

SI Financial Group, Inc.  
Form 10-Q  
May 09, 2016

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 March 31, 2016

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: 0-54241

SI FINANCIAL GROUP, INC.  
(Exact name of registrant as specified in its charter)

\_\_\_\_\_  
Maryland 80-0643149  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

803 Main Street, Willimantic, Connecticut 06226  
(Address of principal executive offices) (Zip Code)

(860) 423-4581  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  Smaller Reporting Company

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

Yes  No

As of May 2, 2016, there were 12,220,680 shares of the registrant's common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## SI FINANCIAL GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts / Unaudited)

	March 31, 2016	December 31, 2015
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$ 14,991	\$ 14,373
Interest-bearing	54,407	26,405
Total cash and cash equivalents	69,398	40,778
Available for sale securities, at fair value	181,144	175,132
Loans held for sale	494	1,804
Loans receivable (net of allowance for loan losses of \$10,133 at March 31, 2016 and \$9,863 at December 31, 2015)	1,159,023	1,165,372
Federal Home Loan Bank stock, at cost	12,874	12,874
Federal Reserve Bank stock, at cost	3,624	3,621
Bank-owned life insurance	22,065	21,924
Premises and equipment, net	20,766	21,188
Goodwill and other intangibles	17,945	18,096
Accrued interest receivable	4,240	4,283
Deferred tax asset, net	8,448	8,961
Other real estate owned, net	1,048	1,088
Other assets	7,138	6,713
Total assets	\$ 1,508,207	\$ 1,481,834
<b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>		
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 157,093	\$ 163,893
Interest-bearing	940,070	894,124
Total deposits	1,097,163	1,058,017
Mortgagors' and investors' escrow accounts	2,134	3,508
Federal Home Loan Bank advances	218,245	234,595
Junior subordinated debt owed to unconsolidated trust	8,248	8,248
Accrued expenses and other liabilities	25,569	23,136
Total liabilities	1,351,359	1,327,504
Shareholders' Equity:		
Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)	—	—
Common stock (\$.01 par value; 35,000,000 shares authorized; 12,221,578 and 12,218,818 shares issued and outstanding at March 31, 2016 and December 31, 2015, respectively)	122	122
Additional paid-in-capital	125,160	124,997
Unallocated common shares held by ESOP	(3,528	) (3,648
Unearned restricted shares	(694	) (815
Retained earnings	34,932	33,864

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Accumulated other comprehensive income (loss)	856	(190 )
Total shareholders' equity	156,848	154,330
Total liabilities and shareholders' equity	\$1,508,207	\$ 1,481,834

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(In Thousands, Except Per Share Amounts / Unaudited)

Three Months  
Ended  
March 31,  
2016      2015

Interest and dividend income:		
Loans, including fees	\$11,571	\$10,614
Securities:		
Taxable interest	839	733
Tax-exempt interest	14	59
Dividends	162	45
Other	56	19
Total interest and dividend income	12,642	11,470
Interest expense:		
Deposits	1,549	1,368
Federal Home Loan Bank advances	874	596
Subordinated debt and other borrowings	45	83
Total interest expense	2,468	2,047
Net interest income	10,174	9,423
Provision for loan losses	311	335
Net interest income after provision for loan losses	9,863	9,088
Noninterest income:		
Service fees	1,644	1,648
Wealth management fees	299	298
Increase in cash surrender value of bank-owned life insurance	141	162
Mortgage banking	270	147
Net loss on fair value of derivatives	(1	) (5
Other	349	87
Total noninterest income	2,702	2,337
Noninterest expenses:		
Salaries and employee benefits	5,178	4,944
Occupancy and equipment	1,743	2,053
Computer and electronic banking services	1,468	1,297
Outside professional services	635	466
Marketing and advertising	213	246
Supplies	168	148
FDIC deposit insurance and regulatory assessments	272	245
Core deposit intangible amortization	151	150
Other real estate owned operations	56	82
Other	382	430
Total noninterest expenses	10,266	10,061

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Income before income tax provision	2,299	1,364
Income tax provision	758	443
Net income	\$1,541	\$921
Earnings per share:		
Basic	\$0.13	\$0.07
Diluted	\$0.13	\$0.07

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (In Thousands / Unaudited)

	Three Months Ended March 31,	
	2016	2015
Net income	\$1,541	\$921
Other comprehensive income, net of tax:		
Available for sale securities:		
Net unrealized holding gains	1,046	702
Net unrealized holding gains on available for sale securities	1,046	702
Net unrealized gain on interest-rate swap derivative	—	25
Other comprehensive income	1,046	727
Comprehensive income	\$2,587	\$1,648

See accompanying notes to unaudited interim consolidated financial statements.



SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2016  
(In Thousands, Except Share Data / Unaudited)

	Common Stock		Additional	Unallocated	Unearned	Retained	Accumulated	Total
	Shares	Dollars	Paid-in	Common	Restricted	Earnings	Other	Shareholders'
			Capital	Shares	Shares		Comprehens	Equity
				Held			Income	
				by ESOP			(Loss)	
Balance at December 31, 2015	12,218,818	\$ 122	\$124,997	\$ (3,648 )	\$ (815 )	\$33,864	\$ (190 )	\$ 154,330
Comprehensive income	—	—	—	—	—	1,541	1,046	2,587
Cash dividends declared (\$0.04 per share)	—	—	—	—	—	(473 )	—	(473 )
Equity incentive plans compensation	—	—	102	—	121	—	—	223
Allocation of 12,159 ESOP shares	—	—	49	120	—	—	—	169
Tax benefit from share-based compensation	—	—	8	—	—	—	—	8
Stock options exercised	5,092	—	37	—	—	—	—	37
Common shares repurchased	(2,332 )	—	(33 )	—	—	—	—	(33 )
Balance at March 31, 2016	12,221,578	\$ 122	\$125,160	\$ (3,528 )	\$ (694 )	\$34,932	\$ 856	\$ 156,848

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In Thousands / Unaudited)

	Three Months Ended March 31,	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 1,541	\$ 921
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	311	335
Employee stock ownership plan expense	169	139
Equity incentive plan expense	223	183
Excess tax benefit from share-based compensation	(8 )	(5 )
Amortization of investment premiums and discounts, net	206	308
Amortization of loan premiums and discounts, net	384	375
Depreciation and amortization of premises and equipment	622	699
Amortization of core deposit intangible	151	150
Amortization of deferred debt issue costs	—	9
Net loss on fair value of derivatives	1	5
Deferred income tax provision (benefit)	(26 )	151
Loans originated for sale	(5,907 )	(3,390 )
Proceeds from sale of loans held for sale	7,316	3,599
Net gain on sales of loans held for sale	(203 )	(87 )
Net gain on sales or write-downs of other real estate owned	(14 )	(1 )
Increase in cash surrender value of bank-owned life insurance	(141 )	(162 )
Change in operating assets and liabilities:		
Accrued interest receivable	43	18
Other assets	(321 )	(114 )
Accrued expenses and other liabilities	2,440	541
Net cash provided by operating activities	6,787	3,674
Cash flows from investing activities:		
Purchases of available for sale securities	(12,130)	(10,306)
Proceeds from maturities of and principal repayments on available for sale securities	7,497	7,607
Purchases of Federal Reserve Bank stock	(3 )	—
Loan principal collections (originations), net	9,820	12,222
Purchases of loans	(4,333 )	(11,280)
Proceeds from sales of other real estate owned	221	—
Purchases of premises and equipment	(200 )	(903 )
Net cash provided by (used in) investing activities	872	(2,660)

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Concluded)  
(In Thousands / Unaudited)

	Three Months Ended March 31,	
	2016	2015
Cash flows from financing activities:		
Net increase in deposits	39,146	18,934
Net decrease in mortgagors' and investors' escrow accounts	(1,374 )	(1,561 )
Proceeds from Federal Home Loan Bank advances	—	6,000
Repayments of Federal Home Loan Bank advances	(16,350 )	(10,280 )
Excess tax benefit from share-based compensation	8	5
Cash dividends on common stock	(473 )	(493 )
Stock options exercised	37	20
Common shares repurchased	(33 )	(213 )
Net cash provided by financing activities	20,961	12,412
Net change in cash and cash equivalents	28,620	13,426
Cash and cash equivalents at beginning of period	40,778	39,251
Cash and cash equivalents at end of period	\$69,398	\$52,677
Supplemental cash flow information:		
Interest paid	\$2,448	\$2,031
Income taxes paid, net	150	—
Transfer of loans to other real estate owned	167	52
Stock options exercised by net-share settlement	—	2,136

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2016 AND 2015 AND DECEMBER 31, 2015

NOTE 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

SI Financial Group, Inc. (the "Company") is the holding company for Savings Institute Bank and Trust Company (the "Bank"). Established in 1842, the Bank is a community-oriented financial institution headquartered in Willimantic, Connecticut. The Bank provides a variety of financial services to individuals, businesses and municipalities through its twenty-five offices in eastern Connecticut and Rhode Island. Its primary products include savings, checking and certificate of deposit accounts, residential and commercial mortgage loans, commercial business loans and consumer loans. In addition, wealth management services, which include trust, financial planning, life insurance and investment services, are offered to individuals and businesses through the Bank's offices. The Company does not conduct any material business other than owning all of the stock of the Bank and making payments on the subordinated debentures held by the Company.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank, and the Bank's wholly-owned subsidiaries, SI Mortgage Company and SI Realty Company, Inc. All significant intercompany accounts and transactions have been eliminated.

