risk grading of 6 or worse are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated and the loan is reported at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment and they are not separately identified for impairment disclosures.

Troubled debt restructurings are also considered impaired with impairment generally measured at the present value of estimated future cash flows using the loan's effective rate at inception or using the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral.

Foreclosed Assets: Assets acquired through or instead of loan foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed unless they add value to the property.

Income Taxes: Income tax expense is the sum of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

We recognize a tax position as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. We recognize interest and penalties related to income tax matters in income tax expense.

Derivatives: Certain of our commercial loan customers have entered into interest rate swap agreements directly with the Bank. At the same time the Bank enters into a swap agreement with its customer, the Bank enters into a corresponding interest rate swap agreement with a correspondent bank at terms mirroring the Bank's interest rate swap with its commercial loan customer. This is known as a back-to-back swap agreement. Under this arrangement the Bank has two freestanding interest rate swaps, both of which are carried at fair value. As the terms mirror each other, there is no income statement impact to the Bank. At June 30, 2017 and December 31, 2016, the total notional amount of such agreements was \$43.1 million and \$48.1 million and resulted in a derivative asset with a fair value of \$395,000 and \$494,000, respectively, which were included in other assets and a derivative liability of \$395,000 and \$494,000, respectively, which were included in other liabilities.

Reclassifications: Some items in the prior period financial statements were reclassified to conform to the current presentation.

Adoption of New Accounting Standards: The Financial Accounting Standards Board "FASB" issued Accounting Standards Update ("ASU") ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting. This ASU simplifies several aspects of the accounting for employee share-based payment transactions for both public and



nonpublic entities, including the following: Accounting for income taxes, classification of excess tax benefits on the statement of cash flows, forfeitures, statutory tax withholding requirements, classification of awards as either equity or liabilities and classification of employee taxes paid on the statement of cash flows when an employer withholds shares for tax-withholding purposes. The amendments are effective for annual periods beginning after December 15, 2016, and for interim periods within those annual periods. The impact of adoption of this ASU by the Company was not material as no stock awards vested or were exercised in the six months ended June 30, 2017, but could cause some volatility in income tax expense in future periods where stock awards vest.

FASB issued ASU No. 2017-08, Premium Amortization on Purchased Callable Debt Securities. This ASU changes generally accepted accounting principles (“GAAP”) to require premiums on purchased callable debt securities to be amortized to the earliest call date. Previous GAAP allowed entities to amortize to contractual maturity or to call date. The amendments in this ASU are effective for annual periods beginning after December 15, 2018, with early adoption permitted. As the Company has consistently amortized premiums on its purchased callable debt securities, the Company has elected to early adopt this ASU effective January 1, 2017. There was no impact of adoption of this ASU by the Company.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Newly Issued Not Yet Effective Standards: FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in this Update create a new topic in the Codification, Topic 606. In addition to superseding and replacing nearly all existing U.S. GAAP revenue recognition guidance, including industry-specific guidance, ASC 606 establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, ASU 2014-09 adds a new Subtopic to the Codification, ASC 340-40, Other Assets and Deferred Costs: Contracts with Customers, to provide guidance on costs related to obtaining a contract with a customer and costs incurred in fulfilling a contract with a customer that are not in the scope of another ASC Topic. The new guidance does not apply to certain contracts within the scope of other ASC Topics, such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees other than product or service warranties, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers. The amendments are effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. This ASU may require us to change how we recognize certain recurring revenue streams within trust and investment management fees, however, we do not expect these changes to have a significant effect on our financial statements.

FASB issued ASU 2016-02, Leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. As the Company owns most of its branch locations, this ASU will apply primarily to operating leases and the impact of adoption of this ASU by the Company is not expected to be material.

FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU provides financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date by replacing the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The new guidance eliminates the probable initial recognition threshold and, instead, reflects an entity's current estimate of all expected credit losses. The new guidance broadens the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually to include forecasted information, as well as past events and current conditions. There is no specified method for measuring expected credit losses, and an entity is allowed to apply methods that reasonably reflect its expectations of the credit loss estimate. Although an entity may still use its current systems and methods for recording the allowance for credit losses, under the new rules, the inputs used to record the allowance for credit losses generally will need to change to appropriately reflect an estimate of all expected credit losses and the use of reasonable and supportable forecasts. Additionally, credit losses on available-for-sale debt securities will now have to be presented as an allowance rather than as a write-down. This ASU is effective for fiscal years beginning after December 15, 2019, and for interim periods within those years. The Company is currently evaluating the impact of this new ASU on its consolidated financial statements.

FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force). This ASU addresses concerns regarding diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. In particular, this ASU addresses eight specific cash flow issues in an effort to reduce this diversity in practice: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon bonds; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. The amendments are effective for annual periods beginning after December 15, 2017, and for interim periods within those annual periods. The impact of adoption of this ASU by the Company is not expected to be material.

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## NOTE 2 – SECURITIES

The amortized cost and fair value of securities at period-end were as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>June 30, 2017</u>				
<u>Available for Sale:</u>				
U.S. Treasury and federal agency securities	\$ 85,385	\$ 47	\$ (694 )	\$ 84,738
U.S. Agency MBS and CMOs	11,941	15	(113 )	11,843
Tax-exempt state and municipal bonds	39,097	696	(134 )	39,659
Taxable state and municipal bonds	35,306	78	(316 )	35,068
Corporate bonds and other debt securities	11,983	16	(25 )	11,974
Other equity securities	1,500	---	(21 )	1,479
	\$ 185,212	\$ 852	\$ (1,303 )	\$ 184,761
<u>Held to Maturity</u>				
Tax-exempt state and municipal bonds	\$ 68,818	\$ 1,003	\$ (5 )	\$ 69,816
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>December 31, 2016</u>				
<u>Available for Sale:</u>				
U.S. Treasury and federal agency securities	\$ 85,582	\$ 49	\$ (1,281 )	\$ 84,350
U. S. Agency MBS and CMOs	12,037	11	(231 )	11,817
Tax-exempt state and municipal bonds	39,578	212	(603 )	39,187
Taxable state and municipal bonds	34,255	65	(437 )	33,883
Corporate bonds and other debt securities	13,765	16	(55 )	13,726
Other equity securities	1,500	---	(30 )	1,470
	\$ 186,717	\$ 353	\$ (2,637 )	\$ 184,433
<u>Held to Maturity:</u>				
Tax-exempt state and municipal bonds	\$ 69,378	\$ 573	\$ (102 )	\$ 69,849

Proceeds from the sale of securities available for sale were \$2.4 million in the three month period ended June 30, 2017 and \$5.8 million in the six month period ended June 30, 2017 resulting in no gains or losses on sale for the three month period ended June 30, 2017 and net gains of \$3,000 for the six month period ended June 30, 2017, as reported in the Consolidated Statements of Income. This resulted in reclassifications of \$3,000 (\$2,000 net of tax) from accumulated other comprehensive income to gain on sale of securities in the Consolidated Statements of Income in the six month period ended June 30, 2017. Proceeds from the sale of securities available for sale were \$230,000 in the three month period ended June 30, 2016 and \$9.6 million in the six month period ended June 30, 2016 resulting in net gains on sale of \$10,000 and \$99,000, respectively, as reported in the Consolidated Statements of Income. This resulted in reclassifications of \$10,000 (\$7,000 net of tax) and \$99,000 (\$64,000 net of tax) from accumulated other comprehensive income to gain on sale of securities in the Consolidated Statements of Income in the three and six month periods ended June 30, 2016.



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## NOTE 2 – SECURITIES (Continued)

Contractual maturities of debt securities at June 30, 2017 were as follows (dollars in thousands):

	Held-to-Maturity Securities		Available-for-Sale Securities	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 23,770	\$ 23,820	\$ 19,067	\$ 19,062
Due from one to five years	13,837	14,310	100,966	100,532
Due from five to ten years	10,342	10,659	49,141	49,266
Due after ten years	20,869	21,027	14,538	14,422
	\$ 68,818	\$ 69,816	\$ 183,712	\$ 183,282

Securities with unrealized losses at June 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (dollars in thousands):

<u>June 30, 2017</u>	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and federal agency securities	\$ 60,556	\$ (684 )	\$ 3,025	\$ (9 )	\$ 63,581	\$ (693 )
U.S. Agency MBS and CMOs	10,874	(113 )	---	---	10,874	(113 )
Tax-exempt state and municipal bonds	8,560	(134 )	385	(5 )	8,945	(139 )
Taxable state and municipal bonds	20,420	(308 )	237	(9 )	20,657	(317 )
Corporate bonds and other debt securities	4,264	(21 )	1,000	(4 )	5,264	(25 )
Other equity securities	1,479	(21 )	---	---	1,479	(21 )
Total temporarily impaired	\$ 106,153	\$ (1,281 )	\$ 4,647	\$ (27 )	\$ 110,800	\$ (1,308 )

<u>December 31, 2016</u>	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and federal agency securities	\$ 59,129	\$ (1,271 )	\$ 3,053	\$ (10 )	\$ 62,182	\$ (1,281 )
U.S. Agency MBS and CMOs	10,702	(231 )	---	---	10,702	(231 )
Tax-exempt state and municipal bonds	49,508	(698 )	1,672	(7 )	51,180	(705 )
Taxable state and municipal bonds	22,633	(437 )	---	---	22,633	(437 )
Corporate bonds and other debt securities	5,745	(50 )	500	(5 )	6,245	(55 )
Other equity securities	1,470	(30 )	---	---	1,470	(30 )
Total temporarily impaired	\$ 149,187	\$ (2,717 )	\$ 5,225	\$ (22 )	\$ 154,412	\$ (2,739 )

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## NOTE 2 – SECURITIES (Continued)

## Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Management determined that the unrealized losses for each period were attributable to changes in interest rates and not due to credit quality. As such, no OTTI charges were necessary during the three and six month periods ended June 30, 2017 and 2016.

