AUBURN NATIONAL BANCORPORATION, INC
Form 10-K
March 12, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact name of registrant as specified in charter)

Delaware	63-0885779
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification No.)
100 N. Gay Street, Auburn, Alabama	36830
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (334) 821-9200

Securities registered pursuant to Section 12 (b) of the Act:

Title of Each Class	Name of Exchange on which Registered

Common Stock, par value $0.01 Nasdaq Global Market

Securities registered to Section 12(g) of the Act: None

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by 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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

If an emerging growth company, indicate by check mark if the registrant has selected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. Yes No

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity as of the last business day of the registrant s most recently completed second fiscal quarter: $116,264,607 as of June 30, 2018.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date: 3,593,463 shares of common stock as of March 11, 2019.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held May 14, 2019, are incorporated by reference into Part II, Item 5 and Part III of this Form 10-K.

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PART I

SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Various of the statements made herein under the captions Management s Discussion and Analysis of Financial Condition and Results of Operations , Quantitative and Qualitative Disclosures about Market Risk , Risk Factors and elsewhere, are forward-looking statements within the meaning and protections of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause the actual results, performance, achievements or financial condition of the Company to be materially different from future results, performance, achievements or financial condition expressed or implied by such forward-looking statements. You should not expect us to update any forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as may, will, anticipate, assume, sho indicate, would, believe, contemplate, expect, estimate, continue, plan, point to, project, could, similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

- the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality;
- governmental monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance;
- changes in accounting policies, rules and practices;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest-sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable;
- changes in borrower credit risks and payment behaviors;

changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes;

changes in the prices, values and sales volumes of residential and commercial real estate;

the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services, including the disruption effects of financial technology and other competitors who are not subject to the same regulations as the Company and the Bank;

the failure of assumptions and estimates underlying the establishment of allowances for possible loan losses and other asset impairments, losses valuations of assets and liabilities and other estimates;

the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions;

changes in technology or products that may be more difficult, costly, or less effective than anticipated;

the effects of war or other conflicts, acts of terrorism or other catastrophic events that may affect general economic conditions;

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cyber-attacks and data breaches that may compromise our systems or customers information;

the failure of assumptions and estimates, as well as differences in, and changes to, economic, market and credit conditions, including changes in borrowers credit risks and payment behaviors from those used in our loan portfolio stress tests and other evaluations;

the risks that our deferred tax assets (DTAs), if any, could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards that we may be able to utilize for income tax purposes; and

other factors and risks described under Risk Factors herein and in any of our subsequent reports that we make with the Securities and Exchange Commission (the Commission or SEC) under the Exchange Act.

All written or oral forward-looking statements that are made by us or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

ITEM 1. BUSINESS

Auburn National Bancorporation, Inc. (the Company) is a bank holding company registered with the Board of Governors of the Federal Reserve System (the Federal Reserve) under the Bank Holding Company Act of 1956, as amended (the BHC Act). The Company was incorporated in Delaware in 1990, and in 1994 it succeeded its Alabama predecessor as the bank holding company controlling AuburnBank, an Alabama state member bank with its principal office in Auburn, Alabama (the Bank). The Company and its predecessor have controlled the Bank since 1984. As a bank holding company, the Company may diversify into a broader range of financial services and other business activities than currently are permitted to the Bank under applicable laws and regulations. The holding company structure also provides greater financial and operating flexibility than is presently permitted to the Bank.

The Bank has operated continuously since 1907 and currently conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank has been a member of the Federal Reserve System since April 1995. The Bank s primary regulators are the Federal Reserve and the Alabama Superintendent of Banks (the Alabama Superintendent). The Bank has been a member of the Federal Home Loan Bank of Atlanta (the FHLB) since 1991.

General

The Company s business is conducted primarily through the Bank and its subsidiaries. Although it has no immediate plans to conduct any other business, the Company may engage directly or indirectly in a number of activities that the Federal Reserve has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

The Company s principal executive offices are located at 100 N. Gay Street, Auburn, Alabama 36830, and its telephone number at such address is (334) 821-9200. The Company maintains an Internet website at *www.auburnbank.com*. The Company s website and the information appearing on the website are not included or

incorporated in, and are not part of, this report. The Company files annual, quarterly and current reports, proxy statements, and other information with the SEC. You may read and copy any document we file with the SEC at the SEC s public reference room at 100 F Street, N.E., Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for more information on the operation of the public reference rooms. The SEC maintains an Internet site at *www.sec.gov* that contains reports, proxy, and other information, where SEC filings are available to the public free of charge.

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The Company directly owned all the common equity in Auburn National Bancorporation Capital Trust I (the Trust), a Delaware statutory trust, which was formed in 2003 for the purpose of issuing $7.0 million of floating rate capital securities. In October 2016, the Company purchased $4.0 million par amount of outstanding trust preferred securities issued by the Trust. These securities were sold by the FDIC, as receiver of a failed bank that had held the trust preferred securities. The Company used dividends from the Bank to purchase these trust preferred securities and has deemed an equivalent amount of the related junior subordinated debentures issued by the Company as no longer outstanding. The Company realized a pre-tax gain of $0.8 million on the early extinguishment of debt in this transaction. Following the transaction, the Company had outstanding $3.2 million in junior subordinated debentures held by the trust related to the remaining $3.0 million of trust preferred securities outstanding and not purchased by the Company. At December 31, 2017, the outstanding principal amount of debentures related to those trust preferred securities and were included in the Company s Tier 1 capital for regulatory purposes. On April 27, 2018, the Trust formally redeemed all of its issued and outstanding trust preferred securities at par. All junior subordinated debentures related to the Trust were redeemed and retired as a result of the action. At December 31, 2018 the Company has no outstanding trust preferred securities or junior subordinated debentures, and the Trust has been dissolved.

Services

The Bank offers checking, savings, transaction deposit accounts and certificates of deposit, and is an active residential mortgage lender in its primary service area. The Bank s primary service area includes the cities of Auburn and Opelika, Alabama and nearby surrounding areas in East Alabama, primarily in Lee County. The Bank also offers commercial, financial, agricultural, real estate construction and consumer loan products and other financial services. The Bank is one of the largest providers of automated teller services in East Alabama and operates ATM machines in 13 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank s Visa Checkcards can be used internationally through the Plus® network. The Bank offers online banking, bill payment and other electronic services through its Internet website, *www.auburnbank.com*. Our online banking services, bill payment and electronic services are subject to certain cybersecurity risks. See Risk Factors Our information systems may experience interruptions and security breaches.

Competition

The banking business in East Alabama, including Lee County, is highly competitive with respect to loans, deposits, and other financial services. The area is dominated by a number of regional and national banks and bank holding companies that have substantially greater resources, and numerous offices and affiliates operating over wide geographic areas. The Bank competes for deposits, loans and other business with these banks, as well as with credit unions, mortgage companies, insurance companies, and other local and nonlocal financial institutions, including institutions offering services through the mail, by telephone and over the Internet. As more and different kinds of businesses enter the market for financial services, competition from nonbank financial institutions may be expected to intensify further.

Among the advantages that larger financial institutions have over the Bank are their ability to finance extensive advertising campaigns, to diversify their funding sources, and to allocate and diversify their assets among loans and securities of the highest yield in locations with the greatest demand. Many of the major commercial banks or their affiliates operating in the Bank s service area offer services which are not presently offered directly by the Bank and they typically have substantially higher lending limits than the Bank.

Banks also have experienced significant competition for deposits from mutual funds, insurance companies and other investment companies and from money center banks offerings of high-yield investments and deposits. Certain of these

competitors are not subject to the same regulatory restrictions as the Bank.

Selected Economic Data

Lee County s population was estimated to be 161,604 in 2017, and has increased approximately 15.2% from 2010 to 2017. The largest employers in the area are Auburn University, East Alabama Medical Center, a Wal-Mart Distribution Center, Mando America Corporation, and Briggs & Stratton. Auto manufacturing is of increasing importance along Interstate Highway 85 to the east and west of Auburn. Kia Motors has a large automobile factory in nearby West Point, Georgia, and Hyundai Motors has a large automobile factory in Montgomery, Alabama.

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Loans and Loan Concentrations

The Bank makes loans for commercial, financial and agricultural purposes, as well as for real estate mortgages, real estate acquisition, construction and development and consumer purposes. While there are certain risks unique to each type of lending, management believes that there is more risk associated with commercial, real estate acquisition, construction and development, agricultural and consumer lending than with residential real estate mortgage loans. To help manage these risks, the Bank has established underwriting standards used in evaluating each extension of credit on an individual basis, which are substantially similar for each type of loan. These standards include a review of the economic conditions affecting the borrower, the borrower s financial strength and capacity to repay the debt, the underlying collateral and the borrower s past credit performance. We apply these standards at the time a loan is made and monitor them periodically throughout the life of the loan. See Lending Practices for a discussion of regulatory guidance on commercial real estate lending.

The Bank has loans outstanding to borrowers in all industries within its primary service area. Any adverse economic or other conditions affecting these industries would also likely have an adverse effect on the local workforce, other local businesses, and individuals in the community that have entered into loans with the Bank. For example, the auto manufacturing business and its suppliers have positively affected our local economy, but automobile manufacturing is cyclical and adversely affected by increases in interest rates. Decreases in automobile sales, including adverse changes due to interest rate increases, could adversely affect nearby Kia and Hyundai automotive plants and their suppliers local spending and employment, and could adversely affect economic conditions in the markets we serve. However, management believes that due to the diversified mix of industries located within the Bank s primary service area, adverse changes in one industry may not necessarily affect other area industries to the same degree or within the same time frame. The Bank s primary service area also is subject to both local and national economic conditions and fluctuations. While most loans are made within our primary service area, some residential mortgage loans are originated outside the primary service area, and the Bank from time to time has purchased loan participations from outside its primary service area.

Employees

At December 31, 2018, the Company and its subsidiaries had 158.5 full-time equivalent employees, including 35 officers.

Statistical Information

Certain statistical information is included in response to Item 7 of this Annual Report on Form 10-K. Certain statistical information is also included in response to Item 6, Item 7A and Item 8 of this Annual Report on Form 10-K.

SUPERVISION AND REGULATION

The Company and the Bank are extensively regulated under federal and state laws applicable to financial institutions. The supervision, regulation and examination of the Company and the Bank and their respective subsidiaries by the bank regulatory agencies are primarily intended to maintain the safety and soundness of financial institutions and the federal deposit insurance system, as well as the protection of depositors, rather than holders of Company capital stock and other securities. Any change in applicable law or regulation may have a material effect on the Company s business. The following discussion is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below.

Bank Holding Company Regulation

The Company, as a bank holding company, is subject to supervision, regulation and examination by the Federal Reserve under the BHC Act. Bank holding companies generally are limited to the business of banking, managing or controlling banks, and certain related activities. The Company is required to file periodic reports and other information with the Federal Reserve. The Federal Reserve examines the Company and its subsidiaries. The State of Alabama currently does not regulate bank holding companies.

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The BHC Act requires prior Federal Reserve approval for, among other things, the acquisition by a bank holding company of direct or indirect ownership or control of more than 5% of the voting shares or substantially all the assets of any bank, or for a merger or consolidation of a bank holding company with another bank holding company. The BHC Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in any activity other than banking or managing or controlling banks or performing services for its authorized subsidiary. A bank holding company may, however, engage in or acquire an interest in a company that engages in activities that the Federal Reserve has determined by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Bank holding companies that are and remain well-capitalized and well-managed, as defined in Federal Reserve Regulation Y, and whose insured depository institution subsidiaries maintain satisfactory or better ratings under the Community Reinvestment Act of 1977 (the CRA), may elect to become financial holding companies. Financial holding companies and their subsidiaries are permitted to acquire or engage in activities such as insurance underwriting, securities underwriting, travel agency activities, broad insurance agency activities, merchant banking and other activities that the Federal Reserve determines to be financial in nature or complementary thereto. In addition, under the BHC Act s merchant banking authority and Federal Reserve regulations, financial holding companies are authorized to invest in companies that engage in activities that are not financial in nature, as long as the financial holding company makes its investment with the intention of limiting the terms of its investment, does not manage the company on a day-to-day basis, and the investee company does not cross-market with any depositary institutions controlled by the financial holding company. Financial holding companies continue to be subject to Federal Reserve supervision, regulation and examination, but the Gramm-Leach-Bliley Act of 1999 (the GLB Act) applies the concept of functional regulation to the activities conducted by their subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. The Federal Reserve recommended repeal of the merchant banking powers in its September 16, 2016 study pursuant to Section 620 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). The Company has not elected to become a financial holding company, but it may elect to do so in the future.

The BHC Act permits acquisitions of banks by bank holding companies, subject to various restrictions, including that the acquirer is well capitalized and well managed . Under the Alabama Banking Code, with the prior approval of the Alabama Superintendent, an Alabama bank may acquire and operate one or more banks in other states pursuant to a transaction in which the Alabama bank is the surviving bank. In addition, one or more Alabama banks may enter into a merger transaction with one or more out-of-state banks, and an out-of-state bank resulting from such transaction may continue to operate the acquired branches in Alabama. The Dodd-Frank Act permits banks, including Alabama banks, to branch anywhere in the United States.

The Company is a legal entity separate and distinct from the Bank. Various legal limitations restrict the Bank from lending or otherwise supplying funds to the Company. The Company and the Bank are subject to Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W thereunder. Section 23A defines covered transactions, which include extensions of credit, and limits a bank s covered transactions with any affiliate to 10% of such bank s capital and surplus. All covered and exempt transactions between a bank and its affiliates must be on terms and conditions consistent with safe and sound banking practices, and banks and their subsidiaries are prohibited from purchasing low-quality assets from the bank s affiliates. Finally, Section 23A requires that all of a bank s extensions of credit to its affiliates be appropriately secured by permissible collateral, generally United States government or agency securities. Section 23B of the Federal Reserve Act generally requires covered and other transactions among affiliates to be on terms and under circumstances, including credit standards, that are substantially the same as or at least as favorable to the bank or its subsidiary as those prevailing at the time for similar transactions with unaffiliated companies.

Federal Reserve policy and the Federal Deposit Insurance Act, as amended by the Dodd-Frank Act, require a bank holding company to act as a source of financial and managerial strength to its FDIC-insured bank subsidiaries and to take measures to preserve and protect such bank subsidiaries in situations where additional investments in a bank subsidiary may not otherwise be warranted. In the event an FDIC-insured subsidiary becomes subject to a capital restoration plan with its regulators, the parent bank holding company is required to guarantee performance of such plan up to 5% of the bank s assets, and such guarantee is given priority in bankruptcy of the bank holding company. In addition, where a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company s subsidiary depository institutions may be responsible for any losses to the FDIC s Deposit Insurance Fund (DIF), if an affiliated depository institution fails. As a result, a bank holding company may be required to loan money to a bank subsidiary in the form of subordinate capital notes or other instruments which qualify as capital under bank regulatory rules. However, any loans from the holding company to such subsidiary banks likely will be unsecured and subordinated to such bank s depositors and to other creditors of the bank. See Capital.

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Public Law 113-250 was enacted on December 18, 2014. This law directed the Federal Reserve to publish, within six months, changes to the Federal Reserve s Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors (the Small BHC Policy) to expand the coverage of the Small BHC Policy to include thrift holding companies and increase the size of small for qualifying bank and thrift holding companies from $500 million to up to $1 billion of pro forma consolidated assets. The Federal Reserve implemented changes to its Small BHC Policy effective May 15, 2015.

The Economic Growth, Regulatory Relief and Consumer Protection Act (P.L. 115-174) (the 2018 Growth Act) became law on May 24, 2018. The Growth Act directed the Federal Reserve to further raise the Small BHC Policy s consolidated asset threshold from $1 billion to $3 billion. The Federal Reserve issued an interim final rule implementing this change effective August 30, 2018.

The Federal Reserve has confirmed in 2018 that the Company is eligible for treatment as a small banking holding company under the Small BHC Policy. As a result, unless and until the Company fails to qualify under the Small BHC Policy, the Company s capital adequacy will continue to be evaluated on a bank only basis. See Capital.

Bank Regulation

The Bank is a state bank that is a member of the Federal Reserve. It is subject to supervision, regulation and examination by the Federal Reserve and the Alabama Superintendent, which monitor all areas of the Bank s operations, including loans, reserves, mortgages, issuances and redemption of capital securities, payment of dividends, establishment of branches, capital adequacy and compliance with laws. The Bank is a member of the FDIC and, as such, its deposits are insured by the FDIC to the maximum extent provided by law. See FDIC Insurance Assessments.

Alabama law permits statewide branching by banks. The powers granted to Alabama-chartered banks by state law include certain provisions designed to provide such banks competitive equality with national banks.

The Federal Reserve has adopted the Federal Financial Institutions Examination Council s (FFIEC) rating system, which assigns each financial institution a confidential composite CAMELS rating based on an evaluation and rating of six essential components of an institution s financial condition and operations: **C**apital **A**dequacy, **A**sset **Q**uality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to market risk, as well as the quality of risk management practices. For most institutions, the FFIEC has indicated that market risk primarily reflects exposures to changes in interest rates. When regulators evaluate this component, consideration is expected to be given to: management s ability to identify, measure, monitor and control market risk; the institution s size; the nature and complexity of its activities and its risk profile; and the adequacy of its capital and earnings in relation to its level of market risk exposure. Market risk is rated based upon, but not limited to, an assessment of the sensitivity of the financial institution s earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices or equity prices; management s ability to identify, measure, monitor and control exposure to market risk; and the nature and complexity of interest rate risk exposure arising from non-trading positions. Composite ratings are based on evaluations of an institution s managerial, operational, financial and compliance performance. The composite CAMELS rating is not an arithmetical formula or rigid weighting of numerical component ratings. Elements of subjectivity and examiner judgment, especially as these relate to qualitative assessments, are important elements in assigning ratings.

The GLB Act and related regulations require banks and their affiliated companies to adopt and disclose privacy policies, including policies regarding the sharing of personal information with third parties. The GLB Act also permits bank subsidiaries to engage in financial activities similar to those permitted to financial holding companies. In December 2015, Congress amended the GLB Act as part of the Fixing America s Surface Transportation Act. This amendment provided financial institutions that meet certain conditions an exemption to the requirement to deliver an

annual privacy notice. On August 10, 2018, the federal Consumer Financial Protection Bureau (CFPB) announced that it had finalized conforming amendments to its implementing regulation, Regulation P.

A variety of federal and state privacy laws govern the collection, safeguarding, sharing and use of customer information, and require that financial institutions have policies regarding information privacy and security. Some state laws also protect the privacy of information of state residents and require adequate security of such data, and certain state laws may, in some circumstances, require us to notify affected individuals of security breaches of computer databases that contain their personal information. These laws may also require us to notify law enforcement, regulators or consumer reporting agencies in the event of a data breach, as well as businesses and governmental agencies that own data.

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Community Reinvestment Act and Consumer Laws

The Bank is subject to the provisions of the CRA and the Federal Reserve s regulations thereunder. Under the CRA, all FDIC-insured institutions have a continuing and affirmative obligation, consistent with their safe and sound operation, to help meet the credit needs for their entire communities, including low- and moderate-income neighborhoods. The CRA requires a depository institution s primary federal regulator, in connection with its examination of the institution, to assess the institution s record of assessing and meeting the credit needs of the communities served by that institution, including low- and moderate-income neighborhoods. The bank regulatory agency s assessment of the institution s record is made available to the public. Further, such assessment is required of any institution that has applied to: (i) charter a national bank; (ii) obtain deposit insurance coverage for a newly-chartered institution; (iii) establish a new branch office that accepts deposits; (iv) relocate an office; or (v) merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. In the case of bank holding company applications to acquire a bank or other bank holding company, the Federal Reserve will assess the records of each subsidiary depository institution of the applicant bank holding company, and such records may be the basis for denying the application. A less than satisfactory CRA rating will slow, if not preclude, acquisitions, and new branches and other expansion activities and may prevent a company from becoming a financial holding company.

The CRA performance of a banking organization s depository institution subsidiaries is considered by the Federal Reserve and other applicable Federal bank regulators in connection with bank holding company and bank mergers and acquisition and branch applications. A less than satisfactory CRA rating will slow, if not preclude, acquisitions, and new banking centers and other expansion activities and will prevent a bank holding company from becoming a financial holding company.

As a result of the GLB Act, CRA agreements with private parties must be disclosed and annual CRA reports must be made to a bank s primary federal regulator. No new activities authorized under the GLB Act may be commenced by a bank holding company or by a bank financial subsidiary, if any affiliated bank has received less than a satisfactory CRA rating in its latest CRA examination. The federal CRA regulations require that evidence of discriminatory, illegal or abusive lending practices be considered in the CRA evaluation.

On August 28, 2018, the OCC proposed rulemaking to modernize the regulatory framework implementing the CRA. The proposal seeks comments on ways to increase lending and services to people and in low- and moderate-income areas and clarify and expand the types of activities eligible for CRA consideration. The OCC shares responsibility for enforcing CRA rules with the Federal Reserve and the FDIC. Even though the Federal Reserve did not join the OCC in the publication of its proposed rulemaking concerning revisions to the CRA regulations, it is considering ideas regarding modernizing the CRA, tailoring the CRA regulations for banks of different sizes and improving the consistency and predictability of CRA evaluations and ratings.

The Bank is also subject to, among other things, the provisions of the Equal Credit Opportunity Act (the ECOA) and the Fair Housing Act, both of which prohibit discrimination based on race or color, religion, national origin, sex and familial status in any aspect of a consumer or commercial credit or residential real estate transaction. The Department of Justice (the DOJ), and the federal bank regulatory agencies have issued an Interagency Policy Statement on Discrimination in Lending to provide guidance to financial institutions in determining whether discrimination exists, how the agencies will respond to lending discrimination, and what steps lenders might take to prevent discriminatory lending practices. The DOJ has increased its efforts to prosecute what it regards as violations of the ECOA, the Fair Housing Act, and the fair lending laws, generally.

The federal bank regulators have updated their guidance several times on overdrafts, including overdrafts incurred at automated teller machines and point of sale terminals. Overdrafts have become a focus of the CFPB. Among other

things, the federal regulators require banks to monitor accounts and to limit the use of overdrafts by customers as a form of short-term, high-cost credit, including, for example, giving customers who overdraw their accounts on more than six occasions where a fee is charged in a rolling 12 month period a reasonable opportunity to choose a less costly alternative and decide whether to continue with fee-based overdraft coverage. It also encourages placing appropriate daily limits on overdraft fees, and asks banks to consider eliminating overdraft fees for transactions that overdraw an account by a *de minimis* amount. Overdraft policies, processes, fees and disclosures are frequently the subject of litigation against banks in various jurisdictions. In May 2018, the OCC encouraged national banks to offer short-term, small-Dollar installment lending. The Federal Reserve expressed similar support for responsible small Dollar lending in its June 2018 Consumer Compliance Supervision Bulletin and recently commented on certain bank practices with respect to overdraft fees being unfair or deceptive acts or practices in violation of Section 5 of the Federal Trade Commission Act. The CFPB proposed on February 6, 2019 to rescind its mandatory underwriting standards for loans covered by its 2017 Payday, Vehicle Title and Certain High-Cost Installment Loans rule, and has separately proposed delaying the effectiveness of such 2017 rule.

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The CFPB has the authority to adopt regulations and enforce various laws, including the ECOA, and other fair lending laws, the Truth in Lending Act, the Electronic Funds Transfer Act, mortgage lending rules, the Truth in Savings Act, the Fair Credit Reporting Act and Privacy of Consumer Financial Information rules. Although the CFPB does not examine or supervise banks with less than $10 billion in assets, it exercises broad authority in making rules and providing guidance that affects bank regulation in these areas and the scope of bank regulators consumer regulation, examination and enforcement. Banks of all sizes are affected by the CFPB s regulations, and the precedents set in CFPB enforcement actions and interpretations. The CFPB has focused on various practices to date, including revising mortgage lending rules, overdrafts, credit card add-on products, indirect automobile lending, student lending, and payday and similar short-term lending, and has a broad mandate to regulate consumer financial products and services, whether or not offered by banks or their affiliates.

Residential Mortgages

CFPB regulations require that lenders determine whether a consumer has the ability to repay a mortgage loan. These regulations establish certain minimum requirements for creditors when making ability to repay determinations, and provide certain safe harbors from liability for mortgages that are qualified mortgages and are not higher-priced. Generally, these CFPB regulations apply to all consumer, closed-end loans secured by a dwelling including home-purchase loans, refinancing and home equity loans whether first or subordinate lien. Qualified mortgages must generally satisfy detailed requirements related to product features, underwriting standards, and requirements where the total points and fees on a mortgage loan cannot exceed specified amounts or percentages of the total loan amount. Qualified mortgages must have: (1) a term not exceeding 30 years; (2) regular periodic payments that do not result in negative amortization, deferral of principal repayment, or a balloon payment; (3) and be supported with documentation of the borrower and its credit. We focus our residential mortgage origination on qualified mortgages and those that meet our investors requirements, but we may make loans that do not meet the safe harbor requirements for qualified mortgages.

The 2018 Growth Act provides that certain residential mortgages held in portfolio by banks with less than $10 billion in consolidated assets automatically are deemed qualified mortgages. This relieves smaller institutions from many of the requirements to satisfy the criteria listed above for qualified mortgages. Mortgages meeting the qualified mortgage safe harbor may not have negative amortization, must follow prepayment penalty limitations included in the Truth in Lending Act, and may not have fees greater than three percent of the total value of the loan.

The Bank generally services the loans it originates, including those it sells. The CFPB s mortgage servicing standards include requirements regarding force-placed insurance, certain notices prior to rate adjustments on adjustable rate mortgages, and periodic disclosures to borrowers. Servicers are prohibited from processing foreclosures when a loan modification is pending, and must wait until a loan is more than 120 days delinquent before initiating a foreclosure action. Servicers must provide borrowers with direct and ongoing access to its personnel, and provide prompt review of any loss mitigation application. Servicers must maintain accurate and accessible mortgage records for the life of a loan and until one year after the loan is paid off or transferred. These standards increase the cost and compliance risks of servicing mortgage loans, and the mandatory delays in foreclosures could result in loss of value on collateral or the proceeds we may realize from a sale of foreclosed property.

The Federal Housing Finance Authority (FHFA) updated Fannie Mae s and Freddie Mac s (individually and collectively, GSE) repurchase rules, including the kinds of loan defects that could lead to a repurchase request to, or alternative remedies with, the mortgage loan originator or seller. These rules became effective January 1, 2016. FHFA also has updated these GSEs representations and warranties framework and announced on February 2, 2016 an independent dispute resolution (IDR) process to allow a neutral third party to resolve demands after the GSEs quality control and appeal processes have been exhausted. The GSEs are expected to update their repurchase demand

escalation and appeal processes later this year to resolve disputes before any IDR process begins.

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The Bank is subject to the CFPB s integrated disclosure rules under the Truth in Lending Act and the Real Estate Settlement Procedures Act, referred to as TRID , for credit transactions secured by real property. The TRID rules adversely affected our mortgage originations in 2016, while we revised our systems and processes to comply with these rules. Our residential mortgage strategy, product offerings, and profitability may change as these regulations are interpreted and applied in practice, and may also change due to any restructuring of Fannie Mae and Freddie Mac as part of the resolution of their conservatorships. The 2018 Growth Act reduced the scope of TRID rules by eliminating the wait time for a mortgage, if an additional creditor offers a consumer a second offer with a lower annual percentage rate. Congress encouraged federal regulators to provide better guidance on TRID in an effort to provide a clearer understanding for consumers and bankers alike. The law also provides partial exemptions from the collection, recording and reporting requirements under Sections 304(b)(5) and (6) of the Home Mortgage Disclosure Act (HMDA), for those banks with fewer than 500 closed-end mortgages or less than 500 open-end lines of credit in both of the preceding two years, provided the bank s rating under the CRA for the previous two years has been at least satisfactory. On August 31, 2018, the CFPB issued an interpretive and procedural rule to implement and clarify these requirements under the 2018 Growth Act.

Other Laws and Regulations

The International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001 specifies new know your customer requirements that obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Bank regulators are required to consider compliance with anti-money laundering laws in acting upon merger and acquisition and other expansion proposals, and sanctions for violations of this Act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to $1 million.

New federal Financial Crimes Enforcement Network (FinCEN) rules effective May 2018 require banks to know the beneficial owners of customers that are not natural persons, update customer information in order to develop a customer risk profile, and generally monitor such matters.

Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act), financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as to enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers.

The USA PATRIOT Act requires financial institutions to establish anti-money laundering programs, and sets forth minimum standards, or pillars for these programs, including:

- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program;
- an independent audit function to test the programs; and

ongoing customer due diligence and monitoring.

The Company is also required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as related rules and regulations adopted by the SEC, the Public Company Accounting Oversight Board and Nasdaq. In particular, the Company is required to report annually on internal controls as part of its annual report pursuant to Section 404 of the Sarbanes-Oxley Act.

The Company has evaluated its controls, including compliance with the SEC rules on internal controls, and expects to continue to spend significant amounts of time and money on compliance with these rules. If the Company fails to comply with these internal control rules in the future, it may materially adversely affect its reputation, its ability to obtain the necessary certifications to its financial statements, its relations with its regulators and other financial institutions with which it deals, and its ability to access the capital markets and offer and sell Company securities on terms and conditions acceptable to the Company. The Company s assessment of its financial reporting controls as of December 31, 2018 are included elsewhere in this report with no material weaknesses reported.

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Payment of Dividends

The Company is a legal entity separate and distinct from the Bank. The Company s primary source of cash is dividends from the Bank. Prior regulatory approval is required if the total of all dividends declared by a state member bank (such as the Bank) in any calendar year will exceed the sum of such bank s net profits for the year and its retained net profits for the preceding two calendar years, less any required transfers to surplus. During 2018, the Bank paid cash dividends of approximately $6.5 million to the Company. At December 31, 2018, the Bank could have declared additional dividends of approximately $8.0 million without prior regulatory approval.

In addition, the Company and the Bank are subject to various general regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. The appropriate federal and state regulatory authorities are authorized to determine when the payment of dividends would be an unsafe or unsound practice, and may prohibit such dividends. The Federal Reserve has indicated that paying dividends that deplete a state member bank s capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve has indicated that depository institutions and their holding companies should generally pay dividends only out of current year s operating earnings.

Under Federal Reserve Supervisory Letter SR-09-4 (February 24, 2009), as revised December 21, 2015, the board of directors of a bank holding company must consider different factors to ensure that its dividend level is prudent relative to maintaining a strong financial position, and is not based on overly optimistic earnings scenarios, such as potential events that could affect its ability to pay, while still maintaining a strong financial position. As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should consult with the Federal Reserve and eliminate, defer or significantly reduce the bank holding company s dividends if:

- its net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
- its prospective rate of earnings retention is not consistent with its capital needs and overall current and prospective financial condition; or
- It will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

The Basel III Capital Rules further limit permissible dividends, stock repurchases and discretionary bonuses by the Company and the Bank, respectively, unless the Company and the Bank meet the fully phased-in capital conservation buffer requirement effective January 1, 2019. See Basel III Capital Rules.

Capital

The Federal Reserve has risk-based capital guidelines for bank holding companies and state member banks, respectively. These guidelines required at year end 2018 a minimum ratio of capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) and capital conservation buffer of 9.875%. Tier 1 capital includes common equity and related retained earnings and a limited amount of qualifying preferred stock, less goodwill and certain core deposit intangibles. Voting common equity must be the predominant form of capital. Tier 2 capital consists of non qualifying preferred stock, qualifying subordinated, perpetual, and/or mandatory convertible debt, term subordinated debt and intermediate term preferred stock, up to 45% of pretax unrealized holding gains on

available for sale equity securities with readily determinable market values that are prudently valued, and a limited amount of general loan loss allowance. Tier 1 and Tier 2 capital equals total capital.

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In addition, the Federal Reserve has established minimum leverage ratio guidelines for bank holding companies not subject to the Small BHC Policy, and state member banks, which provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets (leverage ratio) equal to 4%. However, bank regulators expect banks and bank holding companies to operate with a higher leverage ratio. The guidelines also provide that institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Higher capital may be required in individual cases and depending upon a bank holding company s risk profile. All bank holding companies and banks are expected to hold capital commensurate with the level and nature of their risks including the volume and severity of their problem loans. Lastly, the Federal Reserve s guidelines indicate that the Federal Reserve will continue to consider a tangible Tier 1 leverage ratio (deducting all intangibles) in evaluating proposals for expansion or new activity. The level of Tier 1 capital to risk-adjusted assets is becoming more widely used by the bank regulators to measure capital adequacy. The Federal Reserve has not advised the Company or the Bank of any specific minimum leverage ratio or tangible Tier 1 leverage ratio applicable to them. Under Federal Reserve policies, bank holding companies are generally expected to operate with capital positions well above the minimum ratios. The Federal Reserve believes the risk-based ratios do not fully take into account the quality of capital and interest rate, liquidity, market and operational risks. Accordingly, supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization s risk-based capital ratio.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), among other things, requires the federal banking agencies to take prompt corrective action regarding depository institutions that do not meet minimum capital requirements. FDICIA establishes five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. A depository institution s capital tier will depend upon how its capital levels compare to various relevant capital measures and certain other factors, as established by regulation.

All of the federal bank regulatory agencies regulations establish risk-adjusted measures and relevant capital levels that implement the prompt corrective action standards. The relevant capital measures are the total risk-based capital ratio, Tier 1 risk-based capital ratio, Common Equity Tier 1 capital ratio, as well as, the leverage capital ratio. Under the regulations, a state member bank will be:

well capitalized if it has a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 8% or greater, a Common Equity Tier 1 capital ratio of 6.5% or greater, a leverage capital ratio of 5% or greater and is not subject to any written agreement, order, capital directive or prompt corrective action directive by a federal bank regulatory agency to maintain a specific capital level for any capital measure;

adequately capitalized if it has a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital ratio of 6% or greater, a Common Equity Tier 1 capital ratio of 4.5% or greater, and generally has a leverage capital ratio of 4% or greater;

undercapitalized if it has a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 6%, a Common Equity Tier 1 capital ratio of less than 4.5% or generally has a leverage capital ratio of less than 2%;

significantly undercapitalized if it has a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 4%, a Common Equity Tier 1 capital ratio of less than 3%, or a leverage capital ratio of less than 3%; or

critically undercapitalized if its tangible equity is equal to or less than 2% to total assets. The federal bank regulatory agencies have authority to require additional capital, and have indicated that higher capital levels may be required in light of market conditions and risk.

The federal bank regulators have authority to require additional capital.

The Dodd Frank Act significantly modified the capital rules applicable to the Company and required increased capital, generally.

The generally applicable prompt corrective action leverage and risk-based capital standards (the generally applicable standards), including the types of instruments that may be counted as Tier 1 capital, will be applicable on a consolidated basis to depository institution holding companies (except for companies subject to the Small BHC Policy), as well as their bank and thrift subsidiaries.

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The generally applicable standards in effect prior to the Dodd-Frank Act will be floors for the regulators capital standards.

Bank holding companies with assets of less than $15 billion as of December 31, 2009, will be permitted to include trust preferred securities that were issued before May 19, 2010, as Tier 1 capital, but trust preferred securities issued by a bank holding company (other than those with assets of less than $1 billion that meet the Federal Reserve s qualitative standards under the Small BHC Policy) after May 19, 2010, will no longer count as Tier 1 capital.

Information concerning the Company s and the Bank s regulatory capital ratios at December 31, 2018 is included in Note 18 of the consolidated financial statements that accompany this report.

Depository institutions that are adequately capitalized for bank regulatory purposes must receive a waiver from the FDIC prior to accepting or renewing brokered deposits, and cannot pay interest rates that exceeds market rates by more than 75 basis points. Banks that are less than adequately capitalized cannot accept or renew brokered deposits. FDICIA generally prohibits a depository institution from making any capital distribution (including paying dividends) or paying any management fee to its holding company, if the depository institution thereafter would be undercapitalized . Institutions that are undercapitalized are subject to growth limitations and are required to submit a capital restoration plan for approval.

A depository institution s parent holding company must guarantee that the institution will comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of 5% of the depository institution s total assets at the time it became undercapitalized and the amount necessary to bring the institution into compliance with applicable capital standards. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized . If the controlling holding company fails to fulfill its obligations under FDICIA and files (or has filed against it) a petition under the federal Bankruptcy Code, the claim against the holding company s capital restoration obligation would be entitled to a priority in such bankruptcy proceeding over third party creditors of the bank holding company.

Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized , requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator. Because the Company and the Bank exceed applicable capital requirements, Company and Bank management do not believe that the provisions of FDICIA have had or are expected to have any material effect on the Company and the Bank or their respective operations.

Basel III Capital Rules

The Federal Reserve and the other bank regulators adopted in June 2013 final capital rules for bank holding companies and banks implementing the Basel Committee on Banking Supervision s Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems. These new U.S. capital rules are called the Basel III Capital Rules, and generally were fully phased-in on January 1, 2019.

The Basel III Capital Rules limit Tier 1 capital to common stock and noncumulative perpetual preferred stock, as well as certain qualifying trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010, each of which were grandfathered in Tier 1 capital for bank holding companies with less than $15 billion in assets. The Basel III Capital Rules also introduced a new capital measure, Common Equity Tier I Capital or CET1. CET1 includes common stock and related surplus, retained earnings and, subject to certain adjustments, minority common

equity interests in subsidiaries. CET1 is reduced by deductions for:

Goodwill and other intangibles, other than mortgage servicing assets (MSRs), which are treated separately, net of associated deferred tax liabilities (DTLs);

Deferred tax assets (DTAs) arising from operating losses and tax credit carryforwards net of allowances and DTLs;

Gains on sale from any securitization exposure; and

Defined benefit pension fund net assets (i.e., excess plan assets), net of associated DTLs.

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The Company made a one-time election in 2015 and, as a result, CET1 will not be adjusted for certain accumulated other comprehensive income (AOCI).

Additional threshold deductions of the following that are individually greater than 10% of CET1 or collectively greater than 15% of CET1 (after the above deductions are also made):

MSAs, net of associated DTLs;

DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any valuation allowances and DTLs; and

Significant common stock investments in unconsolidated financial institutions, net of associated DTLs.

Noncumulative perpetual preferred stock, Tier 1 minority interest not included in CET1, subject to limits, and current Tier 1 capital instruments issued to the U.S. Treasury, including shares issued pursuant to the TARP or SBLF programs, will qualify as additional Tier I capital. All other qualifying preferred stock, subordinated debt and qualifying minority interests will be included in Tier 2 capital.

In addition to the minimum risk-based capital requirements, a new capital conservation buffer of CET1 capital of at least 2.5% of total risk weighted assets, will be required. The capital conservation buffer will be calculated as the *lowest* of:

the banking organization s CET1 capital ratio minus 4.5%;

the banking organization s tier 1 risk-based capital ratio minus 6.0%; and

the banking organization s total risk-based capital ratio minus 8.0%.

In 2018, the capital conservation trigger was 1.875% or less.

Full compliance with the capital conservation buffer is required by January 1, 2019. At such time, permissible dividends, stock repurchases and discretionary bonuses will be limited to the following percentages based on the capital conservation buffer as calculated above, subject to any further regulatory limitations, including those based on risk assessments and enforcement actions:

Buffer %	Buffer % Limit
More than 2.50%	None
> 1.875% - 2.50%	60.0%

> 1.250% - 1.875%	40.0%
> 0.625% - 1.250%	20.0%
£ 0.625	- 0 -

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The various capital elements and total capital under the Basel III Capital Rules, at January 1, 2018 were and as fully phased in on January 1, 2019 are:

	January 1, 2018	Fully Phased In January 1, 2019
Minimum CET1	4.50%	4.50%
CET1 Conservation Buffer	1.875%	2.50%
Total CET1	6.375%	7.0%
Deductions from CET1	100%	100%
Minimum Tier 1 Capital	6.0%	6.0%
Minimum Tier 1 Capital *plus* conservation buffer	7.875%	8.5%
Minimum Total Capital	8.0%	8.0%
Minimum Total Capital *plus* conservation buffer	9.875%	10.5%

Changes in Risk-Weightings

The Basel III Capital Rules significantly change the risk weightings used to determine risk weighted capital adequacy. Among various other changes, the Basel III Capital Rules apply a 250% risk-weighting to MSRs, DTAs that cannot be realized through net operating loss carry-backs and significant (greater than 10%) investments in other financial institutions. A 150% risk-weighted category applies to high volatility commercial real estate loans, or HVCRE, which are credit facilities for the acquisition, construction or development of real property, excluding one-to-four family residential properties or commercial real estate projects where: (i) the loan-to-value ratio is not in excess of interagency real estate lending standards; and (ii) the borrower has contributed capital equal to not less than 15% of the real estate s as completed value before the loan was made.

The Basel III Capital Rules also changed some of the risk weightings used to determine risk-weighted capital adequacy. Among other things, the Basel III Capital Rules:

Assigned a 250% risk weight to MSRs;

Assigned up to a 1,250% risk weight to structured securities, including private label mortgage securities, trust preferred CDOs and asset backed securities;

Retained existing risk weights for residential mortgages, but assign a 100% risk weight to most commercial real estate loans and a 150% risk-weight for HVCRE;

Assigned a 150% risk weight to past due exposures (other than sovereign exposures and residential mortgages);

Assigned a 250% risk weight to DTAs, to the extent not deducted from capital (subject to certain maximums);

Retained the existing 100% risk weight for corporate and retail loans; and

Increased the risk weight for exposures to qualifying securities firms from 20% to 100%.

HVCRE loans currently have a risk weight of 150%. Section 214 of the 2018 Growth Act, restricts the federal bank regulators from applying this risk weight except to certain ADC loans. The federal bank regulators issued a notice of a proposed rule on September 18, 2018 to implement Section 214 of the 2018 Growth Act, by revising the definition HVCRE. If this proposal is adopted, it is expected that this proposal could reduce the Company s risk weighted assets and thereby may increase the Company s risk-weighted capital.

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Illustrations of Current Prompt Corrective Action Rules

Under the Basel III Capital Rules, the prompt corrective action rules and categories changed as of January 1, 2015. The following illustrates the current range of well capitalized, to undercapitalized, to critically undercapitalized categories. The adequately capitalized and significantly undercapitalized categories are not included in the following illustration.

	Basel III
Well capitalized	
CET1	6.5%
Tier 1 risk-based capital	8.0%
Total risk-based capital	10.0%
Tier 1 leverage ratio	5.0%
Undercapitalized	
CET1	< 4.5%
Tier 1 risk-based capital	£ 6.0%
Total risk-based capital	< 8.0%
Tier 1 leverage ratio	< 4.0%
Critically undercapitalized	Tier 1 capital plus non-Tier 1 perpetual preferred stock to total assets £ 2.0%

Section 201 of the 2018 Growth Act provides that banks and bank holding companies with consolidated assets of less than $10 billion that meet a community bank leverage ratio, established by the federal bank regulators between 8% and 10%, are deemed to satisfy applicable risk-based capital requirements necessary to be considered well capitalized. The federal banking agencies have the discretion to determine that an institution does not qualify for such treatment due to its risk profile. An institution s risk profile may be assessed by its off-balance sheet exposure, trading of assets and liabilities, notional derivatives exposure, and other methods. On November 21, 2018, the federal banking agencies issued for public comment a proposal under which a community banking organization would be eligible to elect the community bank leverage ratio framework if it has less than $10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a community bank leverage ratio greater than 9%. A qualifying community banking organization that has chosen the proposed framework would not be required to calculate the existing risk-based and leverage capital requirements. This proposal further provides that an institution would be considered to be well-capitalized under the agencies prompt corrective action rules, provided it has a community bank leverage ratio greater than 9%.

The Financial Accounting Standards Board (FASB) has adopted ASU 2016-13 Financial Instruments Credit Losses which applies a current expected credit losses (CECL) model to financial instruments. It is effective for fiscal years after December 31, 2019 for the Company and other public companies. The CECL may affect the amount, timing and variability of the Company s credit charges, and therefore its net income and regulatory capital. The Federal Reserve and other federal bank regulators adopted a three-year phase-in of CECL s effects on regulatory capital on

December 21, 2018 (the CECL Capital Phase-In).

FDICIA

FDICIA directs that each federal bank regulatory agency prescribe standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth composition, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value for publicly traded shares, safety and soundness, and such other standards as the federal bank regulatory agencies deem appropriate.

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Enforcement Policies and Actions

The Federal Reserve and the Alabama Superintendent monitor compliance with laws and regulations. The CFPB monitors compliance with laws and regulations applicable to consumer financial products and services. Violations of laws and regulations, or other unsafe and unsound practices, may result in these agencies imposing fines, penalties and/or restitution, cease and desist orders, or taking other formal or informal enforcement actions. Under certain circumstances, these agencies may enforce these remedies directly against officers, directors, employees and others participating in the affairs of a bank or bank holding company, in the form of fines, penalties, or the recovery, or claw-back, of compensation.

Fiscal and Monetary Policy

Banking is a business that depends on interest rate differentials. In general, the difference between the interest paid by a bank on its deposits and its other borrowings, and the interest received by a bank on its loans and securities holdings, constitutes the major portion of a bank s earnings. Thus, the earnings and growth of the Company and the Bank, as well as the values of, and earnings on, its assets and the costs of its deposits and other liabilities are subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve. The Federal Reserve regulates the supply of money through various means, including open market dealings in United States government securities, the setting of discount rate at which banks may borrow from the Federal Reserve, and the reserve requirements on deposits.

The Federal Reserve has been paying interest on depository institutions required and excess reserve balances since October 2008. The payment of interest on excess reserve balances was expected to give the Federal Reserve greater scope to use its lending programs to address conditions in credit markets while also maintaining the federal funds rate close to the target rate established by the Federal Open Market Committee. The Federal Reserve has indicated that it may use this authority to implement a mandatory policy to reduce excess liquidity, in the event of inflation or the threat of inflation.

In April 2010, the Federal Reserve Board amended Regulation D (Reserve Requirements of Depository Institutions) authorizing the Reserve Banks to offer term deposits to certain institutions. Term deposits, which are deposits with specified maturity dates, will be offered through a Term Deposit Facility. Term deposits will be one of several tools that the Federal Reserve could employ to drain reserves when policymakers judge that it is appropriate to begin moving to a less accommodative stance of monetary policy.

In 2011, the Federal Reserve repealed its historical Regulation Q to permit banks to pay interest on demand deposits. The Federal Reserve also engaged in several rounds of quantitative easing (QE) to reduce interest rates by buying bonds, and Operation Twist to reduce long term interest rates by buying long term bonds, while selling intermediate term securities. Beginning December 2013, the Federal Reserve began to taper the level of bonds purchased, but continues to reinvest the principal of its securities as these mature.

The Federal Reserve adopted, in September 2014, a normalization of monetary policy that includes gradually raising the Federal Reserve s target range for the Federal Funds rate to more normal levels and gradually reducing the Federal Reserve s holdings of U.S. government and agency securities. The Federal Reserve s target Federal Funds rate has increased nine times since December 2015 in 25 basis point increments from 0.25% to 2.50% on December 30, 2018. Although the Federal Reserve considers the target Federal Funds rate its primary means of monetary policy normalization, in September 2017 it began reducing its securities holdings by not reinvesting the principal of maturing securities, subject to certain monthly caps on amounts not reinvested. In 2019, due to various factors, the Federal Reserve indicated no immediate further increases in its target Federal Funds rate, and that the Federal Reserve was

reconsidering an appropriate level for its securities holdings, and therefore its securities sales.

The nature and timing of any changes in monetary policies and their effect on the Company and the Bank cannot be predicted. The turnover of a majority of the Federal Reserve Board and the members of its FOMC and the appointment of a new Federal Reserve Chairman may result in changes in policy and the timing and amount of monetary policy normalization.

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FDIC Insurance Assessments

The Bank s deposits are insured by the FDIC s DIF, and the Bank is subject to FDIC assessments for its deposit insurance, as well as assessments by the FDIC to pay interest on Financing Corporation (FICO) bonds.

Since 2011, and as discussed above under Recent Regulatory Developments , the FDIC has been calculating assessments based on an institution s average consolidated total assets less its average tangible equity (the FDIC Assessment Base) in accordance with changes mandated by the Dodd-Frank Act. The FDIC changed its assessment rates which shifted part of the burden of deposit insurance premiums toward depository institutions relying on funding sources other than deposits.

In 2016, the FDIC again changed its deposit insurance pricing and eliminated all risk categories and now uses financial ratios method based on CAMELS composite ratings to determine assessment rates for small established institutions with less than $10 billion in assets (Small Banks). The financial ratios method sets a maximum assessment for CAMELS 1 and 2 rated banks, and set minimum assessments for lower rated institutions. All basis points are annual amounts.

The following table shows the FDIC assessment schedule for 2018 applicable to Small Banks, such as the Bank.

	Established Small Institution		
	CAMELS Composite		
	1 or 2	**3**	**4 or 5**
Initial Base Assessment Rule	3 to 16 basis points	6 to 30 basis points	16 to 30 basis points
Unsecured Debt Adjustment	-5 to 0 basis points	-5 to 0 basis points	-5 to 0 basis points
Total Base Assessment Rate	1.5 to 16 basis points	3 to 30 basis points	11 to 30 basis points

On March 15, 2016 the FDIC implemented Dodd-Frank Act provisions by raising the DIF s minimum Reserve Ratio from 1.15% to 1.35%. The FDIC imposed a 4.5 basis point annual surcharge on insured depository institutions with total consolidated assets of $10 billion or more (Large Banks). The new rules grant credits to smaller banks for the portion of their regular assessments that contribute to increasing the reserve ratio from 1.15% to 1.35%.

The FDIC s reserve ratio reached 1.36% on September 30, 2018, exceeding the minimum requirement. As a result, deposit insurance surcharges on Large Banks ceased, and smaller banks will receive credits against their deposit assessments from the FDIC for their portion of assessments that contributed to the growth in the reserve ratio from 1.15% to 1.35%. The Bank s credit was $0.2 million, and credits will be received and applied against the Bank s deposit insurance assessment each quarter that the reserve ratio exceeds 1.36%.

Prior to June 30, 2016, when the new assessment system became effective, the Bank s overall rate for assessment calculations was 9 basis points or less, which was within the range of assessment rates for the lowest risk category under the former FDIC assessment rules. In 2018 and 2017, the Company recorded FDIC insurance premiums expenses of $0.2 million and $0.3 million, respectively.

In addition, all FDIC-insured institutions are required to pay a pro rata portion of the interest due on FICO bonds, which mature during 2017 through 2019. FICO assessments are set by the FDIC quarterly on each institution s FDIC Assessment Base. The FICO Assessment rate was 0.560 basis points in the first quarter of 2017, and 0.540 basis points through December 31, 2017. FICO assessments have been set at 0.460 basis points in the first quarter of 2018, 0.440 basis points in the second quarter of 2018 and 0.320 basis points for the third and fourth quarters of 2018. FICO assessments of approximately $40 thousand and $20 thousand were paid to the FDIC in 2017 and 2018, respectively. The FICO assessments should continue to decline through 2019 when the last FICO bonds mature and such assessments end.

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Lending Practices

The federal bank regulatory agencies released guidance in 2006 on Concentrations in Commercial Real Estate Lending (the Guidance). The Guidance defines CRE loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50% or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of this property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risks in CRE markets would also be considered CRE loans under the Guidance. Loans on owner occupied CRE are generally excluded.

The Guidance requires that appropriate processes be in place to identify, monitor and control risks associated with real estate lending concentrations. This could include enhanced strategic planning, CRE underwriting policies, risk management, internal controls, portfolio stress testing and risk exposure limits as well as appropriately designed compensation and incentive programs. Higher allowances for loan losses and capital levels may also be required. The Guidance is triggered when either:

- Total reported loans for construction, land development, and other land of 100% or more of a bank s total capital; or

- Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land are 300% or more of a bank s total risk-based capital.

This Guidance was supplemented by the Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending (December 18, 2015). The Guidance also applies when a bank has a sharp increase in CRE loans or has significant concentrations of CRE secured by a particular property type.

The Guidance did not apply to the Bank s CRE lending activities during 2017 or 2018. At December 31, 2018, the Bank had outstanding $40.2 million in construction and land development loans and $243.2 million in total CRE loans (excluding owner occupied), which represent approximately 41.6% and 251.6%, respectively, of the Bank s total risk-based capital at December 31, 2018. The Company has always had significant exposures to loans secured by commercial real estate due to the nature of its markets and the loan needs of both its retail and commercial customers. The Company believes its long term experience in CRE lending, underwriting policies, internal controls, and other policies currently in place, as well as its loan and credit monitoring and administration procedures, are generally appropriate to manage its concentrations as required under the Guidance.

The federal bank regulators continue to look at the risks of various assets and asset categories and risk management. In December 2015, the Federal Reserve and other bank regulators issued an interagency statement to highlight prudent risk management practices from existing guidance that regulated financial institutions should implement along with maintaining capital levels commensurate with the level and nature of their CRE concentration risk.

In 2013, the Federal Reserve and other banking regulators issued their Interagency Guidance on Leveraged Lending highlighting standards for originating leveraged transactions and managing leveraged portfolios, as well as requiring banks to identify their highly leveraged transactions, or HLTs. The Government Accountability Office issued a statement on October 23, 2017 that this guidance constituted a rule for purposes of the Congressional Review Act, which provides Congress with the right to review the guidance and issue a joint resolution for signature by the

President disapproving it. No such action was taken, and instead, the federal bank regulators issued a September 11, 2018 Statement Reaffirming the Role of Supervisory Guidance. This Statement indicated that guidance does not have the force or effect of law or provide the basis for enforcement actions, and that guidance can outline supervisory agencies views of supervisory expectations and priorities, and appropriate practices.

The Bank did not have any loans at year-end 2018 or 2017 that were leveraged loans subject to the Interagency Guidance on Leveraged Lending (February 19, 2013).

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Other Dodd-Frank Act Provisions

In addition to the capital, liquidity and FDIC deposit insurance changes discussed above, some of the provisions of the Dodd-Frank Act we believe may affect us are set forth below.

Financial Stability Oversight Council

The Dodd-Frank Act created the Financial Stability Oversight Council or FSOC , which is chaired by the Secretary of the Treasury and composed of representatives from various financial services regulators. The FSOC has responsibility for identifying risks and responding to emerging threats to financial stability.

Executive Compensation

The Dodd-Frank Act provides shareholders of all public companies with a say on executive compensation. Under the Dodd-Frank Act, each company must give its shareholders the opportunity to vote on the compensation of its executives, on a non-binding advisory basis, at least once every three years. The Dodd-Frank Act also adds disclosure and voting requirements for golden parachute compensation that is payable to named executive officers in connection with sale transactions.

The SEC is required under the Dodd-Frank Act to issue rules obligating companies to disclose in proxy materials for annual shareholders meetings, information that shows the relationship between executive compensation actually paid to their named executive officers and their financial performance, taking into account any change in the value of the shares of a company s stock and dividends or distributions. The Dodd-Frank Act also provides that a company s compensation committee may only select a consultant, legal counsel or other advisor on methods of compensation after taking into consideration factors to be identified by the SEC that affect the independence of a compensation consultant, legal counsel or other advisor.

Section 954 of the Dodd-Frank Act added section 10D to the Exchange Act. Section 10D directs the SEC to adopt rules prohibiting a national securities exchange or association from listing a company unless it develops, implements, and discloses a policy regarding the recovery or claw-back of executive compensation in certain circumstances. The policy must require that, in the event an accounting restatement due to material noncompliance with a financial reporting requirement under the federal securities laws, the company will recover from any current or former executive officer any incentive-based compensation (including stock options) received during the three year period preceding the date of the restatement, which is in excess of what would have been paid based on the restated financial statements. There is no requirement of wrongdoing by the executive, and the claw-back is mandatory and applies to all executive officers. Section 954 augments section 304 of the Sarbanes-Oxley Act, which requires the CEO and CFO to return any bonus or other incentive or equity-based compensation received during the 12 months following the date of similarly inaccurate financial statements, as well as any profit received from the sale of employer securities during the period, if the restatement was due to misconduct. Unlike section 304, under which only the SEC may seek recoupment, the Dodd-Frank Act requires the Company to seek the return of compensation.

The SEC adopted rules in September 2013 to implement pay ratios pursuant to Section 953 of the Dodd-Frank Act, which apply to fiscal year 2017 annual reports and proxy statements. The SEC proposed Rule 10D-1 under Section 954 on July 1, 2015 which would direct Nasdaq and the other national securities exchanges to adopt listing standards requiring companies to adopt policies requiring executive officers to pay back erroneously awarded incentive-based compensation. In February 2017, the acting SEC Chairman indicated interest in reconsidering the pay ratio rule.

The Dodd-Frank Act, Section 955, requires the SEC, by rule, to require that each company disclose in the proxy materials for its annual meetings whether an employee or board member is permitted to purchase financial instruments designed to hedge or offset decreases in the market value of equity securities granted as compensation or otherwise held by the employee or board member. The SEC proposed implementing rules in February 2015, though the rules have not been implemented to date.

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Section 956 of the Dodd-Frank Act prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions, are deemed to be excessive, or that may lead to material losses. In June 2010, the federal bank regulators adopted Guidance on Sound Incentive Compensation Policies, which, although targeted to larger, more complex organizations than the Company, includes principles that have been applied to smaller organizations similar to the Company. This Guidance applies to incentive compensation to executives as well as employees, who, individually or a part of a group, have the ability to expose the relevant banking organization to material amounts of risk. Incentive compensation should:

- Provide employees incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk-management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization s board of directors.

The federal bank regulators, the SEC and other regulators proposed regulations implementing Section 956 in April 2011, which would have been applicable to, among others, depository institutions and their holding companies with $1 billion or more in assets. An advance notice of a revised proposed joint rulemaking under Section 956 was published by the financial services regulators in May 2016, but these rules have not been adopted.

Other

The Dodd-Frank Act requires an estimated 240-300 rulemakings and an estimated 130 studies. Many of these rules and studies have been completed. Generally, the Dodd-Frank Act and the related rules are complex, have increased our compliance costs, as well as costs imposed on the markets and on others with whom we do business. Many of the rules lack authoritative interpretative guidance from the applicable government agencies.

Credit Ratings

The Dodd-Frank Act includes a number of provisions that are targeted at improving the reliability of credit ratings. The federal bank regulators and the SEC have adopted rules to implement the Securities Act s requirement to delete references to rating agency ratings for various purposes, including investment securities, which are permissible bank investments.

Debit Card Interchange Fees

The Durbin Amendment to the Dodd-Frank Act provides for a set of new rules requiring that interchange transaction fees for electric debit transactions be reasonable and proportional to certain costs associated with processing the transactions. The Federal Reserve has established standards for assessing whether interchange fees are reasonable and proportional, which a Federal District Court ruled were improperly adopted. This decision in NACS v. Board of Governors of the Federal Reserve System, was reversed by the District of Columbia Circuit Court of Appeals in 2014 and the Supreme Court declined to hear an appeal on January 20, 2015. The Durbin Amendment is not applicable to banks with assets less than $10 billion.

Derivatives

The Dodd-Frank Act requires a new regulatory system for the U.S. market for swaps and other over-the counter derivatives, which includes strict capital and margin requirements, central clearing of standardized over-the-counter derivatives, and heightened supervision of over-the-counter derivatives dealers and major market participants. These

rules likely have increased the costs and collateral required to utilize derivatives, that we may determine are useful to reduce our interest rate and other risks.

Other Legislative and Regulatory Changes

Various legislative and regulatory proposals, including substantial changes in banking, and the regulation of banks, thrifts and other financial institutions, compensation, and the regulation of financial markets and their participants and financial instruments, and the regulators of all of these, as well as the taxation of these entities, are being considered by the executive branch of the federal government, Congress and various state governments, including Alabama.

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The President has frozen new rulemaking generally, and on February 3, 2017 issued an executive order containing Core Principles for Regulating the United States Financial System (Core Principles). The Core Principles direct the Secretary of the Treasury to consult with heads of Financial Stability Oversight Council s members and report to the President within 120 days and periodically thereafter on how laws and government policies promote the Core Principles and to identify laws, regulations, guidance and reporting that inhibit financial services regulation in a manner consistent with the Core Principles. Another executive order required the repeal of two existing rules for any new significant regulatory proposal. Although this executive order does not apply to the SEC, the federal bank regulators or the CFPB, these independent agencies were encouraged to seek cost savings that would offset the costs of new significant regulatory actions.

The 2018 Growth Act, which, was enacted on May 24, 2018, amends the Dodd-Frank Act, the BHC Act, the Federal Deposit Insurance Act and other federal banking and securities laws to provide regulatory relief in these areas:

- consumer credit and mortgage lending;
- capital requirements;
- Volcker Rule compliance;
- stress testing and enhanced prudential standards;
- increased the asset threshold under the Federal Reserve s Small BHC Policy from $1 billion to $3 billion; and
- capital formation.

On July 6, 2018, the Federal Reserve, OCC and FDIC issued an interagency statement describing their interim positions on regulations affected by the 2018 Growth Act that remain in effect until the agencies amend their regulations to conform to that Act.

We are evaluating the 2018 Growth Act and its likely effects on us. We believe it will facilitate our business, subject to its interpretation and implementation by our regulators. The following provisions of the 2018 Growth Act may be especially helpful to banks of our size:

- qualifying community banks, defined as institutions with total consolidated assets of less than $10 billion, which meet a community bank leverage ratio of 8.00% to 10.00%, may be deemed to have satisfied applicable risk based capital requirements as well as the capital ratio requirements;
- section 13(h) of the BHC Act, or the Volcker Rule, is amended to exempt from the Volcker Rule, banks with total consolidated assets valued at less than $10 billion, and trading assets and liabilities comprising not more

than 5.00% of total assets;

reciprocal deposits will not be considered brokered deposits for FDIC purposes, provided such deposits do not exceed the lesser of $5 billion or 20% of the bank s total liabilities; and

The Volcker Rule change may enable us to invest in certain collateralized loan obligations that are treated as covered funds prohibited to banking entities by the Volcker Rule. Reciprocal deposits, such as CDARs, may expand our funding sources without being subjected to FDIC limitations and potential insurance assessments increases for brokered deposits. The FDIC announced on December 19, 2018 a final rules that change existing rules to comply with the 2018 Growth Act s reciprocal deposits provisions effective March 26, 2019. Well-capitalized and well-rated banks are not required to treat reciprocal deposits as brokered deposits up to the lesser of 20% of total liabilities or $5 billion. Banks that are not both well-capitalized and well-rated may exclude reciprocal deposits under certain circumstances. The December 19, 2018 release also included a proposal seeking comments on the brokered deposits and related interest rates restrictions rules. Reciprocal deposits, such as CDARs, may expand our funding sources without being subjected to FDIC limitations and potential insurance assessments increases for brokered deposits.

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On November 21, 2018, the federal banking agencies issued for public comment a proposal that would simplify regulatory capital requirements for qualifying community banking organizations, as required by the 2018 Growth Act. Under the proposal, a community banking organization would be eligible to elect the community bank leverage ratio framework if it has less than $10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a community bank leverage ratio greater than 9.00%. A qualifying community banking organization that has chosen the proposed framework would not be required to calculate the existing risk-based and leverage capital requirements. A firm would also be considered to have met the capital ratio requirements to be well-capitalized under the agencies prompt corrective action rules provided it has a community bank leverage ratio greater than 9%.

On December 21, 2018, the federal banking agencies issued for public comment a proposal that would amend the Volcker rule consistent with the 2018 Growth Act. The Volcker Rule change may enable us to invest in certain collateralized loan obligations that are treated as covered funds prohibited to banking entities by the Volcker Rule.

In addition, the federal banking agencies issued an interim final rule on December 21, 2018, as authorized by the 2018 Growth Act, that generally allows qualifying insured depository institutions with less than $3 billion in total assets to benefit from an extended 18-month on-site examination cycle. The FDIC announced on September 12, 2018 proposed rules that change existing rules to comply with the 2018 Growth Act s reciprocal deposits provisions, and plans to later seek comments on its brokered deposits rules generally.

Certain of these proposals, if adopted, could significantly change the regulation or operations of banks and the financial services industry. New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation s financial institutions.

ITEM 1A. RISK FACTORS

Any of the following risks could harm our business, results of operations and financial condition and an investment in our stock. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.

Market conditions and economic cyclicality may adversely affect our industry.

We are exposed to the U.S. economy and market conditions generally. Local employment and local economic conditions may be affected increasingly because of the growth of automobile manufacturing and related suppliers located in our markets and nearby. These businesses are adversely affected by higher interest rates and experience cyclicality of sales.

We believe the following, among other things, may affect us in 2019:

We expect to face continued high levels of regulation of our industry as a result of rulemaking and other initiatives by the U.S. government and its regulatory agencies. Compliance with such laws and regulations may increase our costs, reduce our profitability, and limit our ability to pursue business opportunities and serve customers needs. In addition to the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (the 2018 Growth Act), various pending bills in Congress and statements by our regulators have provided some, and may provide further regulatory relief for

banking organizations of our size. We believe that comprehensive regulatory relief will be slow and contentious. We are uncertain about the scope, nature and timing of any regulatory relief, and its effect on us.

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The Federal Reserve adopted in September 2014 a normalization of monetary policy (the Federal Reserve Normalization Policy), which includes gradually raising the Federal Reserve s target range for the Federal Funds rate to more normal levels and gradually reducing the Federal Reserve s holdings of U.S. government and agency securities. The Federal Reserve s target Federal Funds rate has increased nine times since December 2015 in 25 basis point increments from 0.25% to 2.50% on December 20, 2018. Although the Federal Reserve considers the target Federal Funds rate its primary means of monetary policy normalization, in September 2017, it also began reducing its securities holdings by not reinvesting the principal of maturing securities, subject to certain monthly caps on amounts not reinvested. Such reduction may also push interest rates higher and reduce liquidity in the financial system. Since its December 2018 increase in the target Federal Funds rate of 25 basis points, the Federal Reserve has expressed that it will remain patient in raising rates in 2019 and has indicated that it is evaluating its securities sales and the target size of the Federal Reserve s securities portfolio in light of its inflation and employment goals, subject to domestic or global events. The nature and timing of any changes in monetary policies and their effect on us and the Bank cannot be predicted. The turnover of a majority of the Federal Reserve Board and the members of its Federal Open Market Committee (FOMC) and the appointment of a new Federal Reserve Chairman may result in changes in policy and timing and amount of monetary policy normalization.

Market developments, including employment and price levels, stock market volatility and declines, and tax changes, such as the Tax Cuts and Jobs Act (the 2017 Tax Act), may affect consumer confidence levels from time to time in different directions, and may cause adverse changes in payment behaviors and payment rates, causing increases in delinquencies and default rates, which could affect our charge-offs and provisions for credit losses.

Our ability to assess the creditworthiness of our customers and those we do business with, and to estimate the values of our assets and collateral for loans may be impaired if the models and approaches we use become less predictive of future behaviors and valuations. The process we use to estimate losses inherent in our credit exposure or estimate the value of certain assets requires difficult, subjective, and complex judgments, including forecasts of economic conditions and how those economic predictions might affect the ability of our borrowers to repay their loans or the value of assets.

The 2017 Tax Act substantially limits the deductibility of all state and local taxes for U.S. taxpayers, including property taxes, lowers the cap on residential mortgage indebtedness for which U.S. taxpayers may deduct interest. These changes could have adverse effects on home sales, the volume of new mortgage and home equity loans and the values and salability of residences held as collateral for loans.

Our ability to borrow from and engage in other business with other financial institutions on favorable terms or at all could be adversely affected by disruptions in the capital markets or other events, including, among other things, investor expectations and changes in regulations.

Failures of other financial institutions in our markets and increasing consolidation of financial services companies as a result of market conditions could increase our deposits

and assets and necessitate additional capital, and could have unexpected adverse effects upon us and our business.

The Volcker Rule, including final regulations adopted in December 2013, may affect us adversely by reducing market liquidity and securities inventories at those institutions where we buy and sell securities for our portfolio and increasing the bid-ask spreads on securities we purchase or sell. These rules have decreased the range of permissible investments, such as certain collateralized loan obligation (CLO) interests, which we could otherwise use to diversify our assets and for asset/liability management. The 2018 Growth Act removed Volcker Rule restrictions generally on banks under $10 billion in assets, and the federal banking agencies have asked for public comment on a proposal that is intended to simplify and tailor compliance requirements relating to the Volcker Rule.

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The soundness of other financial institutions could adversely affect us.

We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, central clearinghouses, commercial banks, and investment funds, our correspondent banks and other financial institutions. Our ability to engage in routine investment and banking transactions, as well as the quality and values of our investments in equity securities and obligations of other financial institutions, could be adversely affected by the actions, financial condition, and profitability of such other financial institutions with which we deal, including, without limitation, the FHLB and our correspondent banks. At December 31, 2018, the amortized cost of the Bank s investments in FHLB and our correspondent bank s common stock was approximately $1.1 million. Financial services institutions are interrelated as a result of shared credits, trading, clearing, counterparty and other relationships. As a result, defaults by, or even rumors or questions about, one or more financial institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor or counterparty confidence in certain institutions and could lead to losses or defaults by other institutions, and in some cases, failure of such institutions. Any losses, defaults by, or failures of, the institutions we do business with could adversely affect our holdings of the debt of and equity in, such other institutions, our participation interests in loans originated by other institutions, and our business, including our liquidity, financial condition and earnings.

Nonperforming and similar assets take significant time to resolve and may adversely affect our results of operations and financial condition.

At December 31, 2018, our nonaccrual loans totaled $0.2 million, or 0.04% of total loans. We had $0.2 million in properties held as other real estate owned at December 31, 2018. Our non-performing assets may adversely affect our net income in various ways. We do not record interest income on nonaccrual loans or OREO and these assets require higher loan administration and other costs, thereby adversely affecting our income. Decreases in the value of these assets, or the underlying collateral, or in the related borrowers performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires commitments of time from management, which can be detrimental to the performance of their other responsibilities. There can be no assurance that we will not experience increases in nonperforming loans in the future.

Our allowance for loan losses may prove inadequate or we may be negatively affected by credit risk exposures.

We periodically review our allowance for loan losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. We cannot be certain that our allowance for loan losses will be adequate over time to cover credit losses in our portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets, and changes in borrower behaviors. If the credit quality of our customer base materially decreases, if the risk profile of the market, industry or group of customers changes materially or weaknesses in the real estate markets worsen, borrower payment behaviors change, or if our allowance for loan losses is not adequate, our business, financial condition, including our liquidity and capital, and results of operations could be materially adversely affected. The Financial Accounting Standards Board (the FASB) adopted Accounting Standards Update (ASU) No. 2016-13 Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments on June 16, 2016, which changed the loss model to take into account current expected credit losses (CECL). ASU No. 2016-13 is effective for our fiscal year beginning January 1, 2020. We have not yet determined how ASU No. 2016-13 will affect our results of operations and financial condition. CECL implementation requires significant time and costs, and CECL s effect on our income, the variability of our income and regulatory capital could be material, notwithstanding a three-year phase-in of CECL for regulatory capital purposes.

Changes in the real estate markets, including the secondary market for residential mortgage loans, may continue to adversely affect us.

Notwithstanding changes made by the 2018 Growth Act, the effects of the CFPB changes to mortgage and servicing rules effective at the beginning of 2014, the CFPB s TRID rules for closed end credit transactions secured by real property that became effective in October 2015, enforcement actions, reviews and settlements, changes in the securitization rules under the Dodd-Frank Act, including the risk retention rules that became effective on December 24, 2016, and the Basel III Rules could have serious adverse effects on the mortgage markets and our mortgage operations.

The TRID rules have affected our current and proposed mortgage business and have increased our costs as a result of our compliance efforts. In addition, the CFPB s regulations that lenders determine whether a consumer has the ability to repay a mortgage loan have limited the secondary market for and liquidity of many mortgage loans that are not qualified mortgages.

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Increasing interest rates and the 2017 Tax Act s limitations on the deductibility of residential mortgage interest and state and local property and other taxes could adversely affect consumer behaviors and the volumes of housing sales, mortgage and home equity loan originations, as well as the value and liquidity of residential property held as collateral by lenders such as the Bank, and the secondary markets for residential loans. Acquisition, construction and development loans for residential development may be similarly adversely affected.

The Federal National Mortgage Association (Fannie Mae,) and the Federal Home Loan Mortgage Corporation (Freddie Mac), have been in conservatorship since September 2008. Minimal capital, the levels of risky assets at the Federal Housing Administration (the FHA), and its relatively low capital and reserves for losses, the current levels of home sales, and the risks of interest rates increasing materially from historically low levels, as well as the 2017 Tax Act, could also have serious adverse effects on the mortgage markets and our mortgage operations. Such adverse effects could include, among other things, price reductions in single family home values, further adversely affecting the liquidity and value of collateral securing commercial loans for residential acquisition, construction and development, as well as residential mortgage loans that we hold, mortgage loan originations and gains on sale of mortgage loans. In the event our allowance for loan losses is insufficient to cover such losses, if any, our earning, capital and liquidity could be adversely affected.

Significant ongoing disruptions in the secondary market for residential mortgage loans have limited the market for and liquidity of most mortgage loans other than conforming Fannie Mae, Freddie Mac, and FHA loans. Declines in real estate values, low home sales volumes, financial stress on borrowers as a result of job losses or reduced incomes, interest rate increases, generally, including resets on adjustable rate mortgage loans, maturities of second lien mortgages or other factors have adversely affected borrowers during recent years. Higher interest rate and changes in mortgage loan rules, could result in fewer mortgage originations, higher delinquencies and greater charge-offs in future periods, as well as increased regulation capital requirement which would adversely affect our financial condition, including capital and liquidity, and our results of operations. In the event our allowance for loan losses is insufficient to cover such losses, if any, our earnings, capital and liquidity could be adversely affected. Fannie Mae and Freddie Mac, the largest purchasers of residential mortgage loans, remain in federal conservatorship and the timing and effects of their resolution cannot be predicted.

Weaknesses in real estate markets may adversely affect the length of time and costs required to manage and dispose of, and the values realized from the sale of our OREO.

We may be contractually obligated to repurchase mortgage loans we sold to third parties on terms unfavorable to us.

As a routine part of its business, the Company originates mortgage loans that it subsequently sells in the secondary market, including to governmental agencies and GSEs, such as Fannie Mae. In connection with the sale of these loans, the Company makes customary representations and warranties, the breach of which may result in the Company being required to repurchase the loan or loans. Furthermore, the amount paid may be greater than the fair value of the loan or loans at the time of the repurchase. Although mortgage loan repurchase requests made to us have been limited, if these increased notwithstanding new repurchase procedures adopted in late 2015 and early 2016 by the Federal Housing Finance Agency (FHFA), Fannie Mae and Freddie Mac, we may have to establish reserves for possible repurchases and adversely affect our results of operation and financial condition.

Mortgage servicing rights requirements may change and require us to incur additional costs and risks.

The CFPB s residential mortgage servicing standards include servicing requirements, require servicer activities and delay foreclosures, among other things. These may adversely affect our costs to service residential mortgage loans, and together with the Basel III Rules, may decrease the returns on our MSRs. The CFPB and the bank regulators

continue to bring enforcement actions and develop proposals, rules and practices that could increase the costs of providing mortgage servicing. This could reduce our income from servicing these types of loans and make it more difficult and costly to timely realize the value of collateral securing such loans upon a borrower default.

Fannie Mae and Freddie Mac restructuring may adversely affect the mortgage markets and our sales of mortgages we originated.

Fannie Mae and Freddie Mac remain in conservatorship, and although legislation has been introduced at various times to restructure Fannie Mae and Freddie Mac to take them out of conservatorship and substantially change the way they conduct business in the future, no proposal has been enacted. Through 2017, all of Fannie Mae and Freddie Mac s earnings above a specified capital reserve have been swept into the U.S. Treasury and have not been available to build Fannie Mae s or Freddie Mac s capital. At the end of 2017, the capital reserve was increased to $3 billion for each of Fannie Mae and Freddie Mac.

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In February 2018, Fannie Mae reported that the 2017 Tax Act had reduced its DTAs, and that it had a net worth deficit of $3.7 billion as of December 31, 2017. To eliminate its net worth deficit, the Treasury Department provided Fannie Mae with $3.7 billion of capital in the first quarter of 2018. Fannie Mae reported that it had a net worth of $6.2 billion as of December 31, 2018. Freddie Mac had a net worth deficit of $312 million at December 31, 2017, and the Treasury Department provided Freddie Mac with $312 million of capital in the first quarter of 2018. Freddie Mac reported that it had a net worth of $4.5 billion as of December 31, 2018.

Since Fannie Mae and Freddie Mac dominate the residential mortgage markets, any changes in their structure and operations, as well as their respective capital, could adversely affect the primary and secondary mortgage markets, and our residential mortgage businesses, our results of operations and the returns on capital deployed in these businesses.

Our concentration of commercial real estate loans could result in further increased loan losses, and adversely affect our business, earnings, and financial condition.

Commercial real estate (CRE), is cyclical and poses risks of possible loss due to concentration levels and risks of the assets being financed, which include loans for the acquisition and development of land and residential construction. The federal bank regulatory agencies released guidance in 2006 on Concentrations in Commercial Real Estate Lending. The guidance defines CRE loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property, and non-farm non-residential property, where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50% or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risks in CRE markets would also be considered CRE loans under the guidance. Loans on owner occupied commercial real estate are generally excluded from CRE for purposes of this guidance. We had 62.8% of our portfolio in CRE loans, as defined by the Federal Reserve, at year-end 2018 compared to 61.1% at year-end 2017. The banking regulators continue to give CRE lending scrutiny and further addressed their concerns over CRE activity in December 2016, requiring banks with higher levels of CRE loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, as well as higher levels of allowances for possible losses and capital levels as a result of CRE lending growth and exposures. Lower demand for CRE, and reduced availability of, and higher interest rates and costs for, CRE lending could adversely affect our CRE loans and sales of our OREO, and therefore our earnings and financial condition, including our capital and liquidity.

Our ability to realize our deferred tax assets may be reduced in the future if our estimates of future taxable income from our operations and tax planning strategies do not support this amount, and the amount of net operating loss carry-forwards realizable for income tax purposes may be reduced under Section 382 of the Internal Revenue Code by sales of our capital securities.

We are allowed to carry-back losses for two years for Federal income tax purposes. As of December 31, 2018, we had net deferred tax assets of $1.8 million. These and future deferred tax assets may be further reduced in the future if our estimates of future taxable income from our operations and tax planning strategies do not support the amount of the deferred tax asset. The amount of net operating loss carry-forwards realizable for income tax purposes potentially could be further reduced under Section 382 of the Internal Revenue Code by a significant offering and/or other sales of our capital securities. The Basel III Rules reduce the regulatory capital benefits of deferred tax assets, also.

Our future success is dependent on our ability to compete effectively in highly competitive markets.

The East Alabama banking markets in which we do business are highly competitive and our future growth and success will depend on our ability to compete effectively in these markets. We compete for loans, deposits and other financial services in our markets with other local, regional and national commercial banks, thrifts, credit unions, mortgage lenders, and securities and insurance brokerage firms. Marketplace lenders operating nationwide over the internet are growing rapidly. Many of our competitors offer products and services different from us, and have substantially greater resources, name recognition and market presence than we do, which benefits them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than we are able to and have broader and more diverse customer and geographic bases to draw upon. The Dodd-Frank Act allows others to branch into our markets more easily from other states. Failures of other banks with offices in our markets could also lead to the entrance of new, stronger competitors in our markets.

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Our success depends on local economic conditions where we operate.

Our success depends on the general economic conditions in the geographic markets we serve in Alabama. The local economic conditions in our markets have a significant effect on our commercial, real estate and construction loans, the ability of borrowers to repay these loans and the value of the collateral securing these loans. Adverse changes in the economic conditions of the Southeastern United States in general, or in one or more of our local markets could negatively affect our results of operations and our profitability. Our local economy is also affected by the growth of automobile manufacturing and related suppliers located in our markets and nearby. Auto sales are cyclical and are affected adversely by higher interest rates.

Our cost of funds may increase as a result of general economic conditions, interest rates, inflation and competitive pressures.

Although the Federal Reserve has raised the target Federal Funds rate nine times between December 2015 and January 2018 and has been selling securities in accordance with efforts to normalize monetary policy, the Federal Reserve has kept interest rates low over recent years, and the federal government continues large deficit spending. Our costs of funds may increase as a result of general economic conditions, interest rates and competitive pressures, and potential inflation resulting from government deficit spending, the effects of the 2017 Tax Act and monetary policies. Traditionally, we have obtained funds principally through local deposits and borrowings from other institutional lenders. Generally, we believe local deposits are a cheaper and more stable source of funds than borrowings because interest rates paid for local deposits are typically lower than interest rates charged for borrowings from other institutional lenders. Increases in interest rates may cause consumers to shift their funds to more interest bearing instruments and to increase the competition for and costs of deposits. While the Federal Reserve has indicated it will seek to gradually adjust low interest rates through its target Federal Funds rate and securities sales by taking a patient approach in light of market conditions and risks, and its inflation and employment goals, interest rates could increase more than anticipated. See Supervision and Regulation Fiscal and Monetary Policy . If customers move money out of bank deposits and into other investment assets or from transaction deposits to higher interest bearing time deposits, we could lose a relatively low cost source of funds, increasing our funding costs and reducing our net interest income and net income. Additionally, any such loss of funds could result in lower loan originations and growth, which could materially and adversely affect our results of operations and financial condition.

Our profitability and liquidity may be affected by changes in interest rates and interest rate levels, the shape of the yield curve and economic conditions.

Our profitability depends upon net interest income, which is the difference between interest earned on interest-earning assets, such as loans and investments, and interest expense on interest-bearing liabilities, such as deposits and borrowings. Net interest income will be adversely affected if market interest rates change where the interest we pay on deposits and borrowings increases faster than the interest earned on loans and investments. Interest rates, and consequently our results of operations, are affected by general economic conditions (domestic and institutional) and fiscal and monetary policies, as well as expectations of these rates and policies and the shape of the yield curve. Our income is primarily driven by the spread between these rates. As a result, a steeper yield curve, meaning long-term interest rates are significantly higher than short-term interest rates, would provide the Bank with a better opportunity to increase net interest income. Conversely, a flattening yield curve could pressure our net interest margin as our cost of funds increases relative to the spread we can earn on our assets. In addition, net interest income could be affected by asymmetrical changes in the different interest rate indexes, given that not all of our assets or liabilities are priced with the same index. The normalization of the Federal Reserve s monetary policy, which is gradually increasing the Federal Reserve s target Federal Funds rates and decreasing the Federal Reserve s holdings of securities, may have unpredictable effects on the shape of the yield curve and longer term interest rates.

The production of mortgages and other loans and the value of collateral securing our loans, are dependent on demand within the markets we serve, as well as interest rates.

Increases in interest rates generally decrease the market values of fixed-rate, interest-bearing investments and loans held, the value of mortgage and other loans produced and the value of loans sold, mortgage loan activities and the collateral securing our loans, and therefore may adversely affect our liquidity and earnings, to the extent not offset by potential increases in our net interest margin and the value of our mortgage servicing rights.

The 2017 Tax Act, including its limitations on the deductibility of residential mortgage interest, state and local taxes and business interest expenses and other changes, could have mixed effects on economic activity and reduce the demand for loans and increase competition among lenders for loans. This Act could promote inflation and higher interest rates, including as a result of increased fiscal deficits.

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The Company is an entity separate and distinct from the Bank.

The Company is an entity separate and distinct from the Bank. Company transactions with the Bank are limited by Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. We depend upon the Bank s earnings and dividends, which are limited by law and regulatory policies and actions, for cash to pay the Company s debt and corporate obligations, and to pay dividends to our shareholders. If the Bank s ability to pay dividends to the Company was terminated or limited, the Company s liquidity and financial condition could be materially and adversely affected.

Liquidity risks could affect operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, proceeds from loan repayments or sales proceeds from, maturing loans and securities, and other sources could have a substantial negative effect on our liquidity. Our funding sources include federal funds purchased, securities sold under repurchase agreements, core and non-core deposits, and short- and long-term debt. We maintain a portfolio of securities that can be used as a source of liquidity. We are also members of the FHLB and the Federal Reserve Bank of Atlanta, where we can obtain advances collateralized with eligible assets. There are other sources of liquidity available to the Company or the Bank should they be needed, including our ability to acquire additional non-core deposits. We may be able, depending upon market conditions, to otherwise borrow money or issue and sell debt and preferred or common securities in public or private transactions. Our access to funding sources in amounts adequate to finance or capitalize our activities on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or the economy in general. Our ability to borrow or obtain funding, if General conditions that are not specific to us, such as disruptions in the financial markets or negative views and expectations about the prospects for the financial services industry could adversely affect us.

We are subject to extensive regulation that could limit or restrict our activities and adversely affect our earnings.

We and our subsidiaries are regulated by several regulators, including the Federal Reserve, the Alabama Superintendent, the SEC and the FDIC. Our success is affected by state and federal regulations affecting banks and bank holding companies, and the securities markets, and our costs of compliance could adversely affect our earnings. Banking regulations are primarily intended to protect depositors, and the FDIC Deposit Insurance Fund (DIF), not shareholders. The financial services industry also is subject to frequent legislative and regulatory changes and proposed changes. In addition, the interpretations of regulations by regulators may change and statutes may be enacted with retroactive impact. From time to time, regulators raise issues during examinations of us which, if not determined satisfactorily, could have a material adverse effect on us. Compliance with applicable laws and regulations is time consuming and costly and may affect our profitability.

The current President and members of his political party in Congress have promoted and supported regulatory relief for the banking industry. The nature, effects and timing of administrative and legislative change, including the 2018 Growth Act, and possible changes in regulations or regulatory approach, as a result of a Democrat-controlled House of Representatives elected in 2018, cannot be predicted. The federal bank regulators and the Treasury Department, as well as the Congress and the President, are evaluating the regulation of banks, other financial services providers and the financial markets and such changes, if any, could require us to maintain more capital and liquidity, and restrict our activities, which could adversely affect our growth, profitability and financial condition. Our consumer finance products, including residential mortgage loans, are subject to CFPB regulations and evolving standards reflecting CFPB releases, rule-making and enforcement actions.

Changes in accounting and tax rules applicable to banks could adversely affect our financial conditions and results of operations.

From time to time, the FASB and the SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in us restating prior period financial statements. The FASB s new guidance under ASU No. 2016-13 includes significant changes to the manner in which banks allowance for loan losses will be calculated beginning January 1, 2020. Instead of using historical losses, the CECL model will be forward-looking with respect to expected losses over the life of loans and other instruments, and could materially affect our results of operations and financial condition, including the variability of our results of operations and our regulatory capital, notwithstanding a three-year phase-in of CECL for regulatory capital purposes.

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The 2017 Tax Act may have adverse effects on certain of our customers and our businesses.

The 2017 Tax Act will benefit the Bank by reducing the maximum U.S. corporate income tax rate on its taxable income from 35% to 21%. This benefit may be diminished by the complexity, uncertainty and possible adverse effects of this legislation on certain of our borrowers, including limitations on the deductibility of:

- residential mortgage interest;
- state and local taxes, including property taxes; and
- business interest expenses.

These changes may adversely affect borrowers cash flows and the values and liquidity of collateral we hold to secure our loans. Fewer borrowers may be able to meet the CFPB s ability to repay standards under the Truth in Lending Act and CFPB regulations, which include the borrower s ability to pay taxes and assessments. Demand for loans by qualified borrowers could be reduced, and therefore competition among lenders could increase. Customer behaviors toward incurring and repaying debt could also change as a result of the 2017 Tax Act. As a result, the 2017 Tax Act could materially and adversely affect our business and results of operations, at least before taking into account our lower U.S. corporate income tax rate.

We are required to maintain capital to meet regulatory requirements, and if we fail to maintain sufficient capital, our financial condition, liquidity and results of operations would be adversely affected.

We and the Bank must meet regulatory capital requirements and maintain sufficient liquidity, including liquidity at the Company, as well as the Bank. If we fail to meet these capital and other regulatory requirements, including more rigorous requirements arising from our regulators implementation of Basel III, our financial condition, liquidity and results of operations would be materially and adversely affected. Our failure to remain well capitalized and well managed , including meeting the Basel III capital conservation buffers, for bank regulatory purposes could affect customer confidence, our ability to grow, our costs of funds and FDIC insurance, our ability to raise brokered deposits, our ability to pay dividends on our common stock and our ability to make acquisitions, and we would no longer meet the requirements for becoming a financial holding company. These could also affect our ability to use discretionary bonuses to attract and retain quality personnel. The Basel III Capital Rules include a new minimum ratio of common equity tier 1 capital, or CET1, to risk-weighted assets of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets. *See* Supervision and Regulation Basel III Capital Rules. Although we currently have capital ratios that exceed all these minimum levels currently and on a fully phased-in basis and a strategic plan to maintain these levels, we or the Bank may be unable to continue to satisfy the capital adequacy requirements for the following reasons:

- losses and/or increases in the Bank s credit risk assets and expected losses resulting from the deterioration in the creditworthiness of borrowers and the issuers of equity and debt securities;

difficulty in refinancing or issuing instruments upon redemption or at maturity of such instruments to raise capital under acceptable terms and conditions;

declines in the value of our securities portfolios;

revisions to the regulations or their application by our regulators that increase our capital requirements;

reductions in the value of our DTAs; and other adverse developments; and

unexpected growth and an inability to increase capital timely.

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A failure to remain well capitalized, for bank regulatory purposes, including meeting the Basel III Capital Rule s conservation buffer, could adversely affect customer confidence, and our:

- ability to grow;
- the costs of and availability of funds;
- FDIC deposit insurance premiums;
- ability to raise or replace brokered deposits;
- ability to make acquisitions or engage in new activities;
- flexibility if we become subject to prompt corrective action restrictions;
- ability to make discretionary bonuses to attract and retain quality personnel;
- ability to make payments of principal and interest on our capital instruments; and
- ability to pay dividends on our capital stock.

The Dodd-Frank Act restricts our future issuance of trust preferred securities and cumulative preferred securities as eligible Tier 1 risk-based capital for purposes of the regulatory capital guidelines for bank holding companies.

We repurchased and retired all our outstanding trust preferred securities in 2018, and the Dodd-Frank Act does not permit us to issue new trust preferred securities as Tier 1 capital. Accordingly, should we determine it is advisable, or should our regulators require us, based upon new capital or liquidity regulations or otherwise, to raise additional Tier 1 risk-based capital, we would not be able to issue additional trust preferred securities. Under the Federal Reserve s Small BHC Policy, the Company could issue senior or secured debt, the proceeds of which could be down-streamed as capital to the Bank as capital. We also could issue noncumulative preferred stock or common equity. To the extent we issue new equity, it could result in dilution to our existing shareholders. To the extent we issue preferred stock, dividends on the preferred stock, unlike distributions paid on trust preferred securities, would not be tax deductible.

We may need to raise additional capital in the future, but that capital may not be available when it is needed or on favorable terms.

We anticipate that our current capital resources will satisfy our capital requirements for the foreseeable future under currently effective rules. We may, however, need to raise additional capital to support our growth or currently unanticipated losses, or to meet the needs of our communities, resulting from failures or cutbacks by our competitors,

and the Basel III Rules. Our ability to raise additional capital, if needed, will depend, among other things, on conditions in the capital markets at that time, which are limited by events outside our control, and on our financial performance. If we cannot raise additional capital on acceptable terms when needed, our ability to further expand our operations through internal growth and acquisitions could be limited.

Future acquisitions and expansion activities may disrupt our business, dilute shareholder value and adversely affect our operating results.

We regularly evaluate potential acquisitions and expansion opportunities, including new branches and other offices. To the extent that we grow through acquisitions, we cannot assure you that we will be able to adequately or profitably manage this growth. Acquiring other banks, branches, or businesses, as well as other geographic and product expansion activities, involve various risks including:

risks of unknown or contingent liabilities;

unanticipated costs and delays;

risks that acquired new businesses will not perform consistent with our growth and profitability expectations;

risks of entering new markets or product areas where we have limited experience;

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risks that growth will strain our infrastructure, staff, internal controls and management, which may require additional personnel, time and expenditures;

exposure to potential asset quality issues with acquired institutions;

difficulties, expenses and delays of integrating the operations and personnel of acquired institutions;

potential disruptions to our business;

possible loss of key employees and customers of acquired institutions;

potential short-term decreases in profitability; and

diversion of our management s time and attention from our existing operations and business.

Attractive acquisition opportunities may not be available to us in the future.

While we seek continued organic growth, we also may consider the acquisition of other businesses. We expect that other banking and financial companies, many of which have significantly greater resources, will compete with us to acquire financial services businesses. This competition could increase prices for potential acquisitions that we believe are attractive. Also, acquisitions are subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate an acquisition that we believe is in our best interests, and regulatory approvals could contain conditions that reduce the anticipated benefits of any transaction. Among other things, our regulators consider our capital, liquidity, profitability, regulatory compliance and levels of goodwill and intangibles when considering acquisition and expansion proposals. Any acquisition could be dilutive to our earnings and shareholders equity per share of our common stock.

Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology driven products and services and a growing demand for mobile and user-based banking applications. In addition to allowing us to analyze our customers better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs, risks associated with fraud and compliance with anti-money laundering and other laws, and various operational risks. Largely unregulated fintech businesses have increased their participation in the lending and payments business, and have increased competition in these businesses. Our future success will depend, in part, upon our ability to use technology to provide products and services that meet our customers preferences and create additional efficiencies in operations, while avoiding cyber-attacks and disruptions, and data breaches. We may need to make significant additional capital investments in technology, including cyber and data security, and we may not be able to effectively implement new technology-driven products and services, or such technology may prove less effective than anticipated. Many larger competitors have substantially greater resources to invest in technological improvements and, increasingly, non-banking firms are using technology to compete with traditional lenders for loans and other banking services.

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Operational risks are inherent in our businesses.

Operational risks and losses can result from internal and external fraud; gaps or weaknesses in our risk management or internal audit procedures; errors by employees or third parties; failure to document transactions properly or to obtain proper authorization; failure to comply with applicable regulatory requirements and conduct of business rules in the various jurisdictions where we do business or have customers; failures in the models we generate and rely on; equipment failures, including those caused by natural disasters or by electrical, telecommunications or other essential utility outages; business continuity and data security system failures, including those caused by computer viruses, cyberattacks, unforeseen problems encountered while implementing major new computer systems or, upgrades to existing systems or inadequate access to data or poor response capabilities in light of such business continuity and data security system failures; or the inadequacy or failure of systems and controls, including those of our suppliers or counterparties. In addition, we face certain risks inherent in the ownership and operation of our bank premises and other real-estate, including liability for slip and fall and other accidents on our properties. Although we have implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures, identifying and rectifying weaknesses in existing procedures and training staff, it is not possible to be certain that such actions have been or will be effective in controlling each of the operational risks faced by us.

Potential gaps in our risk management policies and internal audit procedures may leave us exposed unidentified or unanticipated risk, which could negatively affect our business.

Our enterprise risk management and internal audit program is designed to mitigate material risks and loss to us. We have developed and continue to develop risk management and internal audit policies and procedures to reflect the ongoing review of our risks and expect to continue to do so in the future. Nonetheless, our policies and procedures may not be comprehensive and may not identify every risk to which we are exposed, and our internal audit process may fail to detect such weaknesses or deficiencies in our risk management framework. Many of our methods for managing risk and exposures use observed historical market behavior to model or project potential future exposure. Models used by our business are based on assumptions and projections. These models may not operate properly or our inputs and assumptions may be inaccurate. As a result, these methods may not fully predict future exposures, which can be significantly greater than historical measures indicate. Other risk management methods depend upon the evaluation of information regarding markets, clients, or other matters that are publicly available or otherwise accessible to us. This information may not always be accurate, complete, up-to-date or properly evaluated. Furthermore, there can be no assurance that we can effectively review and monitor all risks or that all of our employees will closely follow our risk management policies and procedures, nor can there be any assurance that our risk management policies and procedures will enable us to accurately identify all risks and limit our exposures based on our assessments. In addition, we may have to implement more extensive and perhaps different risk management policies and procedures under new or pending regulations. All of these could adversely affect our financial condition and results of operations.

Any failure to protect the confidentiality of customer information could adversely affect our reputation and have a material adverse effect on our business, financial condition and results of operations.

Various federal and state laws enforced by the bank regulators and other agencies protect the privacy and security of customers non-public personal information. Many of our employees have access to, and routinely process personal information of clients through a variety of media, including information technology systems. We rely on various internal processes and controls to protect the confidentiality of client information that is accessible to, or in the possession of, us and our employees. It is possible that an employee could, intentionally or unintentionally, disclose or misappropriate confidential client information or our data could be the subject of a cybersecurity attack. Such personal data could also be compromised by third party hackers via intrusions into our systems or those of service providers or

persons we do business with such as credit bureaus, data processors and merchants who accept credit or debit cards for payment. If we fail to maintain adequate internal controls, or if our employees fail to comply with our policies and procedures, misappropriation or intentional or unintentional inappropriate disclosure or misuse of client information could occur. Such internal control inadequacies or non-compliance could materially damage our reputation, lead to civil or criminal penalties, or both, which, in turn, could have a material adverse effect on our business, financial condition and results of operations.

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Our information systems may experience interruptions and security breaches.

We rely heavily on communications and information systems, including those provided by third-party service providers, to conduct our business. Any failure, interruption, or security breach of these systems could result in failures or disruptions which could affect our customers privacy and our customer relationships, generally. Our systems and networks, as well as those of our third-party service providers, are subject to security risks and could be susceptible to cyber-attacks, such as denial of service attacks, hacking, terrorist activities or identity theft. Although we do not believe that we and our third-party service providers have been subject to a cyber-attack, other financial service institutions and their service providers have reported security breaches in their websites or other systems, some of which have involved sophisticated and targeted attacks, including use of stolen access credentials, malware, ransomware, phishing, structured query language injection attacks and distributed denial-of-service attacks, among other means. Such cyber-attacks may also be directed at disrupting the operations of public companies or their business partners, which are intended to effect unauthorized fund transfers, obtain unauthorized access to confidential information, to destroy data, disable or degrade service, or sabotage systems, often through the introduction of computer viruses or malware, cyberattacks and other means. Denial of service attacks have been launched against a number of large financial services institutions, and we may be subject to these types of attacks in the future. Hacking and identity theft risks, in particular, could cause serious reputational harm. Cyber threats are rapidly evolving and we may not be able to anticipate or prevent all such attacks and could be held liable for any security breach or loss.

Despite our cybersecurity policies and procedures and our Board of Director s and Management s efforts to monitor and ensure the integrity of our and our service providers systems, we may not be able to anticipate all types of security threats, nor may we be able to implement preventive measures effective against all such security threats. The techniques used by cyber criminals change frequently, may not be recognized until launched and can originate from a wide variety of sources, including outside groups such as external service providers, organized crime affiliates, terrorist organizations or hostile foreign governments. These risks may increase in the future as the use of mobile banking and other internet-based products and services continues to grow.

Security breaches or failures may have serious adverse financial and other consequences, including significant legal and remediation costs, disruptions to operations, misappropriation of confidential information, damage to systems operated by us or our third-party service providers, as well as damages to our customers and our counterparties. In addition to the immediate costs of any failure, interruption or security breach, including those at our third-party service providers, these events could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

Severe weather, natural disasters, acts of war or terrorism or other external events could have significant effects on our business.

Severe weather and natural disasters, including hurricanes, tornados, drought and floods, acts of war or terrorism or other external events could have a significant effect on our ability to conduct business. Such events could affect the stability of our deposit base; impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Although management has established disaster recovery and business continuity policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Our associates may take excessive risks which could negatively affect our financial condition and business.

As a banking enterprise, we are in the business of accepting certain risks. The associates who conduct our business, including executive officers and other members of management, sales intermediaries, investment professionals, product managers, and other associates, do so in part by making decisions and choices that involve exposing us to risk. We endeavor, in the design and implementation of our compensation programs and practices, to avoid giving our associates incentives to take excessive risks; however, associates may nonetheless take such risks and our policies and procedures, generally. Similarly, although we employ controls and procedures designed to prevent employee misconduct, to monitor associates business decisions and prevent them from taking excessive risks, these controls and procedures may not be effective. If our associates take excessive risks, the impact of those risks could harm our reputation and have a material adverse effect on our financial condition and business operations.

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We may be unable to attract and retain key people to support our business.

Our success depends, in large part, on our ability to attract and retain key people. We compete with other financial services companies for people primarily on the basis of compensation, support services and financial position. Intense competition exists for key employees with demonstrated ability, and we may be unable to hire or retain such employees. Effective succession planning is also important to our long-term success. The unexpected loss of services of one or more of our key personnel and failure to ensure effective transfer of knowledge and smooth transitions involving key personnel could have a material adverse effect on our business due to loss of their skills, knowledge of our business, their years of industry experience and the potential difficulty of promptly finding qualified replacement employees.

Proposed rules implementing the executive compensation provisions of the Dodd-Frank Act may limit the type and structure of compensation arrangements into which we may enter with certain of our employees and officers. In addition, proposed rules under the Dodd-Frank Act would prohibit the payment of excessive compensation to our executives. These restrictions could negatively affect our ability to compete with other companies in recruiting and retaining key personnel.

Our ability to continue to pay dividends to shareholders in the future is subject to profitability, capital, liquidity and regulatory requirements and these limitations may prevent us from paying dividends in the future.

Cash available to pay dividends to our shareholders is derived primarily from dividends paid to the Company by the Bank. The ability of the Bank to pay dividends, as well as our ability to pay dividends to our shareholders, will continue to be subject to and limited by applicable laws limiting dividend payments by the Bank, the results of operations of our subsidiaries and our need to maintain appropriate liquidity and capital at all levels of our business consistent with regulatory requirements and the needs of our businesses. See Supervision and Regulation .

A limited trading market exists for our common shares, which could lead to price volatility.

Your ability to sell or purchase common shares depends upon the existence of an active trading market for our common stock. Although our common stock is quoted on the Nasdaq Global Market under the trading symbol AUBN, the volume of trades on any given day has been limited historically. As a result, you may be unable to sell or purchase shares of our common stock at the volume, price and time that you desire. Additionally, whether the purchase or sales prices of our common stock reflects a reasonable valuation of our common stock also is affected by an active trading market, and thus the price you receive for a thinly-traded stock such as common stock, may not reflect its true or intrinsic value. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market.

Our operations are subject to risk of loss from unfavorable fiscal, monetary and political developments in the U.S.

Our businesses and earnings are affected by the fiscal, monetary and other policies and actions of various U.S. governmental and regulatory authorities. Changes in these are beyond our control and are difficult to predict and, consequently, changes in these policies could have negative effects on our activities and results of operations. Failures of the executive and legislative branches to agree on spending plans and budgets have led to Federal government shutdowns, which may adversely affect the U.S. economy. Additionally, a prolonged government shutdown may inhibit our ability to evaluate the economy, generally, and affect government workers who are not paid during such events, and where the absence of government services and data could adversely affect consumer and business sentiment, our local economy and our customers and therefore our business.

Litigation and regulatory investigations are increasingly common in our businesses and may result in significant financial losses and/or harm to our reputation.

We face risks of litigation and regulatory investigations and actions in the ordinary course of operating our businesses, including the risk of class action lawsuits. Plaintiffs in class action and other lawsuits against us may seek very large and/or indeterminate amounts, including punitive and treble damages. Due to the vagaries of litigation, the outcome of a litigation matter and the amount or range of potential loss at particular points in time may normally be difficult to ascertain. We do not have any material pending litigation or regulatory matters affecting us.

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A substantial legal liability or a significant federal, state or other regulatory action against us, as well as regulatory inquiries or investigations, could harm our reputation, result in material fines or penalties, result in significant legal costs, divert management resources away from our business, and otherwise have a material adverse effect on our ability to expand on our existing business, financial condition and results of operations. Even if we ultimately prevail in the litigation, regulatory action or investigation, our ability to attract new customers, retain our current customers and recruit and retain employees could be materially and adversely affected. Regulatory inquiries and litigation may also adversely affect the prices or volatility of our securities specifically, or the securities of our industry, generally.

The Federal Reserve may require us to commit capital resources to support the Bank.

As a matter of policy, the Federal Reserve, which examines us, expects a bank holding company to act as a source of financial and managerial strength to a subsidiary bank and to commit resources to support such subsidiary bank. The Federal Reserve may require a bank holding company to make capital injections into a troubled subsidiary bank. In addition, the Dodd-Frank Act amended the Federal Deposit Insurance Corporation Act to require that all companies that control a FDIC-insured depository institution serve as a source of financial strength to their depository institution subsidiaries. Under this requirement, we could be required to provide financial assistance to the Bank should it experience financial distress, even if further investment was not otherwise warranted. See Supervision and Regulation.

Failures to comply with the fair lending laws, CFPB regulations or the Community Reinvestment Act, or CRA, could adversely affect us.

The Bank is subject to, among other things, the provisions of the Equal Credit Opportunity Act, or ECOA, and the Fair Housing Act, both of which prohibit discrimination based on race or color, religion, national origin, sex and familial status in any aspect of a consumer, commercial credit or residential real estate transaction. The DOJ and the federal bank regulatory agencies have issued an Interagency Policy Statement on Discrimination in Lending to provide guidance to financial institutions in determining whether discrimination exists and how the agencies will respond to lending discrimination, and what steps lenders might take to prevent discriminatory lending practices. Failures to comply with ECOA, the Fair Housing Act and other fair lending laws and regulations, including CFPB regulations, could subject us to enforcement actions or litigation, and could have a material adverse effect on our business financial condition and results of operations. Our Bank is also subject to the CRA and periodic CRA examinations. The CRA requires us to serve our entire communities, including low- and moderate-income neighborhoods. Our CRA ratings could be adversely affected by actual or alleged violations of the fair lending or consumer financial protection laws. Even though we have maintained an satisfactory CRA rating since 2000, we cannot predict our future CRA ratings. Violations of fair lending laws or if our CRA rating falls to less than satisfactory could adversely affect our business, including expansion through branching or acquisitions.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. DESCRIPTION OF PROPERTY

The Bank conducts its business from its main office and eight full-service branches. The Bank also operates a commercial loan production office in Phenix City, Alabama. The bank owns its main office building, which is located in downtown Auburn, Alabama, and has approximately 16,150 square feet of space. The original building was constructed in 1964, and an addition was completed in 1981. Portions of the building have been renovated to

accommodate growth and changes in the Bank s operational structure and to adapt to technological changes. The main office offers the full line of the Bank s services and has one ATM. The Bank completed construction on a new drive-through facility located on the main office campus in October 2012. This drive-through facility has five drive-through lanes, including an ATM, and a walk-up teller window.

The Bank also owns a commercial office building, the AuburnBank Center (the Center), which is located next to the Bank s main office. The Center has approximately 23,000 square feet of space. The Bank s mortgage servicing, data processing activities, and other operations, are located in the Center. In total, the main office and Center parking lots provide parking for approximately 190 vehicles.

The Opelika branch is located in Opelika, Alabama. This branch, built in 1991, is owned by the Bank and has approximately 4,000 square feet of space. This branch offers the full line of the Bank s services and has drive-through windows and an ATM. This branch offers parking for approximately 36 vehicles.

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The Bank s Notasulga branch was opened in August 2001. This branch is located in Notasulga, Alabama, about 15 miles west of Auburn, Alabama. This branch is owned by the Bank and has approximately 1,344 square feet of space. The Bank leased the land for this branch from a third party. In May 2018, the Bank s land lease renewed for another one year term. This branch offers the full line of the Bank s services including safe deposit boxes and a drive-through window. This branch offers parking for approximately 11 vehicles, including a handicapped ramp.

In November 2002, the Bank opened a loan production office in Phenix City, Alabama, about 35 miles south of Auburn, Alabama. In November 2018, the Bank renewed its lease for another year.

In February 2009, the Bank opened a branch located on Bent Creek Road in Auburn, Alabama. This branch is owned by the Bank and has approximately 4,000 square feet of space. This branch offers the full line of the Bank s services and has drive-through windows and a drive-up ATM. This branch offers parking for approximately 29 vehicles.

In December 2011, the Bank opened a branch located on Fob James Drive in Valley, Alabama, about 30 miles northeast of Auburn, Alabama. This branch is owned by the Bank and has approximately 5,000 square feet of space. This branch offers the full line of the Bank s services and has drive-through windows and a drive-up ATM. This branch offers parking for approximately 35 vehicles. Prior to December 2011, the Bank leased office space for a loan production office in Valley, Alabama. The loan production office was originally opened in September 2004.

In February 2015, the Bank relocated its Auburn Kroger branch to a new location within the Corner Village Shopping Center, in Auburn, Alabama. In February 2015, the Bank entered into a new lease agreement for five years with options for two 5-year extensions. The Bank leases approximately 1,500 square feet of space for the Corner Village branch. Prior to relocation, the Bank s Auburn Kroger branch was located in the Kroger supermarket in the same shopping center. The Auburn Kroger branch was originally opened in August 1988. The Corner Village branch offers the full line of the Bank s deposit and other services including an ATM, except safe deposit boxes.

In September 2015, the Bank relocated its Auburn Wal-Mart Supercenter branch to a new location the Bank purchased in December 2014 at the intersection of S. Donahue Avenue and E. University Drive in Auburn, Alabama. The South Donahue branch, built in 2015, has approximately 3,600 square feet of space. Prior to relocation, the Bank s Auburn Wal-Mart Supercenter branch was located inside the Wal-Mart shopping center on the south side of Auburn, Alabama. The Auburn Wal-Mart Supercenter branch was originally opened in September 2000. The South Donahue branch offers the full line of the Bank s services and has drive-through windows and an ATM. This branch offers parking for approximately 28 vehicles.

In May 2017, the Bank relocated its Opelika Kroger branch to a new location to a new location the Bank purchased in August 2016 near the Tiger Town Retail Shopping Center and the intersection of U.S. Highway 280 and Frederick Road in Opelika, Alabama. The Tiger Town branch, built in 2017, has approximately 5,500 square feet of space. Prior to relocation, the Bank s Opelika Kroger branch was located inside the Kroger supermarket in the Tiger Town retail center in Opelika, Alabama. The Opelika Kroger branch was originally opened in July 2007. The Tiger Town branch offers the full line of the Bank s services and has drive-through windows and an ATM. This branch offers parking for approximately 36 vehicles.

In September 2018, the Bank opened a mortgage loan production office on East Samford Avenue in Auburn, Alabama. The location has approximately 2,500 square feet of space and is leased through 2028. The mortgage loan production office was previously located in the Center on the Bank s main campus. This location offers parking for approximately 16 vehicles.

ITEM 3. LEGAL PROCEEDINGS

In the normal course of its business, the Company and the Bank from time to time are involved in legal proceedings. The Company s management believe there are no pending or threatened legal proceedings that, upon resolution, are expected to have a material adverse effect upon the Company s or the Bank s financial condition or results of operations.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s Common Stock is listed on the Nasdaq Global Market, under the symbol AUBN . As of March 12, 2018, there were approximately 3,593,463 shares of the Company s Common Stock issued and outstanding, which were held by approximately 386 shareholders of record. The following table sets forth, for the indicated periods, the high and low closing sale prices for the Company s Common Stock as reported on the Nasdaq Global Market, and the cash dividends declared to shareholders during the indicated periods.

	Closing Price Per Share (1)		Cash Dividends Declared
	High	Low	
2018			
First Quarter	$ 39.25	$ 35.50	$ 0.24
Second Quarter	50.99	37.40	0.24
Third Quarter	53.50	38.31	0.24
Fourth Quarter	41.50	28.88	0.24
2017			
First Quarter	$ 33.69	$ 30.75	$ 0.23
Second Quarter	37.79	32.65	0.23
Third Quarter	37.71	34.82	0.23
Fourth Quarter	40.25	33.25	0.23

(1) The price information represents actual transactions.

The Company has paid cash dividends on its capital stock since 1985. Prior to this time, the Bank paid cash dividends since its organization in 1907, except during the Depression years of 1932 and 1933. Holders of Common Stock are entitled to receive such dividends as may be declared by the Company s Board of Directors. The amount and frequency of cash dividends will be determined in the judgment of the Board based upon a number of factors, including the Company s earnings, financial condition, capital requirements and other relevant factors. The Board currently intends to continue its present dividend policies.

Federal Reserve policy could restrict future dividends on our Common Stock, depending on our earnings and capital position and likely needs. See Supervision and Regulation Payment of Dividends and Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Adequacy .

The amount of dividends payable by the Bank is limited by law and regulation. The need to maintain adequate capital in the Bank also limits dividends that may be paid to the Company.

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Performance Graph

The following performance graph compares the cumulative, total return on the Company s Common Stock from December 31, 2013 to December 31, 2018, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a $100 investment on December 31, 2013). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.

	Period Ending					
Index	**12/31/13**	**12/31/14**	**12/31/15**	**12/31/16**	**12/31/17**	**12/31/18**
Auburn National Bancorporation, Inc.	100.00	97.93	126.92	138.44	176.60	147.15
NASDAQ Composite	100.00	114.75	122.74	133.62	173.22	168.30
SNL Southeast Bank	100.00	112.63	110.87	147.18	182.06	150.42

Issuer Purchases of Equity Securities

Not applicable.

Securities Authorized for Issuance Under Equity Compensation Plans

See the information included under Part III, Item 12, which is incorporated in response to this item by reference.

Unregistered Sale of Equity Securities

Not applicable.

ITEM 6. SELECTED FINANCIAL DATA

See Table 2 Selected Financial Data and general discussion in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations .

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition at December 31, 2018 and 2017 and our results of operations for the years ended December 31, 2018 and 2017. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, Risk Factors and Special Cautionary Notice Regarding Forward-Looking Statements .

OVERVIEW

The Company was incorporated in 1990 under the laws of the State of Delaware and became a bank holding company after it acquired its Alabama predecessor, which was a bank holding company established in 1984. The Bank, the Company s principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Notasulga and Valley, Alabama. The Bank also operates a commercial loan production office in Phenix City, Alabama.

Summary of Results of Operations

	Year ended December 31	
(Dollars in thousands, except per share data)	**2018**	**2017**
Net interest income (a)	$ 26,183	$ 25,731
Less: tax-equivalent adjustment	613	1,205
Net interest income (GAAP)	25,570	24,526
Noninterest income	3,325	3,441
Total revenue	28,895	27,967
Provision for loan losses		(300)
Noninterest expense	17,874	16,784
Income tax expense	2,187	3,637
Net earnings	$ 8,834	$ 7,846
Basic and diluted net earnings per share	$ 2.42	$ 2.15

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures .

Financial Summary

The Company s net earnings were $8.8 million for the full year 2018, compared to $7.8 million for the full year 2017. Basic and diluted net earnings per share were $2.42 per share for the full year 2018, compared to $2.15 per share for the full year 2017.

Net interest income (tax-equivalent) was $26.2 million in 2018, a 2% increase compared to $25.7 million in 2017. This increase was primarily due to loan growth and recent increases in short-term market interest rates, offset by declines on yields of tax exempt securities. Average loans were up 3% to $456.3 million in 2018, compared to $441.0 million in 2017. The Company s net interest margin (tax-equivalent) increased to 3.40% in 2018, compared to 3.29% in 2017 as yields on earning assets improved.

The Company recorded no provision for loan losses during 2018 and a negative provision for loan losses of $0.3 million during the 2017. The provision for loan losses is based upon various estimates and judgements, including the absolute level of loans, loan growth, credit quality and the amount of net charge-offs. Annualized net recoveries as a percent of average loans were 0.01% and 0.09% for 2018 and 2017, respectively. The Company recognized a recovery of $0.4 million from the payoff of two nonperforming commercial loans during 2017.

Noninterest income was $3.3 million in 2018 compared to $3.4 million in 2017. This decrease was primarily due to a $0.1 million decrease in mortgage lending income as production volume declined.

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Noninterest expense was $17.9 million compared to $16.8 million in 2017. This increase in noninterest expense was primarily due to increases in salaries and benefits expense of $0.6 million and a $0.4 million loss related to misappropriation of assets, for which the Company filed a claim with its insurance provider. In March 2019, the Company received a settlement of $0.3 million from its insurance provider related to this claim.

Income tax expense was $2.2 million in 2018 and $3.6 million in 2017 reflecting an effective tax rate of 19.84% and 31.67%, respectively. The decrease in the income tax expense and effective tax rate was primarily due to the 2017 Tax Act which lowered the Company s statutory federal tax rate from 34% in 2017 to 21% in 2018 and required the Company to remeasure the value of its net deferred tax assets by $0.4 million as of December 31, 2017.

The Company paid cash dividends of $0.96 per share in 2018, an increase of 4.3% from 2017. At December 31, 2018, the Bank s regulatory capital ratios were well above the minimum amounts required to be well capitalized under current regulatory standards with a total risk-based capital ratio of 17.38%, a tier 1 leverage ratio of 11.33% and common equity tier 1 (CET1) of 16.49% at December 31, 2018.

CRITICAL ACCOUNTING POLICIES

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, the valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal, independent loan review process. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

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As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2018 and 2017, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. Since the fourth quarter of 2016, the Company has increased its look-back period each quarter to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. For the year ended December 31, 2018, the Company increased its look-back period to 39 quarters to continue to include losses incurred by the Company beginning with the first quarter of 2009. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. Other than expanding the look-back period each quarter, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Assessment for Other-Than-Temporary Impairment of Securities

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities for which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell

the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security s amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security s fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

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Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company s assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 16, Fair Value, of the consolidated financial statements that accompany this report.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company s assets or liabilities lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management s best estimates for appropriate discount rates, default rates, prepayments, market volatility and other factors, taking into account current observable market data and experience.

These assumptions may have a significant effect on the reported fair values of assets and liabilities and the related income and expense. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

Other Real Estate Owned

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal of OREO are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other OREO.

Deferred Tax Asset Valuation

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2018. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

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Average Balance Sheet and Interest Rates

	Year ended December 31			
	2018		2017	
(Dollars in thousands)	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
Loans and loans held for sale	$ 457,610	4.76%	$ 442,101	4.70%
Securities - taxable	181,485	2.23%	197,108	2.15%
Securities - tax-exempt (a)	71,065	4.11%	69,881	5.07%
Total securities	252,550	2.76%	266,989	2.91%
Federal funds sold	28,689	1.93%	32,342	1.05%
Interest bearing bank deposits	31,339	1.81%	41,317	1.04%
Total interest-earning assets	770,188	3.88%	782,749	3.75%
Deposits:				
NOW	125,533	0.34%	125,935	0.20%
Savings and money market	220,810	0.39%	230,121	0.37%
Certificates of deposits	184,010	1.27%	198,457	1.18%
Total interest-bearing deposits	530,353	0.68%	554,513	0.62%
Short-term borrowings	2,634	0.68%	3,476	0.52%
Long-term debt	1,022	4.50%	3,217	3.89%
Total interest-bearing liabilities	534,009	0.69%	561,206	0.64%
Net interest income and margin (a)	$ 26,183	3.40%	$ 25,731	3.29%

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures .

RESULTS OF OPERATIONS

Net Interest Income and Margin

Net interest income (tax-equivalent) was $26.2 million in 2018, compared to $25.7 million in 2017. This increase was primarily due to loan growth and improved yields on interest-earning assets.

The tax-equivalent yield on total interest-earning assets increased by 13 basis points in 2018 from 2017 to 3.88%. Expansion of our earning asset yields was primarily driven by loan growth and recent increases in short-term market interest rates, which positively impacted the yields on our short-term assets, including federal funds sold and interest bearing bank deposits. This expansion was partially offset by a decrease in the tax-equivalent yield on tax-exempt available-for-sale securities due to a reduction in the Company s statutory federal tax rate from 34% to 21%.

The cost of total interest-bearing liabilities increased 5 basis points in 2018 from 2017 to 0.69%. The increase in our funding costs was primarily due to higher prevailing market interest rates.

The Company continues to deploy various asset liability management strategies to manage its risk to interest rate fluctuations. The Company s net interest margin could experience pressure due to reduced earning asset yields during the extended period of low interest rates, increased competition for quality loan opportunities, and possible increases in our costs of funds, if the Federal Reserve continues its gradual increase in interest rates. The Company anticipates that this challenging, competitive environment will continue in 2019. However, the Company believes our net interest income should continue to increase in 2019 compared to 2018 primarily due to an increase in average loan balances.

Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, in management s evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The Company recorded no provision for loan losses in 2018 and a negative provision for loan losses of $0.3 million for the year ended December 31, 2017.

Net recoveries were $33 thousand, or 0.01% of average loans and $0.4 million, or 0.09% of average loans, for the years ended December 31, 2018 and 2017, respectively. The Company recognized a recovery of $0.4 million from the payoff of two nonperforming commercial loans during 2017.

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Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes to be appropriate to adequately cover probable losses in the loan portfolio. The Company s allowance for loan losses to total loans decreased to 1.00% at December 31, 2018 from 1.05% at December 31, 2017. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2018. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are believed adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgment and are therefore approximate and imprecise. Factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions exist which may negatively and materially affect our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

Noninterest Income

(Dollars in thousands)	Year ended December 31 2018	2017
Service charges on deposit accounts	$ 749	$ 746
Mortgage lending	655	777
Bank-owned life insurance	435	442
Securities gains, net		51
Other	1,486	1,425
Total noninterest income	$ 3,325	$ 3,441

The Company s income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing of mortgage loans. Origination income, net, is comprised of gains or losses from the sale of the mortgage loans originated, origination fees, underwriting fees and other fees associated with the origination of loans, which are netted against the commission expense associated with these originations. The Company s normal practice is to originate mortgage loans for sale in the secondary market and to either sell or retain the MSRs when the loan is sold.

MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Servicing fee income is reported net of any related amortization expense.

The Company evaluates MSRs for impairment on a quarterly basis. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group s aggregate fair value, a valuation allowance for that group is established. The valuation allowance is adjusted as the fair value changes. An increase in mortgage interest rates typically results in an increase in the fair value of the MSRs while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSRs.

The following table presents a breakdown of the Company s mortgage lending income for 2018 and 2017.

(Dollars in thousands)	Year ended December 31 2018	2017
Origination income	$ 311	$ 504
Servicing fees, net	344	272
Decrease in MSR valuation allowance		1
Total mortgage lending income	$ 655	$ 777

The decrease in mortgage lending income was primarily due to a decrease in the volume of mortgage loans originated and sold as refinance activity declined. The decrease in origination income was partially offset by an increase in servicing fees, net, as MSR amortization expense decreased.

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Noninterest Expense

		Year ended December 31	
(Dollars in thousands)		**2018**	**2017**
Salaries and benefits	$	10,653	$ 10,011
Net occupancy and equipment		1,465	1,471
Professional fees		902	966
FDIC and other regulatory assessments		310	346
Other		4,544	3,990
Total noninterest expense	$	17,874	$ 16,784

The increase in salaries and benefits expense reflects an increase in the number of full-time equivalent employees and routine annual increases.

The increase in other noninterest expense was primarily due to a $0.4 million loss related to a misappropriation of assets for which the Company filed a claim with its insurance provider. In March 2019, the Company received a settlement of $0.3 million from its insurance provider related to this claim.

Income Tax Expense

Income tax expense was $2.2 million in 2018 compared to $3.6 million in 2017. The Company s effective income tax rate was 19.84% in 2018, compared to 31.67% in 2017. The decrease was mainly due to decrease in effect tax rate related to the 2017 Tax Cuts and Jobs Act which lowered the Company s statutory federal tax rate from 34% to 21% and required the Company to remeasure the value of its net deferred tax assets by $0.4 million as of December 31, 2017.

BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $239.8 million at December 31, 2018, a decrease of $17.9 million, or 7%, compared to $257.7 million as of December 31, 2017. This decline reflects a decrease in the amortized cost basis of securities available-for-sale of $13.6 million as proceeds from principal repayments on mortgage-backed securities were not reinvested and a decrease in the fair value of securities available-for-sale of $4.3 million. The average tax-equivalent yields earned on total securities were 2.76% in 2018 and 2.91% in 2017.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2018 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities (RMBS) because the mortgages underlying the securities may be called or prepaid with or without penalty.

			December 31, 2018		
(Dollars in thousands)	**1 year**	**1 to 5**	**5 to 10**	**After 10**	**Total**

		or less	years	years	years	Fair Value
Agency obligations	$	14,437	19,865	16,869		51,171
Agency RMBS				8,368	110,230	118,598
State and political subdivisions			3,682	7,726	58,624	70,032
Total available-for-sale	$	14,437	23,547	32,963	168,854	239,801
Weighted average yield:						
Agency obligations		1.96%	1.71%	2.11%		1.91%
Agency RMBS				2.49%	2.50%	2.50%
State and political subdivisions			3.87%	3.02%	3.22%	3.23%
Total available-for-sale		1.96%	2.05%	2.42%	2.75%	2.59%

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Loans

		December 31				
(In thousands)		**2018**	**2017**	**2016**	**2015**	**2014**
Commercial and industrial	$	63,467	59,086	49,850	52,479	54,329
Construction and land development		40,222	39,607	41,650	43,694	37,298
Commercial real estate		261,896	239,033	220,439	203,853	192,006
Residential real estate		102,597	106,863	110,855	116,673	107,641
Consumer installment		9,295	9,588	8,712	10,220	12,335
Total loans		477,477	454,177	431,506	426,919	403,609
Less: unearned income		(569)	(526)	(560)	(509)	(655)
Loans, net of unearned income	$	476,908	453,651	430,946	426,410	402,954

Total loans, net of unearned income, were $476.9 million at December 31, 2018, an increase of $23.3 million, or 5%, from $453.7 million at December 31, 2017. Four loan categories represented the majority of the loan portfolio at December 31, 2018: commercial real estate mortgage loans (55%), residential real estate mortgage loans (22%), commercial and industrial loans (13%) and construction and land development loans (8%). Approximately 22% of the Company s commercial real estate loans were classified as owner-occupied at December 31, 2018.

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately $12.3 million, or 3%, and $12.6 million, or 3%, of total loans, net of unearned income at December 31, 2018 and 2017, respectively. For residential real estate mortgage loans with a consumer purpose, approximately $0.5 million and $2.1 million required interest-only payments at December 31, 2018 and 2017, respectively. The Company s residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

Purchased loan participations included in the Company s loan portfolio were approximately $5.4 million and $1.4 million as of December 31, 2018 and 2017, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company s normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described under Critical Accounting Policies Allowance for Loan Losses .

The average yield earned on loans and loans held for sale was 4.76% in 2018 and 4.70% in 2017.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the effects of current economic conditions on our borrowers cash flows, real estate market sales volumes, valuations, and availability and cost of financing for properties, real estate industry concentrations, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of applicable laws and regulations.

The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers financial positions. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit a bank s credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital accounts; or 20% of capital accounts, if loans in excess of 10% are fully secured. Under these regulations, we are prohibited from having secured loan relationships in excess of approximately $19.3 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of $17.4 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2018, the Bank had no loan relationships exceeding our internal limit.

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We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank s total risk-based capital at December 31, 2018 (and related balances at December 31, 2017).

	December 31	
(In thousands)	**2018**	**2017**
Hotel/motel	$ 47,936	$ 22,384
Lessors of 1-4 family residential properties	46,374	47,323
Multi-family residential properties	40,455	52,167
Shopping centers	35,789	39,966
Office buildings	25,421	24,483

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company s estimate of probable losses in the loan portfolio. As of December 31, 2018 and 2017, respectively, the allowance for loan losses was $4.8 million which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under Critical Accounting Policies .

A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2018 is presented below.

	Year ended December 31				
(Dollars in thousands)	**2018**	**2017**	**2016**	**2015**	**2014**
Allowance for loan losses:					
Balance at beginning of period	$ 4,757	4,643	4,289	4,836	5,268
Charge-offs:					
Commercial and industrial	(52)	(449)	(97)	(100)	(46)
Construction and land development					(235)
Commercial real estate	(38)		(194)	(866)	
Residential real estate	(26)	(107)	(182)	(89)	(438)
Consumer installment	(52)	(40)	(67)	(59)	(89)
Total charge-offs	(168)	(596)	(540)	(1,114)	(808)
Recoveries:					
Commercial and industrial	70	461	29	22	71

Construction and land development		347	1,212	17	8
Commercial real estate	19				119
Residential real estate	79	115	127	313	112
Consumer installment	33	87	11	15	16
Total recoveries	201	1,010	1,379	367	326
Net recoveries (charge-offs)	33	414	839	(747)	(482)
Provision for loan losses		(300)	(485)	200	50
Ending balance	$ 4,790	4,757	4,643	4,289	4,836
as a % of loans	1.00 %	1.05	1.08	1.01	1.20
as a % of nonperforming loans	2,691 %	160	196	158	433
Net (recoveries) charge-offs as a % of average loans	(0.01) %	(0.09)	(0.19)	0.18	0.12

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As noted under Critical Accounting Policies , management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.00% at December 31, 2018, compared to 1.05% at December 31, 2017. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net recoveries were $33 thousand, or 0.01%, of average loans in 2018, compared to recoveries of $0.4 million, or 0.09%, in 2017. In 2017, the Company recognized a recovery of $0.4 million from the payoff of two nonperforming commercial loans.

Our regulators, as an integral part of their examination process, periodically review the Company s allowance for loan losses, and may require the Company to make additional provisions to the allowance for loan losses based on their judgment about information available to them at the time of their examinations.

Nonperforming Assets

At December 31, 2018 the Company had $0.4 million in nonperforming assets compared to $3.0 million at December 31, 2017. The decrease in nonperforming assets was primarily due to the resolution of two nonperforming commercial real estate loans with a recorded investment of $2.1 million at December 31, 2017.

The table below provides information concerning total nonperforming assets and certain asset quality ratios.

					December 31	
(Dollars in thousands)		**2018**	**2017**	**2016**	**2015**	**2014**
Nonperforming assets:						
Nonperforming (nonaccrual) loans	$	178	2,972	2,370	2,714	1,117
Other real estate owned		172		152	252	534
Total nonperforming assets	$	350	2,972	2,522	2,966	1,651
as a % of loans and other real estate owned		0.07 %	0.66	0.59	0.70	0.41
as a % of total assets		0.04 %	0.35	0.30	0.36	0.21
Nonperforming loans as a % of total loans		0.04 %	0.66	0.55	0.64	0.28
Accruing loans 90 days or more past due	$					

The table below provides information concerning the composition of nonaccrual loans at December 31, 2018 and 2017, respectively.

(In thousands)		December 31 2018	2017
Nonaccrual loans:			
Commercial and industrial	$		31
Commercial real estate			2,188
Residential real estate		178	739
Consumer installment			14
Total nonaccrual loans / nonperforming loans	$	178	2,972

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2018, the Company had $0.2 million in loans on nonaccrual, compared to $3.0 million at December 31, 2017.

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Due to the weakening credit status of a borrower, the Company may elect to formally restructure certain loans to facilitate a repayment plan that minimizes the potential losses that we might incur. Restructured loans, or troubled debt restructurings (TDRs), are classified as impaired loans, and if the loans are on nonaccrual status as of the date of restructuring, the loans are included in the nonaccrual loan balances noted above. Nonaccrual loan balances do not include loans that have been restructured that were performing as of the restructure date. At December 31, 2018 and 2017, the Company had $0.2 and $0.5 million, respectively, in accruing TDRs.

At December 31, 2018 and 2017, there were no loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of OREO at December 31, 2018 and 2017, respectively.

(In thousands)	December 31 2018	2017
Other real estate owned:		
Residential	$ 172	
Total other real estate owned	$ 172	

Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower s ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company s primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to $6.5 million, or 1.4% of total loans at December 31, 2018, compared to $5.7 million, or 1.3% of total loans at December 31, 2017.

The table below provides information concerning the composition of potential problem loans at December 31, 2018 and 2017, respectively.

(In thousands)	December 31 2018	2017
Potential problem loans:		
Commercial and industrial	$ 522	119
Construction and land development	741	468
Commercial real estate	688	733
Residential real estate	4,506	4,253
Consumer installment	71	78
Total potential problem loans	$ 6,528	5,651

At December 31, 2018, approximately $0.7 million or 10.4% of total potential problem loans were past due at least 30 but less than 90 days.

The following table is a summary of the Company s performing loans that were past due at least 30 days but less than 90 days as of December 31, 2018 and 2017, respectively.

(In thousands)		December 31 2018	2017
Performing loans past due 30 to 89 days:			
Commercial and industrial	$	100	8
Construction and land development		225	
Commercial real estate			
Residential real estate		1,740	1,058
Consumer installment		41	57
Total performing loans past due 30 to 89 days	$	2,106	1,123

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Deposits

(In thousands)		December 31 2018	2017
Noninterest bearing demand	$	201,648	193,917
NOW		120,769	146,999
Money market		161,464	173,251
Savings		59,075	55,421
Certificates of deposit under $100,000		62,207	69,960
Certificates of deposit and other time deposits of $100,000 or more		108,620	107,711
Brokered certificates of deposit		10,410	10,400
Total deposits	$	724,193	757,659

Total deposits were $724.2 million and $757.7 million at December 31, 2018 and 2017, respectively. Decreases of $41.2 million in interest-bearing deposits were partially offset by increases in noninterest-bearing deposits of $7.7 million during 2018. Of the $41.2 million decrease in interest-bearing deposits, $28.0 million was due to fluctuations in public depositor account balances.

The average rates paid on total interest-bearing deposits were 0.68% in 2018 and 0.62% in 2017. Noninterest bearing deposits were 28% and 26% of total deposits at December 31, 2018 and 2017, respectively.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity of one year or less. The Bank had available federal fund lines totaling $41.0 million with none outstanding at December 31, 2018 and 2017, respectively. Securities sold under agreements to repurchase totaled $2.3 million and $2.7 million at December 31, 2018 and 2017, respectively.

The average rates paid on short-term borrowings was 0.68% and 0.52% in 2018 and 2017, respectively. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the two-year period ended December 31, 2018 is included in Note 9 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes junior subordinated debentures related to trust preferred securities. The Company had $3.2 million in junior subordinated debentures related to trust preferred securities outstanding at December 31, 2017. On April 27, 2018, the Company formally redeemed all of the issued and outstanding junior subordinated debentures, including accrued and unpaid distributions, and the Trust formally redeemed all of the issued and outstanding trust preferred securities and common securities at par, including accrued and unpaid distributions. The junior subordinated debentures would have matured on December 31, 2033 and were redeemable since December 31, 2008.

The average rates paid on long-term debt were 4.50% in 2018 and 3.89% in 2017.

CAPITAL ADEQUACY

The Company s consolidated stockholders equity was $89.1 million and $86.9 million as of December 31, 2018 and 2017, respectively. The change from December 31, 2017 was primarily driven by net earnings of $8.8 million, partially offset by cash dividends paid of $3.5 million and an other comprehensive loss due to the change in unrealized losses on securities available-for-sale, net of tax, of $3.2 million.

The Bank s Tier 1 leverage ratio was 11.33%, Common Equity Tier 1 (CET1) risk-based capital ratio was 16.49%, Tier 1 risk-based capital ratio was 16.49%, and total risk-based capital ratio was 17.38% at December 31, 2018. These ratios exceed the minimum regulatory capital percentages of 5.0% for Tier 1 leverage ratio, 6.5% for CET1 risk-based capital ratio, 8.0% for Tier 1 risk-based capital ratio, and 10.0% for total risk-based capital ratio to be considered well capitalized. Based on current regulatory standards, the Bank is classified as well capitalized.

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MARKET AND LIQUIDITY RISK MANAGEMENT

Management s objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. The Bank s Asset Liability Management Committee (ALCO) is charged with the responsibility of monitoring these policies, which are designed to ensure an acceptable asset/liability composition. Two critical areas of focus for ALCO are interest rate risk and liquidity risk management.

Interest Rate Risk Management

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates because assets and liabilities may mature or reprice at different times. For example, if liabilities reprice faster than assets, and interest rates are generally rising, earnings will initially decline. In addition, assets and liabilities may reprice at the same time but by different amounts. For example, when the general level of interest rates is rising, the Company may increase rates paid on interest bearing demand deposit accounts and savings deposit accounts by an amount that is less than the general increase in market interest rates. Also, short-term and long-term market interest rates may change by different amounts. For example, a flattening yield curve may reduce the interest spread between new loan yields and funding costs. Further, the remaining maturity of various assets and liabilities may shorten or lengthen as interest rates change. For example, if long-term mortgage interest rates decline sharply, mortgage-backed securities in the securities portfolio may prepay earlier than anticipated, which could reduce earnings. Interest rates may also have a direct or indirect effect on loan demand, loan losses, mortgage origination volume, the fair value of MSRs and other items affecting earnings.

ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements used to help manage interest rate sensitivity include an earnings simulation and an economic value of equity model.

Earnings simulation. Management believes that interest rate risk is best estimated by our earnings simulation modeling. On at least a quarterly basis, the following 12 month time period is simulated to determine a baseline net interest income forecast and the sensitivity of this forecast to changes in interest rates. The baseline forecast assumes an unchanged or flat interest rate environment. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and other factors in order to produce various earnings simulations and estimates.

To help limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income from gradual changes in interest rates. For changes up or down in rates from management s flat interest rate forecast over the next 12 months, policy limits for net interest income variances are as follows:

+/- 20% for a gradual change of 400 basis points

+/- 15% for a gradual change of 300 basis points

+/- 10% for a gradual change of 200 basis points

+/- 5% for a gradual change of 100 basis points

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The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates up or down when compared to the baseline net interest income forecast at December 31, 2018.

Changes in Interest Rates	Net Interest Income % Variance
400 basis points	(3.47) %
300 basis points	(2.13)
200 basis points	(1.16)
100 basis points	(0.82)
(100) basis points	0.92
(200) basis points	0.08
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2018, our earnings simulation model indicated that we were in compliance with the policy guidelines noted above.

Economic Value of Equity. Economic value of equity (EVE) measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case EVE. In contrast with our earnings simulation model which evaluates interest rate risk over a 12 month timeframe, EVE uses a terminal horizon which allows for the re-pricing of all assets, liabilities, and off-balance sheet items. Further, EVE is measured using values as of a point in time and does not reflect any actions that ALCO might take in responding to or anticipating changes in interest rates, or market and competitive conditions.

To help limit interest rate risk, we have stated policy guidelines for an instantaneous basis point change in interest rates, such that our EVE should not decrease from our base case by more than the following:

45% for an instantaneous change of +/- 400 basis points

35% for an instantaneous change of +/- 300 basis points

25% for an instantaneous change of +/- 200 basis points

15% for an instantaneous change of +/- 100 basis points

The following table reports the variance of EVE assuming an immediate change in interest rates up or down when compared to the baseline EVE at December 31, 2018.

Changes in Interest Rates	EVE % Variance

400 basis points	(21.50) %
300 basis points	(15.62)
200 basis points	(10.03)
100 basis points	(4.56)
(100) basis points	0.45
(200) basis points	(5.77)
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2018, our EVE model indicated that we were in compliance with the policy guidelines noted above.

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Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors, including market perceptions. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types of assets and liabilities may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company s established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2018 and 2017, the Company had no derivative contracts to assist in managing interest rate sensitivity.

Liquidity Risk Management

Liquidity is the Company s ability to convert assets into cash equivalents in order to meet daily cash flow requirements, primarily for deposit withdrawals, loan demand and maturing obligations. Without proper management of its liquidity, the Company could experience higher costs of obtaining funds due to insufficient liquidity, while excessive liquidity can lead to a decline in earnings due to the opportunity cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels: at the Company and at the Bank. The management of liquidity at both levels is essential, because the Company and the Bank have different funding needs and sources, are separate legal entities, and each are subject to regulatory guidelines and requirements.

The primary source of funding and the primary source of liquidity for the Company includes dividends received from the Bank, and secondarily proceeds from the issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the accompanying consolidated balance sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB s advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of December 31, 2018, the Bank had a remaining available line of credit with the FHLB totaling $238.6 million. As of December 31, 2018, the Bank also had $41.0 million of federal funds lines,

with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

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The following table presents additional information about our contractual obligations as of December 31, 2018, which by their terms had contractual maturity and termination dates subsequent to December 31, 2018:

			Payments due by period			
(Dollars in thousands)		**Total**	**1 year or less**	**1 to 3 years**	**3 to 5 years**	**More than 5 years**
Contractual obligations:						
Deposit maturities (1)	$	724,193	651,319	45,518	27,356	
Operating lease obligations		718	152	161	120	285
Total	$	724,911	651,471	45,679	27,476	285

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the 1 year or less column

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next 12 months.

Off-Balance Sheet Arrangements

At December 31, 2018, the Bank had outstanding standby letters of credit of $7.0 million and unfunded loan commitments outstanding of $61.9 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

Residential mortgage lending and servicing activities

Since 2009, we have primarily sold residential mortgage loans in the secondary market to Fannie Mae while retaining the servicing of these loans. The sale agreements for these residential mortgage loans with Fannie Mae and other investors include various representations and warranties regarding the origination and characteristics of the residential mortgage loans. Although the representations and warranties vary among investors, they typically cover ownership of the loan, validity of the lien securing the loan, the absence of delinquent taxes or liens against the property securing the loan, compliance with loan criteria set forth in the applicable agreement, compliance with applicable federal, state, and local laws, among other matters.

As of December 31, 2018, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was $290.0 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or the documents we deliver are defective. Investors also may require the

repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

In 2018, as a result of the representation and warranty provisions contained in the Company s sale agreements with Fannie Mae, the Company was required to repurchase one loan with an aggregate principal balance of $53 thousand, which was current as to principal and interest at the time of repurchase. During 2017, the Company was required to repurchase three loans with an aggregate principal balance of $0.6 million that were current as to principal and interest at the time of repurchase. At December 31, 2018, the Company had no pending repurchase requests related to representation and warranty provisions.

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We service all residential mortgage loans originated and sold by us to Fannie Mae. As servicer, our primary duties are to: (1) collect payments due from borrowers; (2) advance certain delinquent payments of principal and interest; (3) maintain and administer any hazard, title, or primary mortgage insurance policies relating to the mortgage loans; (4) maintain any required escrow accounts for payment of taxes and insurance and administer escrow payments; and (5) foreclose on defaulted mortgage loans or take other actions to mitigate the potential losses to investors consistent with the agreements governing our rights and duties as servicer.

The agreement under which we act as servicer generally specifies a standard of responsibility for actions taken by us in such capacity and provides protection against expenses and liabilities incurred by us when acting in compliance with the respective servicing agreements. However, if we commit a material breach of our obligations as servicer, we may be subject to termination if the breach is not cured within a specified period following notice. The standards governing servicing and the possible remedies for violations of such standards are determined by servicing guides issued by Fannie Mae as well as the contract provisions established between Fannie Mae and the Bank. Remedies could include repurchase of an affected loan.

Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of December 31, 2018, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, the results of our quality control reviews, and the fact that 99% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

Effects of Inflation and Changing Prices

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution s performance than the effects of general levels of inflation.

CURRENT ACCOUNTING DEVELOPMENTS

The following Accounting Standards Updates (Updates or ASUs) have been issued by the FASB but are not yet effective.

ASU 2016-02, *Leases;*

ASU 2016-13, *Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments;*

ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities;*

ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework Changes to the Disclosure Requirements for Fair Value Measurement; and*

ASU 2018-15, *Intangibles Goodwill and Other Internal Use Software (Subtopic 350-40): Customer s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*.

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Information about these pronouncements is described in more detail below.

ASU 2016-02, *Leases,* requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. In July 2018, the FASB issued ASU 2018-10 and 2018-11, which are designed to make targeted improvements to and clarifications regarding ASU 2016-02. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The amendment should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently finalizing its evaluation of its lease obligations as potential lease assets and liabilities as defined by ASU 2016-02. Based on the Company s preliminary analysis of its existing lease contracts, it is estimated that the adoption of ASU 2016-02 will result in a right-of-use asset and a lease liability of approximately $0.6 million from operating leases, primarily from our facilities.

ASU 2016-13, *Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, amends guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, the new standard eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses using a broader range of information regarding past events, current conditions and forecasts assessing the collectability of cash flows. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP, however the new standard will require that credit losses be presented as an allowance rather than as a write-down. The new guidance affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public business entities that are SEC filers, the new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019, and early adoption is permitted beginning in 2019. Entities will apply the standard s provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company is planning to adopt the standard in the first quarter of 2020 and is continuing its implementation efforts through its Company-wide implementation team. This team has assigned roles and responsibilities, key tasks to complete, and a general timeline to be followed. The team meets periodically to discuss the latest developments and ensure progress is being made. The team has been working with an advisory consultant and is finalizing the methodologies that will be utilized, which will be followed by developing and documenting processes, controls, policies and disclosure requirements in preparation for performing a full parallel run. The Company s preliminary evaluation indicates the provisions of ASU No. 2016-13 are expected to impact the Company s Consolidated Financial Statements, in particular the level of the reserve for credit losses. The Company is continuing to evaluate the extent of the potential impact and expects that portfolio composition and economic conditions at the time of adoption will be a factor.

ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*, improves the transparency and understandability of information conveyed to financial statement users about an entity s risk management activities by better aligning the entity s financial reporting for hedging relationships with those risk management activities and reduces the complexity of and simplifies the application of hedge accounting by preparers. For public entities, the guidance is effective for fiscal years beginning after December 15, 2018, and interim periods therein; however, early adoption by all entities is permitted. The Company is currently evaluating this ASU to determine whether its provisions will enhance the Company s ability to employ risk management strategies, while improving the

transparency and understanding of those strategies for financial statement users.

ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework Changes to the Disclosure Requirements for Fair Value Measurement,* improves the disclosure requirements on fair value measurements by eliminating the requirements to disclose (i) the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy; (ii) the policy for timing of transfers between levels; and (iii) the valuation processes for Level 3 fair value measurements. This ASU also added specific disclosure requirements for fair value measurements for public entities including the requirement to disclose the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements.

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The amendments in this ASU are effective for all entities for fiscal years beginning after December 15, 2019, and all interim periods within those fiscal years. Early adoption is permitted upon issuance of the ASU. Entities are permitted to early adopt amendments that remove or modify disclosures and delay the adoption of the additional disclosures until their effective date. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

ASU 2018- 15, *Intangibles Goodwill and Other Internal Use Software (Subtopic 350-40): Customer s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract* aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include internal-use software license). This ASU requires entities to use the guidance in FASB ASC 350-40, Intangibles - Goodwill and Other - Internal Use Software, to determine whether to capitalize or expense implementation costs related to the service contract. This ASU also requires entities to (i) expense capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement; (ii) present the expense related to the capitalized implementation costs in the same line item on the income statement as fees associated with the hosting element of the arrangement; (iii) classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element; and (iv) present the capitalized implementation costs in the same balance sheet line item that a prepayment for the fees associated with the hosting arrangement would be presented.

The amendments in this ASU are effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

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Table 1 Explanation of Non-GAAP Financial Measures

In addition to results presented in accordance with GAAP, this annual report on Form 10-K includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation of total revenue and the calculation of the efficiency ratio.

The Company believes the presentation of net interest income on a tax-equivalent basis provides comparability of net interest income from both taxable and tax-exempt sources and facilitates comparability within the industry. Although the Company believes these non-GAAP financial measures enhance investors understanding of its business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliation of these non-GAAP financial measures from GAAP to non-GAAP is presented below.

		Year ended December 31				
(In thousands)		**2018**	**2017**	**2016**	**2015**	**2014**
Net interest income (GAAP)	$	25,570	24,526	22,732	22,718	21,453
Tax-equivalent adjustment		613	1,205	1,276	1,342	1,288
Net interest income (Tax-equivalent)	$	26,183	25,731	24,008	24,060	22,741

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Table 2 - Selected Financial Data

(Dollars in thousands, except per share amounts)		Year ended December 31 2018	2017	2016	2015	2014
Income statement						
Tax-equivalent interest income (a)	$	29,859	29,325	28,092	28,495	28,105
Total interest expense		3,676	3,594	4,084	4,435	5,364
Tax equivalent net interest income (a)		26,183	25,731	24,008	24,060	22,741
Provision for loan losses			(300)	(485)	200	50
Total noninterest income		3,325	3,441	3,383	4,532	3,933
Total noninterest expense		17,874	16,784	15,348	16,372	15,104
Net earnings before income taxes and tax-equivalent adjustment		11,634	12,688	12,528	12,020	11,520
Tax-equivalent adjustment		613	1,205	1,276	1,342	1,288
Income tax expense		2,187	3,637	3,102	2,820	2,784
Net earnings	$	8,834	7,846	8,150	7,858	7,448
Per share data:						
Basic and diluted net earnings	$	2.42	2.15	2.24	2.16	2.04
Cash dividends declared	$	0.96	0.92	0.90	0.88	0.86
Weighted average shares outstanding						
Basic and diluted		3,643,780	3,643,616	3,643,504	3,643,428	3,643,278
Shares outstanding		3,643,868	3,643,668	3,643,523	3,643,478	3,643,328
Book value	$	24.44	23.85	22.55	21.94	20.80
Common stock price						
High	$	53.50	40.25	31.31	30.39	25.80
Low		28.88	30.75	24.56	23.15	22.10
Period-end	$	31.66	38.90	31.31	29.62	23.64
To earnings ratio		13.08 x	18.09	13.98	13.78	11.59
To book value		130 %	163	139	135	114
Performance ratios:						
Return on average equity		10.14 %	9.17	9.65	9.98	10.53
Return on average assets		1.08 %	0.94	0.98	0.98	0.97
Dividend payout ratio		39.67 %	42.79	40.18	40.74	42.16
Average equity to average assets		10.63 %	10.30	10.14	9.79	9.17
Asset Quality:						
Allowance for loan losses as a % of:						
Loans		1.00 %	1.05	1.08	1.01	1.20
Nonperforming loans		2,691 %	160	196	158	433
Nonperforming assets as a % of:						
Loans and other real estate owned		0.07 %	0.66	0.59	0.70	0.41
Total assets		0.04 %	0.35	0.30	0.36	0.21
Nonperforming loans as % of loans		0.04 %	0.66	0.55	0.64	0.28

Net (recoveries) charge-offs as a % of average loans	(0.01) %	(0.09)	(0.19)	0.18	0.12
Capital Adequacy:					
CET 1 risk-based capital ratio	16.49 %	16.42	16.44	15.28	na
Tier 1 risk-based capital ratio	16.49 %	16.98	17.00	16.57	17.45
Total risk-based capital ratio	17.38 %	17.91	17.95	17.44	18.54
Tier 1 leverage ratio	11.33 %	10.95	10.27	10.35	10.32
Other financial data:					
Net interest margin (a)	3.40 %	3.29	3.05	3.17	3.15
Effective income tax rate	19.84 %	31.67	27.57	26.41	27.21
Efficiency ratio (b)	60.57 %	57.53	56.03	57.26	56.62
Selected period end balances:					
Securities	$ 239,801	257,697	243,572	241,687	267,603
Loans, net of unearned income	476,908	453,651	430,946	426,410	402,954
Allowance for loan losses	4,790	4,757	4,643	4,289	4,836
Total assets	818,077	853,381	831,943	817,189	789,231
Total deposits	724,193	757,659	739,143	723,627	693,390
Long-term debt		3,217	3,217	7,217	12,217
Total stockholders equity	89,055	86,906	82,177	79,949	75,799

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures .

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

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Table 3 - Average Balance and Net Interest Income Analysis

	Year ended December 31					
	2018			2017		
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Interest-earning assets:						
Loans and loans held for sale (1)	$ 457,610	$ 21,766	4.76%	$ 442,101	$ 20,781	4.70%
Securities - taxable	181,485	4,051	2.23%	197,108	4,229	2.15%
Securities - tax-exempt (2)	71,065	2,921	4.11%	69,881	3,545	5.07%
Total securities	252,550	6,972	2.76%	266,989	7,774	2.91%
Federal funds sold	28,689	554	1.93%	32,342	341	1.05%
Interest bearing bank deposits	31,339	567	1.81%	41,317	429	1.04%
Total interest-earning assets	770,188	29,859	3.88%	782,749	29,325	3.75%
Cash and due from banks	13,802			13,386		
Other assets	35,539			34,291		
Total assets	$ 819,529			$ 830,426		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 125,533	428	0.34%	$ 125,935	248	0.20%
Savings and money market	220,810	855	0.39%	230,121	852	0.37%
Certificates of deposits	184,010	2,329	1.27%	198,457	2,351	1.18%
Total interest-bearing deposits	530,353	3,612	0.68%	554,513	3,451	0.62%
Short-term borrowings	2,634	18	0.68%	3,476	18	0.52%
Long-term debt	1,022	46	4.50%	3,217	125	3.89%

Total interest-bearing liabilities	534,009	3,676	0.69%	561,206	3,594	0.64%
Noninterest-bearing deposits	195,924			180,891		
Other liabilities	2,489			2,788		
Stockholders equity	87,107			85,541		
Total liabilities and and stockholders equity	$ 819,529			$ 830,426		
Net interest income and margin		$ 26,183	3.40%		$ 25,731	3.29%

(1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.
(2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 21% for 2018 and 34% for prior years.

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Table 4 - Volume and Rate Variance Analysis

	Years ended December 31, 2018 vs. 2017			Years ended December 31, 2017 vs. 2016		
	Net	Due to change in		Net	Due to change in	
(Dollars in thousands)	Change	Rate (2)	Volume (2)	Change	Rate (2)	Volume (2)
Interest income:						
Loans and loans held for sale	$ 985	247	738	$ 328	(138)	466
Securities - taxable	(178)	171	(349)	947	298	649
Securities - tax-exempt (1)	(624)	(673)	49	(209)	(279)	70
Total securities	(802)	(502)	(300)	738	19	719
Federal funds sold	213	284	(71)	92	272	(180)
Interest bearing bank deposits	138	319	(181)	75	373	(298)
Total interest income	$ 534	348	186	$ 1,233	526	707
Interest expense:						
Deposits:						
NOW	$ 180	181	(1)	$ (85)	(93)	8
Savings and money market	3	39	(36)	(38)	(29)	(9)
Certificates of deposits	(22)	161	(183)	(267)	(99)	(168)
Total interest-bearing deposits	161	381	(220)	(390)	(221)	(169)
Short-term borrowings		6	(6)	3		3
Long-term debt	(79)	20	(99)	(103)	24	(127)
Total interest expense	82	407	(325)	(490)	(197)	(293)
Net interest income	$ 452	(59)	511	$ 1,723	723	1,000

(1) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 21% for 2018 and 34% for prior years.
(2) Changes that are not solely a result of volume or rate have been allocated to volume.

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Table 5 - Loan Portfolio Composition

		December 31				
(In thousands)		**2018**	**2017**	**2016**	**2015**	**2014**
Commercial and industrial	$	63,467	59,086	49,850	52,479	54,329
Construction and land development		40,222	39,607	41,650	43,694	37,298
Commercial real estate		261,896	239,033	220,439	203,853	192,006
Residential real estate		102,597	106,863	110,855	116,673	107,641
Consumer installment		9,295	9,588	8,712	10,220	12,335
Total loans		477,477	454,177	431,506	426,919	403,609
Less: unearned income		(569)	(526)	(560)	(509)	(655)
Loans, net of unearned income		476,908	453,651	430,946	426,410	402,954
Less: allowance for loan losses		(4,790)	(4,757)	(4,643)	(4,289)	(4,836)
Loans, net	$	472,118	448,894	426,303	422,121	398,118

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Table 6 - Loan Maturities and Sensitivities to Changes in Interest Rates

December 31, 2018

(Dollars in thousands)		**1 year or less**	**1 to 5 years**	**After 5 years**	**Total**	**Adjustable Rate**	**Fixed Rate**	**Total**
Commercial and industrial	$	37,237	9,600	16,630	63,467	21,505	41,962	63,467
Construction and land development		22,910	16,420	892	40,222	16,016	24,206	40,222
Commercial real estate		34,196	98,083	129,617	261,896	11,932	249,964	261,896
Residential real estate		9,654	26,347	66,596	102,597	50,992	51,605	102,597
Consumer installment		3,359	5,372	564	9,295	422	8,873	9,295
Total loans	$	107,356	155,822	214,299	477,477	100,867	376,610	477,477

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Table 7 - Allowance for Loan Losses and Nonperforming Assets

	Year ended December 31				
(Dollars in thousands)	**2018**	**2017**	**2016**	**2015**	**2014**
Allowance for loan losses:					
Balance at beginning of period	$ 4,757	4,643	4,289	4,836	5,268
Charge-offs:					
Commercial and industrial	(52)	(449)	(97)	(100)	(46)
Construction and land development					(235)
Commercial real estate	(38)		(194)	(866)	
Residential real estate	(26)	(107)	(182)	(89)	(438)
Consumer installment	(52)	(40)	(67)	(59)	(89)
Total charge-offs	(168)	(596)	(540)	(1,114)	(808)
Recoveries:					
Commercial and industrial	70	461	29	22	71
Construction and land development		347	1,212	17	8
Commercial real estate	19				119
Residential real estate	79	115	127	313	112
Consumer installment	33	87	11	15	16
Total recoveries	201	1,010	1,379	367	326
Net recoveries (charge-offs)	33	414	839	(747)	(482)
Provision for loan losses		(300)	(485)	200	50
Ending balance	$ 4,790	4,757	4,643	4,289	4,836
as a % of loans	1.00 %	1.05	1.08	1.01	1.20
as a % of nonperforming loans	2,691 %	160	196	158	433
Net (recoveries) charge-offs as % of average loans	(0.01) %	(0.09)	(0.19)	0.18	0.12
Nonperforming assets:					
Nonaccrual/nonperforming loans	$ 178	2,972	2,370	2,714	1,117
Other real estate owned	172		152	252	534
Total nonperforming assets	$ 350	2,972	2,522	2,966	1,651
as a % of loans and other real estate owned	0.07 %	0.66	0.59	0.70	0.41
as a % total assets	0.04 %	0.35	0.30	0.36	0.21
Nonperforming loans as a % of total loans	0.04 %	0.66	0.55	0.64	0.28
Accruing loans 90 days or more past due	$				

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Table 8 - Allocation of Allowance for Loan Losses

	December 31									
	2018		2017		2016		2015		2014	
llars in thousands)	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%
mmercial and strial	$ 778	13.3	$ 653	13.0	$ 540	11.6	$ 523	12.3	$ 639	1
struction and land elopment	700	8.4	734	8.7	812	9.7	669	10.2	974	
mmercial real estate	2,218	54.9	2,126	52.7	2,071	51.0	1,879	47.8	1,928	4
dential real estate	946	21.5	1,071	23.5	1,107	25.7	1,059	27.3	1,119	2
sumer installment	148	1.9	173	2.1	113	2.0	159	2.4	176	
l allowance for losses	$ 4,790		$ 4,757		$ 4,643		$ 4,289		$ 4,836	

* Loan balance in each category expressed as a percentage of total loans.

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Table 9 - CDs and Other Time Deposits of $100,000 or More

(Dollars in thousands)	**December 31, 2018**
Maturity of:	
3 months or less	$ 21,837
Over 3 months through 6 months	10,828
Over 6 months through 12 months	39,008
Over 12 months	47,357
Total CDs and other time deposits of $100,000 or more (1)	$ 119,030

(1) Includes brokered certificates of deposit.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information called for by ITEM 7A is set forth in ITEM 7 under the caption Market and Liquidity Risk Management and is incorporated herein by reference.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Auburn National Bancorporation, Inc.

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Auburn National Bancorporation, Inc. and its subsidiaries (the Company) as of December 31, 2018 and 2017, the related consolidated statements of earnings, comprehensive income, stockholders equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements and schedules (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company s internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 12, 2019 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on the Company s consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Elliott Davis, LLC

We have served as the Company s auditor since 2015.

Greenville, South Carolina

March 12, 2019

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	December 31	
(Dollars in thousands, except share data)	**2018**	**2017**
Assets:		
Cash and due from banks	$ 13,043	$ 12,942
Federal funds sold	26,918	41,540
Interest bearing bank deposits	25,115	51,046
Cash and cash equivalents	65,076	105,528
Securities available-for-sale	239,801	257,697
Loans held for sale	383	1,922
Loans, net of unearned income	476,908	453,651
Allowance for loan losses	(4,790)	(4,757)
Loans, net	472,118	448,894
Premises and equipment, net	13,596	13,791
Bank-owned life insurance	18,765	18,330
Other assets	8,338	7,219
Total assets	$ 818,077	$ 853,381
Liabilities:		
Deposits:		
Noninterest-bearing	$ 201,648	$ 193,917
Interest-bearing	522,545	563,742
Total deposits	724,193	757,659
Federal funds purchased and securities sold under agreements to repurchase	2,300	2,658
Long-term debt		3,217
Accrued expenses and other liabilities	2,529	2,941
Total liabilities	729,022	766,475
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; issued shares - none		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,779	3,771

Retained earnings	95,635	90,299
Accumulated other comprehensive loss, net	(3,763)	(566)
Less treasury stock, at cost - 313,267 shares and 313,467 shares at December 31, 2018 and 2017, respectively	(6,635)	(6,637)
Total stockholders equity	89,055	86,906
Total liabilities and stockholders equity	$ 818,077	$ 853,381

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

	Year ended December 31	
(Dollars in thousands, except share and per share data)	**2018**	**2017**
Interest income:		
Loans, including fees	$ 21,766	$ 20,781
Securities:		
Taxable	4,051	4,229
Tax-exempt	2,308	2,340
Federal funds sold and interest bearing bank deposits	1,121	770
Total interest income	29,246	28,120
Interest expense:		
Deposits	3,612	3,451
Short-term borrowings	18	18
Long-term debt	46	125
Total interest expense	3,676	3,594
Net interest income	25,570	24,526
Provision for loan losses		(300)
Net interest income after provision for loan losses	25,570	24,826
Noninterest income:		
Service charges on deposit accounts	749	746
Mortgage lending	655	777
Bank-owned life insurance	435	442
Other	1,486	1,425
Securities gains, net		51
Total noninterest income	3,325	3,441
Noninterest expense:		
Salaries and benefits	10,653	10,011
Net occupancy and equipment	1,465	1,471
Professional fees	902	966
FDIC and other regulatory assessments	310	346
Other	4,544	3,990

Total noninterest expense		17,874		16,784
Earnings before income taxes		11,021		11,483
Income tax expense		2,187		3,637
Net earnings	$	8,834	$	7,846
Net earnings per share:				
Basic and diluted	$	2.42	$	2.15
Weighted average shares outstanding:				
Basic and diluted		3,643,780		3,643,616

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

	Year ended December 31	
(Dollars in thousands)	**2018**	**2017**
Net earnings	$ 8,834	$ 7,846
Other comprehensive (loss) income, net of tax:		
Unrealized net holding (loss) gain on all other securities	(3,197)	263
Reclassification adjustment for net gain on securities recognized in net earnings		(32)
Other comprehensive (loss) income	(3,197)	231
Comprehensive income	$ 5,637	$ 8,077

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Dollars in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Treasury stock	Total
Balance, December 31, 2016	3,957,135	$ 39	3,767	85,716	(708)	(6,637)	$ 82,177
Net earnings				7,846			7,846
Other comprehensive income					231		231
Reclassification of certain tax effects				89	(89)		
Cash dividends paid ($0.92 per share)				(3,352)			(3,352)
Sale of treasury stock (145 shares)			4				4
Balance, December 31, 2017	3,957,135	$ 39	$ 3,771	$ 90,299	$ (566)	$ (6,637)	$ 86,906
Net earnings				8,834			8,834
Other comprehensive loss					(3,197)		(3,197)
Cash dividends paid ($0.96 per share)				(3,498)			(3,498)
Sale of treasury stock (200 shares)			8			2	10
Balance, December 31, 2018	3,957,135	$ 39	$ 3,779	$ 95,635	$ (3,763)	$ (6,635)	$ 89,055

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	Year ended December 31	
(In thousands)	**2018**	**2017**
Cash flows from operating activities:		
Net earnings	$ 8,834	$ 7,846
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses		(300)
Depreciation and amortization	938	1,016
Premium amortization and discount accretion, net	2,025	2,133
Deferred tax expense	71	356
Net gain on securities available for sale		(51)
Net gain on sale of loans held for sale	(311)	(504)
Net gain on other real estate owned		(5)
Loans originated for sale	(27,681)	(29,796)
Proceeds from sale of loans	29,323	29,651
Increase in cash surrender value of bank owned life insurance	(435)	(442)
Net (increase) decrease in other assets	(221)	592
Net decrease in accrued expenses and other liabilities	(402)	(1,095)
Net cash provided by operating activities	$ 12,141	$ 9,401
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	8,770	10,374
Proceeds from maturities of securities available-for-sale	22,673	32,945
Purchase of securities available-for-sale	(19,841)	(59,160)
Increase in loans, net	(24,749)	(22,291)
Net purchases of premises and equipment	(240)	(1,618)
Increase in FHLB stock	(20)	(13)
Proceeds from sale of other real estate owned	1,353	157
Net cash used in investing activities	$ (12,054)	$ (39,606)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	7,731	12,027
Net (decrease) increase in interest-bearing deposits	(41,197)	6,489
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(358)	(708)
Repayments or retirement of long-term debt	(3,217)	
Dividends paid	(3,498)	(3,352)
Net cash (used in) provided by financing activities	$ (40,539)	$ 14,456

Net change in cash and cash equivalents	$ (40,452)	$ (15,749)
Cash and cash equivalents at beginning of period	105,528	121,277
Cash and cash equivalents at end of period	$ 65,076	$ 105,528
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 3,616	$ 3,624
Income taxes	2,688	3,289
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	$ 1,525	$

See accompanying notes to consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Auburn National Bancorporation, Inc. (the Company) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, AuburnBank (the Bank). AuburnBank is a commercial bank located in Auburn, Alabama. The Bank provides a full range of banking services in its primary market area, Lee County, which includes the Auburn-Opelika Metropolitan Statistical Area.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I was an affiliate of the Company and was included in these consolidated financial statements pursuant to the equity method of accounting. On April 27, 2018, the Trust was dissolved. Significant intercompany transactions and accounts are eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the balance sheet date and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, fair value measurements, valuation of other real estate owned, and valuation of deferred tax assets.

Accounting Standards Adopted in 2018

In 2018, the Company adopted new guidance related to the following Accounting Standards Update (Update or ASU):

ASU 2014-09, *Revenue from Contracts with Customers;*

ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*;

ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*; and

ASU 2016-18, *Restricted Cash.*

Information about these pronouncements is described in more detail below.

ASU 2014-09*, Revenue from Contracts with Customers (Topic 606),* was developed as a joint project with the International Accounting Standards Board to remove inconsistencies in revenue requirements and provide a more robust framework for addressing revenue issues. The ASU s core principle is that an entity should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU 2015-14, which deferred the effective date by one year (i.e., interim and annual reporting periods beginning after December 15, 2017). Early adoption was permitted, but not before the original effective date (i.e., interim and annual reporting periods beginning after December 15, 2016). The ASU may be adopted using either a modified retrospective method or a full retrospective method. The Company adopted the ASU during the first quarter of 2018, as required, using a modified retrospective approach. The majority of the Company s revenue stream is generated from interest income on loans and deposits, which are outside the scope of Topic 606. The Company s sources of income that fall within the scope of Topic 606 include service charges on deposits, investment services, interchange fees and gains and losses on sales of other real estate, all of which are presented as components of noninterest income. The Company has evaluated the effect of Topic 606 on these fee-based income streams and concluded that adoption of the standard did not materially impact its financial statements. The following is a summary of the implementation considerations for the revenue streams that fall within the scope of Topic 606:

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Service charges on deposits, investment services, ATM and interchange fees Fees from these services are either transaction-based, for which the performance obligations are satisfied when the individual transaction is processed, or set periodic service charges, for which the performance obligations are satisfied over the period the service is provided. Transaction-based fees are recognized at the time the transaction is processed, and periodic service charges are recognized over the service period. The adoption of Topic 606 had no impact on the Company s revenue recognition practice for these services.

Gains on sales of other real estate ASU 2014-09 creates Topic 610-20, under which a gain on sale should be recognized when a contract for sale exists and control of the asset has been transferred to the buyer. Topic 606 lists several criteria required to conclude that a contract for sale exists, including a determination that the institution will collect substantially all of the consideration to which it is entitled. This presents a key difference between the prior and new guidance related to the recognition of the gain when the institution finances the sale of the property. Rather than basing recognition on the amount of the buyer s initial investment, which was the primary consideration under prior guidance, the analysis is now based on various factors including not only the loan to value, but also the credit quality of the borrower, the structure of the loan, and any other factors that may affect collectability. While these differences may affect the decision to recognize or defer gains on sales of other real estate in circumstances where the Company has financed the sale, the effects would not be material to its consolidated financial statements.

ASU 2016-01, *Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Some of the amendments include the following: (1) Require equity investments (except those accounted 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; (2) Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (4) Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this ASU on January 1, 2018 did not have a material impact on the Company s Consolidated Financial Statements. In accordance with (3) above, the Company measured the fair value of its loan portfolio as of December 31, 2018 using an exit price notion and will continue to do so going forward. See Note 16, Fair Value.

ASU 2016-15*, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,* provides guidance on eight specific cash flow issues where current GAAP is either unclear or does not include specific guidance on classification in the statement of cash flows. The new guidance is effective for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company adopted ASU No. 2016-15 on January 1, 2018. ASU No. 2016-15 did not have a material impact on the Company s Consolidated Financial Statements.

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, amends guidance on how the statement of cash flows presents the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Under the new guidance, amounts generally described as restricted cash and restricted cash equivalents are included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this Update do not provide

a definition of restricted cash or restricted cash equivalents. The new guidance is effective for public business entities for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company adopted ASU No. 2016-18 on January 1, 2018. ASU No. 2016-18 did not have a material impact on the Company s Consolidated Financial Statements.

Cash Equivalents

Cash equivalents include cash on hand, cash items in process of collection, amounts due from banks, including interest bearing deposits with other banks, and federal funds sold.

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Securities

Securities are classified based on management s intention at the date of purchase. At December 31, 2018, all of the Company s securities were classified as available-for-sale. Securities available-for-sale are used as part of the Company s interest rate risk management strategy, and they may be sold in response to changes in interest rates, changes in prepayment risks or other factors. All securities classified as available-for-sale are recorded at fair value with any unrealized gains and losses reported in accumulated other comprehensive income (loss), net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are recognized in interest income over the anticipated life of the security using the effective interest method, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses), net.

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security s amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, as a realized loss in securities gains (losses), and is the difference between the security s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security s fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

Loans held for sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Loan sales are recognized when the transaction closes, the proceeds are collected, and ownership is transferred. Continuing involvement, through the sales agreement, consists of the right to service the loan for a fee for the life of the loan, if applicable. Gains on the sale of loans held for sale are recorded net of related costs, such as commissions, and reflected as a component of mortgage lending income in the consolidated statements of earnings.

In the course of conducting the Bank s mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, the Bank makes various representations and warranties to the purchaser of the mortgage loans. Every loan closed by the Bank s mortgage center is run through a government agency automated underwriting system. Any exceptions noted during this process are remedied prior to sale. These representations and warranties also apply to underwriting the real estate appraisal opinion of value for the collateral securing these loans. Failure by the Company to comply with the underwriting and/or appraisal standards could result in the Company

being required to repurchase the mortgage loan or to reimburse the investor for losses incurred (make whole requests) if such failure cannot be cured by the Company within the specified period following discovery.

Loans

Loans are reported at their outstanding principal balances, net of any unearned income, charge-offs, and any deferred fees or costs on originated loans. Interest income is accrued based on the principal balance outstanding. Loan origination fees, net of certain loan origination costs, are deferred and recognized in interest income over the contractual life of the loan using the effective interest method. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period, which results in a recorded amount that approximates fair value.

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The accrual of interest on loans is discontinued when there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or the principal or interest is more than 90 days past due, unless the loan is both well-collateralized and in the process of collection. Generally, all interest accrued but not collected for loans that are placed on nonaccrual status is reversed against current interest income. Interest collections on nonaccrual loans are generally applied as principal reductions. The Company determines past due or delinquency status of a loan based on contractual payment terms.

A loan is considered impaired when it is probable the Company will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement. Individually identified impaired loans are measured based on the present value of expected payments using the loan s original effective rate as the discount rate, the loan s observable market price, or the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as part of the allowance for loan losses. Changes to the valuation allowance are recorded as a component of the provision for loan losses.

Impaired loans also include troubled debt restructurings (TDRs). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. The concessions granted most frequently for TDRs involve reductions or delays in required payments of principal and interest for a specified time, the rescheduling of payments in accordance with a bankruptcy plan or the charge-off of a portion of the loan. In most cases, the conditions of the credit also warrant nonaccrual status, even after the restructuring occurs. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructuring. TDR loans may be returned to accrual status if there has been at least a six-month sustained period of repayment performance by the borrower.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level that management believes is adequate to absorb probable losses inherent in the loan portfolio. Loan losses are charged against the allowance when they are known. Subsequent recoveries are credited to the allowance. Management s determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, growth, composition of the loan portfolio, homogeneous pools of loans, risk ratings of specific loans, historical loan loss factors, identified impaired loans and other factors related to the portfolio. This evaluation is performed quarterly and is inherently subjective, as it requires various material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on any impaired loans. In addition, regulatory agencies, as an integral part of their examination process, will periodically review the Company s allowance for loan losses, and may require the Company to record additions to the allowance based on their judgment about information available to them at the time of their examinations.

Premises and Equipment

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on a straight-line method over the useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured.

Other Real Estate Owned

Other real estate owned (OREO) includes properties acquired through, or in lieu of, loan foreclosure that are held for sale and are initially recorded at the lower of the loan s carrying amount or fair value less cost to sell at the date of

foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying value amount or fair value less cost to sell. Gains or losses realized upon sale of OREO and additional losses related to subsequent valuation adjustments are determined on a specific property basis and are included as a component of noninterest expense along with holding costs.

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Nonmarketable equity investments

Nonmarketable equity investments include equity securities that are not publicly traded and securities acquired for various purposes. The Bank is required to maintain certain minimum levels of equity investments with certain regulatory and other entities in which the Bank has an ongoing business relationship based on the Bank s common stock and surplus (with regard to the relationship with the Federal Reserve Bank) or outstanding borrowings (with regard to the relationship with the Federal Home Loan Bank of Atlanta). These nonmarketable equity securities are accounted for at cost which equals par or redemption value. These securities do not have a readily determinable fair value as their ownership is restricted and there is no market for these securities. These securities can only be redeemed or sold at their par value and only to the respective issuing government supported institution or to another member institution. The Company records these nonmarketable equity securities as a component of other assets, which are periodically evaluated for impairment. Management considers these nonmarketable equity securities to be long-term investments. Accordingly, when evaluating these securities for impairment, management considers the ultimate recoverability of the par value rather than by recognizing temporary declines in value.

Transfers of Financial Assets

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

Mortgage Servicing Rights

The Company recognizes as assets the rights to service mortgage loans for others, known as MSRs. The Company determines the fair value of MSRs at the date the loan is transferred. An estimate of the Company s MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees.

Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income. The amortization of MSRs is analyzed monthly and is adjusted to reflect changes in prepayment speeds, as well as other factors. MSRs are evaluated for impairment based on the fair value of those assets. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established through a charge to earnings. The valuation allowance is adjusted as the fair value changes. MSRs are included in the other assets category in the accompanying consolidated balance sheets.

Derivative Instruments

In accordance with Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*, all derivative instruments are recorded on the consolidated balance sheet at their respective fair values. The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. If the derivative instrument is not designated as part of a hedging relationship, the gain or loss on the derivative instrument is recognized in earnings in the period

of change. None of the derivatives utilized by the Company have been designated as a hedge.

Securities sold under agreements to repurchase

Securities sold under agreements to repurchase generally mature less than one year from the transaction date. Securities sold under agreements to repurchase are reflected as a secured borrowing in the accompanying consolidated balance sheets at the amount of cash received in connection with each transaction.

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Income Taxes

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. The net deferred tax asset is reflected as a component of other assets in the accompanying consolidated balance sheets.

Income tax expense or benefit for the year is allocated among continuing operations and other comprehensive income (loss), as applicable. The amount allocated to continuing operations is the income tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (1) changes in certain circumstances that cause a change in judgment about the realization of deferred tax assets in future years, (2) changes in income tax laws or rates, and (3) changes in income tax status, subject to certain exceptions. The amount allocated to other comprehensive income (loss) is related solely to changes in the valuation allowance on items that are normally accounted for in other comprehensive income (loss) such as unrealized gains or losses on available-for-sale securities.

In accordance with ASC 740, *Income Taxes*, a tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded. It is the Company s policy to recognize interest and penalties related to income tax matters in income tax expense. The Company and its wholly-owned subsidiaries file a consolidated income tax return.

Fair Value Measurements

ASC 820, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards. The definition of fair value focuses on the exit price, i.e., 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, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For more information related to fair value measurements, please refer to Note 16, Fair Value.

Subsequent Events

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to December 31, 2018. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

NOTE 2: BASIC AND DILUTED NET EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the year. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company s common stock. As of December 31, 2018 and 2017, respectively, the Company had no such securities or other rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted net earnings per share calculation.

The basic and diluted net earnings per share computations for the respective years are presented below.

	Year ended December 31	
(Dollars in thousands, except share and per share data)	**2018**	**2017**
Basic and diluted:		
Net earnings	$ 8,834	$ 7,846
Weighted average common shares outstanding	3,643,780	3,643,616
Net earnings per share	$ 2.42	$ 2.15

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NOTE 3: RESTRICTED CASH BALANCES

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. As of December 31, 2018 and 2017, the Bank did not have a required reserve balance at the Federal Reserve Bank.

NOTE 4: SECURITIES

At December 31, 2018 and 2017, respectively, all securities within the scope of ASC 320, *Investments Debt and Equity Securities* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at December 31, 2018 and 2017, respectively, are presented below.

(Dollars in thousands)		**1 year or less**	**1 to 5 years**	**5 to 10 years**	**After 10 years**	**Fair Value**	**Gross Unrealized Gains**	**Gross Unrealized Losses**		**Amortized Cost**
December 31, 2018										
Agency obligations (a)	$	14,437	19,865	16,869		51,171	25	1,200	$	52,346
Agency RMBS (a)				8,368	110,230	118,598	65	3,738		122,271
State and political subdivisions			3,682	7,726	58,624	70,032	518	692		70,206
Total available-for-sale	$	14,437	23,547	32,963	168,854	239,801	608	5,630	$	244,823
December 31, 2017										
Agency obligations (a)	$		29,253	23,809		53,062	79	904	$	53,887
Agency RMBS (a)				11,201	121,871	133,072	330	1,639	$	134,381
State and political subdivisions			2,564	9,999	59,000	71,563	1,616	237	$	70,184
Total available-for-sale	$		31,817	45,009	180,871	257,697	2,025	2,780	$	258,452

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of $133.1 million and $149.4 million at December 31, 2018 and 2017, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets on the accompanying consolidated balance sheets are nonmarketable equity investments. The carrying amounts of nonmarketable equity investments were $1.4 million at December 31, 2018 and 2017, respectively. Nonmarketable equity investments include FHLB of Atlanta stock, Federal Reserve Bank (FRB) stock, and stock in a privately held financial institution.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at December 31, 2018 and 2017, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or more are presented below.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2018:						
Agency obligations	$ 4,724	28	44,307	1,172	49,031	$ 1,200
Agency RMBS	12,325	238	99,184	3,500	111,509	3,738
State and political subdivisions	14,840	181	14,384	511	29,224	692
Total	$ 31,889	447	157,875	5,183	189,764	$ 5,630
December 31, 2017:						
Agency obligations	$ 14,381	99	20,353	805	34,734	$ 904
Agency RMBS	53,440	363	50,729	1,276	104,169	1,639
State and political subdivisions	2,009	22	10,155	215	12,164	237
Total	$ 69,830	484	81,237	2,296	151,067	$ 2,780

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For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. On a quarterly basis, the Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities amortized cost basis.

In determining whether a loss is temporary, the Company considers all relevant information including:

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

Agency obligations

The unrealized losses associated with agency obligations were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Agency residential mortgage-backed securities (RMBS)

The unrealized losses associated with agency RMBS were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Securities of U.S. states and political subdivisions

The unrealized losses associated with securities of U.S. states and political subdivisions were primarily driven by changes in interest rates and were not due to the credit quality of the securities. Some of these securities are guaranteed by a bond insurer, but management did not rely on the guarantee in making its investment decision. These securities will continue to be monitored as part of the Company s quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

The carrying values of the Company s investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that other-than-temporary impairment charges may occur in the future.

Other-Than-Temporarily Impaired Securities

Credit-impaired debt securities are debt securities where the Company has written down the amortized cost basis of a security for other-than-temporary impairment and the credit component of the loss is recognized in earnings. At December 31, 2018 and 2017, respectively, the Company had no credit-impaired debt securities and there were no additions or reductions in the credit loss component of credit-impaired debt securities during the years ended December 31, 2018 and 2017, respectively.

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Realized Gains and Losses

The following table presents the gross realized gains and losses on sales related to securities.

	Year ended December 31	
(Dollars in thousands)	**2018**	**2017**
Gross realized gains	$	51
Realized gains, net	$	51

NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

	December 31	
(In thousands)	**2018**	**2017**
Commercial and industrial	$ 63,467	$ 59,086
Construction and land development	40,222	39,607
Commercial real estate:		
Owner occupied	56,413	44,192
Multifamily	40,455	52,167
Other	165,028	142,674
Total commercial real estate	261,896	239,033
Residential real estate:		
Consumer mortgage	56,223	59,540
Investment property	46,374	47,323
Total residential real estate	102,597	106,863
Consumer installment	9,295	9,588
Total loans	477,477	454,177
Less: unearned income	(569)	(526)
Loans, net of unearned income	$ 476,908	$ 453,651

Loans secured by real estate were approximately 84.9% of the total loan portfolio at December 31, 2018. At December 31, 2018, the Company s geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, *Receivables*, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. As part of the Company s quarterly assessment of the allowance, the loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate and consumer

installment. Where appropriate, the Company s loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity s method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments.

Commercial and industrial (C&I) includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower.

Construction and land development (C&D) includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

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Commercial real estate (CRE) includes loans disaggregated into three classes: (1) owner occupied (2) multi-family and (3) other.

Owner occupied includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.

Multifamily primarily includes loans to finance income-producing multi-family properties. Loans in this class include loans for 5 or more unit residential property and apartments leased to residents. Generally, the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

Other primarily includes loans to finance income-producing commercial properties. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, and warehouses leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates as well as the financial health of the borrower.

Residential real estate (RRE) includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

Consumer mortgage primarily includes first or second lien mortgages and home equity lines to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history and property value.

Investment property primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates as well as the financial health of the borrower.

Consumer installment includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history, and if applicable, property value.

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The following is a summary of current, accruing past due and nonaccrual loans by portfolio class as of December 31, 2018 and 2017.

(In thousands)	Current	Accruing Past Due 30-89 Days	Accruing Past Due Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
December 31, 2018:						
Commercial and industrial	$ 63,367	100		63,467		$ 63,467
Construction and land development	39,997	225		40,222		40,222
Commercial real estate:						
Owner occupied	56,413			56,413		56,413
Multifamily	40,455			40,455		40,455
Other	165,028			165,028		165,028
Total commercial real estate	261,896			261,896		261,896
Residential real estate:						
Consumer mortgage	54,446	1,599		56,045	178	56,223
Investment property	46,233	141		46,374		46,374
Total residential real estate	100,679	1,740		102,419	178	102,597
Consumer installment	9,254	41		9,295		9,295
Total	$ 475,193	2,106		477,299	178	$ 477,477
December 31, 2017:						
Commercial and industrial	$ 59,047	8		59,055	31	$ 59,086
Construction and land development	39,607			39,607		39,607
Commercial real estate:						
Owner occupied	44,192			44,192		44,192
Multifamily	52,167			52,167		52,167
Other	140,486			140,486	2,188	142,674
Total commercial real estate	236,845			236,845	2,188	239,033
Residential real estate:						
Consumer mortgage	58,195	746		58,941	599	59,540
Investment property	46,871	312		47,183	140	47,323

Total residential real estate		105,066	1,058	106,124	739	106,863
Consumer installment		9,517	57	9,574	14	9,588
Total	$	450,082	1,123	451,205	2,972	$ 454,177

The gross interest income which would have been recorded under the original terms of those nonaccrual loans had they been accruing interest, amounted to approximately $12 thousand and $140 thousand for the years ended December 31, 2018 and 2017, respectively.

Allowance for Loan Losses

The allowance for loan losses as of and for the years ended December 31, 2018 and 2017, is presented below.

	Year ended December 31	
(In thousands)	**2018**	**2017**
Beginning balance	$ 4,757	$ 4,643
Charged-off loans	(168)	(596)
Recovery of previously charged-off loans	201	1,010
Net recoveries	33	414
Provision for loan losses		(300)
Ending balance	$ 4,790	$ 4,757

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The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal, independent loan review process. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2018 and 2017, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

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The Company regularly re-evaluates its practices in determining the allowance for loan losses. Since the fourth quarter of 2016, the Company has increased its look-back period each quarter to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. For the year ended December 31, 2018, the Company increased its look-back period to 39 quarters to continue to include losses incurred by the Company beginning with the first quarter of 2009. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. Other than expanding the look-back period each quarter, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

The following table details the changes in the allowance for loan losses by portfolio segment for the years ended December 31, 2018 and 2017.

(in thousands)	**Commercial and industrial**	**Construction and land Development**	**Commercial Real Estate**	**Residential Real Estate**	**Consumer Installment**		**Total**
Balance, December 31, 2016	$ 540	812	2,071	1,107	113	$	4,643
Charge-offs	(449)			(107)	(40)		(596)
Recoveries	461	347		115	87		1,010
Net recoveries	12	347		8	47		414
Provision	101	(425)	55	(44)	13		(300)
Balance, December 31, 2017	$ 653	734	2,126	1,071	173	$	4,757
Charge-offs	(52)		(38)	(26)	(52)		(168)
Recoveries	70		19	79	33		201
Net recoveries	18		(19)	53	(19)		33
Provision	107	(34)	111	(178)	(6)		
Balance, December 31, 2018	$ 778	700	2,218	946	148	$	4,790

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of December 31, 2018 and 2017.

	Collectively evaluated (1)		**Individually evaluated (2)**		**Total**	
	Allowance	**Recorded**	**Allowance**	**Recorded**	**Allowance**	**Recorded**

(In thousands)		for loan losses	investment in loans	for loan losses	investment in loans	for loan losses	investment in loans
December 31, 2018:							
Commercial and industrial	$	778	63,467			778	63,467
Construction and land development		700	40,222			700	40,222
Commercial real estate		2,218	261,739		157	2,218	261,896
Residential real estate		946	102,597			946	102,597
Consumer installment		148	9,295			148	9,295
Total	$	4,790	477,320		157	4,790	477,477
December 31, 2017:							
Commercial and industrial	$	622	59,055	31	31	653	59,086
Construction and land development		734	39,607			734	39,607
Commercial real estate		2,115	236,322	11	2,711	2,126	239,033
Residential real estate		1,071	106,863			1,071	106,863
Consumer installment		173	9,588			173	9,588
Total	$	4,715	451,435	42	2,742	4,757	454,177

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans.
(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

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Credit Quality Indicators

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for qualitative and environmental factors and are defined as follows:

Pass loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.

Special Mention loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company s position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.

Substandard Accruing loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected.

Nonaccrual includes loans where management has determined that full payment of principal and interest is in doubt.

(In thousands)	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
December 31, 2018					
Commercial and industrial	$ 61,568	1,377	522		$ 63,467
Construction and land development	39,481		741		40,222
Commercial real estate:					
Owner occupied	55,942	154	317		56,413
Multifamily	40,455				40,455
Other	163,449	1,208	371		165,028
Total commercial real estate	259,846	1,362	688		261,896
Residential real estate:					
Consumer mortgage	50,903	1,374	3,768	178	56,223
Investment property	45,463	173	738		46,374
Total residential real estate	96,366	1,547	4,506	178	102,597
Consumer installment	9,149	75	71		9,295
Total	$ 466,410	4,361	6,528	178	$ 477,477

December 31, 2017						
Commercial and industrial	$	58,842	94	119	31	$ 59,086
Construction and land development		39,049	90	468		39,607
Commercial real estate:						
Owner occupied		43,615	240	337		44,192
Multifamily		52,167				52,167
Other		139,695	395	396	2,188	142,674
Total commercial real estate		235,477	635	733	2,188	239,033
Residential real estate:						
Consumer mortgage		54,101	1,254	3,586	599	59,540
Investment property		46,463	53	667	140	47,323
Total residential real estate		100,564	1,307	4,253	739	106,863
Consumer installment		9,430	66	78	14	9,588
Total	$	443,362	2,192	5,651	2,972	$ 454,177

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Impaired loans

The following table presents details related to the Company s impaired loans. Loans which have been fully charged-off do not appear in the following table. The related allowance generally represents the following components which correspond to impaired loans:

Individually evaluated impaired loans equal to or greater than $500 thousand secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate).

Individually evaluated impaired loans equal to or greater than $250 thousand not secured by real estate (nonaccrual commercial and industrial and consumer loans).

The following table sets forth certain information regarding the Company s impaired loans that were individually evaluated for impairment at December 31, 2018 and 2017.

		December 31, 2018			
(In thousands)		Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:					
Commercial real estate:					
Owner occupied	$	157		157	
Total commercial real estate		157		157	
Total impaired loans	$	157		157	$

(1) Unpaid principal balance represents the contractual obligation due from the customer.
(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.
(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

	December 31, 2017			
(In thousands)	Unpaid principal	Charge-offs and payments	Recorded investment (3)	Related allowance

	balance (1)	applied (2)		
With no allowance recorded:				
Commercial real estate:				
Other	$ 3,630	(1,094)	2,536	
Total commercial real estate	3,630	(1,094)	2,536	
Total	$ 3,630	(1,094)	2,536	
With allowance recorded:				
Commercial and industrial	$ 52	(21)	31	$ 31
Commercial real estate:				
Owner occupied	175		175	11
Total commercial real estate	175		175	11
Total	$ 227	(21)	206	$ 42
Total impaired loans	$ 3,857	(1,115)	2,742	$ 42

(1) Unpaid principal balance represents the contractual obligation due from the customer.
(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.
(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

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The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

	Year ended December 31, 2018		Year ended December 31, 2017	
(In thousands)	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
Impaired loans:				
Commercial and industrial	$ 9		$ 50	
Construction and land development			11	
Commercial real estate:				
Owner occupied	166	9	184	10
Other	1,145		2,096	1
Total commercial real estate	1,311	9	2,280	11
Total	$ 1,320	9	$ 2,341	11

Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings (TDRs). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. In determining whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. In determining the appropriate accrual status at the time of restructure, the Company evaluates whether a restructured loan has adequate collateral protection, among other factors.

Similar to other impaired loans, TDRs are measured for impairment based on the present value of expected payments using the loan s original effective interest rate as the discount rate, or the fair value of the collateral, less selling costs if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, impairment is recognized by establishing a valuation allowance as part of the allowance for loan losses or a charge-off to the allowance for loan losses. In periods subsequent to the modification, all TDRs are evaluated individually, including those that have payment defaults, for possible impairment.

The following is a summary of accruing and nonaccrual TDRs and the related loan losses, by portfolio segment and class.

(In thousands)	Accruing	Nonaccrual	Total	TDRs Related Allowance
December 31, 2018				
Commercial real estate:				
Owner occupied	$ 157		157	$
Total commercial real estate	157		157	
Total	$ 157		157	$
December 31, 2017				
Commercial and industrial	$	31	31	$ 31
Commercial real estate:				
Owner occupied	175		175	11
Other	287	1,431	1,718	
Total commercial real estate	462	1,431	1,893	11
Total	$ 462	1,462	1,924	$ 42

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At December 31, 2018, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

The following table summarizes loans modified in a TDR during the respective years both before and after modification.

($ in thousands)	**Number of contracts**		**Pre-modification outstanding recorded investment**	**Post-modification outstanding recorded investment**
December 31, 2018				
Commercial real estate:				
Other	2	$	1,447	1,447
Total commercial real estate	2		1,447	1,447
Total	2	$	1,447	1,447
December 31, 2017				
Commercial and industrial	1	$	34	34
Commercial real estate:				
Other	1	$	1,275	1,266
Total commercial real estate	1		1,275	1,266
Total	2	$	1,309	1,300

The majority of the loans modified in a TDR during the years ended December 31, 2018 and 2017, respectively, included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate.

The following table summarizes the recorded investment in loans modified in a TDR within the previous twelve months for which there was a payment default (defined as 90 days or more past due) during the year ended December 31, 2018. During the year ended December 31, 2017, the Company had no loans modified in a TDR within the previous 12 months for which there was a payment default.

($ in thousands)	**Number of**	**Recorded**

	Contracts		investment (1)
December 31, 2018			
Commercial real estate:			
Other	1	$	1,259
Total commercial real estate	1		1,259
Total	1	$	1,259

(1) Amount as of applicable month end during the respective year for which there was a payment default.

NOTE 6: PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2018 and 2017 is presented below.

(Dollars in thousands)		2018	December 31 2017
Land	$	7,473	7,473
Buildings and improvements		10,438	10,394
Furniture, fixtures, and equipment		3,357	3,161
Total premises and equipment		21,268	21,028
Less: accumulated depreciation		(7,672)	(7,237)
Premises and equipment, net	$	13,596	13,791

Depreciation expense was approximately $435 thousand and $428 thousand for the years ended December 31, 2018 and 2017, respectively, and is a component of net occupancy and equipment expense in the consolidated statements of earnings.

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NOTE 7: MORTGAGE SERVICING RIGHTS, NET

MSRs are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the Company s MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income. Servicing fee income is recorded net of related amortization expense and recognized in earnings as part of mortgage lending income.

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSRs are included in other assets on the accompanying consolidated balance sheets.

The Company evaluates MSRs for impairment on a quarterly basis. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

The following table details the changes in amortized MSRs and the related valuation allowance for the years ended December 31, 2018 and 2017.

		Year ended December 31	
(Dollars in thousands)		**2018**	**2017**
Beginning balance	$	1,644	1,952
Additions, net		208	224
Amortization expense		(411)	(533)
Change in valuation allowance			1
Ending balance	$	1,441	1,644
Valuation allowance included in MSRs, net:			
Beginning of period	$		1
End of period			
Fair value of amortized MSRs:			
Beginning of period	$	2,528	2,678
End of period		2,697	2,528

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2018 and 2017, respectively, are presented below.

		December 31	
(Dollars in thousands)		**2018**	**2017**
Unpaid principal balance	$	289,981	312,318
Weighted average prepayment speed (CPR)		8.3 %	10.2
Discount rate (annual percentage)		10.0 %	10.0
Weighted average coupon interest rate		3.9 %	3.8
Weighted average remaining maturity (months)		250	253
Weighted average servicing fee (basis points)		25.0	25.0

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At December 31, 2018, the weighted average amortization period for MSRs was 6.7 years. Estimated amortization expense for each of the next five years is presented below.

(Dollars in thousands)	**December 31, 2018**
2019	$ 198
2020	174
2021	152
2022	131
2023	115

NOTE 8: DEPOSITS

At December 31, 2018, the scheduled maturities of certificates of deposit and other time deposits are presented below.

(Dollars in thousands)	**December 31, 2018**
2019	$ 108,363
2020	28,888
2021	16,630
2022	20,966
2023	6,390
Total certificates of deposit and other time deposits	$ 181,237

Additionally, at December 31, 2018 and 2017, approximately $59.4 million and $55.2 million, respectively, of certificates of deposit and other time deposits were issued in denominations of $250 thousand or greater.

At December 31, 2018 and 2017, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

NOTE 9: SHORT-TERM BORROWINGS

At December 31, 2018 and 2017, the composition of short-term borrowings is presented below.

	2018		**2017**	
(Dollars in thousands)	**Amount**	**Weighted Avg. Rate**	**Amount**	**Weighted Avg. Rate**
Federal funds purchased:				
As of December 31	$		$	

Average during the year	2	2.50 %		9	2.01 %
Maximum outstanding at any month-end					
Securities sold under agreements to repurchase:					
As of December 31	$ 2,300	0.50 %	$	2,658	0.50 %
Average during the year	2,632	0.50 %		3,467	0.52 %
Maximum outstanding at any month-end	3,241			4,152	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling $41.0 million with none outstanding at December 31, 2018.

Securities sold under agreements to repurchase represent short-term borrowings with maturities less than one year collateralized by a portion of the Company s securities portfolio. Securities with an aggregate carrying value of $5.6 million and $5.8 million at December 31, 2018 and 2017, respectively, were pledged to secure securities sold under agreements to repurchase.

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NOTE 10: LONG-TERM DEBT

At December 31, 2018 and 2017, the composition of long-term debt is presented below.

	2018		2017	
(Dollars in thousands)	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
Subordinated debentures, due 2033	$	%	$ 3,217	4.63%
Total long-term debt	$	%	$ 3,217	4.63%

The Company formed Auburn National Bancorporation Capital Trust I (the Trust), a wholly-owned statutory business trust, in 2003. The Trust issued $7.0 million of trust preferred securities that were sold to third parties. The proceeds from the sale of the trust preferred securities and trust common securities that we held, were used to purchase junior subordinated debentures of $7.2 million from the Company, which are presented as long-term debt in the consolidated balance sheets and qualify for inclusion in Tier 1 capital for regulatory capital purposes, subject to certain limitations. The debentures would have matured on December 31, 2033 and had been redeemable since December 31, 2008.

On April 27, 2018, the Trust formally redeemed all of its issued and outstanding trust preferred securities at par. The Company had repurchased $4.0 million par amount of trust preferred securities issued by the Trust in October 2016, at a discount. The additional amount paid on April 27, 2018 for trust preferred securities not previously purchased by the Company was approximately $3.0 million, including accrued and unpaid distributions. All junior subordinated debentures related to the Trust were redeemed and retired as a result of the action.

The Company now has no outstanding trust preferred securities or junior subordinated debentures, and the Trust has been dissolved.

NOTE 11: OTHER COMPREHENSIVE INCOME (LOSS)

Comprehensive income is defined as the change in equity from all transactions other than those with stockholders, and it includes net earnings and other comprehensive (loss) income. Other comprehensive (loss) income for the years ended December 31, 2018 and 2017, is presented below.

(In thousands)	Pre-tax amount	Tax benefit (expense)	Net of tax amount
2018:			
Unrealized net holding loss on all other securities	$ (4,269)	1,072	(3,197)
Other comprehensive loss	$ (4,269)	1,072	(3,197)

2017:			
Unrealized net holding gain on all other securities	$ 417	(154)	263
Reclassification adjustment for net gain on securities recognized in net earnings	(51)	19	(32)
Other comprehensive income	$ 366	(135)	231

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NOTE 12: INCOME TAXES

For the years ended December 31, 2018 and 2017 the components of income tax expense from continuing operations are presented below.

(Dollars in thousands)		Year ended December 31 2018	2017
Current income tax expense:			
Federal	$	1,685	2,782
State		431	499
Total current income tax expense		2,116	3,281
Deferred income tax expense (benefit):			
Federal		56	384
State		15	(28)
Total deferred income tax expense		71	356
Total income tax expense	$	2,187	3,637

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 21% and 34% for the years ended December 31, 2018 and 2017, respectively, to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2018 and 2017, is presented below.

		2018		2017	
(Dollars in thousands)		Amount	Percent of pre-tax earnings	Amount	Percent of pre-tax earnings
Earnings before income taxes	$	11,021		11,483	
Income taxes at statutory rate		2,315	21.0 %	3,904	34.0 %
Tax-exempt interest		(515)	(4.7)	(813)	(7.0)
State income taxes, net of federal tax effect		361	3.3	325	2.8
Bank-owned life insurance		(92)	(0.8)	(150)	(1.3)
Federal tax reform impact				370	3.2
Other		118	1.0	1	
Total income tax expense	$	2,187	19.8 %	3,637	31.7 %

The Tax Cuts and Jobs Act was signed into law on December 22, 2017. The net tax expense recognized as a result of the remeasurement of deferred taxes is presented as Federal tax reform impact in the above table.

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The Company had net deferred tax assets of $1.8 million and $0.8 million at December 31, 2018 and 2017, respectively, included in other assets on the consolidated balance sheets. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2018 and 2017 are presented below:

		December 31	
(Dollars in thousands)		**2018**	**2017**
Deferred tax assets:			
Allowance for loan losses	$	1,203	1,195
Unrealized loss on securities		1,262	190
Other		135	216
Total deferred tax assets		2,600	1,601
Deferred tax liabilities:			
Premises and equipment		280	241
Originated mortgage servicing rights		362	413
Other		168	158
Total deferred tax liabilities		810	812
Net deferred tax asset	$	1,790	789

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion of the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projection for future taxable income over the periods which the temporary differences resulting in the remaining deferred tax assets are deductible, management believes it is more-likely-than-not that the Company will realize the benefits of these deductible differences at December 31, 2018. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

The change in the net deferred tax asset for the years ended December 31, 2018 and 2017, is presented below.

		Year ended December 31	
(Dollars in thousands)		**2018**	**2017**
Net deferred tax asset:			
Balance, beginning of year	$	789	1,280
Deferred tax expense related to continuing operations		(71)	(356)
Stockholders equity, for accumulated other comprehensive loss (income)		1,072	(135)

Balance, end of year	$	1,790	789

ASC 740, *Income Taxes,* defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. This section also provides guidance on the de-recognition, measurement, and classification of income tax uncertainties in interim periods. As of December 31, 2018, the Company had no unrecognized tax benefits related to federal or state income tax matters. The Company does not anticipate any material increase or decrease in unrecognized tax benefits during 2019 relative to any tax positions taken prior to December 31, 2018. As of December 31, 2018, the Company has accrued no interest and no penalties related to uncertain tax positions. It is the Company s policy to recognize interest and penalties related to income tax matters in income tax expense.

The Company and its subsidiaries file consolidated U.S. federal and State of Alabama income tax returns. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service and the State of Alabama for the years ended December 31, 2015 through 2018.

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NOTE 13: EMPLOYEE BENEFIT PLAN

The Company has a 401(k) Plan that covers substantially all employees. Participants may contribute up to 10% of eligible compensation subject to certain limits based on federal tax laws. The Company s matching contributions to the Plan are determined by the board of directors. Participants become 20% vested in their accounts after two years of service and 100% vested after six years of service. Company matching contributions to the Plan were $131 thousand and $127 thousand for the years ended December 31, 2018 and 2017, respectively, and are included in salaries and benefits expense.

NOTE 14: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying consolidated balance sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings within other noninterest income on the accompanying consolidated statements of earnings. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2018 and December 31, 2017, the Company had no derivative contracts to assist in managing its own interest rate sensitivity.

Interest rate swap agreements involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

The Company had no interest rate swaps as of December 31, 2018. A summary of the Company s interest rate swaps as of and for the year ended December 31, 2017 is presented below.

(Dollars in thousands)	**Notional**	**Other Assets Estimated Fair Value**	**Other Liabilities Estimated Fair Value**	**Other noninterest income Gains (Losses)**
December 31, 2017:				
Pay fixed / receive variable	$ 3,617		52	$ 189
Pay variable / receive fixed	3,617	52		(189)

Total interest rate swap agreements	$ 7,234	52	52	$

NOTE 15: COMMITMENTS AND CONTINGENT LIABILITIES

Credit-Related Financial Instruments

The Company is party to credit related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company s exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At December 31, 2018 and 2017, the following financial instruments were outstanding whose contract amount represents credit risk:

	December 31	
(Dollars in thousands)	**2018**	**2017**
Commitments to extend credit	$ 61,889	$ 57,014
Standby letters of credit	7,026	7,390

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management s credit evaluation of the customer.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds various assets as collateral, including accounts receivable, inventory, equipment, marketable securities, and property to support those commitments for which collateral is deemed necessary. The Company has recorded a liability for the estimated fair value of these standby letters of credit in the amount of $73 thousand and $79 thousand at December 31, 2018 and 2017, respectively.

Other Commitments

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2018, are as follows: 2019, $152 thousand; 2020, $94 thousand; 2021, $67 thousand; 2022, $60 thousand; 2023, $60 thousand.

Contingent Liabilities

The Company and the Bank are involved in various legal proceedings, arising in connection with their business. In the opinion of management, based upon consultation with legal counsel, the ultimate resolution of these proceeding will not have a material adverse effect upon the consolidated financial condition or results of operations of the Company and the Bank.

NOTE 16: FAIR VALUE

Fair Value Hierarchy

Fair value is defined by ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs to the valuation methodology are unobservable and reflect the Company s own assumptions about the inputs market participants would use in pricing the asset or liability.

Level changes in fair value measurements

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company s financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the years ended December 31, 2018 and 2017, there were no transfers between levels and no changes in valuation techniques for the Company s financial assets and liabilities.

Assets and liabilities measured at fair value on a recurring basis

Securities available-for-sale

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may

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include broker/dealer quotes, market spreads, cash flows, market consensus prepayment speeds, benchmark yields, reported trades for similar securities, credit information and the securities terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

Interest rate swap agreements

The carrying amount of interest rate swap agreements was included in other assets and accrued expenses and other liabilities on the accompanying consolidated balance sheets. The fair value measurements for our interest rate swap agreements were based on information obtained from a third party bank. This information is periodically tested by the Company and validated against other third party valuations. If needed, other third party market participants may be utilized to corroborate the fair value measurements for our interest rate swap agreements. The Company classified these derivative assets and liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2018 and 2017, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

(Dollars in thousands)	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2018:				
Securities available-for-sale:				
Agency obligations	$ 51,171		51,171	
Agency RMBS	118,598		118,598	
State and political subdivisions	70,032		70,032	
Total securities available-for-sale	239,801		239,801	
Total assets at fair value	$ 239,801		239,801	
December 31, 2017:				
Securities available-for-sale:				

Agency obligations	$	53,062	53,062
Agency RMBS		133,072	133,072
State and political subdivisions		71,563	71,563
Total securities available-for-sale		257,697	257,697
Other assets [1]		52	52
Total assets at fair value	$	257,749	257,749
Other liabilities[1]		52	52
Total liabilities at fair value	$	52	52

[1]Represents the fair value of interest rate swap agreements.

Assets and liabilities measured at fair value on a nonrecurring basis

Loans held for sale

Loans held for sale are carried at the lower of cost or fair value. Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans. Loans held for sale are classified within Level 2 of the fair value hierarchy.

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Impaired Loans

Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan s original effective rate as the discount rate, the loan s observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent.

The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management s historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management s expertise and knowledge of the customer and the customer s business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Other real estate owned

Other real estate owned, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan s carrying amount or the fair value less costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management s historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management s expertise and knowledge of the customer and the customer s business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, a loss is recognized in noninterest expense.

Mortgage servicing rights, net

Mortgage servicing rights, net, included in other assets on the accompanying consolidated balance sheets, are carried at the lower of cost or estimated fair value. MSRs do not trade in an active market with readily observable prices. To determine the fair value of MSRs, the Company engages an independent third party. The independent third party s valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Periodically, the Company will review broker surveys and other market research to validate significant assumptions used in the model. The significant unobservable inputs include prepayment speeds or the constant prepayment rate (CPR) and the weighted average discount rate. Because the valuation of MSRs requires the use of significant unobservable inputs, all of the Company s MSRs are classified within Level 3 of the valuation hierarchy.

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The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2018 and 2017, respectively, by caption, on the accompanying consolidated balance sheets and by ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)		Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2018:					
Loans held for sale	$	383		383	
Loans, net[1]		157			157
Other real estate owned		172			172
Other assets [2]		1,441			1,441
Total assets at fair value	$	2,153		383	1,770
December 31, 2017:					
Loans held for sale	$	1,922		1,922	
Loans, net[1]		2,700			2,700
Other assets [2]		1,644			1,644
Total assets at fair value	$	6,266		1,922	4,344

(1) Loans considered impaired under ASC 310-10-35 Receivables. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.

(2) Represents MSRs, net, carried at lower of cost or estimated fair value.

At December 31, 2018 and 2017 and for the years then ended, the Company had no Level 3 assets measured at fair value on a recurring basis. For Level 3 assets measured at fair value on a non-recurring basis as of December 31,

2018, the significant unobservable inputs used in the fair value measurements are presented below.

(Dollars in thousands)	Carrying Amount	Valuation Technique	Significant Unobservable Input	Weighted Average of Input
Nonrecurring:				
Impaired loans	$ 157	Appraisal	Appraisal discounts (%)	10.0%
Other real estate owned	172	Appraisal	Appraisal discounts (%)	10.0%
Mortgage servicing rights, net	1,441	Discounted cash flow	Prepayment speed or CPR (%)	8.3%
			Discount rate (%)	10.0%

Fair Value of Financial Instruments

ASC 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company s financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow analyses. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company s financial instruments, but rather are a good-faith estimate of the fair value of financial instruments held by the Company. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

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

Loans, net

Fair values for loans were calculated using discounted cash flows. The discount rates reflected current rates at which similar loans would be made for the same remaining maturities. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of December 31, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

Loans held for sale

Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans.

Time Deposits

Fair values for time deposits were estimated using discounted cash flows. The discount rates were based on rates currently offered for deposits with similar remaining maturities.

Long-term debt

The carrying amount of the Company s variable rate long-term debt approximates its fair value.

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company s financial instruments at December 31, 2018 and 2017 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand, interest-bearing demand, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

			Fair Value Hierarchy		
	Carrying	**Estimated**	**Level 1**	**Level 2**	**Level 3**
(Dollars in thousands)	**amount**	**fair value**	**inputs**	**inputs**	**Inputs**
December 31, 2018:					
Financial Assets:					
Loans, net (1)	$ 472,118	$ 465,456	$	$	$ 465,456
Loans held for sale	383	397		397	
Financial Liabilities:					
Time Deposits	$ 181,237	$ 181,168	$	$ 181,168	$

December 31, 2017:					
Financial Assets:					
Loans, net (1)	$ 448,894	$ 447,468	$	$	$ 447,468
Loans held for sale	1,922	1,950		1,950	
Financial Liabilities:					
Time Deposits	$ 188,071	$ 185,564	$	$ 185,564	$
Long-term debt	3,217	3,217		3,217	

(1) Represents loans, net of unearned income and the allowance for loan losses. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of December 31, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

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NOTE 17: RELATED PARTY TRANSACTIONS

The Bank has made, and expects in the future to continue to make in the ordinary course of business, loans to directors and executive officers of the Company, the Bank, and their affiliates. In management s opinion, these loans were made in the ordinary course of business at normal credit terms, including interest rate and collateral requirements, and do not represent more than normal credit risk. An analysis of such outstanding loans is presented below.

(Dollars in thousands)		**Amount**
Loans outstanding at December 31, 2017	$	3,068
New loans/advances		5,871
Repayments		(732)
Loans outstanding at December 31, 2018	$	8,207

During 2018 and 2017, certain executive officers and directors of the Company and the Bank, including companies with which they are affiliated, were deposit customers of the bank. Total deposits for these persons at December 31, 2018 and 2017 amounted to $19.8 million and $17.8 million, respectively.

NOTE 18: REGULATORY RESTRICTIONS AND CAPITAL RATIOS

As required by the Economic Growth, Regulatory Relief, and Consumer Protection Act in August 2018, the Federal Reserve Board issued an interim final rule that expanded applicability of the Board s small bank holding company policy statement. The interim final rule raised the policy statement s asset threshold from $1 billion to $3 billion in total consolidated assets for a bank holding company or savings and loan holding company that: (1) is not engaged in significant nonbanking activities; (2) does not conduct significant off-balance sheet activities; and (3) does not have a material amount of debt or equity securities, other than trust-preferred securities, outstanding. The interim final rule provides that, if warranted for supervisory purposes, the Federal Reserve may exclude a company from the threshold increase. Management believes the Company meets the conditions of the Federal Reserve s small bank holding company policy statement and is therefore excluded from consolidated capital requirements at December 31, 2018.

The Bank remains subject to regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

As of December 31, 2018, the Bank is well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum common equity Tier 1, total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. Management has not received any notification from the Bank s regulators that changes the Bank s regulatory capital status.

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The actual capital amounts and ratios and the aforementioned minimums as of December 31, 2018 and 2017 are presented below.

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
At December 31, 2018:						
Tier 1 Leverage Capital						
AuburnBank	$ 91,719	11.33 %	$ 32,368	4.00 %	$ 40,461	5.00 %
Common Equity Tier 1 Capital						
AuburnBank	$ 91,719	16.49 %	$ 25,031	4.50 %	$ 36,156	6.50 %
Tier 1 Risk-Based Capital						
AuburnBank	$ 91,719	16.49 %	$ 33,375	6.00 %	$ 44,500	8.00 %
Total Risk-Based Capital						
AuburnBank	$ 96,661	17.38 %	$ 44,500	8.00 %	$ 55,625	10.00 %
At December 31, 2017:						
Tier 1 Leverage Capital						
Auburn National Bancorporation	$ 90,382	10.95 %	$ 33,012	4.00 %	N/A	N/A
AuburnBank	89,217	10.82	32,978	4.00	$ 41,222	5.00 %
Common Equity Tier 1 Capital						
Auburn National Bancorporation	$ 87,382	16.42 %	$ 23,949	4.50 %	N/A	N/A
AuburnBank	89,217	16.74	23,987	4.50	$ 34,648	6.50 %
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	$ 90,382	16.98 %	$ 31,932	6.00 %	N/A	N/A
AuburnBank	89,217	16.74	31,983	6.00	$ 42,644	8.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	$ 95,300	17.91 %	$ 42,576	8.00 %	N/A	N/A
AuburnBank	94,135	17.66	42,644	8.00	$ 53,305	10.00 %

Dividends paid by the Bank are a principal source of funds available to the Company for payment of dividends to its stockholders and for other needs. Applicable federal and state statutes and regulations impose restrictions on the amounts of dividends that may be declared by the subsidiary bank. State law and Federal Reserve policy restrict the Bank from declaring dividends in excess of the sum of the current year s earnings plus the retained net earnings from the preceding two years without prior approval. In addition to the formal statutes and regulations, regulatory authorities also consider the adequacy of the Bank s total capital in relation to its assets, deposits, and other such items. Capital adequacy considerations could further limit the availability of dividends from the Bank. At December 31, 2018, the Bank could have declared additional dividends of approximately $8.0 million without prior approval of regulatory authorities. As a result of this limitation, approximately $79.9 million of the Company s investment in the Bank was restricted from transfer in the form of dividends.

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NOTE 19: AUBURN NATIONAL BANCORPORATION (PARENT COMPANY)

The Parent Company s condensed balance sheets and related condensed statements of earnings and cash flows are as follows:

CONDENSED BALANCE SHEETS

		December 31	
(Dollars in thousands)		**2018**	**2017**
Assets:			
Cash and due from banks	$	1,941	1,170
Investment in bank subsidiary		87,956	88,741
Other assets		626	1,760
Total assets	$	90,523	91,671
Liabilities:			
Accrued expenses and other liabilities	$	1,468	1,548
Long-term debt			3,217
Total liabilities		1,468	4,765
Stockholders equity		89,055	86,906
Total liabilities and stockholders equity	$	90,523	91,671

CONDENSED STATEMENTS OF EARNINGS

		Year ended December 31	
(Dollars in thousands)		**2018**	**2017**
Income:			
Dividends from bank subsidiary	$	6,533	3,471
Noninterest income		149	141
Total income		6,682	3,612
Expense:			

Interest expense		51	125
Noninterest expense		237	225
Total expense		288	350
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary		6,394	3,262
Income tax benefit		(28)	(58)
Earnings before equity in undistributed earnings of bank subsidiary		6,422	3,320
Equity in undistributed earnings of bank subsidiary		2,412	4,526
Net earnings	$	8,834	7,846

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CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)	Year ended December 31 2018	2017
Cash flows from operating activities:		
Net earnings	$8,834	7,846
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Net decrease (increase) in other assets	1,134	(879)
Net decrease in other liabilities	(70)	(109)
Equity in undistributed earnings of bank subsidiary	(2,412)	(4,526)
Net cash provided by operating activities	7,486	2,332
Cash flows from financing activities:		
Repayments or retirement of long-term debt	(3,217)	
Dividends paid	(3,498)	(3,352)
Net cash used in financing activities	(6,715)	(3,352)
Net change in cash and cash equivalents	771	(1,020)
Cash and cash equivalents at beginning of period	1,170	2,190
Cash and cash equivalents at end of period	$ 1,941	1,170

NOTE 20: REVENUE RECOGNITION

On January 1, 2018, the Company implemented ASU 2014-09, *Revenue from Contracts with Customers*, codified at *ASC* 606. The Company adopted ASC 606 using the modified retrospective transition method. As of December 31, 2017, the Company had no uncompleted customer contracts and, as a result, no cumulative transition adjustment was made to the Company s accumulated deficit during the year ended December 31, 2018. Results for reporting periods beginning January 1, 2018 are presented under ASC 606, while prior period amounts continue to be reported under legacy U.S. GAAP.

The majority of the Company s revenue stream is generated from interest income on loans and deposits which are outside the scope of ASC 606.

The Company s sources of income that fall within the scope of Topic 606 include service charges on deposits, investment services, interchange fees and gains and losses on sales of other real estate, all of which are presented as components of noninterest income. The following is a summary of the revenue streams that fall within the scope of Topic 606:

Service charges on deposits, investment services, ATM and interchange fees Fees from these services are either transaction-based, for which the performance obligations are satisfied when the individual transaction is processed, or set periodic service charges, for which the performance obligations are satisfied over the period the service is provided. Transaction-based fees are recognized at the time the transaction is processed, and periodic service charges are recognized over the service period.

Gains on sales of other real estate ASU 2014-09 creates Topic 610-20, under which a gain on sale should be recognized when a contract for sale exists and control of the asset has been transferred to the buyer. Topic 606 lists several criteria required to conclude that a contract for sale exists, including a determination that the institution will collect substantially all of the consideration to which it is entitled. This presents a key difference between the prior and new guidance related to the recognition of the gain when the institution finances the sale of the property. Rather than basing recognition on the amount of the buyer s initial investment, which was the primary consideration under prior guidance, the analysis is now based on various factors including not only the loan to value, but also the credit quality of the borrower, the structure of the loan, and any other factors that may affect collectability.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act), the Company s management, under the supervision and with the participation of its principal executive and principal financial officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of the Company s disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based on that evaluation, and the results of the audit process described below, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective to ensure that information required to be disclosed in the Company s reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and regulations, and that such information is accumulated and communicated to the Company s management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure.

Management s Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting. Internal control is designed to provide reasonable assurance to the Company s management and board of directors regarding the preparation of reliable published financial statements. Internal control over financial reporting includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Because of inherent limitations in any system of internal control, no matter how well designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the Company s internal control over financial reporting as of December 31, 2018. This assessment was based on criteria for effective internal control over financial reporting described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework). Based on this assessment, the Chief Executive Officer and Chief Financial Officer assert that the Company maintained effective internal control over financial reporting as of December 31, 2018 based on the specified criteria.

The effectiveness of the Company s internal control over financial reporting as of December 31, 2018 has been audited by Elliott Davis, LLC, the independent registered public accounting firm who also has audited the Company s consolidated financial statements included in this Annual Report on Form 10-K. Elliott Davis, LLC s attestation report on the Company s internal control over financial reporting appears on the following page and is incorporated by reference herein.

Changes in Internal Control Over Financial Reporting

During the period covered by this report, there has not been any change in the Company s internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Auburn National Bancorporation, Inc.

Opinion on the Internal Control Over Financial Reporting

We have audited Auburn National Bancorporation, Inc. and its subsidiaries (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2018 and 2017 and the related consolidated statements of earnings, comprehensive income, stockholders equity, and cash flows of the Company for the years then ended, and the related notes to the consolidated financial statements and our report dated March 12, 2019 expressed an unqualified opinion.

Basis for Opinion

The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide

reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company s assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Elliott Davis, LLC

Greenville, South Carolina

March 12, 2019

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ITEM 9B. OTHER INFORMATION

None.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information required by this item is set forth under the headings Proposal One: Election of Directors - Information about Nominees for Directors, and Executive Officers, Additional Information Concerning the Company s Board of Directors and Committees, Executive Compensation, Audit Committee Report and Compliance with Section 16(a) of the Securities Exchange Act of 1934 in the Proxy Statement, and is incorporated herein by reference.

The Board of Directors has adopted a Code of Conduct and Ethics applicable to the Company s directors, officers and employees, including the Company s principal executive officer, principal financial and principal accounting officer, controller and other senior financial officers. The Code of Conduct and Ethics, as well as the charters for the Audit Committee, Compensation Committee, and the Nominating and Corporate Governance Committee, can be found by hovering over the heading About Us on the Company s website, *www.auburnbank.com*, and then clicking on Investor Relations , and then clicking on Governance Documents . In addition, this information is available in print to any shareholder who requests it. Written requests for a copy of the Company s Code of Conduct and Ethics or the Audit Committee, Compensation Committee, or Nominating and Corporate Governance Committee Charters may be sent to Auburn National Bancorporation, Inc., 100 N. Gay Street, Auburn, Alabama 36830, Attention: Marla Kickliter, Senior Vice President of Compliance and Internal Audit. Requests may also be made via telephone by contacting Marla Kickliter, Senior Vice President of Compliance and Internal Audit, or Laura Carrington, Vice President of Human Resources, at (334) 821-9200.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this item is set forth under the headings Additional Information Concerning the Company s Board of Directors and Committees Board Compensation, and Executive Officers in the Proxy Statement, and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this item is set forth under the headings Proposal One: Election of Directors - Information about Nominees for Directors and Executive Officers and Stock Ownership by Certain Persons in the Proxy Statement, and is incorporated herein by reference.

As of December 31, 2018 the Company had no compensation plans under which equity securities of the Company are authorized for issuance.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information required by this item is set forth under the headings Additional Information Concerning the Company s Board of Directors and Committees Committees of the Board of Directors Independent Directors Committee and Certain Transactions and Business Relationships in the Proxy Statement, and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information required by this item is set forth under the heading Independent Public Accountants in the Proxy Statement, and is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) List of all Financial Statements

The following consolidated financial statements and report of independent registered public accounting firm of the Company are included in this Annual Report on Form 10-K:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2018 and 2017

Consolidated Statements of Earnings for the years ended December 31, 2018 and 2017

Consolidated Statements of Comprehensive Income for the years ended December 31, 2018 and 2017

Consolidated Statements of Stockholders Equity for the years ended December 31, 2018 and 2017

Consolidated Statements of Cash Flows for the years ended December 31, 2018 and 2017

Notes to the Consolidated Financial Statements

(b) Exhibits

3.1.	Certificate of Incorporation of Auburn National Bancorporation, Inc. (incorporated by reference from Registrant s Form 10-Q dated June 30, 2002 (File No. 000-26486)).
3.2.	Amended and Restated Bylaws of Auburn National Bancorporation, Inc., adopted as of November 13, 2007 (incorporated by reference from Registrant s Form 10-K dated March 31, 2008 (File No. 000-26486)).
21.1	Subsidiaries of Registrant
31.1	Certification signed by the Chief Executive Officer pursuant to SEC Rule 13a-14(a).
31.2	Certification signed by the Chief Financial Officer pursuant to SEC Rule 13a-14(a).
32.1	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002 by Robert W. Dumas, Chairman, President and Chief Executive Officer *
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002 by David A. Hedges, EVP, Chief Financial Officer.*
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document

101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

* The certifications attached as exhibits 32.1 and 32.2 to this annual report on Form 10-K are furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

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(c) Financial Statement Schedules

All financial statement schedules required pursuant to this item were either included in the financial information set forth in (a) above or are inapplicable and therefore have been omitted.

ITEM 16. FORM 10-K SUMMARY

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Auburn, State of Alabama, on March 12, 2019.

AUBURN NATIONAL BANCORPORATION, INC.
(Registrant)

By: /S/ ROBERT W. DUMAS
Robert W. Dumas
Chairman, President and CEO

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/S/ ROBERT W. DUMAS Robert W. Dumas	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	March 12, 2019
/S/ DAVID A. HEDGES David A. Hedges	EVP, Chief Financial Officer (Principal Financial Officer)	March 12, 2019
/S/ C. WAYNE ALDERMAN C. Wayne Alderman	Director	March 12, 2019
/S/ TERRY W. ANDRUS Terry W. Andrus	Director	March 12, 2019
/S/ J. TUTT BARRETT J. Tutt Barrett	Director	March 12, 2019
/S/ WILLIAM F. HAM, JR. William F. Ham, Jr.	Director	March 12, 2019
/S/ DAVID E. HOUSEL	Director	March 12, 2019

David E. Housel		
/S/ ANNE M. MAY	Director	March 12, 2019
Anne M. May		
/S/ AMY B. MURPHY	Director	March 12, 2019
Amy B. Murphy		
/S/ EDWARD LEE SPENCER, III	Director	March 12, 2019
Edward Lee Spencer, III		
/S/ PATRICIA WADE	Director	March 12, 2019
Dr. Patricia Wade		