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information, the instructions to Form 10-Q and Rule 10.01 of Regulation S-X of the Securities and Exchange Commission ("SEC") and general practices within the banking industry. Accordingly, certain information and footnote disclosures required by GAAP for complete financial statements have been omitted. Information in the accompanying interim consolidated financial statements and notes to the financial statements of the Company as of March 31, 2016 and for the three months ended March 31, 2016 and 2015 is unaudited. These unaudited interim consolidated financial statements and related notes should be read in conjunction with the audited financial statements of the Company and the accompanying notes for the year ended December 31, 2015 contained in the Company's Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the periods covered herein. The results of operations for the three months ended March 31, 2016 are not necessarily indicative of the operating results for the year ending December 31, 2016 or for any other period.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities, as of the date of the balance sheets and reported amounts of revenues and expenses for the periods presented. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred income taxes and the impairment of long-lived assets.

Reclassifications

Amounts in the Company's prior year consolidated financial statements are reclassified to conform to the current year presentation. Such reclassifications have no effect on net income.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2016 AND 2015 AND DECEMBER 31, 2015

Loans Receivable

Loans receivable are stated at current unpaid principal balances, net of the allowance for loan losses and deferred loan origination fees and costs. Management has the ability and intent to hold its loans receivable for the foreseeable future or until maturity or pay-off.

A loan is impaired when, based on current information and events, it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan by loan basis for residential and commercial mortgage loans and commercial business loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not typically identify individual consumer loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring ("TDR") agreement.

Troubled Debt Restructurings

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and concessions have been made to the original contractual terms that would not otherwise be considered for a borrower with similar risk characteristics, such as reductions of interest rates, deferral of interest or principal payments, or maturity extensions due to the borrower's financial condition, the modification is considered a TDR. Modified terms are dependent upon the financial position and needs of the individual borrower. If the modification agreement is violated, the loan is handled by the Company's Collections Department for resolution, which may result in foreclosure.

Management considers all nonaccrual loans, with the exception of certain consumer loans, to be impaired. Also, all TDRs are initially classified as impaired and follow the Company's nonaccrual policy. If the loan was current prior to modification, nonaccrual status would not be required. If the loan was on nonaccrual prior to modification or if the payment amount significantly increases, the loan will remain on nonaccrual for a period of at least six months. Loans qualify for return to accrual status once the borrower has demonstrated the willingness and the ability to perform in accordance with the restructured terms of the loan agreement for a period of not less than six consecutive months. In most cases, loan payments less than 90 days past due are considered minor collection delays and the related loans are generally not considered impaired.

Impaired classification may be removed after a year following the restructure if the borrower demonstrates compliance with the modified terms and the restructuring agreement specifies an interest rate equal to that which would be provided to a borrower with similar risk characteristics at the time of restructuring.

Allowance for Loan Losses

The allowance for loan losses, a material estimate which could change significantly in the near-term, is established through a provision for loan losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Loan losses are charged against the allowance for loan losses when management believes the uncollectibility of the principal loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance



for loan losses when received. In the determination of the allowance for loan losses, management may obtain independent appraisals for significant properties, when necessary.

Management's judgment in determining the adequacy of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is evaluated on a monthly basis by management and is based on the evaluation of the known and

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2016 AND 2015 AND DECEMBER 31, 2015

inherent risk characteristics and size and composition of the loan portfolio, the assessment of current economic and real estate market conditions, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, historical loan loss experience, the level and trends of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.

The allowance for loan losses consists of the following key elements:

**Specific allowance for identified impaired loans.** For loans identified as impaired, an allowance is established when the present value of expected cash flows (or observable market price of the loan or fair value of the collateral if the loan is collateral dependent) of the impaired loan is lower than the carrying value of that loan.

**General valuation allowance.** The general component represents a valuation allowance on the remainder of the loan portfolio, after excluding impaired loans. For this portion of the allowance, loans are segregated by category and assigned an allowance percentage based on historical loan loss experience adjusted for qualitative factors stratified by the following loan segments: residential one- to four-family, multi-family and commercial real estate, construction, commercial business and consumer. Management uses a rolling average of historical losses based on the time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices; changes in international, national, regional and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments; changes in the size and composition of the loan portfolio and in the terms of the loans; changes in the experience, ability and depth of lending management and other relevant staff; changes in the volume and severity of past due loans, the volume of nonaccrual loans and the volume and severity of adversely classified or graded loans; changes in the quality of the loan review system; changes in the underlying collateral for collateral-dependent loans; the existence and effect of any concentrations of credit and changes in the level of such concentrations; the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the portfolio.

The qualitative factors are determined based on the following various risk characteristics for each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

**Residential – One- to Four-Family –** The Bank primarily originates conventional loans with loan-to-value ratios less than 95% and generally originates loans with loan-to-value ratios in excess of 80% only when secured by first liens on owner-occupied one- to four-family residences. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance or additional collateral. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality of this segment.

**Multi-family and Commercial –** Loans in this segment are originated for the purpose of acquiring, developing, improving or refinancing multi-family and commercial real estate where the property is the primary collateral securing the loan, and the income generated from the property is the primary repayment source. The underlying cash flows generated by the properties can be impacted by the economy as evidenced by increased vacancy rates. Payments

on loans secured by income-producing properties often depend on the successful operation and management of the properties. Management continually monitors the cash flows of these loans.

• Construction – This segment includes loans to individuals and, to a lesser extent, builders to finance the construction of residential dwellings. The Bank also originates construction loans for commercial

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2016 AND 2015 AND DECEMBER 31, 2015

development projects. Upon the completion of construction, the loan generally converts to a permanent mortgage loan. Credit risk is affected by cost overruns, correct estimates of the sale price of the property, time to sell at an adequate price and market conditions.

Commercial Business – Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. The Bank provides loans to investors in the time share industry, which are secured by consumer receivables, and provides loans for capital improvements to condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners. Additionally, the Bank purchases medical loans primarily out of our market area from a company specializing in medical loan originations, which are secured by medical equipment.

Consumer – Loans in this segment primarily include home equity lines of credit (representing both first and second liens), indirect automobile loans and, to a lesser extent, loans secured by marketable securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

In computing the allowance for loan losses, we do not assign a general valuation allowance to the Small Business Administration ("SBA") and United States Department of Agriculture ("USDA") loans that we purchase as such loans are fully guaranteed. These loans are included in commercial business loans. See Note 4 for details.

The majority of the Company's loans are collateralized by real estate located in eastern Connecticut and Rhode Island. To a lesser extent, certain commercial real estate loans are secured by collateral located outside of our primary market area with concentrations in Massachusetts and New Hampshire. Accordingly, the collateral value of a substantial portion of the Company's loan portfolio and real estate acquired through foreclosure is susceptible to changes in local market conditions.

Although management believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and the Company's results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making the determinations. Furthermore, while management believes it has established the allowance for loan losses in conformity with GAAP, our regulators, in reviewing the loan portfolio, may request us to increase our allowance for loan losses based on judgments different from ours. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, the existing allowance for loan losses may not be adequate or increases may be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.

Interest and Fees on Loans

Interest on loans is accrued and included in net interest income based on contractual rates applied to principal amounts outstanding. Accrual of interest is discontinued when loan payments are 90 days or more past due, based on contractual terms, or when, in the judgment of management, collectibility of the loan or loan interest becomes uncertain. Subsequent recognition of income occurs only to the extent payment is received subject to management's

assessment of the collectibility of the remaining interest and principal. A nonaccrual loan is restored to accrual status when it is no longer delinquent and collectibility of interest and principal is no longer in doubt and the borrower has made regular payments in accordance with the terms of the loan over a period of at least six months. Interest collected on nonaccrual loans is recognized only to the extent cash payments are

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2016 AND 2015 AND DECEMBER 31, 2015

received, and may be recorded as a reduction to principal if the collectibility of the principal balance of the loan is unlikely.

Loan origination fees, direct loan origination costs and loan purchase premiums are deferred, and the net amount is recognized as an adjustment of the related loan's yield utilizing the interest method over the contractual life of the loan. In addition, discounts related to fair value adjustments for loans receivable acquired in a business combination or asset purchase are accreted into earnings over the contractual term as an adjustment of the loan's yield. The Company periodically evaluates the cash flows expected to be collected for loans acquired with deteriorated credit quality. Changes in the expected cash flows compared to the expected cash flows as of the date of acquisition may impact the accretable yield or result in a charge to the provision for loan losses to the extent of a shortfall.

Common Share Repurchases

The Company is chartered in the state of Maryland. Maryland law does not provide for treasury shares, rather shares repurchased by the Company constitute authorized but unissued shares. GAAP states that accounting for treasury stock shall conform to state law. Therefore, the cost of shares repurchased by the Company is allocated to common stock, additional paid-in capital and retained earnings balances.

Recent Accounting Pronouncements

Revenue from Contracts with Customers (Topic 606) - In May 2014, the Financial Accounting Standards Board ("FASB") issued guidance that improves the revenue recognition requirements for contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve the core principle, a company should apply a five step approach to revenue recognition. In August 2015, the FASB delayed the effective date for this guidance for one year to fiscal years beginning after December 15, 2017, and we do not expect this to have a significant impact on our financial statements.

Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs - In April 2015, FASB issued guidance simplifying the presentation of debt issuance costs. The amended guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The amended guidance should be applied on a retrospective basis and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. The adoption of the amended guidance on January 1, 2016 did not have a material impact on the Company's consolidated financial statements.

Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - In August 2015, the FASB issued amended guidance pursuant to the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting that the update issued in April 2015 does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within the previous update for debt issuance costs related to line-of-credit-arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there were any outstanding borrowings on the line-of-credit arrangement. The adoption of the amended guidance on January 1, 2016 did not have a material impact on the Company's consolidated

financial statements.

Financial Instruments (Subtopic 825-10): In January 2016, the FASB issued guidance addressing certain aspects of recognition, measurement, presentation and disclosure of financial instruments. Targeted improvements to generally accepted accounting principles include the requirement for equity investments (except those accounted

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for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income and the elimination of the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost. The amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

Leases (Topic 842): In February 2016, the FASB issued amended guidance to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is still reviewing the impact the adoption of this guidance will have on its consolidated financial statements.

Compensation - Stock Compensation (Topic 718): In March 2016, the FASB issued guidance to simplify the accounting for share-based payment transactions, including the income tax consequences of such transactions. Under the provisions of the update, the income tax consequences of excess tax benefits and deficiencies should be recognized in income tax expense in the reporting period in which the awards vest. Currently, excess tax benefits or deficiencies impact shareholders' equity directly to the extent there is a cumulative excess tax benefit. In the event that a tax deficiency has occurred during the reporting period and a cumulative tax benefit does not exist, the tax deficiency is recognized in income tax expense under current GAAP. The update also provides entities may continue to estimate forfeitures in accounting for stock based compensation or recognize them as they occur. The provisions of this update become effective for interim and annual periods beginning after December 15, 2016. The update requires a modified retrospective transition under which cumulative effect to equity will be recognized in the period of adoption. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the net income available to common shareholders by the weighted average number of common shares outstanding during the period. Unvested restricted shares are considered outstanding in the computation of basic earnings per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings per share is computed in a manner similar to basic earnings per share except that the weighted average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's common stock equivalents relate



solely to stock options. Repurchased common shares and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings per share calculations.

Anti-dilutive shares are common stock equivalents with weighted average exercise prices in excess of the weighted average market value for the periods presented, and are not considered in diluted earnings per share calculations.

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The Company had anti-dilutive common shares outstanding of 145,391 and 372,936 for the three months ended March 31, 2016 and 2015, respectively.

The computation of earnings per share is as follows:

	Three Months Ended March 31, 2016 2015 (Dollars in Thousands, Except Per Share Amounts)	
Net income	\$1,541	\$ 921
Weighted average common shares outstanding:		
Basic	11,788,965	11,733
Effect of dilutive stock options	59,959	38,641
Diluted	11,848,924	12,354,374
Earnings per share:		
Basic	\$0.13	\$ 0.07
Diluted	\$0.13	\$ 0.07

## NOTE 3. SECURITIES

## Available for Sale Securities

The amortized cost, gross unrealized gains and losses and fair values of available for sale securities at March 31, 2016 and December 31, 2015 are as follows:

March 31, 2016			
Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)			
Debt securities:			
U.S. Government and agency obligations			
\$73,091	\$ 572	\$ (410 )	\$73,253
Government-sponsored enterprises			
22,293	349	—	22,642

Mortgage-backed securities: <sup>(1)</sup>				
Agency				
- 77,756	1,032	(321	)	78,467
residential				
Non-agency				
- 112	—	(4	)	108
residential				
Corporate				
debt	—	—		1,000
securities				
Collateralized				
debt	—	(14	)	1,143
obligation				
Obligations				
of				
state				
and	—	—		1,270
political				
subdivisions				
Tax-exempt				
securities	93	—		3,261
Total				
available				
for	\$ 179,847	\$ 2,046	\$ (749	) \$ 181,144
sale				
securities				

<sup>(1)</sup> Agency securities refer to debt obligations issued or guaranteed by government corporations or government-sponsored enterprises (“GSEs”). Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

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December 31, 2015			
Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)			
Debt securities:			
U.S.			
Government			
and agency obligations	\$ 71,142	\$ 242	\$ (388 )
			\$ 70,996
Government-sponsored enterprises	25,313	95	(5 )
			25,403
Mortgage-backed securities: <sup>(1)</sup>			
Agency residential			
Non-agency residential	- 72,248	680	(962 )
			71,966
Corporate securities	1,000	—	—
			1,000
Collateralized debt obligation	156	—	(10 )
			1,146
Obligations of state and political subdivisions			
Tax-exempt securities	3,175	64	(1 )
			3,238
Total available for sale securities	\$ 175,420	\$ 1,082	\$ (1,370 )
			\$ 175,132

<sup>(1)</sup> Agency securities refer to debt obligations issued or guaranteed by government corporations or GSEs. Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

The amortized cost and fair value of debt securities by contractual maturities at March 31, 2016 are presented below. Maturities are based on the final contractual payment dates and do not reflect the impact of potential prepayments or early redemptions. Because mortgage-backed securities ("MBS") are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

	Amortized Cost	Fair Value
	(In Thousands)	
Within 1 year	\$918	\$911
After 1 but within 5 years	46,080	46,627
After 5 but within 10 years	11,482	11,498
After 10 years	43,499	43,533
	101,979	102,569
Mortgage-backed securities	77,868	78,575
Total debt securities	\$179,847	\$181,144

There were no sales of available for sale securities for the three months ended March 31, 2016 and 2015.

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The following tables present information pertaining to securities with gross unrealized losses at March 31, 2016 and December 31, 2015, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2016	(In Thousands)					
U.S. Government and agency obligations	\$6,389	\$ 37	\$18,074	\$ 373	\$24,463	\$ 410
Mortgage-backed securities:						
Agency - residential	1,332	7	24,484	314	25,816	321
Non-agency - residential	—	—	108	4	108	4
Collateralized debt obligation	—	—	1,143	14	1,143	14
Total	\$7,721	\$ 44	\$43,809	\$ 705	\$51,530	\$ 749

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2015	(In Thousands)					
U.S. Government and agency obligations	\$9,374	\$ 36	\$18,715	\$ 352	\$28,089	\$ 388
Government-sponsored enterprises	8,454	5	—	—	8,454	5
Mortgage-backed securities:						
Agency - residential	21,956	129	27,210	833	49,166	962
Non-agency - residential	—	—	112	4	112	4
Collateralized debt obligation	—	—	1,146	10	1,146	10
Tax-exempt securities	582	1	—	—	582	1
Total	\$40,366	\$ 171	\$47,183	\$ 1,199	\$87,549	\$ 1,370

At March 31, 2016, twenty-six debt securities with gross unrealized losses had aggregate depreciation of approximately 1.43% of the Company's amortized cost basis. The unrealized losses are primarily related to the Company's agency mortgage-backed securities and U.S. Government and agency obligations. There were no investments deemed other-than-temporarily impaired for the three months ended March 31, 2016 and 2015. The following summarizes, by security type, the basis for management's determination during the preparation of the financial statements of whether the applicable investments within the Company's securities portfolio were not other-than-temporarily impaired at March 31, 2016.

U.S. Government and Agency Obligations and Mortgage-backed Securities - Agency - Residential. The unrealized losses on the Company's U.S. Government and agency obligations and mortgage-backed agency-residential securities related primarily to a widening of the rate spread to comparable treasury securities. The Company does not expect these securities to settle at a price less than the par value of the securities.

Mortgage-backed Securities - Non-agency - Residential. The unrealized losses on the Company's non-agency - residential mortgage-backed securities relate to one investment which has been evaluated by management and no potential credit loss was identified.

Collateralized Debt Obligation. The unrealized loss on the Company's collateralized debt obligation relates to one investment in a pooled trust preferred security ("PTPS") which management does not believe will suffer from any credit-related losses, based on its senior credit profile. The unrealized loss on this security is caused by the low

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interest rate environment, as this security reprices quarterly to the three month LIBOR and market spreads on similar newly issued securities have increased.

NOTE 4. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loan Portfolio

The composition of the Company's loan portfolio at March 31, 2016 and December 31, 2015 is as follows:

March 31,    December 31,  
 2016            2015  
 (In Thousands)

Real estate loans:		
Residential		
-		
1 to 4 family	\$413,482	\$417,458
Multi-family	10,930	385,341
commercial construction	1,786	21,786
Total real estate loans	828,148	824,585
Commercial business loans:		
SBA and USDA guaranteed	141,357	145,238
Time share	48,787	55,192
Condominium association	20,246	21,986
Medical loans	24,590	23,445
Other	47,249	45,588



Total commercial business loans	282,229	291,449
Consumer loans:		
Home equity	53,783	53,779
Indirect automobile	1,346	1,741
Other	1,815	1,946
Total consumer loans	56,944	57,466
Total loans	1,167,321	1,173,500
Deferred loan origination costs, net of fees	1,835	1,735
Allowance for loan losses	(10,133)	(9,863)
Loans receivable, net	\$1,159,023	\$1,165,372

The Company purchased commercial business loans totaling \$4.3 million during the three months ended March 31, 2016. For the twelve months ended December 31, 2015, the Company purchased commercial business loans totaling \$113.2 million.