Securities with a carrying value of approximately \$2.0 million were pledged as security for public deposits, letters of credit and for other purposes required or permitted by law at June 30, 2017 and December 31, 2016.

## NOTE 3 – LOANS

Portfolio loans were as follows (dollars in thousands):

	June 30, 2017	December 31, 2016
Commercial and industrial	\$435,218	\$ 449,342
Commercial real estate:		
Residential developed	8,701	11,970
Unsecured to residential developers	4,734	4,734
Vacant and unimproved	38,357	40,286
Commercial development	492	378
Residential improved	77,047	75,348
Commercial improved	282,884	289,478
Manufacturing and industrial	102,325	95,787
Total commercial real estate	514,540	517,981
Consumer		
Residential mortgage	212,745	217,614
Unsecured	280	396
Home equity	81,779	88,113
Other secured	6,793	7,366
Total consumer	301,597	313,489
Total loans	1,251,355	1,280,812
Allowance for loan losses	(16,570 )	(16,962 )
	\$1,234,785	\$ 1,263,850

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## NOTE 3 – LOANS (Continued)

Activity in the allowance for loan losses by portfolio segment was as follows (dollars in thousands):

<u>Three months ended June 30, 2017</u>	Commercial				Total
	and Industrial	Commercial Real Estate	Consumer	Unallocated	
Beginning balance	\$ 6,469	\$ 6,598	\$ 3,591	\$ 38	\$16,696
Charge-offs	(108 )	---	(31 )	---	(139 )
Recoveries	41	456	16	---	513
Provision for loan losses	(66 )	(471 )	45	(8 )	(500 )
Ending Balance	\$ 6,336	\$ 6,583	\$ 3,621	\$ 30	\$16,570

<u>Three months ended June 30, 2016</u>	Commercial				Total
	and Industrial	Commercial Real Estate	Consumer	Unallocated	
Beginning balance	\$ 4,945	\$ 8,449	\$ 3,699	\$ 36	\$17,129
Charge-offs	---	---	(36 )	---	(36 )
Recoveries	23	557	36	---	616
Provision for loan losses	(8 )	(941 )	195	4	(750 )
Ending Balance	\$ 4,960	\$ 8,065	\$ 3,894	\$ 40	\$16,959

<u>Six months ended June 30, 2017</u>	Commercial				Total
	and Industrial	Commercial Real Estate	Consumer	Unallocated	
Beginning balance	\$ 6,345	\$ 6,703	\$ 3,871	\$ 43	\$16,962
Charge-offs	(108 )	---	(57 )	---	(165 )
Recoveries	64	618	91	---	773
Provision for loan losses	35	(738 )	(284 )	(13 )	(1,000 )
Ending Balance	\$ 6,336	\$ 6,583	\$ 3,621	\$ 30	\$16,570

<u>Six months ended June 30, 2016</u>	Commercial				Total
	and Industrial	Commercial Real Estate	Consumer	Unallocated	
Beginning balance	\$ 4,826	\$ 8,457	\$ 3,761	\$ 37	\$17,081
Charge-offs	---	---	(112 )	---	(112 )
Recoveries	72	678	90	---	840
Provision for loan losses	62	(1,070 )	155	3	(850 )
Ending Balance	\$ 4,960	\$ 8,065	\$ 3,894	\$ 40	\$16,959



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## NOTE 3 – LOANS (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method (dollars in thousands):

	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
<u>June 30, 2017</u>					
Allowance for loan losses:					
Ending allowance attributable to loans:					
Individually reviewed for impairment	\$ 686	\$ 274	\$ 566	\$ ---	\$ 1,526
Collectively evaluated for impairment	5,650	6,309	3,055	30	15,044
Total ending allowance balance	\$ 6,336	\$ 6,583	\$ 3,621	\$ 30	\$ 16,570
Loans:					
Individually reviewed for impairment	\$ 4,343	\$ 9,896	\$ 9,179	\$ ---	\$ 23,418
Collectively evaluated for impairment	430,875	504,644	292,418	---	1,227,937
Total ending loans balance	\$ 435,218	\$ 514,540	\$ 301,597	\$ ---	\$ 1,251,355
	Commercial and Industrial	Commercial Real Estate	Consumer	Unallocated	Total
<u>December 31, 2016</u>					
Allowance for loan losses:					
Ending allowance attributable to loans:					
Individually reviewed for impairment	\$ 605	\$ 368	\$ 723	\$ ---	\$ 1,696
Collectively evaluated for impairment	5,740	6,335	3,148	43	15,266
Total ending allowance balance	\$ 6,345	\$ 6,703	\$ 3,871	\$ 43	\$ 16,962
Loans:					
Individually reviewed for impairment	\$ 5,994	\$ 11,934	\$ 11,726	\$ ---	\$ 29,654
Collectively evaluated for impairment	443,348	506,047	301,763	---	1,251,158
Total ending loans balance	\$ 449,342	\$ 517,981	\$ 313,489	\$ ---	\$ 1,280,812

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## NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of June 30, 2017 (dollars in thousands):

<u>June 30, 2017</u>	Unpaid Principal Balance	Recorded Investment	Allowance Allocated
With no related allowance recorded:			
Commercial and industrial	\$ 1,024	\$ 1,024	\$ ---
Commercial real estate:			
Residential developed	---	---	---
Unsecured to residential developers	---	---	---
Vacant and unimproved	---	---	---
Commercial development	---	---	---
Residential improved	5	5	---
Commercial improved	1,018	1,018	---
Manufacturing and industrial	---	---	---
	1,023	1,023	---
Consumer:			
Residential mortgage	---	---	---
Unsecured	---	---	---
Home equity	---	---	---
Other secured	---	---	---
	---	---	---
Total with no related allowance recorded	\$ 2,047	\$ 2,047	\$ ---
With an allowance recorded:			
Commercial and industrial	\$ 3,319	\$ 3,319	\$ 686
Commercial real estate:			
Residential developed	183	183	4
Unsecured to residential developers	---	---	---
Vacant and unimproved	396	396	10
Commercial development	189	189	6
Residential improved	2,418	2,418	122
Commercial improved	5,499	5,499	129
Manufacturing and industrial	188	188	3
	8,873	8,873	274
Consumer:			
Residential mortgage	7,364	7,364	454
Unsecured	---	---	---
Home equity	1,815	1,815	112
Other secured	---	---	---

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	9,179	9,179	566
Total with an allowance recorded	\$21,371	\$ 21,371	\$ 1,526
Total	\$23,418	\$ 23,418	\$ 1,526

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## NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2016 (dollars in thousands):

<u>December 31, 2016</u>	Unpaid Principal Balance	Recorded Investment	Allowance Allocated
With no related allowance recorded:			
Commercial and industrial	\$ 2,298	\$ 2,298	\$ ---
Commercial real estate:			
Residential developed	---	---	---
Unsecured to residential developers	---	---	---
Vacant and unimproved	---	---	---
Commercial development	---	---	---
Residential improved	27	27	---
Commercial improved	350	350	---
Manufacturing and industrial	---	---	---
	377	377	---
Consumer:			
Residential mortgage	---	---	---
Unsecured	---	---	---
Home equity	---	---	---
Other secured	---	---	---
	---	---	---
Total with no related allowance recorded	\$ 2,675	\$ 2,675	\$ ---
With an allowance recorded:			
Commercial and industrial	\$ 3,696	\$ 3,696	\$ 605
Commercial real estate:			
Residential developed	187	187	4
Unsecured to residential developers	---	---	---
Vacant and unimproved	387	387	9
Commercial development	189	189	6
Residential improved	4,687	4,687	216
Commercial improved	5,879	5,879	128
Manufacturing and industrial	228	228	5
	11,557	11,557	368
Consumer:			
Residential mortgage	7,523	7,523	464
Unsecured	---	---	---
Home equity	4,203	4,203	259
Other secured	---	---	---

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	11,726	11,726	723
Total with an allowance recorded	\$26,979	\$26,979	\$1,696
Total	\$29,654	\$29,654	\$1,696

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## NOTE 3 – LOANS (Continued)

The following table presents information regarding average balances of impaired loans and interest recognized on impaired loans for the three and six month periods ended June 30, 2017 and 2016 (dollars in thousands):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Average of impaired loans during the period:				
Commercial and industrial	\$5,342	\$6,110	\$6,093	\$7,187
Commercial real estate:				
Residential developed	183	---	184	---
Unsecured to residential developers	---	---	---	---
Vacant and unimproved	262	436	320	441
Commercial development	189	192	189	192
Residential improved	2,665	5,488	3,376	5,516
Commercial improved	5,995	6,817	6,077	8,177
Manufacturing and industrial	327	237	276	238
Consumer	10,812	12,842	11,153	12,991
Interest income recognized during impairment:				
Commercial and industrial	239	239	517	537
Commercial real estate	125	143	252	344
Consumer	118	116	226	238
Cash-basis interest income recognized				
Commercial and industrial	266	262	531	551
Commercial real estate	126	144	249	344
Consumer	120	113	227	235

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## NOTE 3 – LOANS (Continued)

Nonaccrual loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of June 30, 2017 and December 31, 2016:

