

AUBURN NATIONAL BANCORPORATION, INC
Form 10-K
March 13, 2018
Table of Contents

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, 2017

OR

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

For the transition period from _____ to _____

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact name of registrant as specified in charter)

Delaware
(State or other jurisdiction
of incorporation)

63-0885779
(I.R.S. Employer
Identification No.)

100 N. Gay Street, Auburn, Alabama
(Address of principal executive offices)

36830
(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 and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark 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. (Check one):

Accelerated

Large Accelerated filer filer Non-accelerated filer Smaller reporting company Emerging Growth Company
(Do not check if a smaller reporting 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: \$87,045,712 as of June 30, 2017.

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: 3,643,698 shares of common stock as of March 12, 2018.

DOCUMENTS INCORPORATED BY REFERENCE

Edgar Filing: AUBURN NATIONAL BANCORPORATION, INC - Form 10-K

Portions of the Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held May 8, 2018, are incorporated by reference into Part II, Item 5 and Part III of this Form 10-K.

Table of Contents

TABLE OF CONTENTS		PAGE
<u>PART I</u>		
ITEM 1.	<u>BUSINESS</u>	2
ITEM 1A.	<u>RISK FACTORS</u>	20
ITEM 1B.	<u>UNRESOLVED STAFF COMMENTS</u>	32
ITEM 2.	<u>PROPERTIES</u>	32
ITEM 3.	<u>LEGAL PROCEEDINGS</u>	33
ITEM 4.	<u>MINE SAFETY DISCLOSURES</u>	33
<u>PART II</u>		
ITEM 5.	<u>MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES</u>	33
ITEM 6.	<u>SELECTED FINANCIAL DATA</u>	34
ITEM 7.	<u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	35
ITEM 7A.	<u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	63
ITEM 8.	<u>FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA</u>	64
ITEM 9.	<u>CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE</u>	103
ITEM 9A.	<u>CONTROLS AND PROCEDURES</u>	103
ITEM 9B.	<u>OTHER INFORMATION</u>	105
<u>PART III</u>		
ITEM 10.	<u>DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE</u>	106
ITEM 11.	<u>EXECUTIVE COMPENSATION</u>	106
ITEM 12.	<u>SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS</u>	106
ITEM 13.	<u>CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE</u>	106
ITEM 14.	<u>PRINCIPAL ACCOUNTING FEES AND SERVICES</u>	106
<u>PART IV</u>		
ITEM 15.	<u>EXHIBITS AND FINANCIAL STATEMENT SCHEDULES</u>	107
ITEM 16.	<u>FORM 10-K SUMMARY</u>	108

Table of Contents

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, should, 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;

Table of Contents

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

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.

Edgar Filing: AUBURN NATIONAL BANCORPORATION, INC - Form 10-K

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.

Table of Contents

The Company directly owns 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. The outstanding principal amount of debentures related to those trust preferred securities remains included in the Company's Tier 1 capital for regulatory purposes.

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 158,991 in 2016, and has increased approximately 13.3% from 2010 to 2016. 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.

Table of Contents

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, 2017, the Company and its subsidiaries had 156 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.

Table of Contents

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'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 depository 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 their 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.

Table of Contents

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. Since the Company's common stock is registered with the Securities Exchange Commission, it does not qualify for the Small BHC Policy. As a result, unless and until the Company qualifies under the Small BHC Policy, the Company's capital adequacy will continue to be evaluated on a consolidated basis with its subsidiaries. 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: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity 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. 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.

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 banks and thrifts 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.

Table of Contents

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.

The Bank is also subject to, among other things, the provisions of the Equal Credit Opportunity Act (the ECOA) and the Fair Housing Act (the FHA), 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 and FHA, 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 federal Consumer Financial Protection Bureau (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.

The Dodd-Frank Act established the CFPB, which began exercising its regulatory authority upon the recess appointment of its director on January 4, 2012. The CFPB has the authority, previously exercised by the federal bank regulators 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, Fair Credit Reporting and Privacy of Consumer Financial Privacy. Although the CFPB does not examine or supervise banks with less than \$10 billion in assets, it exercises broad authority that affects bank regulation in these areas and 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 implement the Dodd-Frank Act requirement that lenders determine whether a consumer has the ability to repay a mortgage loan became effective January 10, 2014. These established certain minimum requirements for creditors when making ability to pay 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 anticipate focusing 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.

Table of Contents

The Bank generally services the loans it originates, including those it sells. The CFPB adopted new mortgage servicing standards, effective in January 2014. These include new requirements regarding force-placed insurance, certain notices prior to rate adjustments on adjustable rate mortgages, and periodic disclosures to borrowers. Servicers will be 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 new standards are expected to 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.

In October 2015, the CFPB issued 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 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.

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.

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 this Act's money laundering provisions in acting upon acquisition and merger 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.

Table of Contents

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, 2017 are included elsewhere in this report with no material weaknesses reported.

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 2017, the Bank paid cash dividends of approximately \$3.5 million to the Company. At December 31, 2017, the Bank could have declared additional dividends of approximately \$10.2 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.