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## Allowance for Loan Losses

Changes in the allowance for loan losses for the three months ended March 31, 2016 and 2015 are as follows:

Three Months Ended March 31, 2016	Residential - 1 to 4 Family	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
	(In Thousands)					
Balance at beginning of period	\$1,036	\$ 5,033	\$ 516	\$ 2,625	\$ 653	\$9,863
Provision (credit) for loan losses	(10 )	193	57	70	1	311
Loans charged-off	(21 )	(24 )	—	(33 )	(3 )	(81 )
Recoveries of loans previously charged-off	28	—	—	12	—	40
Balance at end of period	\$1,033	\$ 5,202	\$ 573	\$ 2,674	\$ 651	\$10,133

Three Months Ended March 31, 2015	Residential - 1 to 4 Family	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
	(In Thousands)					
Balance at beginning of period	\$955	\$ 3,607	\$ 254	\$ 2,382	\$ 599	\$7,797
Provision for loan losses	24	59	38	209	5	335
Loans charged-off	(35 )	(20 )	—	(25 )	(1 )	(81 )
Recoveries of loans previously charged-off	32	—	—	—	—	32
Balance at end of period	\$976	\$ 3,646	\$ 292	\$ 2,566	\$ 603	\$8,083

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Further information pertaining to the allowance for loan losses at March 31, 2016 and December 31, 2015 is as follows:

March 31, 2016	Residential - 1 to 4 Family (In Thousands)	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
Allowance for loans individually evaluated and deemed to be impaired	\$ 290	\$ 55	\$ —	\$ 12	\$ —	\$ 357
Allowance for loans individually or collectively evaluated and not deemed to be impaired	743	5,147	573	2,662	651	9,776
Allowance for loans acquired with deteriorated credit quality	—	—	—	—	—	—
Total loan loss allowance	\$ 1,033	\$ 5,202	\$ 573	\$ 2,674	\$ 651	\$ 10,133
Loans individually evaluated and deemed to be impaired	\$ 5,719	\$ 4,994	\$ —	\$ 348	\$ 239	\$ 11,300
Loans individually or collectively evaluated and not deemed to be impaired	407,361	382,396	23,736	281,881	56,705	1,152,079
Amount of loans acquired with deteriorated credit quality	402	3,540	—	—	—	3,942
Total loans	\$ 413,482	\$ 390,930	\$ 23,736	\$ 282,229	\$ 56,944	\$ 1,167,321
December 31, 2015	Residential - 1 to 4 Family (In Thousands)	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
Allowance for loans individually evaluated and deemed to be impaired	\$ 303	\$ 35	\$ —	\$ —	\$ —	\$ 338
Allowance for loans individually or collectively evaluated and not deemed to be impaired	733	4,998	516	2,625	653	9,525
Allowance for loans acquired with deteriorated credit quality	—	—	—	—	—	—
Total loan loss allowance	\$ 1,036	\$ 5,033	\$ 516	\$ 2,625	\$ 653	\$ 9,863
Loans individually evaluated and deemed to be impaired	\$ 6,354	\$ 3,750	\$ —	\$ 356	\$ 158	\$ 10,618
Loans individually or collectively evaluated and not deemed to be impaired	410,699	377,503	21,786	291,093	57,308	1,158,389
	405	4,088	—	—	—	4,493

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Amount of loans acquired with deteriorated  
credit quality

Total loans	\$417,458	\$ 385,341	\$ 21,786	\$ 291,449	\$ 57,466	\$1,173,500
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## Past Due Loans

The following represents an aging of loans at March 31, 2016 and December 31, 2015:

30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total 30 Days or More Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
------------------------------	------------------------------	---	--	---------	----------------	---

(In Thousands)

Real

Estate:

Residential

-

1	\$4,247	\$—	\$1,453	\$5,700	\$407,782	\$413,482	\$—
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to

4

family

2016	385	424	3,015	387,915	390,930	—
------	-----	-----	-------	---------	---------	---

Multi-family

Commercial	—	—	—	23,736	23,736	—
------------	---	---	---	--------	--------	---

Construction

Commercial

Business:

SBA

and	1,394	—	1,477	2,871	138,486	141,357	1,477
-----	-------	---	-------	-------	---------	---------	-------

USDA

guaranteed

Time	—	—	—	48,787	48,787	—
------	---	---	---	--------	--------	---

share

Condominium	—	—	—	20,246	20,246	—
-------------	---	---	---	--------	--------	---

association

Medical	—	—	—	24,590	24,590	—
---------	---	---	---	--------	--------	---

loans

Other	—	332	609	46,640	47,249	—
-------	---	-----	-----	--------	--------	---

Consumer:

Home	100	121	97	318	53,465	53,783	—
------	-----	-----	----	-----	--------	--------	---

equity

Indirect	46	—	10	56	1,290	1,346	—
----------	----	---	----	----	-------	-------	---

automobile

Other	—	5	5	1,810	1,815	—
-------	---	---	---	-------	-------	---

\$8,170	\$506	\$3,798	\$12,574	\$1,154,747	\$1,167,321	\$1,477
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30-59	60-89		Total 30	Current	Total	
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December 31, 2015	Days Past Due	90 Days or More Past Due	Days or More Past Due	Loans	Past Due 90 Days or More and Accruing
(In Thousands)					
Real Estate: Residential					
1					
\$5,906	\$1,054	\$1,283	\$8,243	\$409,215	\$417,458
-					
4					
family Multi-family					
5,050	203	1,061	7,194	378,147	385,341
commercial Construction					
				21,786	21,786
Commercial Business:					
SBA and USDA guaranteed					
				145,238	145,238
Time share					
				55,192	55,192
Condominium association					
				21,986	21,986
Medical loans					
				23,445	23,445
Other					
22	339	406	45,182	45,588	
Consumer:					
Home equity					
130		121	251	53,528	53,779
Indirect automobile					
31			31	1,710	1,741
Other					
3	25	29	1,917	1,946	
\$12,043	\$1,282	\$2,829	\$16,154	\$1,157,346	\$1,173,500

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Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at March 31, 2016 and December 31, 2015:

Impaired Loans<sup>(1)</sup>

Recorded Investment	Unpaid Principal Balance	Related Allowance	Nonaccrual Loans
------------------------	--------------------------------	----------------------	---------------------

(In Thousands)

Impaired loans without valuation allowance:			
Real Estate: Residential			
-			
1 to	\$3,107	\$3,122	\$ —
4			\$ 2,631
family			
Multi-family			
and	1,357	6,711	—
commercial			1,471
Commercial			
business			
-	336	336	—
320			320
Other			
Consumer:			
Home			
equity	239	239	—
240			240
Indirect			
automobile	—	—	10
Other	—	—	5
Total			
impaired			
loans			
without	10,039	10,408	—
valuation			4,677
allowance			

Impaired  
loans  
with

valuation allowance:				
Real Estate: Residential				
-				
1 to 4 family Multi-family and commercial	2,612	2,623	290	488
Commercial business	12	21	12	12
- Other Total impaired loans with valuation allowance	3,862	3,882	357	607
Total impaired loans	\$ 14,901	\$ 14,290	\$ 357	\$ 5,284

(1) Includes loans acquired with deteriorated credit quality from the Newport Federal Savings Bank ("Newport") merger and performing troubled debt restructurings. Some loans acquired with deteriorated credit quality have not been included as a result of sustained performance.



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Impaired Loans<sup>(1)</sup>  
 December 31, 2015  
 Recorded Investment  
 Unpaid Principal Balance  
 Related Allowance  
 Nonaccrual Loans

(In Thousands)

Impaired loans without valuation allowance:				
Real Estate: Residential				
-				
1 to 4 family Multi-family and commercial	\$3,957	\$3,975	\$ —	\$ 3,748
Commercial business	756	6,159	—	2,167
- Other Consumer	356	356	—	339
- Home equity	158	158	—	183
Total impaired loans without valuation allowance	10,227	10,648	—	6,437

Impaired loans with valuation allowance:  
 Real Estate:

## Residential

-				
1	2,397	2,397	303	146
to				
4				
family				
Multi-family				
and	1,136	1,136	35	—
commercial				
Total				
impaired				
loans	3,533	3,533	338	146
with				
valuation				
allowance				
Total				
impaired	\$ 1,740	\$ 14,181	\$ 338	\$ 6,583
loans				

(1) Includes loans acquired with deteriorated credit quality from the Newport Federal Savings Bank ("Newport") merger and performing troubled debt restructurings. Some loans acquired with deteriorated credit quality have not been included as a result of sustained performance.

The Company reviews and establishes, if necessary, an allowance for certain impaired loans for the amount by which the present value of expected cash flows (or observable market price of loan or fair value of the collateral if the loan is collateral dependent) are lower than the carrying value of the loan. At March 31, 2016 and December 31, 2015, the Company concluded that certain impaired loans required no valuation allowance as a result of management's measurement of impairment. No additional funds are advanced to those borrowers whose loans are deemed impaired without prior approval of the Loan Committee or the Board of Directors.