<u>June 30, 2017</u>	Over 90 days	
	Nonaccrual	Accruing
Commercial and industrial	\$ 6	\$ ---
Commercial real estate:		
Residential developed	---	---
Unsecured to residential developers	---	---
Vacant and unimproved	---	---
Commercial development	49	---
Residential improved	221	---
Commercial improved	166	---
Manufacturing and industrial	---	---
	436	---
Consumer:		
Residential mortgage	2	204
Unsecured	10	---
Home equity	---	---
Other secured	12	---
	24	204
Total	\$ 466	\$ 204

<u>December 31, 2016</u>	Over 90 days	
	Nonaccrual	Accruing
Commercial and industrial	\$ 36	\$ ---
Commercial real estate:		
Residential developed	---	---
Unsecured to residential developers	---	---
Vacant and unimproved	---	---
Commercial development	49	---
Residential improved	6	---
Commercial improved	128	---
Manufacturing and industrial	---	---
	183	---
Consumer:		

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Residential mortgage	58	---
Unsecured	16	---
Home equity	7	---
Other secured	---	---
	81	---
Total	\$ 300	\$ ---

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## NOTE 3 – LOANS (Continued)

The following table presents the aging of the recorded investment in past due loans as of June 30, 2017 and December 31, 2016 by class of loans (dollars in thousands):

<u>June 30, 2017</u>	30-90 Days	Greater Than 90 Days	Total Past Due	Loans Not Past Due	Total
Commercial and industrial	\$ ---	\$ ---	\$ ---	\$435,218	\$435,218
Commercial real estate:					
Residential developed	---	---	---	8,701	8,701
Unsecured to residential developers	---	---	---	4,734	4,734
Vacant and unimproved	---	---	---	38,357	38,357
Commercial development	189	49	238	254	492
Residential improved	142	79	221	76,826	77,047
Commercial improved	29	---	29	282,855	282,884
Manufacturing and industrial	---	---	---	102,325	102,325
	360	128	488	514,052	514,540
Consumer:					
Residential mortgage	75	204	279	212,466	212,745
Unsecured	11	---	11	269	280
Home equity	19	12	31	81,748	81,779
Other secured	6	---	6	6,787	6,793
	111	216	327	301,270	301,597
Total	\$471	\$344	\$815	\$1,250,540	\$1,251,355
<u>December 31, 2016</u>	30-90 Days	Greater Than 90 Days	Total Past Due	Loans Not Past Due	Total
Commercial and industrial	\$425	\$28	\$453	\$448,889	\$449,342
Commercial real estate:					
Residential developed	---	---	---	11,970	11,970
Unsecured to residential developers	---	---	---	4,734	4,734
Vacant and unimproved	---	---	---	40,286	40,286
Commercial development	---	49	49	329	378
Residential improved	74	5	79	75,269	75,348
Commercial improved	478	---	478	289,000	289,478
Manufacturing and industrial	---	---	---	95,787	95,787
	552	54	606	517,375	517,981
Consumer:					
Residential mortgage	64	56	120	217,494	217,614
Unsecured	---	---	---	396	396
Home equity	187	---	187	87,926	88,113
Other secured	81	---	81	7,285	7,366
	332	56	388	313,101	313,489

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Total	\$1,309	\$ 138	\$ 1,447	\$1,279,365	\$1,280,812
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## NOTE 3 – LOANS (Continued)

The Company had allocated \$1,526,000 and \$1,696,000 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of June 30, 2017 and December 31, 2016, respectively. These loans may have involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. The Company has been active at utilizing these programs and working with its customers to reduce the risk of foreclosure. For commercial loans, these modifications typically include an interest only period and, in some cases, a lowering of the interest rate on the loan. In some cases, the modification will include separating the note into two notes with the first note structured to be supported by current cash flows and collateral, and the second note made for the remaining unsecured debt. The second note is charged off immediately and collected only after the first note is paid in full. This modification type is commonly referred to as an A-B note structure. For consumer mortgage loans, the restructuring typically includes a lowering of the interest rate to provide payment and cash flow relief. For each restructuring, a comprehensive credit underwriting analysis of the borrower’s financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally, if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan’s actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status.

In situations where there is a subsequent modification or renewal and the loan is brought to market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, the TDR and impaired loan designations may be removed. In addition, the TDR designation may also be removed from loans modified under an A-B note structure. If the remaining “A” note is at a market rate at the time of restructuring (taking into account the borrower’s credit risk and prevailing market conditions), the loan can be removed from TDR designation in a subsequent calendar year after six months of performance in accordance with the new terms. The market rate relative to the borrower’s credit risk is determined through analysis of market pricing information gathered from peers and use of a loan pricing model. The general objective of the model is to achieve a consistent return on equity from one credit to the next, taking into consideration differences in credit risk. In the model, credits with higher risk receive a higher potential loss allocation, and therefore require a higher interest rate to achieve the target return on equity.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral, less estimated costs to sell. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by measuring cash flows using the new payment terms discounted at the original contractual rate.

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The following table presents information regarding troubled debt restructurings as of June 30, 2017 and December 31, 2016 (dollars in thousands):

	June 30, 2017		December 31, 2016	
	Number	Outstanding	Number	Outstanding
	of	Recorded	of	Recorded
	Loans	Balance	Loans	Balance
Commercial and industrial	21	\$ 4,343	25	\$ 5,994
Commercial real estate	40	9,896	49	11,933
Consumer	107	9,179	116	12,059
	168	\$ 23,418	190	\$ 29,986

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## NOTE 3 – LOANS (Continued)

The following table presents information related to accruing troubled debt restructurings as of June 30, 2017 and December 31, 2016. The table presents the amount of accruing troubled debt restructurings that were on nonaccrual status prior to the restructuring, accruing at the time of restructuring and those that were upgraded to accruing status after receiving six consecutive monthly payments in accordance with the restructured terms as of each period reported (dollars in thousands):

	June 30, 2017	December 31, 2016
Accruing TDR - nonaccrual at restructuring	\$---	\$---
Accruing TDR - accruing at restructuring	20,311	25,665
Accruing TDR - upgraded to accruing after six consecutive payments	2,787	4,172
	\$23,098	\$ 29,837

The following tables present information regarding troubled debt restructurings executed during the three month periods ended June 30, 2017 and 2016 (dollars in thousands):

	Three Months Ended June 30, 2017			Three Months Ended June 30, 2016		
	# of Loans	Pre-TDR Balance	Writedown Upon TDR	# of Loans	Pre-TDR Balance	Writedown Upon TDR
Commercial and industrial	---	\$ ---	\$ ---	---	\$ ---	\$ ---
Commercial real estate	1	1,018	---	---	---	---
Consumer	2	174	---	2	39	---
	3	1,192	\$ ---	2	\$ 39	\$ ---

The following tables present information regarding troubled debt restructurings executed during the six month periods ended June 30, 2017 and 2016 (dollars in thousands):

	Six Months Ended June 30, 2017			Six Months Ended June 30, 2016		
	# of Loans	Pre-TDR Balance	Writedown Upon TDR	# of Loans	Pre-TDR Balance	Writedown Upon TDR
Commercial and industrial	---	\$ ---	\$ ---	---	\$ ---	\$ ---
Commercial real estate	1	1,018	---	---	---	---
Consumer	2	174	---	6	277	---
	3	1,192	\$ ---	6	\$ 277	\$ ---

According to the accounting standards, not all loan modifications are TDRs. TDRs are modifications or renewals where the Company has granted a concession to a borrower in financial distress. The Company reviews all modifications and renewals for determination of TDR status. In some situations a borrower may be experiencing financial distress, but the Company does not provide a concession. These modifications are not considered TDRs. In

other cases, the Company might provide a concession, such as a reduction in interest rate, but the borrower is not experiencing financial distress. This could be the case if the Company is matching a competitor's interest rate. These modifications would also not be considered TDRs. Finally, any renewals at existing terms for borrowers not experiencing financial distress would not be considered TDRs. As with other loans not considered TDR or impaired, allowance allocations are based on the historical based allocation for the applicable loan grade and loan class.

Payment defaults on TDRs have been minimal and during the three and six month periods ended June 30, 2017 and 2016, the balance of loans that became delinquent by more than 90 days past due or that were transferred to nonaccrual within 12 months of restructuring were not material.

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NOTE 3 – LOANS (Continued)

Credit Quality Indicators: The Company categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes commercial loans individually and classifies these relationships by credit risk grading. The Company uses an eight point grading system, with grades 5 through 8 being considered classified, or watch, credits. All commercial loans are assigned a grade at origination, at each renewal or any amendment. When a credit is first downgraded to a watch credit (either through renewal, amendment, loan officer identification or the loan review process), an Administrative Loan Review (“ALR”) is generated by the credit department and the loan officer. All watch credits have an ALR completed monthly which analyzes the collateral position and cash flow of the borrower and its guarantors. The loan officer is required to complete both a short term and long term plan to rehabilitate or exit the credit and to give monthly comments on the progress to these plans. Management meets quarterly with loan officers to discuss each of these credits in detail and to help formulate solutions where progress has stalled. When necessary, the loan officer proposes changes to the assigned loan grade as part of the ALR. Additionally, Loan Review reviews all loan grades upon origination, renewal or amendment and again as loans are selected through the loan review process. The credit will stay on the ALR until either its grade has improved to a 4 or the credit relationship is at a zero balance. The Company uses the following definitions for the risk grades:

1. Excellent - Loans supported by extremely strong financial condition or secured by the Bank’s own deposits. Minimal risk to the Bank and the probability of serious rapid financial deterioration is extremely small.