When fully-phased in by January 1, 2019, the Basel III capital rules will 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. See Basel III Capital Rules.

Table of Contents**Capital**

The Federal Reserve has risk-based capital guidelines for bank holding companies and state member banks, respectively. These guidelines required at year end 2017 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 9.25%. 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.

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 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

Table of Contents

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 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 such companies subject to the Small BHC Policy), as well as their bank and thrift subsidiaries.

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, 2017 is included in Note 19 of the consolidated financial statements that accompany this report.

Depository institutions that are no longer well capitalized for bank regulatory purposes must receive a waiver from the FDIC prior to accepting or renewing 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, the respective managements of the Company and the Bank do not believe that the provisions of FDICIA have had or will 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 Rules.

Table of Contents

The Basel III Rules limit Tier 1 capital to common stock and noncumulative perpetual preferred stock, as well as trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010, each of which are permanently grandfathered in Tier 1 capital for bank holding companies with less than \$15 billion in assets. The Basel III 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.

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%.

The capital conservation buffers and the related restrictions on permissible dividends, stock repurchases and discretionary bonuses were applicable for the first time in 2016. The capital conservation buffer of 0.625% or less became effective in 2016. In 2017, the capital conservation trigger was 1.25% or less.

Table of Contents

When fully-phased in by 2019, 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 -

The various capital elements and total capital under the Basel III Rules, when fully phased by January 1, 2019 will be:

	December 31, 2017	Fully Phased In January 1, 2019
Minimum CET1	4.50%	4.50%
CET1 Conservation Buffer	1.25%	2.50%
Total CET1	5.75%	7.0%
Deductions from CET1	80%	100%
Minimum Tier 1 Capital	6.0%	6.0%
Minimum Tier 1 Capital <i>plus</i> conservation buffer	7.25%	8.5%
Minimum Total Capital	8.0%	8.0%
Minimum Total Capital <i>plus</i> conservation buffer	9.25%	10.5%

Changes in Risk-Weightings

Basel III significantly changed the risk weightings used to determine risk weighted capital adequacy. Among various other changes, Basel III applies 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. The proposal also would change the risk-weighting for residential mortgages, including mortgages sold. A new 150% risk-weighted category would apply 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 sales as completed value before the loan was made.

Table of Contents

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

Illustrations of Changes to Prompt Corrective Action Rules

Under the Basel III Rules, the prompt corrective action rules and categories changed as of January 1, 2015. The following illustrates the range of the changes from well capitalized, to undercapitalized, to critically undercapitalized categories. The adequately capitalized and significantly undercapitalized categories also would be retained with appropriate changes, but are not included in the following illustration.

	<u>Pre-2015</u>	<u>Minimums</u>	<u>Basel III</u>
Well capitalized			
CET1			6.5%
Tier 1 risk-based capital	6.0%		8.0%
Total risk-based capital	10.0%		10.0%
Tier 1 leverage ratio	5.0%		5.0%
Undercapitalized			
CET1			< 4.5%

Tier 1 risk-based capital	< 4.0%	£ 6.0%
Total risk-based capital	< 8.0%	< 8.0%
Tier 1 leverage ratio	< 5.0%	< 4.0%

Critically undercapitalized	Tangible equity to total assets £ 2.0%	Tier 1 capital plus non-Tier 1 perpetual preferred stock to total assets £ 2.0%
------------------------------------	--	---

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.

Table of Contents

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.

On April 30, 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 five times since December 2015 in 25 basis point increments from 0.25% to 1.50% on December 13, 2017. 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.

The nature and timing of any changes in monetary policies and their effect on the Company and the Bank cannot be predicted.

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.

Effective April 1, 2011, and as discussed above under *Recent Regulatory Developments* , the FDIC began 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.

Table of Contents

Effective July 1, 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 2017 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

The FDIC's reserve ratio of the DIF to total industry deposits reached its 1.15% target effective June 30, 2016. 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%.

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 2017 and 2016, 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 for the first quarter of 2016 was 0.58 basis points, which declined to 0.56 basis points for the remainder of the year. The FICO assessment rate for the first quarter of 2017 was 0.56 basis points, which declined to 0.54 basis points for the remainder of the year. FICO assessments of approximately \$42 thousand and \$40 thousand were paid to the FDIC in 2016 and 2017, respectively. The FICO assessments should continue to shrink during 2018-2019, and end when the last FICO bonds mature.

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.

Table of Contents

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 2016 or 2017. At December 31, 2017, the Bank had outstanding \$39.6 million in construction and land development loans and \$233.3 million in total CRE loans (excluding owner occupied), which represent approximately 42.1% and 247.9%, respectively, of the Bank's total risk-based capital at December 31, 2017. 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.

The Bank did not have any loans at year-end 2017 or 2016 that were leveraged loans subject to the Interagency Guidance on Leveraged Lending (February 19, 2013).

Other Dodd-Frank Act Provisions

The Dodd-Frank Act was signed into law on July 21, 2011. 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.

Table of Contents

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 are scheduled to 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.

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 Act's requirement to delete references to rating agency ratings for various purposes, including investment securities, which are permissible bank investments.