Additional information related to impaired loans is as follows:

	Three Months Ended		
	March 31, 2016		
	Average Interest	Interest	Interest
	Recorded	Income	Recognized
	Investment	Recognized	on Cash
			Basis
	(In Thousands)		
Real Estate:			
Residential - 1 to 4 family	\$6,037	\$ 24	\$ —
Multi-family and commercial	7,243	84	—
Commercial business - Other	352	—	—
Consumer - Home equity	199	1	1
Total	\$13,831	\$ 109	\$ 1

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	Three Months Ended March 31, 2015		
	Average Interest Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
	(In Thousands)		
Real Estate:			
Residential - 1 to 4 family	\$5,576	\$ 26	\$ 1
Multi-family and commercial	5,920	79	—
Commercial business - Other	959	6	—
Consumer - Home equity	24	—	—
Total	\$12,479	\$ 111	\$ 1

**Credit Quality Information**

The Company utilizes an eight-grade internal loan rating system for all loans in the portfolio, with the exception of its purchased SBA and USDA commercial business loans that are fully guaranteed by the U.S. government, as follows:

o Pass (Ratings 1-4): Loans in these categories are considered low to average risk.

o Special Mention (Rating 5): Loans in this category are starting to show signs of potential weakness and are being closely monitored by management.

o Substandard (Rating 6): Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.

o Doubtful (Rating 7): Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.

o Loss (Rating 8): Loans in this category are considered uncollectible and of such little value that their continuance as assets is not warranted.

Management periodically reviews the ratings described above and the Company's internal audit function reviews components of the credit files, including the assigned risk ratings, of certain commercial loans as part of its loan review.

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The following tables present the Company's loans by risk rating at March 31, 2016 and December 31, 2015:

March 31, 2016	Not Rated	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(In Thousands)						
Real Estate:							
Residential - 1 to 4 family	\$—	\$404,550	\$1,986	\$ 6,946	\$ —	\$ —	-\$413,482
Multi-family and commercial	—	358,951	17,123	14,856	—	—	390,930
Construction	—	23,736	—	—	—	—	23,736
Total real estate loans	—	787,237	19,109	21,802	—	—	828,148
Commercial Business:							
SBA and USDA guaranteed	141,357	—	—	—	—	—	141,357
Time share	—	48,787	—	—	—	—	48,787
Condominium association	—	20,246	—	—	—	—	20,246
Medical loans	—	24,590	—	—	—	—	24,590
Other	—	44,148	1,744	1,345	12	—	47,249
Total commercial business loans	141,357	137,771	1,744	1,345	12	—	282,229
Consumer:							
Home equity	—	53,439	58	286	—	—	53,783
Indirect automobile	—	1,336	—	10	—	—	1,346
Other	—	1,810	—	5	—	—	1,815
Total consumer loans	—	56,585	58	301	—	—	56,944
Total loans	\$141,357	\$981,593	\$20,911	\$23,448	\$12	\$—	-\$1,167,321

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December 31, 2015	Not Rated	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(In Thousands)						
<b>Real Estate:</b>							
Residential - 1 to 4 family	\$—	\$409,331	\$2,001	\$6,126	\$—	—	—\$417,458
Multi-family and commercial	—	356,921	14,187	14,233	—	—	385,341
Construction	—	21,786	—	—	—	—	21,786
Total real estate loans	—	788,038	16,188	20,359	—	—	824,585
<b>Commercial Business:</b>							
SBA and USDA guaranteed	145,238	—	—	—	—	—	145,238
Time share	—	55,192	—	—	—	—	55,192
Condominium association	—	21,986	—	—	—	—	21,986
Medical loans	—	23,445	—	—	—	—	23,445
Other	—	42,760	1,534	1,294	—	—	45,588
Total commercial business loans	145,238	143,383	1,534	1,294	—	—	291,449
<b>Consumer:</b>							
Home equity	—	53,487	63	229	—	—	53,779
Indirect automobile	—	1,741	—	—	—	—	1,741
Other	—	1,946	—	—	—	—	1,946
Total consumer loans	—	57,174	63	229	—	—	57,466
Total loans	\$145,238	\$988,595	\$17,785	\$21,882	\$—	—	—\$1,173,500

The following table provides information on loans modified as TDRs during the three months ended March 31, 2016 and 2015. During the modification process, there were no loan charge-offs or principal reductions for the loans included in the table below.

	Three Months Ended March 31, 2016			2015		
	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)
(Dollars in Thousands)						
Residential - 1 to 4 family	1	\$85	\$—	—	\$—	\$—
Multi-family and commercial	1	1,448	—	—	—	—
Commercial business - other	—	—	—	1	25	—
Total	2	\$1,533	\$—	—1	\$25	\$—



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The following table provides the recorded investment, by type of modification, during the three months ended March 31, 2016 and 2015 for modified loans identified as TDRs.

Three Months Ended March 31, 2016	2015
(In Thousands)	
Principal deferrals	\$ —
Combination of rate and maturity (1)	25
Maturity only	—
Total	\$ 25

(1) Terms include combination of interest rate adjustments and extensions of maturity.

There were no TDRs in payment default (defined as 90 days or more past due) within twelve months of restructure for the three months ended March 31, 2016 and 2015.

As of March 31, 2016, the Company held \$991,000 in consumer mortgage loans collateralized by residential real estate properties that are in the process of foreclosure according to local requirements of the applicable jurisdiction.

## Loans Acquired with Deteriorated Credit Quality

The following is a summary of loans acquired with evidence of credit deterioration from Newport as of March 31, 2016 and December 31, 2015.

	Contractual Required Payments Receivable	Cash Expected To Be Collected	Non-Accrutable Discount	Accrutable Yield	Loans Receivable
Balance at December 31, 2015	\$5,076	\$ 4,493	\$ 583	\$ 121	\$ 4,372
Additions	—	—	—	—	—
Collections	(45 )	(43 )	(2 )	(9 )	(34 )
Dispositions	(567 )	(508 )	(59 )	—	(508 )
Balance at March 31, 2016	\$4,464	\$ 3,942	\$ 522	\$ 112	\$ 3,830

NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at March 31, 2016 and December 31, 2015 are summarized as follows:

	March 31, December 31,	
	2016	2015
	(In Thousands)	
Land	\$4,746	\$ 4,746
Buildings	13,583	13,583
Leasehold improvements	10,717	10,717
Furniture and equipment	13,045	12,905
Construction in process	86	30
	42,177	41,981
Accumulated depreciation and amortization	(21,411 )	(20,793 )
Premises and equipment, net	\$20,766	\$ 21,188

At March 31, 2016 and December 31, 2015, construction in process related to a project to redesign traffic flow at an existing branch and relocation of another branch.

NOTE 6. OTHER COMPREHENSIVE INCOME

Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of shareholders' equity on the balance sheet, such items, along with net income, are components of comprehensive income.

Components of other comprehensive income and related tax effects are as follows:

	Three Months Ended		
	March 31, 2016		
	Before Tax Amount	Tax Effects	Net of Tax Amount
	(In Thousands)		
Securities:			
Unrealized holding gains on available for sale securities	\$1,585	\$(539)	\$ 1,046
Unrealized holding gains on available for sale securities, net of taxes	1,585	(539 )	1,046
Other comprehensive income	\$1,585	\$(539)	\$ 1,046



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The components of accumulated other comprehensive income (loss) included in shareholders' equity are as follows:

	March 31, 2016		
	Before Tax Amount	Tax Effects	Net of Tax Amount
	(In Thousands)		
Net unrealized gains on available for sale securities	\$ 1,297	\$(441)	\$ 856
Accumulated other comprehensive income	\$ 1,297	\$(441)	\$ 856

	December 31, 2015		
	Before Tax Amount	Tax Effects	Net of Tax Amount
	(In Thousands)		
Net unrealized losses on available for sale securities	\$(288)	\$ 98	\$(190 )
Accumulated other comprehensive loss	\$(288)	\$ 98	\$(190 )

## NOTE 7. REGULATORY CAPITAL

The Company and the Bank are subject to regulatory capital adequacy requirements promulgated by federal bank regulatory agencies. Failure by the Company or the Bank to meet minimum capital requirements could result in certain mandatory and discretionary actions by regulators that could have a material adverse effect on our consolidated financial statements. The following tables present regulatory capital information for the Company and the Bank. Under Basel III capital requirements, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation require the Company and the Bank to maintain certain minimum capital amounts and ratios. Federal bank regulators require the Company and the Bank to maintain minimum ratios of core capital to adjusted average assets, common equity tier 1 capital to risk-weighted assets, tier 1 capital to risk-weighted assets and total risk-based capital to risk-weighted assets. At March 31, 2016, the Company and the Bank met all the capital adequacy requirements to which they were subject and were "well capitalized" under the regulatory requirements. To be "well capitalized," the Company and the Bank must maintain minimum leverage, common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios of at least 5.0%, 6.5%, 8.0% and 10.0%, respectively. Management believes no conditions or events have occurred since March 31, 2016 that would materially adversely change the Company's and the Bank's capital classifications.