2. Above Average - Loans supported by sound financial statements that indicate the ability to repay or borrowings secured (and margined properly) with marketable securities. Nominal risk to the Bank and probability of serious financial deterioration is highly unlikely. The overall quality of these credits is very high.

3. Good Quality - Loans supported by satisfactory asset quality and liquidity, good debt capacity coverage, and good management in all critical positions. Loans are secured by acceptable collateral with adequate margins. There is a slight risk of deterioration if adverse market conditions prevail.

4. Acceptable Risk - Loans carrying an acceptable risk to the Bank, which may be slightly below average quality. The borrower has limited financial strength with considerable leverage. There is some probability of deterioration if adverse market conditions prevail. These credits should be monitored closely by the Relationship Manager.

5. Marginally Acceptable - Loans are of marginal quality with above normal risk to the Bank. The borrower shows acceptable asset quality but very little liquidity with high leverage. There is inconsistent earning performance without the ability to sustain adverse market conditions. The primary source of repayment is questionable, but the secondary source of repayment still remains an option. Very close attention by the Relationship Manager and management is needed.

6. Substandard - Loans are inadequately protected by the net worth and paying capacity of the borrower or the collateral pledged. The primary and secondary sources of repayment are questionable. Heavy debt condition may be evident and volume and earnings deterioration may be underway. It is possible that the Bank will sustain some loss if the deficiencies are not immediately addressed and corrected.

7. Doubtful - Loans supported by weak or no financial statements, as well as the ability to repay the entire loan, are questionable. Loans in this category are normally characterized less than adequate collateral, insolvent, or extremely weak financial condition. A loan classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses makes collection or liquidation in full highly questionable. The possibility of loss is extremely high, however, activity may be underway to minimize the loss or maximize the recovery.

8. Loss - Loans are considered uncollectible and of little or no value as a bank asset.

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## NOTE 3 – LOANS (Continued)

As of June 30, 2017 and December 31, 2016, the risk grade category of commercial loans by class of loans were as follows (dollars in thousands):

<u>June 30, 2017</u>	1	2	3	4	5	6	7	8	Total
Commercial and industrial	\$---	\$17,376	\$118,507	\$284,659	\$11,321	\$3,349	\$6	\$---	\$435,218
Commercial real estate:									
Residential developed	---	---	1,252	6,614	835	---	---	---	8,701
Unsecured to residential developers	---	---	---	4,734	---	---	---	---	4,734
Vacant and unimproved	---	---	15,826	19,012	3,519	---	---	---	38,357
Commercial development	---	---	116	138	---	189	49	---	492
Residential improved	---	---	6,180	67,695	1,628	1,323	221	---	77,047
Commercial improved	---	1,392	62,819	210,873	5,916	1,718	166	---	282,884
Manufacturing & industrial	---	1,386	44,673	53,468	2,249	549	---	---	102,325
	\$---	\$20,154	\$249,373	\$647,193	\$25,468	\$7,128	\$442	\$---	\$949,758
<u>December 31, 2016</u>	1	2	3	4	5	6	7	8	Total
Commercial and industrial	\$---	\$27,619	\$118,243	\$282,527	\$14,610	\$6,307	\$36	\$---	\$449,342
Commercial real estate:									
Residential developed	---	---	2,328	8,786	856	---	---	---	11,970
Unsecured to residential developers	---	---	---	4,734	---	---	---	---	4,734
Vacant and unimproved	---	---	17,672	19,028	3,586	---	---	---	40,286
Commercial development	---	---	---	140	---	189	49	---	378
Residential improved	---	---	7,100	63,957	2,628	1,657	6	---	75,348
Commercial improved	---	2,433	66,259	210,449	9,084	1,125	128	---	289,478
Manufacturing & industrial	---	1,665	38,719	51,718	3,076	609	---	---	95,787
	\$---	\$31,717	\$250,321	\$641,339	\$33,840	\$9,887	\$219	\$---	\$967,323

Commercial loans rated a 6 or worse per the Company's internal risk rating system are considered substandard, doubtful or loss. Commercial loans classified as substandard or worse were as follows at period-end (dollars in thousands):

	June 30, 2017	December 31, 2016
Not classified as impaired	\$ 1,593	\$ 2,608
Classified as impaired	5,977	7,498
Total commercial loans classified substandard or worse	\$ 7,570	\$ 10,106



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## NOTE 3 – LOANS (Continued)

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For consumer loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in consumer loans based on payment activity (dollars in thousands):

<u>June 30, 2017</u>	Residential Mortgage	Consumer Unsecured	Home Equity	Consumer Other
Performing	\$ 212,541	\$ 280	\$81,767	\$ 6,793
Nonperforming	204	---	12	---
Total	\$ 212,745	\$ 280	\$81,779	\$ 6,793

  

<u>December 31, 2016</u>	Residential Mortgage	Consumer Unsecured	Home Equity	Consumer Other
Performing	\$ 217,558	\$ 396	\$88,113	\$ 7,366
Nonperforming	56	---	---	---
Total	\$ 217,614	\$ 396	\$88,113	\$ 7,366

## NOTE 4 – OTHER REAL ESTATE OWNED

Other real estate owned was as follows (dollars in thousands):

	Six Months Ended June 30, 2017	Year Ended December 31, 2016	Six Months Ended June 30, 2016
Beginning balance	\$ 22,864	\$ 28,377	\$ 28,377
Additions, transfers from loans	60	339	102
Proceeds from sales of other real estate owned	(5,601 )	(5,339 )	(3,313 )
Valuation allowance reversal upon sale	(6,395 )	(1,158 )	(334 )
Gain on sales of other real estate owned	470	645	260
	11,398	22,864	25,092
Less: valuation allowance	(4,301 )	(10,611 )	(11,026 )
Ending balance	\$ 7,097	\$ 12,253	\$ 14,066

Activity in the valuation allowance was as follows (dollars in thousands):

	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Beginning balance	\$ 10,611	\$ 10,805
Additions charged to expense	85	555
Reversals upon sale	(6,395 )	(334 )

Ending balance	\$ 4,301	\$ 11,026
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NOTE 5 – FAIR VALUE

ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value include:

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment Securities: The fair values of investment securities are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair values of certain securities held to maturity are determined by computing discounted cash flows using observable and unobservable market inputs (Level 3 inputs).

Loans Held for Sale: The fair value of loans held for sale is based upon binding quotes from third party investors (Level 2 inputs).

Impaired Loans: Loans identified as impaired are measured using one of three methods: the loan's observable market price, the fair value of collateral or the present value of expected future cash flows. For each period presented, no impaired loans were measured using the loan's observable market price. If an impaired loan has had a chargeoff or if the fair value of the collateral is less than the recorded investment in the loan, we establish a specific reserve and report the loan as nonrecurring Level 3. The fair value of collateral of impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Other real estate owned (OREO) properties are initially recorded at fair value, less estimated costs to sell when acquired, establishing a new cost basis. Adjustments to OREO are measured at fair value, less costs to sell. Fair values are generally based on third party appraisals or realtor evaluations of the property. These appraisals and evaluations may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized through a valuation allowance, and the property is reported as nonrecurring Level 3.

Interest Rate Swaps: For interest rate swap agreements, we measure fair value utilizing pricing provided by a third-party pricing source that uses market observable inputs, such as forecasted yield curves, and other

unobservable inputs and accordingly, interest rate swap agreements are classified as Level 3.

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## NOTE 5 – FAIR VALUE (Continued)

Assets measured at fair value on a recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>June 30, 2017</u>				
U.S. Treasury and federal agency securities	\$84,738	\$ ---	\$ 84,738	\$ ---
U.S. Agency MBS and CMOs	11,843	---	11,843	---
Tax-exempt state and municipal bonds	39,659	---	39,659	---
Taxable state and municipal bonds	35,068	---	35,068	---
Corporate bonds and other debt securities	11,974	---	11,974	---
Other equity securities	1,479	---	1,479	---
Loans held for sale	3,184	---	3,184	---
Interest rate swaps	395	---	---	395
Interest rate swaps	(395 )	---	---	(395 )
<u>December 31, 2016</u>				
U.S. Treasury and federal agency securities	\$84,350	\$ ---	\$ 84,350	\$ ---
U.S. Agency MBS and CMOs	11,817	---	11,817	---
Tax-exempt state and municipal bonds	39,187	---	39,187	---
Taxable state and municipal bonds	33,883	---	33,883	---
Corporate bonds and other debt securities	13,726	---	13,726	---
Other equity securities	1,470	---	1,470	---
Loans held for sale	2,181	---	2,181	---
Interest rate swaps	494	---	---	494
Interest rate swaps	(494 )	---	---	(494 )

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>June 30, 2017</u>				
Impaired loans	\$3,052	\$ ---	\$ ---	\$ 3,052
Other real estate owned	4,811	---	---	4,811
<u>December 31, 2016</u>				
Impaired loans	\$3,436	\$ ---	\$ ---	\$ 3,436
Other real estate owned	9,542	---	---	9,542





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## NOTE 5 – FAIR VALUE (Continued)

Quantitative information about Level 3 fair value measurements measured on a non-recurring basis was as follows at period end (dollars in thousands):

	Asset Fair Value	Valuation Technique	Unobservable Inputs	Range (%)
<u>June 30, 2017</u>				
Impaired Loans	\$3,052	Sales comparison approach	Adjustment for differences between comparable sales	5.0 to 15.0 9.5
		Income approach	Capitalization rate	to 11.0
Other real estate owned	4,811	Sales comparison approach	Adjustment for differences between comparable sales	3.0 to 23.0 9.5
		Income approach	Capitalization rate	to 11.0
<u>December 31, 2016</u>				
Impaired Loans	\$3,436	Sales comparison approach	Adjustment for differences between comparable sales	1.0 to 35.0
		Income approach	Capitalization rate	9.5 to 11.5
Other real estate owned	9,542	Sales comparison approach	Adjustment for differences between comparable sales	2.0 to 32.5
		Income approach	Capitalization rate	9.5 to 11.5