Table of Contents

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.

The President of the United States, and the majority party in both houses of Congress appear committed to financial regulatory reform, including changes to the Dodd-Frank Act. 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.

Congress is also considering re-examining regulations adopted by the prior administration since June 13, 2016 under the Congressional Review Act. More sweeping changes to the Dodd-Frank Act are expected to be introduced by the Chairman of the House Financial Services Committee similar to the Financial CHOICE Act legislation introduced in 2016. These may include proposals to reduce regulation on banks and their holding companies that are well capitalized, well managed, and less risky, and eliminate or reduce regulation based on asset size alone.

In addition, on November 13, 2017, a bipartisan group of Senators announced their agreement on proposed legislation, the Economic Growth, Regulatory Relief and Consumer Protection Act, S.2155, which would provide regulatory relief for a range of banking organizations, primarily focused on smaller financial institutions. Among other things, the bill would provide an exemption from the Dodd-Frank Act's Volcker Rule for insured depository institutions with less than \$10 billion in total consolidated assets and lower levels of trading assets and liabilities, and an exemption from the U.S. Basel III-based capital requirements for smaller banking organizations that voluntarily maintain a

leverage ratio of at least 8-10%.

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.

Table of Contents

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 cyclicalities may adversely affect our industry.

We are exposed to downturns in the U.S. economy and market conditions generally. Local employment and local economic conditions may be effected to a greater extent than historically because of the growth of automobile manufacturing and related suppliers located in our markets. These businesses are adversely affected by higher interest rates and experience cyclicalities of sales.

We believe the following, among other things, may affect us in 2018:

We expect to face continued high levels of regulation of our industry as a result of continued Dodd-Frank Act rulemaking and other initiatives by the U.S. government and its regulatory agencies, including the CFPB. Compliance with such regulations may increase our costs, reduce our profitability, and limit our ability to pursue business opportunities and serve customers' needs. Various pending bills in Congress and statements by our regulators may offer some regulatory relief for banking organizations of our size, though we believe that our efforts toward comprehensive regulatory relief would be slow and contentious. We are uncertain about the scope, nature and timing of any regulatory relief and its effect on us.

Although unemployment nationally is low, the economy is growing relatively slowly. The Federal Reserve, adopted in September 2014 a normalization of monetary 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 five times since December 2015 in 25 basis point increments from 0.25% to 1.50% on December 13, 2017. 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 holding 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. We expect the Federal Reserve to continue to increase target rates at a moderate pace, subject to pauses due to any new 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) signed into law by the President on December 22, 2017, 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.

Table of Contents

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 Dodd-Frank Act's Volcker Rule, including final regulations adopted on December 10, 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 interests in collateralized loan obligations (CLOs), which we could otherwise use to diversify our assets and for asset/liability management. Pending legislation to remove Volcker Rule restrictions on banks under \$10 billion in assets may or may not be adopted in a form that changes the applicability of the Volcker Rule to us.

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, 2017, 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, 2017, our nonaccrual loans totaled \$3.0 million, or 0.66% of total loans. We had no properties held as other real estate owned at December 31, 2017. 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, or 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. Any such impact could be material.

Table of Contents

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

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 final regulations implementing the Dodd-Frank Act, which require that lenders determine whether a consumer has the ability to repay a mortgage loan, which became effective in January 2014, have limited the secondary market for and liquidity of many mortgage loans that are not qualified mortgages.

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, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, have been in conservatorship since September 2008. Minimal capital, the levels of risky assets at the Federal Housing Administration, or 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 earnings, 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.

Table of Contents

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

The CFPB adopted new residential mortgage servicing standards in January 2014 that add additional servicing requirements, increase our required 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 MSR's. 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.

In February 2018 Fannie Mae reported that the new Tax Act had reduced its deferred tax assets, and that it had a net worth deficit of \$3.7 billion as of December 31, 2017. To eliminate its net worth deficit, Fannie Mae expects that the Director of the Federal Housing Finance Agency, or FHFA, will submit a request to the Treasury Department on the Fannie Mae's behalf for \$3.7 billion. Freddie Mac had a net worth deficit of \$312 million at December 31, 2017, and expects FHFA, will submit a draw request to the Treasury Department for \$312 million.

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, or 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 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 the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risks in commercial real estate markets would also be considered CRE loans under the guidance. Loans on owner occupied commercial real estate are generally excluded. We had 61.1% of our portfolio in CRE loans, as defined by the Federal Reserve, at year-end 2017 compared to 60.7% at year-end 2016. 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 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.

Table of Contents

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, 2017, we had net deferred tax assets of \$0.8 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.

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 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 five times between December 2015 and January 2018 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 could also cause consumers to shift their funds to more interest bearing instruments and to increase the competition for funds. While the Federal Reserve has indicated it will seek to gradually adjust low interest rates, interest rates could increase more than anticipated. See [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.

Table of Contents

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.

The 2017 Tax Act, including its fiscal stimulus limitations on the deductibility of residential mortgage interest 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.

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, 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 needed, could also be impaired by factors 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.

Table of Contents

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, not shareholders. The financial services industry also is subject to frequent legislative and regulatory changes and proposed changes. The current President and the majority party in both houses of Congress have espoused regulatory relief of the banking industry, but the nature, effects and timing of administrative and legislative change cannot be predicted. Federal bank regulatory agencies and the Treasury, 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.

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.

Table of Contents

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.

While banks and thrift holding companies with assets of less than \$15 billion as of December 31, 2009 are permitted to include trust preferred securities that were issued before May 19, 2010 as Tier 1 capital under the Dodd-Frank Act, only bank holding companies with assets of less than \$500 million are permitted to continue to issue trust preferred securities and have them count 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 or Company senior or secured debt, the proceeds of which could be downstreamed as capital to the Bank. Instead, we would have to issue noncumulative preferred stock or common equity. To the extent we issue new equity, it could result in dilution to our 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;

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.

Table of Contents

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 other 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.

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.

Table of Contents

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 are based upon the use of 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 pending regulations.

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.

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 breaches in the security of 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, 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.

Table of Contents

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 remediation costs, disruption of operations, misappropriation of confidential information, damage to systems operated by us or our third-party service providers, as well as damaging 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 take such risks regardless of the structure of our compensation programs and practices. Similarly, although we employ controls and procedures designed to monitor associates business decisions and prevent them from taking excessive risks, and to prevent employee misconduct, 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.

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.

Table of Contents

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 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, 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.

Table of Contents

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 division, data processing activities, as well as other operations, are located in the Center. In total, the main office and Center parking lots provide parking for approximately 196 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.

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 2015, the Bank's land lease renewed for another three 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 2017, 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.

Table of Contents

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.

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.

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 3,643,698 shares of the Company's Common Stock issued and outstanding, which were held by approximately 397 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	
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
2016			

Edgar Filing: AUBURN NATIONAL BANCORPORATION, INC - Form 10-K

First Quarter	\$ 30.49	\$ 24.56	\$ 0.225
Second Quarter	29.85	26.81	0.225
Third Quarter	28.91	27.45	0.225
Fourth Quarter	31.31	27.45	0.225

(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](#) .

Table of Contents

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.

Performance Graph

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2012 to December 31, 2017, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2012). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.

<i>Index</i>	<i>Period Ending</i>					
	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Auburn National Bancorporation, Inc.	100.00	124.35	121.78	157.82	172.15	219.60
NASDAQ Composite	100.00	140.12	160.78	171.97	187.22	242.71
SNL Southeast Bank	100.00	135.52	152.63	150.24	199.45	246.72

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.

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.

Table of Contents**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, 2017 and 2016 and our results of operations for the years ended December 31, 2017 and 2016. 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	
	2017	2016
<i>(Dollars in thousands, except per share data)</i>		
Net interest income (a)	\$ 25,731	\$ 24,008
Less: tax-equivalent adjustment	1,205	1,276
Net interest income (GAAP)	24,526	22,732
Noninterest income	3,441	3,383
Total revenue	27,967	26,115
Provision for loan losses	(300)	(485)
Noninterest expense	16,784	15,348
Income tax expense	3,637	3,102
Net earnings	\$ 7,846	\$ 8,150
Basic and diluted net earnings per share	\$ 2.15	\$ 2.24

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

Financial Summary

The Company's net earnings were \$7.8 million, or \$2.15 per share, for the full year 2017, compared to \$8.2 million, or \$2.24 per share, for the full year 2016. The decrease in the Company's 2017 earnings was primarily due to a deferred tax asset remeasurement adjustment of \$0.4 million as a result of a lowered enacted corporate tax rate. The Tax Cuts and Jobs Act, signed into law December 22, 2017, lowered the Company's federal corporate tax rate from 34% to 21%,

which will lower the Company's provision for federal income taxes in future years. However, the Company was required to remeasure the value of its net deferred tax assets by \$0.4 million as of December 31, 2017. Excluding the impact of the tax remeasurement adjustment, net earnings would have been \$8.2 million, or \$2.25 per share, for the full year 2017, compared to \$8.2 million, or \$2.24 per share for the full year 2016.

Net interest income (tax-equivalent) was \$25.7 million in 2017, compared to \$24.0 million in 2016. This increase was primarily due to loan growth and an increase in interest income from securities available-for-sale as management reduced its investment in federal funds sold and interest-bearing bank deposits and increased its investment in securities as market yields improved. The Company also lowered its deposit costs and repurchased higher-cost wholesale funding sources. Average loans were \$441.0 million in 2017, an increase of \$10.2 million or 2%, from 2016.

Table of Contents

The Company recorded a negative provision for loan losses of \$0.3 million for 2017, compared to a negative provision of \$0.5 million for 2016. Annualized net recoveries as a percent of average loans were 0.09% and 0.19% for 2017 and 2016, respectively. The Company recognized a recovery of \$0.4 million from the payoff of two nonperforming commercial loans during 2017 and \$1.2 million from the payoff of one nonperforming construction and land development loan during 2016.

Noninterest income was \$3.4 million in 2017 and 2016, respectively. A decrease in mortgage lending income of \$0.2 million as mortgage loan production declined was offset by \$0.2 million improvement in securities gains (losses), net.

Noninterest expense was \$16.8 million in 2017, compared to \$15.3 million in 2016. The increase was primarily due to a gain on early extinguishment of debt of \$0.8 million realized in 2016. The Company purchased \$4.0 million of trust preferred securities related to its junior subordinated debentures with a floating rate of 3.63% in 2016. In addition, other real estate owned expense increased \$0.4 million primarily due to realized holding gains on the sale of OREO in 2016 and salaries and benefits increased \$0.2 million in 2017 due to routine annual increases.

Income tax expense was \$3.6 million in 2017 compared to \$3.1 million in 2016. The Company's effective income tax rate was 31.67% in 2017, compared to 27.57% in 2016. The increase in the effective tax rate was primarily attributable to a \$0.4 million tax remeasurement adjustment discussed above. We continue to review the impact of the 2017 Tax Act to our operations, which may result in additional adjustments to future periods' results of operations. Excluding the impact of the tax remeasurement adjustment, the Company's effective tax rate would have been 28.46% during 2017 reflecting an increase in the level of earnings before taxes and a decrease in tax exempt earnings from the bank-owned life insurance.

In 2017, the Company paid cash dividends of \$3.4 million, or \$0.92 per share. The Company remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 17.91%, a Tier 1 risk-based capital ratio of 16.98%, a Tier 1 leverage capital ratio of 10.95% and a Common Equity Tier 1 (CET1) capital ratio of 16.42% at December 31, 2017.

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.

Table of Contents

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, 2017 and 2016, 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. Beginning with the quarter ended December 31, 2016, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. First, the Company increased its look-back period for calculating average losses for all loan segments to 31 quarters. Prior to December 31, 2016, the Company calculated average losses for all loan segments using a rolling 20 quarter look-back period. For the year ended December 31, 2017, the Company increased its look-back period to 35 quarters to continue to include the losses incurred by the Company beginning with the first quarter 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. 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. Second, the Company increased the range of basis point adjustments allowed for qualitative and

environmental factors to approximately 200 basis points, an increase of 65 basis points, or 48%, compared to the 135 basis point range used prior to December 31, 2016. After performing sensitivity testing of its calculation of the allowance for loan losses, the Company determined that it should increase the range of basis points allowed for qualitative and environmental factors in order to provide sufficient latitude in determining estimated probable credit losses during periods of economic stress. Third, the Company reduced the percentage allocation for qualitative and environmental factors on a weighted average basis to 21% of total basis points allocable at December 31, 2016, compared to 25% of total basis points allocable at September 30, 2016. The Company believes a decrease in the percentage allocation of qualitative environmental factors on a weighted average basis was appropriate due to the extension of its look-back period described above. If the Company did not make the changes described above, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$0.9 million, or 0.21% of total loans, at December 31, 2016. Other than the changes discussed above, 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.

Table of Contents

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.

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 17, 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.

Table of Contents**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, 2017. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

The 2017 Tax Act reduced the federal corporate income tax rate to 21% compared to 35%. We believe this reduction in tax rate will benefit us in 2018 and later years. We continue reviewing the impact of the 2017 Tax Act to our operations, which may result in additional adjustments to future periods' results of operations.

Average Balance Sheet and Interest Rates

	2017		Year ended December 31	
	Average	Yield/	Average	Yield/
<i>(Dollars in thousands)</i>	Balance	Rate	Balance	Rate
Loans and loans held for sale	\$ 442,101	4.70%	\$ 432,180	4.73%
Securities - taxable	197,108	2.15%	166,870	1.97%
Securities - tax-exempt (a)	69,881	5.07%	68,507	5.48%
Total securities	266,989	2.91%	235,377	2.99%
Federal funds sold	32,342	1.05%	49,446	0.50%
Interest bearing bank deposits	41,317	1.04%	70,064	0.51%
Total interest-earning assets	782,749	3.75%	787,067	3.57%
Deposits:				
NOW	125,935	0.20%	121,723	0.27%
Savings and money market	230,121	0.37%	232,601	0.38%
Certificates of deposits	198,457	1.18%	212,662	1.23%
Total interest-bearing deposits	554,513	0.62%	566,986	0.68%
Short-term borrowings	3,476	0.52%	2,973	0.50%
Long-term debt	3,217	3.89%	6,474	3.52%
Total interest-bearing liabilities	561,206	0.64%	576,433	0.71%
Net interest income and margin (a)	\$ 25,731	3.29%	\$ 24,008	3.05%

(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 \$25.7 million in 2017, compared to \$24.0 million in 2016. This increase was primarily due to loan growth and an increase in interest income from securities available-for-sale as management reduced its investment in federal funds sold and interest bearing bank deposits and increased its investment securities as market yields improved. The Company also lowered its deposit costs and repurchased higher-cost wholesale funding sources.

The tax-equivalent yield on total interest-earning assets increased by 18 basis points in 2017 from 2016 to 3.75%. Increases in yields on short-term assets, including federal funds sold and interest bearing bank deposits, due to recent increases in the Federal Reserve's federal funds rate targets, were partially offset by declining loan yields resulting from pricing competition for quality loan opportunities in our markets and declining securities yields due to lower reinvestment rates for municipal bonds.

Table of Contents

The cost of total interest-bearing liabilities decreased 7 basis points in 2017 from 2016 to 0.64%. The net decrease was largely a result of the continued shift in our funding mix, as we increased our lower-cost interest-bearing demand deposits (NOW accounts) and concurrently reduced our balances of higher-cost certificates of deposits and long-term debt.

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 this extended period of low interest rates, increased competition for quality loan opportunities, and possible increases in our costs of funds and our variable rate assets, if the Federal Reserve continues its gradual increase in interest rates. The Company anticipates that this challenging competitive environment will continue in 2018 and it is unclear what impact the reduction in corporate tax rates under the Tax Cuts and Jobs Act will have on the interest rates the Company is able to charge for loans or pay on deposits though it is believed it will increase competition. However, the Company believes our net interest income should increase in 2018 compared to 2017 primarily due to an increase in average earning asset volumes, primarily loans.

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 a negative provision for loan losses of \$0.3 million and \$0.5 million for the years ended December 31, 2017 and 2016, respectively.

Net recoveries were \$0.4 million, or 0.09% of average loans and \$0.08 million, or 0.19% of average loans, for the years ended December 31, 2017 and 2016, respectively. The Company recognized a recovery of \$0.4 million from the payoff of two nonperforming commercial loans during 2017 and \$1.2 million from the payoff of one nonperforming construction and land development loan during 2016.

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 1.05% at December 31, 2017 from 1.08% at December 31, 2016. 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, 2017. 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

<i>(Dollars in thousands)</i>	Year ended December 31	
	2017	2016
Service charges on deposit accounts	\$ 746	\$ 773
Mortgage lending	777	947

Bank-owned life insurance	442	456
Securities gains (losses), net	51	(221)
Other	1,425	1,428
Total noninterest income	\$ 3,441	\$ 3,383

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 MSR's when the loan is sold.

MSR's 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 MSR's under the amortization method. Servicing fee income is reported net of any related amortization expense.

Table of Contents

The Company evaluates MSR's for impairment on a quarterly basis. Impairment is determined by grouping MSR's by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSR's 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 MSR's while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSR's.

The following table presents a breakdown of the Company's mortgage lending income for 2017 and 2016.

<i>(Dollars in thousands)</i>	Year ended December 31	
	2017	2016
Origination income	\$ 504	\$ 764
Servicing fees, net	272	184
Decrease (increase) in MSR valuation allowance	1	(1)
Total mortgage lending income	\$ 777	\$ 947

The decrease in mortgage lending income was primarily due to a decrease in the volume of mortgage loans originated and sold.

Securities gains (losses), net consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net gains realized on the sale of securities were \$51 thousand for 2017, compared to net losses realized on the sale of securities of \$221 thousand for 2016. The Company did not incur any other-than-temporary impairment charges in 2017 and 2016.

Noninterest Expense

<i>(Dollars in thousands)</i>	Year ended December 31	
	2017	2016
Salaries and benefits	\$ 10,011	\$ 9,826
Net occupancy and equipment	1,471	1,474
Professional fees	966	825
FDIC and other regulatory assessments	346	406
Other real estate owned, net	5	(371)
Gain on early extinguishment of debt		(790)
Other	3,985	3,978
Total noninterest expense	\$ 16,784	\$ 15,348

The increase in salaries and benefits expense reflects routine annual increases.

The increase in professional fees expense was primarily due to increases in professional fees associated with our mortgage lending division.

The decrease in FDIC and other regulatory assessments expense was primarily due to a decrease in the Bank's initial assessment rate during the third quarter of 2016. In addition to changes in the FDIC assessment rate formula for banks with less than \$10 billion in assets, the initial assessment rate for all banks decreased effective July 1, 2016 due to the Deposit Insurance Reserve Fund ratio exceeding 1.15% at June 30, 2016.

The increase in other real estate owned expense was primarily due to gains realized from sale of OREO in 2016.

During 2016 the Company recognized a \$0.8 million gain on early extinguishment of debt when it purchased \$4.0 million of the \$7.0 million in outstanding trust preferred securities issued by Auburn National Bancorporation Capital Trust I. (the Trust) and deemed an equivalent amount of the related junior subordinated debentures issued by the Company as no longer outstanding.

Table of Contents**Income Tax Expense**

Income tax expense was \$3.6 million in 2017 compared to \$3.1 million in 2016. The Company's effective income tax rate was 31.67% in 2017, compared to 27.57% in 2016. The increase in the effective tax rate was primarily attributable to a \$0.4 million tax remeasurement adjustment previously discussed. Excluding the impact of the tax remeasurement adjustment, the Company's effective tax rate would have been 28.46% during 2017 reflecting an increase in the level of earnings before taxes and a decrease in tax exempt earnings from the bank-owned life insurance.

BALANCE SHEET ANALYSIS**Securities**

Securities available-for-sale were \$257.7 million at December 31, 2017, an increase of \$14.1 million, or 5%, compared to \$243.6 million as of December 31, 2016. This increase reflects an increase in the amortized cost basis of securities available-for-sale of \$13.7 million and an increase in the fair value of securities available-for-sale of \$0.4 million. The increase in the amortized cost basis of securities available-for-sale was primarily due to management increasing the Company's investment securities as market yields improved in early 2017. The average tax-equivalent yields earned on total securities were 2.91% in 2017 and 2.99% in 2016.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2017 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.

		1 year	1 to 5	5 to 10	December 31, 2017	
		or less	years	years	After 10	Total
<i>(Dollars in thousands)</i>					years	Fair Value
Agency obligations	\$		29,253	23,809		53,062
Agency RMBS				11,201	121,871	133,072
State and political subdivisions			2,564	9,999	59,000	71,563
Total available-for-sale	\$		31,817	45,009	180,871	257,697
Weighted average yield:						
Agency obligations			1.85%	2.04%		1.93%
Agency RMBS				2.45%	2.37%	2.38%
State and political subdivisions			3.97%	3.65%	3.21%	3.30%
Total available-for-sale			2.02%	2.50%	2.64%	2.54%

Loans

	December 31				
<i>(In thousands)</i>	2017	2016	2015	2014	2013
Commercial and industrial	\$ 59,086	49,850	52,479	54,329	57,780
Construction and land development	39,607	41,650	43,694	37,298	36,479
Commercial real estate	239,033	220,439	203,853	192,006	174,920
Residential real estate	106,863	110,855	116,673	107,641	101,706
Consumer installment	9,588	8,712	10,220	12,335	12,893
Total loans	454,177	431,506	426,919	403,609	383,778
Less: unearned income	(526)	(560)	(509)	(655)	(439)
Loans, net of unearned income	\$ 453,651	430,946	426,410	402,954	383,339

Total loans, net of unearned income, were \$453.7 million at December 31, 2017, an increase of \$22.7 million, or 5%, from \$430.9 million at December 31, 2016. Four loan categories represented the majority of the loan portfolio at December 31, 2017: commercial real estate mortgage loans (53%), residential real estate mortgage loans (24%), commercial and industrial loans (13%) and construction and land development loans (9%). Approximately 18% of the Company's commercial real estate loans were classified as owner-occupied at December 31, 2017.

Table of Contents

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$12.6 million, or 3%, and \$13.7 million, or 3%, of total loans, net of unearned income at December 31, 2017 and 2016, respectively. For residential real estate mortgage loans with a consumer purpose, approximately \$2.1 million and \$1.4 million required interest-only payments at December 31, 2017 and 2016, 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.

The average yield earned on loans and loans held for sale was 4.70% in 2017 and 4.73% in 2016.

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 \$18.8 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$16.9 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, 2017, the Bank had one loan relationship exceeding our internal limit.

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, 2017 (and related balances at December 31, 2016).

	December 31	
<i>(In thousands)</i>	2017	2016
Multi-family residential properties	\$ 52,167	\$ 46,998
Lessors of 1-4 family residential properties	47,323	45,291
Shopping centers	39,966	40,925
Office buildings	24,483	22,366
Hotel/motel	22,384	19,080

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, 2017 and 2016,

respectively, the allowance for loan losses was \$4.8 million and \$4.6 million, respectively, 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 .

Table of Contents

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, 2017 is presented below.

<i>(Dollars in thousands)</i>		2017	2016	2015	Year ended December 31	
					2014	2013
Allowance for loan losses:						
Balance at beginning of period	\$	4,643	4,289	4,836	5,268	6,723
Charge-offs:						
Commercial and industrial		(449)	(97)	(100)	(46)	(514)
Construction and land development					(235)	(39)
Commercial real estate			(194)	(866)		(262)
Residential real estate		(107)	(182)	(89)	(438)	(808)
Consumer installment		(40)	(67)	(59)	(89)	(397)
Total charge-offs		(596)	(540)	(1,114)	(808)	(2,020)
Recoveries:						
Commercial and industrial		461	29	22	71	48
Construction and land development		347	1,212	17	8	6
Commercial real estate					119	4
Residential real estate		115	127	313	112	88
Consumer installment		87	11	15	16	19
Total recoveries		1,010	1,379	367	326	165
Net recoveries (charge-offs)		414	839	(747)	(482)	(1,855)
Provision for loan losses		(300)	(485)	200	50	400
Ending balance	\$	4,757	4,643	4,289	4,836	5,268
as a % of loans		1.05 %	1.08	1.01	1.20	1.37
as a % of nonperforming loans		160 %	196	158	433	124
Net (recoveries) charge-offs as a % of average loans		(0.09) %	(0.19)	0.18	0.12	0.48

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 1.05% at December 31, 2017, compared to 1.08% at December 31, 2016. 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 \$0.4 million, or 0.09% of average loans, in 2017, compared to recoveries of \$0.8 million, or 0.19%, in 2016. In 2017, the Company recognized a recovery of \$0.4 million from the payoff of two nonperforming commercial loans. In 2016, the Company recognized a recovery of \$1.2 million from the payoff of one nonperforming construction and land development loan.

At December 31, 2017 and 2016, the Company's recorded investment in loans considered impaired was \$2.7 million and \$2.1 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) of \$42 thousand and \$31 thousand at December 31, 2017 and 2016, respectively.

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.

Table of Contents**Nonperforming Assets**

At December 31, 2017 the Company had \$3.0 million in nonperforming assets compared to \$2.5 million at December 31, 2016.

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

<i>(Dollars in thousands)</i>		2017	2016	2015	December 31 2014	2013
Nonperforming assets:						
Nonperforming (nonaccrual) loans	\$	2,972	2,370	2,714	1,117	4,261
Other real estate owned			152	252	534	3,884
Total nonperforming assets	\$	2,972	2,522	2,966	1,651	8,145
as a % of loans and other real estate owned		0.66 %	0.59	0.70	0.41	2.10
as a % of total assets		0.35 %	0.30	0.36	0.21	1.08
Nonperforming loans as a % of total loans		0.66 %	0.55	0.64	0.28	1.11
Accruing loans 90 days or more past due	\$					73

The table below provides information concerning the composition of nonaccrual loans at December 31, 2017 and 2016, respectively.

<i>(In thousands)</i>		2017	December 31 2016
Nonaccrual loans:			
Commercial and industrial	\$	31	37
Construction and land development			32
Commercial real estate		2,188	2,027
Residential real estate		739	252
Consumer installment		14	22
Total nonaccrual loans / nonperforming loans	\$	2,972	2,370

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, 2017, the Company had \$3.0 million in loans on nonaccrual, compared to \$2.4 million at December 31, 2016.

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, 2017 and 2016, the Company had \$0.5 and \$0.2 million, respectively, in accruing TDRs.

At December 31, 2017 and 2016, 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, 2017 and 2016, respectively.

<i>(In thousands)</i>	2017	December 31 2016
Other real estate owned:		
Commercial:		
Developed lots	\$	37
Residential		115
Total other real estate owned	\$	152

Table of Contents

At December 31, 2017, the Company held no OREO properties acquired from borrowers compared to \$0.2 million at December 31, 2016.

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 \$5.7 million, or 1.3% of total loans at December 31, 2017, compared to \$5.8 million, or 1.4% of total loans at December 31, 2016.

The table below provides information concerning the composition of potential problem loans at December 31, 2017 and 2016, respectively.

<i>(In thousands)</i>	2017	December 31 2016
Potential problem loans:		
Commercial and industrial	\$ 119	233
Construction and land development	468	340
Commercial real estate	733	854
Residential real estate	4,253	4,326
Consumer installment	78	90
Total potential problem loans	\$ 5,651	5,843

At December 31, 2017, approximately \$0.8 million or 13.4% 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, 2017 and 2016, respectively.

<i>(In thousands)</i>	2017	December 31 2016
Performing loans past due 30 to 89 days:		
Commercial and industrial	\$ 8	66
Construction and land development		395
Commercial real estate		242
Residential real estate	1,058	1,301
Consumer installment	57	38
Total performing loans past due 30 to 89 days	\$ 1,123	2,042

Deposits

<i>(In thousands)</i>		December 31
		2017 2016
Noninterest bearing demand	\$	193,917 181,890
NOW		146,999 117,943
Money market		173,251 179,643
Savings		55,421 51,530
Certificates of deposit under \$100,000		69,960 77,255
Certificates of deposit and other time deposits of \$100,000 or more		107,711 120,510
Brokered certificates of deposit		10,400 10,372
Total deposits	\$	757,659 739,143

Table of Contents

Total deposits were \$757.7 million and \$739.1 million at December 31, 2017 and 2016, respectively. The increase in total deposits of \$18.5 million and the change in deposit mix reflect customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 0.62% in 2017 and 0.68% in 2016. Noninterest bearing deposits were 26% and 25% of total deposits at both December 31, 2017 and 2016, 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, 2017 and 2016, respectively. Securities sold under agreements to repurchase totaled \$2.7 million and \$3.4 million at December 31, 2017 and 2016, respectively.

The average rates paid on short-term borrowings was 0.52% in 2017 and 2016, 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, 2017 is included in Note 10 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes 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 and 2016, respectively. The debentures mature on December 31, 2033 and have been redeemable since December 31, 2008.

The average rates paid on long-term debt were 3.89% in 2017 and 3.52% in 2016.

CAPITAL ADEQUACY

The Company's consolidated stockholders' equity was \$86.9 million and \$82.2 million as of December 31, 2017 and 2016, respectively. The change from December 31, 2016 was primarily driven by net earnings of \$7.8 million, partially offset by cash dividends paid of \$3.4 million.

The Company's Tier 1 leverage ratio was 10.95%, Common Equity Tier 1 (CET1) risk-based capital ratio was 16.42%, Tier 1 risk-based capital ratio was 16.98%, and total risk-based capital ratio was 17.91% at December 31, 2017. 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 Company is classified as well capitalized.

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 MSR's and other items affecting earnings.

Table of Contents

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

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, 2017.

Changes in Interest Rates	Net Interest Income % Variance
400 basis points	2.39 %