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized
	Amount	Ratio	Amount	Ratio	Amount
	(Dollars in Thousands)				
March 31, 2016					

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Tier 1 Capital to Average Assets:						
Company	\$ 149,167	10.09%	\$ 59,162	4.000%	\$ 73,953	5.000 %
Bank	136,251	9.26	58,835	4.000	73,544	5.000
Tier 1 Capital to Risk Weighted Assets:						
Company	149,167	15.76	62,702	6.625	75,715	8.000
Bank	136,251	14.44	62,517	6.625	75,492	8.000
Total Capital to Risk Weighted Assets:						
Company	159,769	16.88	81,630	8.625	94,644	10.000
Bank	146,853	15.56	81,390	8.625	94,365	10.000
Common Equity Tier 1 Capital:						
Company	141,167	14.92	48,505	5.125	61,518	6.500
Bank	136,251	14.44	48,362	5.125	61,337	6.500

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2015	(Dollars in Thousands)					
Tier 1 Capital to Average Assets:						
Company	\$ 140,862	9.73 %	\$ 57,896	4.00%	\$ 72,370	5.00 %
Bank	134,992	9.38	57,550	4.00	71,937	5.00
Tier 1 Capital to Risk Weighted Assets:						
Company	140,862	14.86	56,861	6.00	75,814	8.00
Bank	134,992	14.27	56,773	6.00	75,698	8.00
Total Capital to Risk Weighted Assets:						
Company	151,327	15.97	75,814	8.00	94,768	10.00
Bank	145,457	15.37	75,698	8.00	94,622	10.00
Common Equity Tier 1 Capital:						
Company	140,862	14.86	42,645	4.50	61,599	6.50
Bank	134,992	14.27	42,580	4.50	61,504	6.50

Effective January 1, 2016, Basel III implemented a requirement for all banking organizations to maintain a capital conservation buffer above the minimum risk-based capital requirements in order to avoid certain limitations on capital distributions, stock repurchases and discretionary bonus payments to executive officers. The capital

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conservation buffer is exclusively composed of common equity tier 1 capital. The capital conservation buffer increases the three risk-based capital ratios by 0.625% each year through 2019, at which point, the minimum common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios will be 7.0%, 8.5% and 10.5%, respectively. Also, certain new deductions from, and adjustments to, regulatory capital will be phased in over several years. As of March 31, 2016, the Company and the Bank complied with the capital conservation buffer requirement.

NOTE 8. FAIR VALUE OF ASSETS AND LIABILITIES

Fair Value Hierarchy

The Company groups its assets and liabilities in three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Transfers between levels are recognized at the end of a reporting period, if applicable.

Valuation is based on quoted prices in active markets for identical assets or liabilities. Level 1 assets and Level liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations 1: are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2: Valuation is based on observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3: Valuation is based on unobservable inputs supported by little or no market activity and significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using unobservable inputs to pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The following methods and assumptions were used by the Company in estimating fair value disclosures of its financial instruments:

• Cash and cash equivalents. The carrying amounts of cash and cash equivalents approximate the fair values based on the short-term nature of the assets.

Securities available for sale. Included in the available for sale category are debt securities. The securities measured at fair value in Level 1 are based on quoted market prices in an active exchange market. Securities measured at fair value in Level 2 are based on pricing models that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. The Company utilizes a nationally-recognized third-party pricing service

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to estimate fair value measurements for the majority of its portfolio. The pricing service evaluates each asset class based on relevant market information considering observable data, but these prices do not represent binding quotes. The fair value prices on all investments are reviewed for reasonableness by management. Securities measured at fair value in Level 3 include one collateralized debt obligation that was backed by a trust preferred security issued by banks and insurance companies. Management determined that an orderly and active market for this security and similar securities did not exist based on a significant reduction in trading volume and widening spreads relative to historical levels. The Company estimates future cash flows discounted using a rate management believes is representative of current market conditions. Factors in determining the discount rate include the current level of deferrals and/or defaults, changes in credit rating and the financial condition of the debtors within the underlying securities, broker quotes for securities with similar structure and credit risk, interest rate movements and pricing for new issuances.

• Federal Home Loan Bank stock. The carrying value of Federal Home Loan Bank ("FHLB") stock approximates fair value based on the redemption provisions of the FHLB.

• Federal Reserve Bank stock. The carrying value of Federal Reserve Bank ("FRB") stock approximates fair value based on the redemption provisions of the FRB.

• Loans held for sale. The fair value of loans held for sale is estimated using quoted market prices.

Loans receivable. For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans are estimated by discounting the future cash flows using the rates at the end of the period in which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

• Accrued interest receivable. The carrying amount of accrued interest approximates fair value.

Deposits. The fair value of demand deposits, negotiable orders of withdrawal, regular savings, certain money market deposits and mortgagors' and investors' escrow accounts is the amount payable on demand at the reporting date. The fair value of certificates of deposit and other time deposits is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities to a schedule of aggregated expected maturities on such deposits.

• Federal Home Loan Bank advances. The fair value of the advances is estimated using a discounted cash flow calculation that applies current FHLB interest rates for advances of similar maturity to a schedule of maturities of such advances.

• Junior subordinated debt owed to unconsolidated trust. Rates currently available for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

• Interest rate swap agreement. The fair value of the Company's interest rate swap is obtained from a third-party pricing service and is determined using a discounted cash flow analysis on the expected cash flows of the derivative. The

pricing analysis is based on observable inputs for the contractual term of the derivative, including the period to maturity, credit component and interest rate curves.

Forward loan sale commitments and derivative loan commitments. Forward loan sale commitments and derivative loan commitments are based on the fair values of the underlying mortgage loans, including the

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servicing rights for derivative loan commitments, and the probability of such commitments being exercised. Significant management judgment and estimation is required in determining these fair value measurements.

Off-balance sheet instruments. Fair values for off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings.

## Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present assets and liabilities measured at fair value on a recurring basis as of March 31, 2016 and December 31, 2015. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the three months ended March 31, 2016.

	March 31, 2016			Total
	Level 1	Level 2	Level 3	
	(In Thousands)			
Assets:				
U.S. Government and agency obligations	\$25,263	\$47,990	\$—	\$73,253
Government-sponsored enterprises	—	22,642	—	22,642
Mortgage-backed securities	—	78,575	—	78,575
Corporate debt securities	—	1,000	—	1,000
Collateralized debt obligation	—	—	1,143	1,143
Obligations of state and political subdivisions	—	1,270	—	1,270
Tax-exempt securities	—	3,261	—	3,261
Forward loan sale commitments and derivative loan commitments	—	—	120	120
Total assets	\$25,263	\$154,738	\$1,263	\$181,264
Liabilities:				
Interest rate swap agreement	\$—	\$65	\$—	\$65
Total liabilities	\$—	\$65	\$—	\$65

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	December 31, 2015			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
<b>Assets:</b>				
U.S. Government and agency obligations	\$25,045	\$45,951	\$—	\$70,996
Government-sponsored enterprises	—	25,403	—	25,403
Mortgage-backed securities	—	72,078	—	72,078
Corporate debt securities	—	1,000	—	1,000
Collateralized debt obligation	—	—	1,146	1,146
Obligations of state and political subdivisions	—	1,271	—	1,271
Tax-exempt securities	—	3,238	—	3,238
Forward loan sale commitments and derivative loan commitments	—	—	71	71
<b>Total assets</b>	<b>\$25,045</b>	<b>\$148,941</b>	<b>\$1,217</b>	<b>\$175,203</b>
<b>Liabilities:</b>				
Forward loan sale commitments and derivative loan commitments	\$—	\$—	\$1	\$1
Interest rate swap agreement	—	64	—	64
<b>Total liabilities</b>	<b>\$—</b>	<b>\$64</b>	<b>\$1</b>	<b>\$65</b>

The following table shows a reconciliation of the beginning and ending balances for Level 3 assets:

	Collateralized Debt Obligations	Derivative Loan and Forward Loan Sale Commitments, Net
	(In Thousands)	
Balance at December 31, 2015	\$1,146	\$ 70
Total realized gains included in net income	—	50
Total unrealized losses included in other comprehensive income	(3 )	—
Balance at March 31, 2016	\$1,143	\$ 120

**Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis**

The Company may also be required, from time to time, to measure certain other financial assets on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following table summarizes the fair value hierarchy used to determine each adjustment and the carrying value of the related individual assets at March 31, 2016 and December 31, 2015. There were no liabilities measured at fair value on a nonrecurring basis at March 31, 2016 and December 31, 2015.



	At March 31, 2016			At December 31, 2015		
	Level			Level		
	1	2	3	1	2	3
	(In Thousands)					
Impaired loans	\$-	\$-	-\$696	\$-	\$-	-\$588
Other real estate owned	—	—	1,048	—	—	1,088
Total assets	\$-	\$-	-\$1,744	\$-	\$-	-\$1,676

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The following table summarizes losses resulting from fair value adjustments for assets measured at fair value on a nonrecurring basis.

	Three Months Ended March 31, 2016 2015 (In Thousands)	
Impaired loans	\$ 48	\$ 215
Other real estate owned	8	—
Total losses	\$ 56	\$ 215

The Company measures the impairment of loans that are collateral dependent based on the fair value of the collateral (Level 3). The fair value of collateral used by the Company represents the amount expected to be received from the sale of the property, net of selling costs, as determined by an independent, licensed or certified appraiser using observable market data. This data includes information such as selling price of similar properties, expected future cash flows or earnings of the subject property based on current market expectations, and relevant legal, physical and economic factors. The appraised values of collateral are adjusted as necessary by management based on observable inputs for specific properties. Losses applicable to write-downs of impaired loans are based on the appraised market value of the underlying collateral, assuming foreclosure of these loans is imminent, and are recorded through the provision for loan losses.

The amount of other real estate owned represents the carrying value of the collateral based on the appraised value of the underlying collateral less estimated selling costs. The loss on foreclosed assets represents adjustments in the valuation recorded during the time period indicated and not for losses incurred on sales.