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## NOTE 5 – FAIR VALUE (Continued)

The carrying amounts and estimated fair values of financial instruments, not previously presented, were as follows at June 30, 2017 and December 31, 2016 (dollars in thousands):

	Level in Fair Value Hierarchy	June 30, 2017		December 31, 2016	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets					
Cash and due from banks	Level 1	\$31,165	\$31,165	\$27,690	\$27,690
Cash equivalents	Level 2	114,104	114,104	62,129	62,129
Securities held to maturity	Level 3	68,818	69,816	69,378	69,849
FHLB stock		11,558	NA	11,558	NA
Loans, net	Level 2	1,237,837	1,234,678	1,260,414	1,247,842
Bank owned life insurance	Level 3	39,781	39,781	39,274	39,274
Accrued interest receivable	Level 2	4,084	4,084	4,092	4,092
Financial liabilities					
Deposits	Level 2	(1,459,990)	(1,459,895)	(1,448,724)	(1,448,692)
Other borrowed funds	Level 2	(82,785 )	(82,623 )	(84,173 )	(84,051 )
Long-term debt	Level 2	(41,238 )	(36,440 )	(41,238 )	(36,112 )
Accrued interest payable	Level 2	(283 )	(283 )	(282 )	(282 )
Off-balance sheet credit-related items					
Loan commitments		---	---	---	---

The methods and assumptions used to estimate fair value are described as follows.

Carrying amount is the estimated fair value for cash and cash equivalents, bank owned life insurance, accrued interest receivable and payable, demand deposits, short-term borrowings and variable rate loans or deposits that repriced frequently and fully. Security fair values are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities as discussed above. For fixed rate loans, interest-bearing time deposits in other financial institutions, or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk (including consideration of widening credit spreads). Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance sheet credit-related items is not significant.

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## NOTE 6 – DEPOSITS

Deposits are summarized as follows (in thousands):

	June 30, 2017	December 31, 2016
Noninterest-bearing demand	\$481,769	\$ 501,478
Interest bearing demand	342,551	340,715
Savings and money market accounts	557,922	532,853
Certificates of deposit	77,748	73,678
	\$1,459,990	\$ 1,448,724

Time deposits that exceed the FDIC insurance limit of \$250,000 were approximately \$19.2 million at June 30, 2017 and \$17.4 million at December 31, 2016.

## NOTE 7 - OTHER BORROWED FUNDS

Other borrowed funds include advances from the Federal Home Loan Bank and borrowings from the Federal Reserve Bank.

Federal Home Loan Bank Advances

At period-end, advances from the Federal Home Loan Bank were as follows (dollars in thousands):

<u>Principal Terms</u>	Advance Amount	Range of Maturities	Weighted Average Interest Rate	
June 30, 2017				
Single maturity fixed rate advances	\$ 80,000	February 2018 to April 2021	1.60	%
Amortizable mortgage advances	2,785	March 2018 to July 2018	3.75	%
	\$82,785			
<u>Principal Terms</u>	Advance Amount	Range of Maturities	Weighted Average Interest Rate	
December 31, 2016				
Single maturity fixed rate advances	\$ 80,000	February 2018 to April 2021	1.60	%
Amortizable mortgage advances	4,173	March 2018 to July 2018	3.78	%
	\$84,173			

Each advance is subject to a prepayment fee if paid prior to its maturity date. Fixed rate advances are payable at maturity. Amortizable mortgage advances are fixed rate advances with scheduled repayments based upon amortization to maturity. These advances were collateralized by residential and commercial real estate loans totaling \$442.9 million and \$425.0 million under a blanket lien arrangement at June 30, 2017 and December 31, 2016, respectively.



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## NOTE 7 - OTHER BORROWED FUNDS

Scheduled repayments of FHLB advances as of June 30, 2017 were as follows (in thousands):

2017	\$667
2018	52,118
2019	10,000
2020	10,000
2021	10,000
Thereafter	---
	\$82,785

Federal Reserve Bank borrowings

The Company has a financing arrangement with the Federal Reserve Bank. There were no borrowings outstanding at June 30, 2017 and December 31, 2016, and the Company had approximately \$13.1 million and \$18.1 million in unused borrowing capacity based on commercial and mortgage loans pledged to the Federal Reserve Bank totaling \$15.7 million and \$20.7 million at June 30, 2017 and December 31, 2016, respectively.

## NOTE 8 - EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per common share for the three and six month periods ended June 30, 2017 and 2016 are as follows (dollars in thousands, except per share data):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Net income available to common shares	\$4,762	\$3,745	\$9,223	\$7,240
Weighted average shares outstanding, including participating stock awards - Basic	33,942,318	33,922,506	33,941,668	33,923,810
Dilutive potential common shares:				
Stock options	5,809	---	6,703	---
Stock warrants	---	---	---	---
Weighted average shares outstanding - Diluted	33,948,127	33,922,506	33,948,371	33,923,810
Basic earnings per common share	\$0.14	\$0.11	\$0.27	\$0.21
Diluted earnings per common share	\$0.14	\$0.11	\$0.27	\$0.21

Stock options for 100,896 shares of common stock for both the three and six month periods ended June 30, 2016, were not considered in computing diluted earnings per share because they were antidilutive. There were no antidilutive shares of common stock in the three and six month periods ended June 30, 2017.



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## NOTE 9 - FEDERAL INCOME TAXES

Income tax expense was as follows (dollars in thousands):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Current	\$ (62 )	\$ 1,757	\$ 1,742	\$ 3,226
Deferred	2,191	(78 )	2,353	(147 )
	\$ 2,129	\$ 1,679	\$ 4,095	\$ 3,079

The difference between the financial statement tax expense and amount computed by applying the statutory federal tax rate to pretax income was reconciled as follows (dollars in thousands):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Statutory rate	35 %	35 %	35 %	35 %
Statutory rate applied to income before taxes	\$ 2,412	\$ 1,899	\$ 4,661	\$ 3,612
Deduct				
Tax-exempt interest income	(186 )	(149 )	(369 )	(297 )
Bank-owned life insurance	(85 )	(56 )	(168 )	(211 )
Other, net	(12 )	(15 )	(29 )	(25 )
	\$ 2,129	\$ 1,679	\$ 4,095	\$ 3,079

The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and tax planning strategies. No valuation allowance was necessary at June 30, 2017 or December 31, 2016.

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## NOTE 9 - FEDERAL INCOME TAXES (Continued)

The net deferred tax asset recorded included the following amounts of deferred tax assets and liabilities (dollars in thousands):

	June 30, 2017	December 31, 2016
Deferred tax assets		
Allowance for loan losses	\$ 5,800	\$ 5,937
Nonaccrual loan interest	620	718
Valuation allowance on other real estate owned	1,505	3,714
Unrealized loss on securities available for sale	158	799
Other	255	176
Gross deferred tax assets	8,338	11,344
Valuation allowance	---	---
Total net deferred tax assets	8,338	11,344
Deferred tax liabilities		
Depreciation	(1,669 )	(1,705 )
Prepaid expenses	(399 )	(399 )
Unrealized gain on securities available for sale	---	---
Other	(401 )	(377 )
Gross deferred tax liabilities	(2,469 )	(2,481 )
Net deferred tax asset	\$ 5,869	\$ 8,863

There were no unrecognized tax benefits at June 30, 2017 or December 31, 2016 and the Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. The Company is no longer subject to examination by the Internal Revenue Service for years before 2013.

## NOTE 10 – COMMITMENTS AND OFF BALANCE-SHEET RISK

Some financial instruments are used to meet customer financing needs and to reduce exposure to interest rate changes. These financial instruments include commitments to extend credit and standby letters of credit. These involve, to varying degrees, credit and interest rate risk in excess of the amount reported in the financial statements.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment, and generally have fixed expiration dates. Standby letters of credit are conditional commitments to guarantee a customer's performance to a third party. Exposure to credit loss if the other party does not perform is represented by the contractual amount for commitments to extend credit and standby letters of credit. Collateral or other security is normally not obtained for these financial instruments prior to their use and many of the commitments are expected to expire without being used.

A summary of the contractual amounts of financial instruments with off balance sheet risk was as follows at period-end (dollars in thousands):



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	June 30, 2017	December 31, 2016
Commitments to make loans	\$ 129,918	\$ 90,293
Letters of credit	12,450	13,823
Unused lines of credit	465,621	437,435

The notional amount of commitments to fund mortgage loans to be sold into the secondary market was approximately \$10.6 million and \$19.8 million at June 30, 2017 and December 31, 2016, respectively.

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NOTE 10 – COMMITMENTS AND OFF BALANCE-SHEET RISK (Continued)

At June 30, 2017, approximately 36.3% of the Bank's commitments to make loans were at fixed rates, offered at current market rates. The remainder of the commitments to make loans were at variable rates tied to prime or one month LIBOR and generally expire within 30 days. The majority of the unused lines of credit were at variable rates tied to prime.

NOTE 11 – CONTINGENCIES

The Company and its subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business. As of June 30, 2017, there were no material pending legal proceedings to which the Company or any of its subsidiaries are a party or which any of its properties are the subject.

NOTE 12 – SHAREHOLDERS' EQUITY

Regulatory Capital

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.

In July 2013, the Board of Governors of the Federal Reserve Board and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), which effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance-sheet exposures.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## NOTE 12 – SHAREHOLDERS' EQUITY (Continued)

At June 30, 2017 and December 31, 2016, actual capital levels and minimum required levels were (dollars in thousands):

	Actual Amount	Ratio	Minimum Capital Adequacy Amount	Ratio	Minimum Capital Adequacy With Capital Buffer Amount	Ratio	To Be Well Capitalized Under Prompt Corrective Action Regulations Amount	Ratio
<u>June 30, 2017</u>								
CET1 capital (to risk weighted assets)								
Consolidated	\$170,426	11.6 %	\$66,101	4.5 %	\$84,463	5.8 %	N/A	N/A
Bank	204,469	13.9	66,228	4.5	84,626	5.8	\$95,664	6.5 %
Tier 1 capital (to risk weighted assets)								
Consolidated	210,426	14.3	88,135	6.0	106,497	7.3	N/A	N/A
Bank	204,469	13.9	88,304	6.0	106,702	7.3	117,740	8.0
Total capital (to risk weighted assets)								
Consolidated	226,996	15.5	117,153	8.0	135,876	9.3	N/A	N/A
Bank	221,039	15.0	117,739	8.0	136,137	9.3	147,175	10.0
Tier 1 capital (to average assets)								
Consolidated	210,426	12.2	68,961	4.0	N/A	N/A	N/A	N/A
Bank	204,469	11.9	68,898	4.0	N/A	N/A	86,122	5.0
<u>December 31, 2016</u>								
CET1 capital (to risk weighted assets)								
Consolidated	\$163,663	11.0 %	\$66,743	4.5 %	\$76,013	5.1 %	N/A	N/A
Bank	197,972	13.4	66,737	4.5	76,006	5.1	\$96,398	6.5 %
Tier 1 capital (to risk weighted assets)								
Consolidated	203,663	13.7	88,991	6.0	98,261	6.6	N/A	N/A
Bank	197,972	13.4	88,983	6.0	98,252	6.6	118,644	8.0
Total capital (to risk weighted assets)								
Consolidated	220,625	14.9	118,655	8.0	127,925	8.6	N/A	N/A
Bank	214,934	14.5	118,644	8.0	127,913	8.6	148,305	10.0
Tier 1 capital (to average assets)								
Consolidated	203,663	12.0	67,810	4.0	N/A	N/A	N/A	N/A
Bank	197,972	11.7	67,742	4.0	N/A	N/A	84,677	5.0

Approximately \$40.0 million of trust preferred securities outstanding at June 30, 2017 and December 31, 2016, respectively, qualified as Tier 1 capital. Refer to our 2016 Form 10-K for more information on the trust preferred securities.

The Bank was categorized as "well capitalized" at June 30, 2017 and December 31, 2016.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. It wholly-owns Macatawa Bank, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the FDIC. The Bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in our Consolidated Financial Statements. For further information regarding consolidation, see the Notes to Consolidated Financial Statements.

At June 30, 2017, we had total assets of \$1.76 billion, total loans of \$1.25 billion, total deposits of \$1.46 billion and shareholders' equity of \$170.2 million. During the second quarter of 2017, we recognized net income of \$4.8 million compared to net income of \$3.7 million in the second quarter of 2016. For the six months ended June 30, 2017, we recognized net income of \$9.2 million compared to \$7.2 million for the same period in 2016. The Bank was categorized as "well capitalized" under regulatory capital standards at June 30, 2017.

We paid a dividend of \$0.03 per share in each quarter of 2016. We increased the dividend to \$0.04 per share in the first and second quarters of 2017.

RESULTS OF OPERATIONS

Summary: Net income for the quarter ended June 30, 2017 was \$4.8 million, compared to net income of \$3.7 million in the second quarter of 2016. Net income per common share on a diluted basis was \$0.14 for the second quarter of 2017 and \$0.11 for the second quarter of 2016. For the six months ended June 30, 2017, net income was \$9.2 million, compared to \$7.2 million for the same period in 2016. Net income per share on a diluted basis for the six months ended June 30, 2017 was \$0.27 compared to \$0.21 for the same period in 2016.

The increase in earnings in the second quarter of 2017 compared to the second quarter of 2016 was due primarily to increased net interest income and reduced nonperforming asset expenses. Net interest income increased to \$12.7 million in the second quarter of 2017 compared to \$11.6 million in the same period in 2016. The provision for loan losses was a negative \$500,000 for the second quarter of 2017, compared to a negative \$750,000 for the second quarter of 2016. Nonperforming asset expenses (including administration costs and losses) were a negative \$158,000 for the second quarter of 2017 compared to \$460,000 for the second quarter of 2016, primarily as a result of a decrease of \$469,000 in writedowns of other real estate owned. We again were in a net loan recovery position for the second quarter of 2017, with \$374,000 in net loan recoveries, compared to \$580,000 in net loan recoveries in the second quarter of 2016.

The increase in earnings for the six month period ended June 30, 2017 compared to the same period of 2016, was due primarily to increased net interest income and reduced nonperforming asset expenses. Net interest income increased to \$25.3 million in the first six months of 2017 compared to \$23.3 million in the same period in 2016. Nonperforming asset expenses (including administration costs and losses) were a negative \$63,000 for the first six months of 2017 compared to \$871,000 for the first six months of 2016, primarily as a result of a net gains on other real estate owned of \$385,000 for the first six months of 2017 compared to net losses of \$294,000 for the same period in 2016. The provision for loan losses was a negative \$1.0 million for the first six months of 2017, compared to a negative \$850,000 for the first six months of 2016. We again were in a net loan recovery position for the first half of 2017, with \$608,000 in net loan recoveries, compared to \$728,000 in net loan recoveries in the first half of 2016. Each of these items is discussed more fully below.



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Net Interest Income: Net interest income totaled \$12.7 million for the second quarter of 2017 and \$11.6 million for the second quarter of 2016. For the first six months of 2017, net interest income was \$25.3 million compared to \$23.3 million for the same period in 2016.

Net interest income was positively impacted in the second quarter of 2017 by an increase in average earning assets of \$63.3 million compared to the second quarter of 2016. Our average yield on earning assets for the second quarter of 2017 increased 17 basis points compared to the same period in 2016 from 3.41% to 3.58%. Average interest earning assets totaled \$1.59 billion for the second quarter of 2017 compared to \$1.53 billion for the second quarter of 2016. The net interest margin was 3.24% for the second quarter of 2017 compared to 3.08% for the second quarter of 2016. An increase of \$35.2 million in average securities between periods and an increase of \$48.5 million in average loans were the primary drivers of the increase. Yield on commercial loans increased from 3.86% for the second quarter of 2016 to 4.02% for the second quarter of 2017. Yield on residential mortgage loans decreased from 3.49% for the second quarter of 2016 to 3.47% for the second quarter of 2017, while yields on consumer loans increased from 3.99% for the second quarter of 2016 to 4.17% for the second quarter of 2017. The December 2016 and March 2017 increases in the federal funds rate had a net positive impact on our net interest margin position as more loans repriced at the higher rate than our funding sources.

Average interest earning assets increased to \$1.59 billion for the first six months of 2017, compared to \$1.54 billion for the first six months of 2016. Our average yield on earning assets increased 17 basis points for the first half of 2017 in comparison to the same period in 2016. Our net interest margin was 3.25% for the first six months of 2017 compared to 3.09% for the same period in 2016. Net interest margin for the first six months of 2017 benefitted from the December 2016 and March 2017 increases in the federal funds rate. The commercial loan yield in the first six months of 2017 was also positively impacted by the complete payoff of a loan that had been on nonaccrual, resulting in the realization of \$267,000 in interest income that had been deferred.

The cost of funds increased to 0.49% and 0.48% in the three and six month periods of 2017 from 0.47% in the same periods of 2016. Increases in the rates paid on our savings and money market accounts in response to the December 2016 and March 2017 federal funds rate increases caused the slight increase in our cost of funds.

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The following table shows an analysis of net interest margin for the three month periods ended June 30, 2017 and 2016 (dollars in thousands):

	For the three months ended June 30,					
	2017			2016		
	Average Balance	Interest Earned or Paid	Average Yield or Cost	Average Balance	Interest Earned or Paid	Average Yield or Cost
<u>Assets</u>						
Taxable securities	\$ 145,596	\$ 646	1.77 %	\$ 132,431	\$ 565	1.71 %
Tax-exempt securities (1)	106,495	545	3.21	84,468	441	3.37
Commercial loans (2)	956,815	9,730	4.02	899,336	8,768	3.86
Residential mortgage loans	214,857	1,863	3.47	219,301	1,917	3.49
Consumer loans	91,157	948	4.17	95,722	949	3.99
Federal Home Loan Bank stock	11,558	121	4.15	11,558	122	4.18
Federal funds sold and other short-term investments	68,371	189	1.09	88,719	111	0.49
Total interest earning assets (1)	1,594,849	14,042	3.58	1,531,535	12,873	3.41
Noninterest earning assets:						
Cash and due from banks	30,499			26,537		
Other	98,227			96,253		
Total assets	\$ 1,723,575			\$ 1,654,325		
<u>Liabilities</u>						
Deposits:						
Interest bearing demand	\$ 325,429	\$ 68	0.08 %	\$ 325,432	\$ 77	0.10 %
Savings and money market accounts	557,075	350	0.25	509,098	231	0.18
Time deposits	79,085	139	0.70	85,585	131	0.62
Borrowings:						
Other borrowed funds	87,894	358	1.61	102,642	458	1.77
Long-term debt	41,238	422	4.05	41,238	368	3.53
Total interest bearing liabilities	1,090,721	1,337	0.49	1,063,995	1,265	0.47
Noninterest bearing liabilities:						
Noninterest bearing demand accounts	458,186			426,588		
Other noninterest bearing liabilities	6,427			7,078		
Shareholders' equity	168,241			156,664		
Total liabilities and shareholders' equity	\$ 1,723,575			\$ 1,654,325		
Net interest income		\$ 12,705			\$ 11,608	
Net interest spread (1)			3.09 %			2.94 %
Net interest margin (1)			3.24 %			3.08 %
Ratio of average interest earning assets to average interest bearing liabilities	146.22 %			143.94 %		

(1) Yields are presented on a tax equivalent basis using a 35% tax rate.

(2) Includes loan fees of \$157,000 and \$114,000 for the three months ended June 30, 2017 and 2016. Includes average nonaccrual loans of approximately \$592,000 and \$367,000 for the three months ended June 30, 2017 and 2016.





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The following table shows an analysis of net interest margin for the six month periods ended June 30, 2017 and 2016 (dollars in thousands):

	For the six months ended June 30, 2017			2016		
	Average Balance	Interest Earned or Paid	Average Yield or Cost	Average Balance	Interest Earned or Paid	Average Yield or Cost
<u>Assets</u>						
Taxable securities	\$ 146,612	\$ 1,285	1.75 %	\$ 130,986	\$ 1,115	1.70 %
Tax-exempt securities (1)	107,546	1,084	3.18	84,551	874	3.28
Commercial loans (2)	956,484	19,387	4.03	895,287	17,660	3.90
Residential mortgage loans	216,050	3,743	3.47	216,182	3,801	3.51
Consumer loans	92,263	1,865	4.08	97,695	1,929	3.97
Federal Home Loan Bank stock	11,558	245	4.21	11,558	246	4.21
Federal funds sold and other short-term investments	56,832	281	0.98	99,092	256	0.51
Total interest earning assets (1)	1,587,345	27,890	3.58	1,535,351	25,881	3.41
Noninterest earning assets:						
Cash and due from banks	28,387			25,784		
Other	99,424			97,823		
Total assets	\$ 1,715,156			\$ 1,658,958		
<u>Liabilities</u>						
Deposits:						
Interest bearing demand	\$ 323,231	\$ 138	0.08 %	\$ 330,079	\$ 162	0.10 %
Savings and money market accounts	553,404	641	0.23	511,171	469	0.19
Time deposits	78,529	259	0.67	87,931	271	0.62
Borrowings:						
Other borrowed funds	93,427	740	1.57	99,282	900	1.79
Long-term debt	41,238	824	3.98	41,238	733	3.52
Total interest bearing liabilities	1,089,829	2,602	0.48	1,069,701	2,535	0.47
Noninterest bearing liabilities:						
Noninterest bearing demand accounts	453,583			427,111		
Other noninterest bearing liabilities	5,454			6,692		
Shareholders' equity	166,290			155,454		
Total liabilities and shareholders' equity	\$ 1,715,156			\$ 1,658,958		
Net interest income		\$ 25,288			\$ 23,346	
Net interest spread (1)			3.10 %			2.94 %
Net interest margin			3.25 %			3.09 %
Ratio of average interest earning assets to average interest bearing liabilities	145.65 %			143.53 %		

(1) Yields are presented on a tax equivalent basis using a 35% tax rate.

(2) Includes loan fees of \$366,000 and \$358,000 for the six months ended June 30, 2017 and 2016. Includes average nonaccrual loans of approximately \$488,000 and \$476,000 for the six months ended June 30, 2017 and 2016.



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Provision for Loan Losses: The provision for loan losses for the second quarter of 2017 was a negative \$500,000 compared to a negative \$750,000 for the second quarter of 2016. The negative provisions for loan losses for each period were the result of continued stabilization of real estate values on problem credits, continued improvement in asset quality metrics and net loan recoveries of \$374,000 in the second quarter of 2017 and \$580,000 in the second quarter of 2016. At June 30, 2017, we had experienced net loan recoveries in twelve of the past thirteen quarters, and in each of the past ten quarters. The provision for loan losses for the first half of 2017 was a negative \$1.0 million compared to a negative \$850,000 for the same period in 2016.

Gross loan recoveries were \$513,000 for the second quarter of 2017 and \$616,000 for the same period in 2016. In the second quarter of 2017, we had \$139,000 in charge-offs, compared to \$36,000 in the second quarter of 2016. For the six months ended June 30, 2017, we experienced gross loan recoveries of \$773,000 compared to \$840,000 for the same period in 2016. Loan charge-offs were \$165,000 for the six months ended June 30, 2017 compared to \$112,000 for the same period in 2016. We continue to experience positive results from our collection efforts as evidenced by our net loan recoveries. While we expect our collection efforts to produce further recoveries, they may not continue at the same level we have experienced the past several quarters.

The amounts of loan loss provision in both the most recent quarter and comparable prior year period were the result of establishing our allowance for loan losses at levels believed necessary based upon our methodology for determining the adequacy of the allowance. The sustained lower level of quarterly net charge-offs over the past several quarters had a significant effect on the historical loss component of our methodology. More information about our allowance for loan losses and our methodology for establishing its level may be found under the heading "Allowance for Loan Losses" below.

Noninterest Income: Noninterest income for the three and six month periods ended June 30, 2017 were \$4.5 million and \$8.7 million compared to \$4.5 million and \$9.1 million for the same periods in 2016. The components of noninterest income are shown in the table below (in thousands):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Service charges and fees on deposit accounts	\$ 1,110	\$ 1,112	\$ 2,170	\$ 2,159
Net gains on mortgage loans	476	572	904	1,060
Trust fees	833	788	1,611	1,496
Gain as sales of securities	---	10	3	99
ATM and debit card fees	1,338	1,257	2,539	2,443
Bank owned life insurance ("BOLI") income	243	158	481	602
Investment services fees	250	270	466	573
Other income	228	369	535	712
Total noninterest income	\$ 4,478	\$ 4,536	\$ 8,709	\$ 9,144

Net gains on mortgage loans were down \$96,000 in the second quarter of 2017 compared to the second quarter of 2016 as a result of an overall lower level of volume. Mortgage loans originated for sale in the second quarter of 2017 were \$16.7 million, compared to \$19.0 million in the second quarter of 2016. Mortgage loans originated for portfolio in the second quarter of 2017 were \$12.1 million, compared to \$23.1 million in the second quarter of 2016. ATM and debit card fees were up in the three and six months ended June 30, 2017 due to higher volume of usage by our customers. Mortgage loans originated for sale for the first six months of 2017 were \$33.7 million, down from \$37.9 million in the first six months of 2016. BOLI income in the first six months of 2016 included \$290,000 in net benefits from the distribution of a death claim on a covered former employee. Trust fees were up in the first six months of 2017 due to investment market value changes and growth in trust assets.



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Noninterest Expense: Noninterest expense decreased to \$10.8 million for the three month period ended June 30, 2017, from \$11.5 million for the same period in 2016. Noninterest expense decreased to \$21.7 million for the six month period ended June 30, 2017 compared to \$23.0 million for the same period in 2016. The components of noninterest expense are shown in the table below (in thousands):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Salaries and benefits	\$ 6,153	\$ 6,168	\$ 12,152	\$ 12,355
Occupancy of premises	991	901	2,017	1,883
Furniture and equipment	750	839	1,482	1,704
Legal and professional	197	188	422	347
Marketing and promotion	225	275	453	550
Data processing	731	688	1,413	1,347
FDIC assessment	134	220	270	472
Interchange and other card expense	324	308	637	594
Bond and D&O insurance	118	131	234	263
Net (gains) losses on repossessed and foreclosed properties	(300 )	258	(385 )	294
Administration and disposition of problem assets	142	202	322	577
Outside services	408	389	857	758
Other noninterest expense	919	903	1,805	1,877
Total noninterest expense	\$ 10,792	\$ 11,470	\$ 21,679	\$ 23,021

Most categories of noninterest expense were relatively flat or had reductions compared to the second quarter of 2016 due to our ongoing efforts to manage expenses and scale our operations. Our largest component of noninterest expense, salaries and benefits, decreased by \$15,000 in the second quarter of 2017 from the second quarter of 2016. This decrease is largely due to a lower level of costs associated with employee benefits, particularly medical insurance, which were down \$28,000 compared to the second quarter of 2017 due to a lower level of claims. Variable based compensation was down \$84,000 compared to the second quarter of 2016 and was down \$159,000 for the first six months of 2017 compared to the same period in 2016 due to lower mortgage production and brokerage volume. We had 344 full-time equivalent employees at June 30, 2017 compared to 343 at June 30, 2016.

Occupancy expenses were up \$90,000 in the second quarter of 2017 and were up \$134,000 for the first six months of 2017 compared to the same periods in 2016 due to higher maintenance costs incurred associated with certain branch facilities.

Our FDIC assessment costs decreased by \$86,000 in the second quarter of 2017 compared to the same period in 2016 and by \$202,000 for the first six months of 2017 due primarily to positive changes in our assessment rates. These costs have been trending down for the past few years and we believe the rate has stabilized and future expense fluctuations will likely be dependent on changes in our asset size.

Costs associated with administration and disposition of problem assets have decreased significantly over the past several years. These expenses include legal costs, repossessed and foreclosed property administration expense and losses on repossessed and foreclosed properties. Repossessed and foreclosed property administration expense includes survey and appraisal, property maintenance and management and other disposition and carrying costs. Losses on repossessed and foreclosed properties include both net gains and losses on the sale of properties and unrealized losses from value declines for outstanding properties. We experienced decreases in each of these three expense categories in the second quarter of 2017 and the first six month of 2017 compared to the same periods in the prior year.

These costs are itemized in the following table (in thousands):

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Legal and professional – nonperforming assets	\$ 18	\$ 29	\$ 35	\$ 99
Reposessed and foreclosed property administration	124	173	287	478
Net (gains) losses on reposessed and foreclosed properties	(300 )	258	(385 )	294
Total	\$ (158 )	\$ 460	\$ (63 )	\$ 871

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As problem loans move through the collection process, the costs associated with nonperforming assets remained elevated, but have decreased significantly over the past several years. Other real estate owned decreased from \$14.1 million at June 30, 2016 to \$7.1 million at June 30, 2017. During the second quarter of 2017, we sold our largest individual other real estate owned property (carry value of \$3.4 million) for a net gain of \$68,000. This property was responsible for a significant portion of our nonperforming asset expense, including maintenance, property taxes and utility costs. With the reductions in other real estate owned properties, we believe we will experience more reductions in these costs going forward.

Losses on repossessed assets and foreclosed properties for the three month period ended June 30, 2017 decreased \$558,000 from the same period in 2016. For the first six months of 2017, these expenses decreased \$679,000 from the same period in 2016. These decreases were primarily due to a lower level of writedowns of other real estate properties in these periods. In the second quarter of 2016, valuation writedowns totaled \$426,000, due primarily to a writedown on our largest other real estate owned property. As discussed above, this property was sold in the second quarter of 2017. Also contributing to the decrease was an increase of \$153,000 in net gains on sales of other real estate owned. In the first six months of 2017, we recognized net gains totaling \$470,000 on such sales, compared to \$260,000 for the same period in 2016.

Federal Income Tax Expense: We recorded \$2.1 million and \$4.1 million in federal income tax expense for the three and six month periods ended June 30, 2017 compared to \$1.7 million and \$3.1 million, respectively, in the same periods in 2016. Our effective tax rate for the three and six month periods ended June 30, 2017 was 30.90% and 30.75%, compared to 30.96% and 29.83%, respectively, for the same periods in 2016.

## FINANCIAL CONDITION

Total assets were \$1.76 billion at June 30, 2017, an increase of \$18.1 million from \$1.74 billion at December 31, 2016. This change reflected increases of \$55.5 million in cash and cash equivalents offset by decreases of \$29.5 million in our loan portfolio and \$3.1 million in other assets. Total deposits increased by \$11.3 million and other borrowed funds decreased by \$1.4 million at June 30, 2017 compared to December 31, 2016.

Cash and Cash Equivalents: Our cash and cash equivalents, which include federal funds sold and short-term investments, were \$145.3 million at June 30, 2017 compared to \$89.8 million at December 31, 2016. The increase in these balances related primarily to the decrease in our total loans and increase in total deposits in the same period.

Securities: Securities available for sale were \$184.8 million at June 30, 2017 compared to \$184.4 million at December 31, 2016. The balance at June 30, 2017 primarily consisted of U.S. agency securities, agency mortgage backed securities and various municipal investments. Our held to maturity portfolio decreased from \$69.4 million at December 31, 2016 to \$68.8 million at June 30, 2017. Our held to maturity portfolio is comprised of state and municipal bonds.

Portfolio Loans and Asset Quality: Total portfolio loans decreased by \$29.5 million in the first six months of 2017 and were \$1.25 billion at June 30, 2017 compared to \$1.28 billion at December 31, 2016. During the first six months of 2017, our commercial portfolio decreased by \$17.6 million, while our consumer portfolio decreased by \$7.0 million and our residential mortgage portfolio decreased by \$4.9 million. The decrease in the commercial portfolio is seasonal and we expect balances to increase throughout the remainder of 2017. In addition, we have been focusing efforts to increase our consumer and residential mortgage portfolio segments to further diversify our credit risk.

The volume of residential mortgage loans originated for sale in the first six months of 2017 decreased \$4.2 million compared to the same period in 2016 due to a higher interest rate environment. Residential mortgage loans originated for sale were \$33.7 million in the first six months of 2017 compared to \$37.9 million in the first six months of 2016. Mortgage loans originated for portfolio in the first six months of 2017 were \$12.1 million, compared to \$37.2 million



in the first six months of 2016. Mortgage loans originated for portfolio are typically loans that conform to secondary market requirements and have a term of fifteen years or less.

Overall, the commercial loan portfolio decreased \$17.6 million in the first six months of 2017. Our commercial and industrial portfolio decreased by \$14.1 million and our commercial real estate loans decreased by \$3.5 million. Considering our pipeline of commercial credits at June 30, 2017, we expect to achieve measured, high quality loan portfolio growth throughout the remainder of 2017.

Commercial and commercial real estate loans remained our largest loan segment and accounted for approximately 76% of the total loan portfolio at June 30, 2017 and December 31, 2016. Residential mortgage and consumer loans comprised approximately 24% of total loans at June 30, 2017 and December 31, 2016.

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A further breakdown of the composition of the loan portfolio is shown in the table below (in thousands):

	June 30, 2017		December 31, 2016		
	Balance	Percent of Total Loans	Balance	Percent of Total Loans	
Commercial real estate: (1)					
Residential developed	\$8,701	0.7	% \$11,970	0.9	%
Unsecured to residential developers	4,734	0.4	4,734	0.4	
Vacant and unimproved	38,357	3.1	40,286	3.1	
Commercial development	492	---	378	---	
Residential improved	77,047	6.2	75,348	5.9	
Commercial improved	282,884	22.6	289,478	22.6	
Manufacturing and industrial	102,325	8.2	95,787	7.5	
Total commercial real estate	514,540	41.2	517,981	40.4	
Commercial and industrial	435,218	34.8	449,342	35.1	
Total commercial	949,758	76.0	967,323	75.5	
Consumer					
Residential mortgage	212,745	17.0	217,614	17.0	
Unsecured	280	---	396	---	
Home equity	81,779	6.5	88,113	6.9	
Other secured	6,793	0.5	7,366	0.6	
Total consumer	301,597	24.0	313,489	24.5	
Total loans	\$1,251,355	100.0	% \$1,280,812	100.0	%

(1) Includes both owner occupied and non-owner occupied commercial real estate.

Commercial real estate loans accounted for approximately 41% of the total loan portfolio at June 30, 2017 and consisted primarily of loans to business owners and developers of owner and non-owner occupied commercial properties and loans to developers of single and multi-family residential properties. In the table above, we show our commercial real estate portfolio by loans secured by residential and commercial real estate, and by stage of development. Improved loans are generally secured by properties that are under construction or completed and placed in use. Development loans are secured by properties that are in the process of development or fully developed. Vacant and unimproved loans are secured by raw land for which development has not yet begun and agricultural land.

Our consumer residential mortgage loan portfolio, which also includes residential construction loans made to individual homeowners, comprised approximately 17% of portfolio loans at both June 30, 2017 and December 31, 2016. We expect to continue to retain in our loan portfolio certain types of residential mortgage loans (primarily high quality, low loan-to-value loans) in an effort to continue to diversify our credit risk and deploy our excess liquidity. A large portion of our residential mortgage loan production continues to be sold on the secondary market with servicing released.

The volume of residential mortgage loans originated for sale during the first six months of 2017 decreased from the first six months of 2016 as a result of interest rate conditions. We are also experiencing a shift in production to financing new home purchases versus refinancings.

Our portfolio of other consumer loans includes loans secured by personal property and home equity fixed term and line of credit loans. Consumer loans decreased by \$7.0 million to \$88.9 million at June 30, 2017 from \$95.9 million at December 31, 2016, due primarily to a decrease in home equity loans. Consumer loans comprised approximately 7% of our portfolio loans at June 30, 2017 and December 31, 2016.



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The following table shows our loan origination activity for portfolio loans during the first six months of 2017 and 2016, broken out by loan type and also shows average originated loan size (dollars in thousands):

	Six months ended June 30, 2017			Six months ended June 30, 2016		
	Portfolio Originations	Percent of Total Originations	Average Loan Size	Portfolio Originations	Percent of Total Originations	Average Loan Size
Commercial real estate:						
Residential developed	\$ 1,494	1.1	% \$ 498	\$ 5,227	3.4	% \$ 871
Unsecured to residential developers	---	---	---	---	---	---
Vacant and unimproved	1,663	1.2	238	221	0.2	110
Commercial development	125	0.1	125	2,200	1.5	2,200
Residential improved	22,673	16.5	246	37,174	24.4	409
Commercial improved	15,144	11.0	891	21,382	14.0	1,018
Manufacturing and industrial	5,700	4.1	814	10,956	7.2	996
Total commercial real estate	46,799	34.0	368	77,160	50.7	584
Commercial and industrial	46,992	34.2	712	18,088	11.9	266
Total commercial	93,791	68.2	486	95,248	62.6	476
Consumer						
Residential mortgage	21,274	15.5	239	37,201	24.4	201
Unsecured	---	---	---	12	---	12
Home equity	21,177	15.4	84	18,496	12.1	80
Other secured	1,235	0.9	16	1,316	0.9	20
Total consumer	43,686	31.8	104	57,025	37.4	118
Total loans	\$ 137,477	100.0	% 224	\$ 152,273	100.0	% 223

The following table shows a breakout of our commercial loan activity during the first six months of 2017 and 2016 (dollars in thousands):

	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Commercial loans originated	\$ 93,791	\$ 95,248
Repayments of commercial loans	(88,690 )	