Summary of Fair Values of Financial Instruments

The estimated fair values and related carrying or notional amounts of the Company's financial instruments are presented in the following table. Certain financial instruments and all nonfinancial instruments are exempt from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates presented herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction at March 31, 2016 and December 31, 2015. The estimated fair value amounts at March 31, 2016 and December 31, 2015 have been measured as of each respective date, and have not been re-evaluated or updated for purposes of the consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end. The information presented should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only required for a limited portion of the Company's assets. Due to the

wide range of valuation techniques and the degree of subjectivity used in making the estimate, comparisons between the Company's disclosures and those of other banks may not be meaningful.

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As of March 31, 2016 and December 31, 2015, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

	March 31, 2016				
	Carrying Amount	Level 1	Level 2	Level 3	Total
<b>Financial Assets:</b>					
(In Thousands)					
Cash and cash equivalents	\$69,398	\$69,398	\$ —	—	—\$ 69,398
Available for sale securities	181,144	25,263	154,738	1,143	181,144
Loans held for sale	494	—	—	518	518
Loans receivable, net	1,159,023	—	—	1,168,331	1,168,331
Federal Home Loan Bank stock	12,874	—	—	12,874	12,874
Federal Reserve Bank stock	3,624	—	—	3,624	3,624
Accrued interest receivable	4,240	—	—	4,240	4,240
<b>Financial Liabilities:</b>					
Deposits	1,097,163	—	—	1,102,059	1,102,059
Mortgagors' and investors' escrow accounts	2,134	—	—	2,134	2,134
Federal Home Loan Bank advances	218,245	—	220,306	—	220,306
Junior subordinated debt owed to unconsolidated trust	8,248	—	4,975	—	4,975
<b>On-balance Sheet Derivative Financial Instruments:</b>					
<b>Assets:</b>					
Derivative loan commitments	90	—	—	90	90
Forward loan sale commitments	30	—	—	30	30
<b>Liabilities:</b>					
Interest rate swap agreement	65	—	65	—	65
	December 31, 2015				
	Carrying Amount	Level 1	Level 2	Level 3	Total
<b>Financial Assets:</b>					
(In Thousands)					
Cash and cash equivalents	\$40,778	\$40,778	\$ —	—	—\$ 40,778
Available for sale securities	175,132	25,045	148,941	1,146	175,132
Loans held for sale	1,804	—	—	1,825	1,825
Loans receivable, net	1,165,372	—	—	1,179,487	1,179,487
Federal Home Loan Bank stock	12,874	—	—	12,874	12,874
Federal Reserve Bank stock	3,621	—	—	3,621	3,621
Accrued interest receivable	4,283	—	—	4,283	4,283
<b>Financial Liabilities:</b>					
Deposits	1,058,017	—	—	1,062,884	1,062,884
Mortgagors' and investors' escrow accounts	3,508	—	—	3,508	3,508
Federal Home Loan Bank advances	234,595	—	234,504	—	234,504
Junior subordinated debt owed to unconsolidated trust	8,248	—	5,442	—	5,442
<b>On-balance Sheet Derivative Financial Instruments:</b>					

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Assets:

Derivative loan commitments	51	—	—	51	51
Forward loan sale commitments	20	—	—	20	20

Liabilities:

Forward loan sale commitments	1	—	—	1	1
Interest rate swap agreement	64	—	64	—	64

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## NOTE 9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

## Derivative Financial Instruments

The Company has a stand-alone derivative financial instrument in the form of an interest rate swap agreement which derives its value from underlying interest rates. This transaction involves both credit and market risk. The notional amount is an amount on which calculations, payments and the value of the derivative is based. The notional amount does not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instrument, is reflected on the Company's balance sheets as other assets and other liabilities. The Company is exposed to credit-related losses in the event of nonperformance by the counterparty to this agreement. The Company controls the credit risk of its financial contract through credit approvals, limits and monitoring procedures and does not expect any counterparty to fail its obligations.

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

## Derivative Instruments Not Designated As Hedging Instruments

Certain derivative instruments do not meet the requirements to be accounted for as hedging instruments. These undesignated derivative instruments are recognized on the consolidated balance sheets at fair value, with changes in fair value recorded in noninterest income.

Interest Rate Swap Agreement - In 2012, management entered into an interest rate swap agreement that does not meet the strict hedge accounting requirements of FASB's "Derivatives and Hedging" standard to manage the Company's exposure to interest rate movements and other identified risks. At March 31, 2016 and December 31, 2015, information pertaining to the Company's interest rate swap agreement not designated as a hedge is as follows:

	March 31, 2016	December 31, 2015
	(Dollars in Thousands)	
Notional amount	\$15,000	\$15,000
Weighted average fixed pay rate	1.26 %	1.26 %
Weighted average variable receive rate	0.62 %	0.32 %
Weighted average maturity in years	0.8	1.0
Unrealized loss relating to interest rate swap	\$65	\$64

The Company reported a loss in fair value on the interest rate swap not designated as a hedge in noninterest income of \$1,000 and \$5,000 for the three months ended March 31, 2016 and 2015, respectively.

Derivative Loan Commitments - Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. The Company enters into commitments to fund residential mortgage loans at specified times in the future, with the intention that these loans will

subsequently be sold in the secondary market. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2016 AND 2015 AND DECEMBER 31, 2015

increases in mortgage interest rates. If interest rates increase, the values of these loan commitments decrease. Conversely, if interest rates decrease, the value of these loan commitments increase.

Forward Loan Sale Commitments - To protect against the price risk inherent in derivative loan commitments, the Company utilizes “mandatory delivery” forward loan sale commitments to mitigate the risk of potential decreases in the value of loans that would result from the exercise of the derivative loan commitments.

With a “mandatory delivery” contract, the Company commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the Company fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor for the shortfall.

The Company expects that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments.

**Interest Rate Risk Management - Derivative Instruments**

The following table presents the fair values of derivative instruments as well as their classification on the consolidated balance sheets at March 31, 2016 and December 31, 2015.

	Balance Sheet Location	March 31, 2016		December 31, 2015	
		Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
(In Thousands)					
Derivatives not designated as hedging instruments:					
Interest rate swap	Other Liabilities	\$15,000	\$ (65 )	\$15,000	\$ (64 )
Derivative loan commitments	Other Assets	7,552	90	6,170	51
Forward loan sale commitments	Other Assets	2,834	30	3,656	19



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

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding changes in the Company's financial condition as of March 31, 2016 and December 31, 2015 and the results of operations for the three months ended March 31, 2016 and 2015. The information contained in this section should be read in conjunction with the consolidated financial statements and notes thereto appearing in Part I, Item 1 of this document as well as with management's discussion and analysis of financial condition and results of operations and consolidated financial statements included in the Company's 2015 Annual Report on Form 10-K.

This report may contain certain "forward-looking statements" within the meaning of the federal securities laws, which are made in good faith pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally preceded by terms such as "expects," "believes," "anticipates," "intends," "estimates," "projects" and similar expressions. These statements are not historical facts; rather, they are statements based on management's current expectations regarding our business strategies, intended results and future performance.

Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the United States government, including policies of the United States Treasury and the Federal Reserve Board, the quality and composition of the loan and investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area, changes in real estate market values in the Company's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect the Company's results are discussed in the Company's Annual Report on Form 10-K and in other reports filed with the Securities and Exchange Commission. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims, any obligation to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

### Critical Accounting Policies

The Company considers accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. The Company considers the determination of allowance for loan losses, deferred income taxes and the impairment of long-lived assets to be its critical accounting policies. Additional information about the Company's accounting policies is included in the notes to the Company's consolidated financial statements contained in Part I, Item 1 of this document and in the Company's 2015 Annual Report on Form 10-K.

### Impact of New Accounting Standards

Refer to Note 1 of the consolidated financial statements in this report for a discussion of recent accounting pronouncements.

### Comparison of Financial Condition at March 31, 2016 and December 31, 2015

#### Assets:

Summary. Assets increased \$26.4 million, or 1.8%, to \$1.51 billion at March 31, 2016, compared to \$1.48 billion at December 31, 2015, principally due to increases of \$28.6 million in cash and cash equivalents and \$6.0 million in available for sale securities, offset by reductions in net loans receivable of \$6.3 million and loans held for sale of \$1.3

million.

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Loans Receivable, Net. Net loans decreased \$6.3 million due to reductions in time share loans, residential real estate loans and SBA and USDA guaranteed loans, offset by an increase in multi-family and commercial real estate loans. Changes in the loan portfolio consisted of the following:

**Residential Real Estate.** Residential mortgage loans comprised 35.4% of the total loan portfolio at March 31, 2016 and decreased \$4.0 million to \$413.5 million as compared to \$417.5 million at December 31, 2015. Residential mortgage loan originations decreased \$6.5 million, or 29.9%, during the first quarter of 2016 over the comparable period in 2015, as a result of decreased activity in the housing market.

**Multi-family and Commercial Real Estate.** Multi-family and commercial real estate loans represented 33.5% of total loans at March 31, 2016 and increased \$5.6 million, or 1.5%, during the first quarter of 2016. Loan originations for multi-family and commercial real estate loans were \$11.5 million, representing a decrease of \$310,000, during the first quarter of 2016 compared to the same period in 2015.

**Construction.** Construction loans, which include both residential and commercial construction loans, increased \$2.0 million to \$23.7 million for the first quarter of 2016 as a result of increased commercial construction volume.

**Commercial Business.** Commercial business loans represented 24.2% of total loans at March 31, 2016. Commercial business loans decreased \$9.2 million, or 3.2%, for the first quarter of 2016 primarily due to decreases of \$6.4 million in time share loans, \$3.9 million in SBA and USDA guaranteed loans and \$1.7 million in condominium association loans. Commercial business loan originations decreased \$6.6 million as compared to the same period in 2015. At March 31, 2016, unfunded lines of credit related to time share lending totaled \$28.1 million as a result of focused efforts within the time share industry.

**Consumer.** Consumer loans represented 4.9% of the Company's total loan portfolio at March 31, 2016. Consumer loans decreased \$522,000 during the first quarter of 2016 primarily as a result of a decrease of \$395,000 in indirect automobile loans and \$131,000 in other consumer loans. Loan originations for consumer loans totaled \$5.3 million, representing an increase of \$666,000, for the first quarter of 2016 over the comparable period in 2015.

The allowance for loan losses totaled \$10.1 million at March 31, 2016 compared to \$9.9 million at December 31, 2015. The ratio of the allowance for loan losses to total loans increased to 0.87% at March 31, 2016 from 0.84% at December 31, 2015. This was necessitated by an increase in the commercial loan portfolio, which carries a higher degree of risk (excluding guaranteed SBA and USDA loans) than other loans held in the portfolio.

The following table provides information with respect to nonperforming assets and TDRs as of the dates indicated.

March 31, 2016      December 31, 2015

Nonaccrual  
(Dollars in Thousands)  
loans:

Real estate loans:		
Residential		
-		
1 to 4 family	\$3,119	\$ 3,894
Multi-family		
and commercial	578	2,167
Total real estate loans	4,697	6,061
Commercial business loans		
Consumer loans:		
Home equity	240	183
Indirect automobile	10	—
Other	5	—
Total consumer loans	255	183
Total nonaccrual loans	5,284	6,583
Accruing loans past due 90 days or more (1)	90,477	—
Total nonperforming loans	6,761	6,583

(2)  
 Other  
 real  
 estate  
 owned,  
 net  
 (3)  
 Total  
 nonperforming  
 assets  
 Accruing  
 troubled  
 debt  
 restructurings  
 Total  
 nonperforming  
 assets  
 and  
 troubled  
 debt  
 restructurings

Allowance  
 for  
 loan  
 losses  
 as  
 a  
 percent  
 of  
 nonperforming  
 loans  
 Total  
 nonperforming  
 loans  
 to  
 total  
 loans  
 Total  
 nonperforming  
 loans  
 to  
 total  
 assets  
 Total  
 nonperforming  
 assets  
 and  
 troubled  
 debt  
 restructurings

1,048 1,088

7,896 7,671

6,708 4,659

\$14,517 \$ 12,330

149.87 % 149.83 %

0.58 % 0.56 %

0.45 % 0.44 %

0.96 % 0.83 %

to  
total  
assets

- (1) Represents a USDA loan guaranteed by the U.S. government.
- (2) Includes nonperforming TDRs totaling \$465,000 and \$991,000 at March 31, 2016 and December 31, 2015, respectively.
- (3) Other real estate owned balances are shown net of related write-downs.

At March 31, 2016, the increase in nonperforming loans was primarily due to a delinquent loan of \$1.5 million guaranteed by the U.S. government in the process of collections (shown as an accruing loan past due 90 days or more in the table above), offset by decreases in nonperforming residential real estate loans of \$775,000 and multi-family and commercial mortgage loans of \$589,000. Nonperforming home equity loans increased \$57,000 during the first quarter of 2016.

Other real estate owned decreased \$40,000 to \$1.0 million at March 31, 2016, due to the sale of two residential properties and the write-down of one commercial property, offset by the addition of one residential property net of capital improvements. At March 31, 2016, other real estate owned included three commercial properties and one residential property.

Over the past few years, the Company has sought to restructure nonperforming loans rather than pursue foreclosure or liquidation, believing this approach achieves the best economic outcome for the Company in view of the current economic environment. Modified payment terms for TDRs generally involve deferred principal payments, interest rate concessions, maturity extensions, or a combination of these items. TDRs increased to \$7.2 million at March 31, 2016, compared to \$5.7 million at December 31, 2015. Of the TDRs, \$6.7 million and \$4.7 million were performing in accordance with their restructured terms at March 31, 2016 and December 31, 2015, respectively. The Company anticipates these borrowers will repay all contractual principal and interest in accordance with the terms of their restructured loan agreements.

**Liabilities:**

Summary. Liabilities increased \$23.9 million, or 1.8%, to \$1.35 billion at March 31, 2016 compared to \$1.33 billion at December 31, 2015. Deposits increased \$39.1 million, or 3.7%, which included increases in certificates of deposit of \$35.4 million, NOW and money market accounts of \$8.7 million and savings accounts of \$1.7 million, offset by a decrease in noninterest-bearing demand deposits of \$6.8 million. Deposit growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products. Borrowings decreased \$16.4 million from \$242.8 million at December 31, 2015 to \$226.5 million at March 31, 2016, resulting from net repayments of Federal Home Loan Bank advances.

**Equity:**

Summary. Shareholders' equity increased \$2.5 million from \$154.3 million at December 31, 2015 to \$156.8 million at March 31, 2016. The increase in shareholders' equity was attributable to net income of \$1.5 million and a net unrealized gain on available for sale securities aggregating \$1.0 million (net of taxes), partially offset by dividends declared of \$473,000.

Accumulated Other Comprehensive Income (Loss). Accumulated other comprehensive income is comprised of the unrealized gains and losses on available for sale securities. The net unrealized gains on available for sale securities, net of taxes, totaled \$856,000 at March 31, 2016 compared to net unrealized losses of \$190,000 at December 31, 2015.

**Results of Operations for the Three Months Ended March 31, 2016 and 2015**

General. The Company's results of operations depend primarily on net interest income, which is the difference between the interest income earned on the Company's interest-earning assets, such as loans and investments, and the interest expense on its interest-bearing liabilities, such as deposits and borrowings. The Company also generates noninterest income such as gains on the sale of securities, fees earned from mortgage banking activities, fees from deposits, trust and investment management services, insurance commissions and other fees. The Company's noninterest expenses primarily consist of employee compensation and benefits, occupancy, computer services, furniture and equipment, outside professional services, electronic banking fees, FDIC deposit insurance and regulatory assessments, marketing and other general and administrative expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, governmental policies and actions of regulatory agencies.

Summary. The Company reported net income of \$1.5 million for the three months ended March 31, 2016 compared to \$921,000 for the three months ended March 31, 2015.

Interest and Dividend Income. Total interest and dividend income increased \$1.2 million, or 10.2%, to \$12.6 million for the quarter ended March 31, 2016, compared to the same period in 2015. The increase in interest and dividend income was primarily due to a higher average balance on total interest-earning assets versus the same period in 2015, offset by lower yields on loans. Interest income on loans and securities reflect net amortization of \$12,000 and \$171,000 for the quarters ended March 31, 2016 and 2015, respectively, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets for the quarter ended March 31, 2016 decreased seven basis points to 3.61% compared to 3.68% for the quarter ended March 31, 2015, as an eight basis point decrease in the yields of loans was offset by a 28 basis point increase in securities. Average interest-earning assets increased \$142.6 million to \$1.41 billion during the first quarter of 2016, due to increases of \$116.8 million in the average balance of loans, \$17.8 million in the average balance of other interest-earning assets and \$8.0 million in the average balance of securities, respectively, as compared to the same quarter in 2015.

Interest Expense. For the quarter ended March 31, 2016, interest expense increased \$421,000, or 20.6%, resulting from higher average balances of FHLB advances and deposits compared to the same quarter in 2015. Higher interest expense on interest-bearing liabilities reflect net accretion of \$150,000 and \$344,000 for the three months



ended March 31, 2016 and 2015, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. Average interest-bearing deposits increased \$37.5 million to \$916.9 million for the quarter ended March 31, 2016 and the average rate paid increased five basis points to 0.68%, compared to the same period in 2015. Increases in the average balance of certificates of deposit and NOW and money market deposits totaled \$30.3 million and \$16.4 million, respectively, while the average balance of savings accounts decreased \$9.6 million compared to the first quarter ended March 31, 2015. The average balance of FHLB advances increased \$82.5 million for the first quarter ended March 31, 2016, while the average rate paid decreased 11 basis points to 1.54%. The average rate paid on subordinated debt decreased 186 basis points to 2.19%, compared to the same period in 2015 due to the maturity of a derivative financial instrument.

Average Balance Sheet. The following sets forth information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resulting yields and rates paid, interest rate spread, net interest margin, and the ratio of average interest-earning assets to average interest-bearing liabilities for the periods indicated.

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At or For the Three Months Ended March 31,  
2016

2015

Average Balance	Interest & Dividends	Average Yield/ Rate	Average Balance	Interest & Dividends	Average Yield/ Rate
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(Dollars in Thousands)

Interest-earning assets:

Loans <sup>(1) (2)</sup>	\$ 1,170,830	\$ 11,571	3.97 %	\$ 1,054,069	\$ 10,614	4.05 %
Securities <sup>(3)</sup>	194,666	1,020	2.11	186,630	848	1.83
Other interest-earning assets	42,271	56	0.53	24,514	19	0.31
Total interest-earning assets	1,407,767	12,647	3.61	1,265,213	11,481	3.68

Noninterest-earning assets	86,112			90,429		
Total assets	\$ 1,493,879			\$ 1,355,642		

Interest-bearing liabilities:

Deposits: