

SB FINANCIAL GROUP, INC.
Form 10-Q
November 14, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission file number 1-36785

SB FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Ohio 34-1395608
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

401 Clinton Street, Defiance, Ohio 43512

(Address of principal executive offices)

(Zip Code)

(419) 783-8950

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

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

Title of each class	Name of each exchange on which registered
Common Shares, No Par Value	The NASDAQ Stock Market, LLC
4,852,551 Outstanding at November 14, 2016	(NASDAQ Capital Market)

SB FINANCIAL GROUP, INC.

FORM 10-Q

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements	1
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	29
Item 3. Quantitative and Qualitative Disclosures About Market Risk	41
Item 4. Controls and Procedures	41

PART II – OTHER INFORMATION

Item 1. Legal Proceedings	42
Item 1A. Risk Factors	42
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	42
Item 3. Defaults Upon Senior Securities	42
Item 4. Mine Safety Disclosures	42
Item 5. Other Information	42
Item 6. Exhibits	42
<u>Signatures</u>	43

PART I – FINANCIAL INFORMATION**Item 1. Financial Statements**

SB Financial Group, Inc.

Condensed Consolidated Balance Sheets
September 30, 2016 and December 31, 2015

(\$ in Thousands)	September 2016	December 2015
(Unaudited)		
ASSETS		
Cash and due from banks	\$ 25,167	\$ 20,459
Securities available for sale, at fair value	92,689	89,789
Other securities - FRB and FHLB Stock	3,748	3,748
Total investment securities	96,437	93,537
Loans held for sale	5,865	7,516
Loans, net of unearned income	619,352	557,659
Allowance for loan losses	(7,320)	(6,990)
Net loans	612,032	550,669
Premises and equipment, net	18,673	19,010
Cash surrender value of life insurance	13,653	13,437
Goodwill & other intangibles	16,426	16,435
Foreclosed assets held for sale, net	73	286
Mortgage servicing rights	6,887	7,152
Accrued interest receivable	1,641	1,260
Other assets	4,946	3,310
Total assets	\$ 801,800	\$ 733,071
LIABILITIES AND EQUITY		
Deposits		
Non interest bearing demand	\$ 116,976	\$ 113,113
Interest bearing demand	135,729	126,443
Savings	89,265	83,447
Money market	126,501	104,412
Time deposits	193,673	159,038
Total deposits	662,144	586,453
Advances from Federal Home Loan Bank	23,000	35,000

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Repurchase agreements	11,363	12,406
Trust preferred securities	10,310	10,310
Accrued interest payable	427	264
Other liabilities	8,293	7,397
Total liabilities	715,537	651,830
Commitments & Contingent Liabilities	-	-
Stockholders' Equity		
Preferred stock, Series A	13,983	13,983
Common stock	12,569	12,569
Additional paid-in capital	15,370	15,438
Retained earnings	44,933	40,059
Accumulated other comprehensive income	1,237	650
Treasury stock, at cost	(1,829)	(1,458)
Total equity	86,263	81,241
Total liabilities and equity	\$ 801,800	\$ 733,071

See notes to condensed consolidated financial statements (unaudited)

Note: The balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date

SB FINANCIAL GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME - (Unaudited)

(\$ in thousands, except share data)	<i>Three Months Ended</i>		Nine Months Ended	
	<i>September 2016</i>	<i>September 2015</i>	September 2016	September 2015
Interest income				
Loans				
Taxable	\$6,954	6,152	19,862	17,606
Nontaxable	22	10	55	25
Securities				
Taxable	378	382	1,172	1,149
Nontaxable	145	173	450	525
Total interest income	7,499	6,717	21,539	19,305
Interest expense				
Deposits	677	492	1,869	1,487
Repurchase Agreements & Other	5	5	14	14
Federal Home Loan Bank advances	83	94	266	280
Trust preferred securities	63	53	184	157
Total interest expense	828	644	2,333	1,938
Net interest income	6,671	6,073	19,206	17,367
Provision for loan losses	-	100	250	950
Net interest income after provision for loan losses	6,671	5,973	18,956	16,417
Noninterest income				
Wealth Management Fees	695	636	1,971	1,961
Customer service fees	692	734	2,052	2,068
Gain on sale of mtg. loans & OMSR's	2,503	1,687	6,170	4,892
Mortgage loan servicing fees, net	205	98	(514)	642
Gain on sale of non-mortgage loans	327	296	927	872
Data service fees	223	294	733	917
Net gain on sale of securities	59	-	262	-
Gain/(loss) on sale/disposal of assets	(31)	-	177	(20)
Other income	342	207	983	659
Total non-interest income	5,015	3,952	12,761	11,991
Noninterest expense				
Salaries and employee benefits	4,672	3,650	12,765	11,062
Net occupancy expense	523	481	1,612	1,464
Equipment expense	649	568	1,883	1,657
Data processing fees	352	286	996	796

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Professional fees	380	416	1,022	1,282
Marketing expense	123	146	493	437
Telephone and communication	101	96	302	284
Postage and delivery expense	154	198	513	633
State, local and other taxes	170	130	440	387
Employee expense	117	126	363	417
Intangible amortization expense	3	54	9	163
Other expenses	686	475	1,834	1,506
Total non-interest expense	7,930	6,626	22,232	20,088
Income before income tax expense	3,756	3,299	9,485	8,320
Income tax expense	1,209	1,035	3,018	2,569
Net income	\$2,547	2,264	6,467	5,751
Preferred Stock Dividends	244	244	731	712
Net income available to common shareholders	2,303	2,020	5,736	5,039
Basic earnings per common share	\$0.47	0.41	1.17	1.03
Diluted earnings per common share	\$0.40	0.35	1.01	0.89
Dividends per common share	\$0.060	0.050	0.175	0.145
Average common shares outstanding (in thousands):				
Basic:	4,874	4,884	4,888	4,882
Diluted:	6,376	6,390	6,384	6,422

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.**Condensed Consolidated Statements of Comprehensive Income (unaudited)**

(\$'s in thousands)	Three Months Ended Sep. 30,		Nine Months Ended Sep. 30,	
	2016	2015	2016	2015
Net income	\$2,547	\$2,264	\$6,467	\$5,751
Other comprehensive income:				
<u>Available-for-sale investment securities:</u>				
Gross unrealized holding gain (loss) arising in the period	(418)	617	1,151	362
Related tax (expense)/benefit	142	(210)	(391)	(123)
Less: Reclassification for gain realized in income	(59)	-	(262)	-
Related tax expense	20	-	89	-
Net effect on other comprehensive income	(315)	407	587	239
Total comprehensive income	\$2,232	\$2,671	\$7,054	\$5,990

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.**Condensed Consolidated Statements of Shareholders' Equity (unaudited)**

(\$'s in thousands)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance, January 1, 2016	\$ 13,983	\$ 12,569	\$ 15,438	\$ 40,059	\$ 650	\$ (1,458)	\$ 81,241
Net Income				6,467			6,467
Other Comprehensive Income					587		587
Dividends on Common Stk., \$0.175 per share				(862)			(862)
Dividends on Preferred Stk., \$0.4875 per share				(731)			(731)
Issuance of Restricted Stock and Stock Options			(154)			253	99
Stock Repurchase						(624)	(624)
Share based compensation expense			86				86
Balance, September 30, 2016	\$ 13,983	\$ 12,569	\$ 15,370	\$ 44,933	\$ 1,237	\$ (1,829)	\$ 86,263
Balance, January 1, 2015	\$ 13,983	\$ 12,569	\$ 15,461	\$ 34,379	\$ 918	\$ (1,627)	\$ 75,683
Net Income				5,751			5,751
Other Comprehensive Income					239		239
Dividends on Common Stk., \$0.145 per share				(713)			(713)
Dividends on Preferred Stk., \$0.475 per share				(712)			(712)
Issuance of Restricted Stock and Stock Options			(78)			96	18
Stock Repurchase						(2)	(2)
Share based compensation expense			61				61
Balance, September 30, 2015	\$ 13,983	\$ 12,569	\$ 15,444	\$ 38,705	\$ 1,157	\$ (1,533)	\$ 80,325

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.

Condensed Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended Sep. 30,	
(\$'s in thousands)	2016	2015
Operating Activities		
Net Income	\$6,467	\$5,751
Items providing/(using) cash		
Depreciation and amortization	892	795
Provision for loan losses	250	950
Expense of share-based compensation plan	86	61
Amortization of premiums and discounts on securities	688	744
Amortization of intangible assets	9	163
Amortization of originated mortgage servicing rights	879	725
Recapture of originated mortgage servicing rights impairment	(71)	(269)
Impairment of mortgage servicing rights	1,236	218
Proceeds from sale of loans held for sale	249,159	224,090
Originations of loans held for sale	(241,732)	(216,963)
Gain from sale of loans	(7,098)	(5,764)
(Gain)/loss on sale of assets	(150)	20
Changes in		
Interest receivable	(381)	(471)
Other assets	(2,848)	(8,276)
Interest payable and other liabilities	1,059	3,535
Net cash provided by operating activities	8,445	5,309
Investing Activities		
Purchases of available-for-sale securities	(17,572)	(25,456)
Proceeds from maturities of available-for-sale securities	11,923	14,830
Proceeds from sales of available-for-sale-securities	2,950	-
Net change in loans	(61,932)	(25,233)
Purchase of premises and equipment and software	(517)	(4,846)
Proceeds from sales or disposal of premises and equipment	96	36
Proceeds from sale of foreclosed assets	785	110
Net cash used in investing activities	(64,267)	(40,559)
Financing Activities		
Net increase in demand deposits, money market, interest checking and savings accounts	41,056	27,018
Net increase (decrease) in certificates of deposit	34,635	(4,356)
Net increase in securities sold under agreements to repurchase	(1,043)	4,171
Repayment of Federal Home Loan Bank advances	(14,000)	(4,000)
Proceeds from Federal Home Loan Bank advances	2,000	4,000
Net proceeds from share based compensation plans	99	18
Repurchase of common stock	(624)	(2)

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Dividends on common stock	(862)	(713)
Dividends on preferred stock	(731)	(712)
Net cash provided by financing activities	60,530	25,425
Increase in Cash and Cash Equivalents	4,708	(9,825)
Cash and Cash Equivalents, Beginning of Year	20,459	28,197
Cash and Cash Equivalents, End of Period	\$25,167	\$18,372
Supplemental Cash Flows Information		
Interest paid	\$2,170	\$1,861
Income taxes paid	\$3,479	\$1,650
Transfer of loans to foreclosed assets	\$319	\$35

See notes to condensed consolidated financial statements (unaudited)

SB FINANCIAL GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1—BASIS OF PRESENTATION

SB Financial Group, Inc., an Ohio corporation (the “Company”) is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiaries, The State Bank and Trust Company (“State Bank”), RFCBC, Inc. (“RFCBC”), Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”), and Rurban Statutory Trust II (“RST II”). In addition, State Bank owns all of the outstanding stock of Rurban Mortgage Company (“RMC”) and State Bank Insurance, LLC (“SBI”).

The consolidated financial statements include the accounts of the Company, State Bank, RFCBC, RDSI, RMC, and SBI. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial statements reflect all adjustments that are, in the opinion of management, necessary to fairly present the financial position, results of operations and cash flows of the Company. Those adjustments consist only of normal recurring adjustments. Results of operations for the nine months ended September 30, 2016, are not necessarily indicative of results for the complete year.

The condensed consolidated balance sheet of the Company as of December 31, 2015 has been derived from the audited consolidated balance sheet of the Company as of that date.

For further information, refer to the consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

The following paragraphs summarize the impact of new accounting pronouncements:

Accounting Standards Update (ASU) No. 2016-13: Financial Instruments – Credit Losses (Topic 326)

This ASU replaces the current GAAP incurred impairment methodology regarding credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments in this update affect an entity to varying degrees depending on the credit quality of the assets held by the entity, their duration, and how the entity applies current GAAP. The amendments in this ASU are effective for reporting periods beginning after December 15, 2019, and management will need further study to determine the impact on the Company's consolidated financial statements.

ASU No. 2016-09: Stock Compensation (Topic 718)

This ASU affects all entities that issue share-based payment awards to their employees. The update is intended to simplify the accounting for these transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and management will need further study to determine the impact on the Company's consolidated financial statements.

ASU No. 2016-06: Derivatives and Hedging (Topic 815)

This ASU clarifies the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the amendments in this Update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and management does not believe this ASU will have a material impact on the Company's consolidated financial statements.

ASU No. 2016-05: Derivatives and Hedging (Topic 815)

This ASU clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedging accounting criteria continue to be met. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and management does not believe this ASU will have a material impact on the Company's consolidated financial statements.

ASU No. 2016-02: Leases (Topic 842)

This ASU is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this ASU are effective for reporting periods beginning after December 15, 2019, and management will need further study to determine the impact on the Company's consolidated financial statements.

ASU No. 2016-01: Financial Instruments – Recognition and measurement of financial assets and financial liabilities (Subtopic 825-10)

This ASU makes targeted improvements to generally accepted accounting principles. Specifically, the amendments require equity securities with readily determinable fair values be classified into different categories and require equity securities to be measured at fair value with changes in the fair value recognized through net income. The amendments in this ASU are effective for reporting periods beginning after December 15, 2017, and management does not believe this ASU will have a material impact on the Company's consolidated financial statements.

ASU No. 2015-16: Business Combinations (Topic 805)

This ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. Further, an entity must present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings that would have been recorded previously if the provisional amounts had been recorded as of the acquisition date. The amendments in this ASU are in effect, and they did not have a material impact on the Company's consolidated financial statements.

ASU No. 2015-15: Interest – Imputation of Interest (Subtopic 835-30)

This ASU requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The amendments in this ASU are in effect, and they did not have a material impact on the Company's consolidated financial statements.

ASU No. 2015-14: Revenue from Contracts with Customers (Subtopic 606)

This ASU defers by one year the effective date of the guidance in ASU 2014-09. The amendments in this ASU are now effective for reporting periods beginning after December 15, 2017, and management still does not believe this ASU will have a material impact on the Company's consolidated financial statements.

NOTE 2—EARNINGS PER SHARE

Earnings per share (EPS) have been computed based on the weighted average number of common shares outstanding during the periods presented. For the period ended September 30, 2016, share-based awards totaling 0 common shares were not considered in computing diluted EPS as they were anti-dilutive. For the period ended September 30, 2015, share-based awards totaling 50,424 common shares were not considered in computing diluted EPS as they were anti-dilutive. Included in the diluted EPS for September 30, 2016 are the impact of the full conversion of the Company's depository shares issued in December of 2014. Based upon the current conversion ratio, the 1,500,000 outstanding depository shares are convertible into an aggregate of 1,454,702 common shares. The average number of common shares used in the computation of basic and diluted earnings per share were:

	Three Months Ended Sep. 30,	
	2016	2015
(\$ in thousands - except per share data)		
Distributed earnings allocated to common shares	\$295	\$246
Undistributed earnings allocated to common shares	2,005	1,773
Net earnings allocated to common shares	2,300	2,019
Net earnings allocated to participating securities	3	1
Dividends on convertible preferred shares	244	244
Net Income allocated to common shares and participating securities	\$2,547	\$2,264
Weighted average shares outstanding for basic earnings per share	4,874	4,884
Dilutive effect of stock compensation	47	55
Dilutive effect of convertible shares	1,455	1,451
Weighted average shares outstanding for diluted earnings per share	6,376	6,390
Basic earnings per common share	\$0.47	\$0.41
Diluted earnings per common share	\$0.40	\$0.35

	Nine Months Ended Sep. 30,	
	2016	2015
(\$ in thousands - except per share data)		
Distributed earnings allocated to common shares	\$862	\$713
Undistributed earnings allocated to common shares	4,868	4,322
Net earnings allocated to common shares	5,730	5,035
Net earnings allocated to participating securities	6	4
Dividends on convertible preferred shares	731	712
Net Income allocated to common shares and participating securities	\$6,467	\$5,751
Weighted average shares outstanding for basic earnings per share	4,888	4,882
Dilutive effect of stock compensation	41	89

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Dilutive effect of convertible shares	1,455	1,451
Weighted average shares outstanding for diluted earnings per share	6,384	6,422
Basic earnings per common share	\$1.17	\$1.03
Diluted earnings per common share	\$1.01	\$0.89

Note 3 - Securities

The amortized cost and appropriate fair values, together with gross unrealized gains and losses, of securities at September 30, 2016 and December 31, 2015 were as follows:

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
September 30, 2016				
U.S. Treasury and Government agencies	\$ 13,920	\$ 115	\$ (2)	\$ 14,033
Mortgage-backed securities	61,882	905	(27)	62,760
State and political subdivisions	14,990	884	(1)	15,873
Equity securities	23	-	-	23
	\$ 90,815	\$ 1,904	\$ (30)	\$ 92,689

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
December 31, 2015:				
U.S. Treasury and Government agencies	\$ 10,804	\$ 101	\$ -	\$ 10,905
Mortgage-backed securities	61,459	311	(427)	61,343
State and political subdivisions	16,519	999	-	17,518
Equity securities	23	-	-	23
	\$ 88,805	\$ 1,411	\$ (427)	\$ 89,789

The amortized cost and fair value of securities available for sale at September 30, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(\$ in thousands)	Available for Sale	
	Amortized Cost	Fair Value
Within one year	\$442	\$447
Due after one year through five years	7,473	7,696
Due after five years through ten years	6,836	7,143
Due after ten years	14,159	14,620
	28,910	29,906
Mortgage-backed securities & equity securities	61,905	62,783
Totals	\$90,815	\$92,689

The fair value of securities pledged as collateral, to secure public deposits and for other purposes, was \$76.6 million at September 30, 2016 and \$42.6 million at December 31, 2015. The fair value of securities delivered for repurchase agreements were \$15.8 million at September 30, 2016 and \$15.8 million at December 31, 2015.

For the nine months ended September 30, 2016, there were gross gains of \$0.26 million resulting from sales of available-for-sale securities, which was a reclassification from accumulated other comprehensive income (OCI) and was included in the net gain on sale of securities. The related \$0.09 million in tax expense was a reclassification from OCI and was included in the income tax expense line item in the income statement. There were no realized gains and losses from sales of available-for-sale securities for the nine months ended September 30, 2015.

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments was \$8.3 million at September 30, 2016, and \$37.2 million at December 31, 2015, which was approximately 9 and 34 percent, respectively, of the Company's available-for-sale investment portfolio at such dates. Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

Securities with unrealized losses, aggregated by investment class and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2016 and December 31, 2015 are as follows:

(\$ in thousands)	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2016						
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$2,598	\$ (2)	\$-	\$ -	\$2,598	\$ (2)
Mortgage-backed securities	\$882	\$ (16)	\$4,011	\$ (11)	\$4,893	\$ (27)
State and Political subdivisions	\$796	\$ (1)	\$0	\$ 0	\$796	\$ (1)
	\$4,276	\$ (19)	\$4,011	\$ (11)	\$8,287	\$ (30)

(\$ in thousands)	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2015						
Available-for-Sale Securities:						
Mortgage-backed securities	\$30,184	\$ (253)	\$7,061	\$ (174)	\$37,245	\$ (427)
	\$30,184	\$ (253)	\$7,061	\$ (174)	\$37,245	\$ (427)

The total potential unrealized loss as of September 30, 2016 in the securities portfolio was \$0.03 million, which was down from the \$0.43 million unrealized loss at December 31, 2015. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the investment and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost. Management has determined there is no other-than-temporary-impairment on these securities.

NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoffs, are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Generally, all loan classes are placed on non-accrual status not later than 90 days past due, unless the loan is well-secured and in the process of collection. All interest accrued, but not collected, for loans that are placed on

non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Loan losses are charged against the allowance when management believes the non-collectability of a loan balance is probable. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as new information becomes available.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical charge-off experience and expected loss given default derived from the Company's internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected on the historical loss or risk rating data.

A loan is considered impaired when, based on current information and events, it is probable that State Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration each of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, agricultural, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent.

When State Bank moves a loan to non-accrual status, total unpaid interest accrued to date is reversed from income. Subsequent payments are applied to the outstanding principal balance with the interest portion of the payment recorded on the balance sheet as a contra-loan. Interest received on impaired loans may be realized once all contractual principal amounts are received or when a borrower establishes a history of six consecutive timely principal and interest payments. It is at the discretion of management to determine when a loan is placed back on accrual status upon receipt of six consecutive timely payments.

Large groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, State Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Categories of loans at September 30, 2016 and December 31, 2015 include:

(\$ in thousands)	Total Loans		Non-Accrual Loans	
	Sept. 2016	Dec. 2015	Sept. 2016	Dec. 2015
Commercial & Industrial	\$100,951	\$86,542	146	188
Commercial RE & Construction	268,408	242,208	1,393	5,670
Agricultural & Farmland	54,609	43,835	5	7
Residential Real Estate	139,757	130,806	1,152	749
Consumer & Other	55,333	54,224	193	32
Total Loans	\$619,058	\$557,615	\$2,889	\$6,646
Unearned Income	\$294	\$44		

Total Loans, net of unearned income \$619,352 \$557,659

Allowance for loan losses \$(7,320) \$(6,990)

The following tables present the activity in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method as of September 30, 2016, December 31, 2015 and September 30, 2015.

	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Three Months Ended - September 30, 2016						
Beginning balance	\$ 1,137	\$ 4,126	\$ 189	\$ 1,342	\$ 656	\$ 7,450
Charge Offs	(42)	(30)	-	-	(64)	\$(136)
Recoveries	1	-	1	1	3	6
Provision	155	(960)	142	460	203	-
Ending Balance	\$ 1,251	\$ 3,136	\$ 332	\$ 1,803	\$ 798	\$ 7,320
For the Nine Months Ended - September 30, 2016						
Beginning balance	\$ 914	\$ 3,886	\$ 204	\$ 1,312	\$ 674	\$ 6,990
Charge Offs	(134)	(30)	-	-	(68)	\$(232)
Recoveries	248	6	2	1	55	312
Provision	223	(726)	126	490	137	250
Ending Balance	\$ 1,251	\$ 3,136	\$ 332	\$ 1,803	\$ 798	\$ 7,320
Loans Receivable at September 30, 2016						
Allowance:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ 127	\$ -	\$ 148	\$ 19	\$ 294
Ending balance:						
collectively evaluated for impairment	\$ 1,251	\$ 3,009	\$ 332	\$ 1,655	\$ 779	\$ 7,026
Loans:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ 1,772	\$ -	\$ 1,874	\$ 346	\$ 3,992
Ending balance:						
collectively evaluated for impairment	\$ 100,951	\$ 266,636	\$ 54,609	\$ 137,883	\$ 54,987	\$ 615,066

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
Loans Receivable at December 31, 2015						
Allowance:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ 1,759	\$ -	\$ 167	\$ 37	\$ 1,963
Ending balance:						
collectively evaluated for impairment	\$ 914	\$ 2,127	\$ 204	\$ 1,145	\$ 637	\$ 5,027
Loans:						
Ending balance:						
individually evaluated for impairment	\$ 126	\$ 5,754	\$ -	\$ 1,713	\$ 464	\$ 8,057
Ending balance:						
collectively evaluated for impairment	\$ 86,416	\$ 236,454	\$ 43,835	\$ 129,093	\$ 53,760	\$ 549,558

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Three Months Ended - September 30, 2015						
Beginning balance	\$ 1,488	\$ 3,066	\$ 261	\$ 1,410	\$ 781	\$ 7,006
Charge Offs	-	(53)	-	(4)	(1)	\$(58)
Recoveries	1	-	1	23	4	29
Provision	(621)	997	(40)	(154)	(82)	100
Ending Balance	\$ 868	\$ 4,010	\$ 222	\$ 1,275	\$ 702	\$ 7,076

For the Nine Months Ended -
September 30, 2015

Beginning balance	\$ 1,630	\$ 2,857	\$ 208	\$ 1,308	\$ 768	\$ 6,771
Charge Offs	(309)	(303)	-	(65)	(34)	\$(711)
Recoveries	22	3	3	28	10	66
Provision	(475)	1,453	11	4	(43)	950
Ending Balance	\$ 868	\$ 4,010	\$ 222	\$ 1,275	\$ 701	\$ 7,076

The risk characteristics of each loan portfolio segment are as follows:

Commercial and Agricultural

Commercial and agricultural loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and may include a personal guarantee. Short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial Real Estate including Construction

Commercial real estate loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The characteristics of properties securing the Company's commercial real estate portfolio are diverse, but with geographic location almost entirely in the Company's market area. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. In general, the Company avoids financing single purpose projects unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate versus non-owner-occupied loans.

Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews and financial analysis of the developers and property owners. Construction loans are generally based on estimates of costs and value associated with the completed project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Residential and Consumer

Residential and consumer loans consist of two segments – residential mortgage loans and personal loans. Residential mortgage loans are secured by 1-4 family residences and are generally owner-occupied, and the Company generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer personal loans are secured by consumer personal assets, such as automobiles or recreational vehicles. Some consumer personal loans are unsecured, such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas, such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that these loans are of smaller individual amounts and spread over a large number of borrowers.

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of September 30, 2016 and December 31, 2015.

<u>September 30, 2016</u>	Commercial	Commercial	Agricultural	Residential	Consumer	
(\$ in thousands)	& Industrial	RE & Construction	& Farmland	Real Estate	& Other	Total
1-2	\$ 1,207	\$ 44	\$ 40	\$ 338	\$ 4	\$1,633
3	27,841	84,276	9,661	111,581	52,185	285,544
4	71,312	176,270	44,908	25,801	2,824	321,115
Total Pass (1 - 4)	100,360	260,590	54,609	137,720	55,013	608,292
Special Mention (5)	-	4,419	-	566	62	5,047
Substandard (6)	150	2,006	-	408	64	2,628
Doubtful (7)	441	1,394	-	1,063	193	3,091
Loss (8)	-	-	-	-	-	-
Total Loans	\$ 100,951	\$ 268,408	\$ 54,609	\$ 139,757	\$ 55,333	\$619,058

<u>December 31, 2015</u>	Commercial	Commercial	Agricultural	Residential	Consumer	
(\$ in thousands)	& Industrial	RE & Construction	& Farmland	Real Estate	& Other	Total
1-2	\$ 709	\$ 767	\$ 47	\$ -	\$ 15	\$1,538
3	23,362	79,915	8,195	118,463	50,745	280,680
4	61,799	149,473	35,593	10,418	3,223	260,506
Total Pass (1 - 4)	85,870	230,155	43,835	128,881	53,983	542,724
Special Mention (5)	330	5,260	-	756	70	6,416
Substandard (6)	110	1,072	-	420	139	1,741
Doubtful (7)	232	5,721	-	749	32	6,734
Loss (8)	-	-	-	-	-	-
Total Loans	\$ 86,542	\$ 242,208	\$ 43,835	\$ 130,806	\$ 54,224	\$557,615

The Company evaluates the loan risk grading system definitions and allowance for loan loss methodology on an ongoing basis.

Credit Risk Profile

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes loans individually by

classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$100 thousand and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

Pass (grades 1 – 4): Loans which management has determined to be performing as expected and in agreement with the terms established at the time of loan origination.

Special Mention (5): Assets have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Company's credit position at some future date. Special mention assets are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification. Ordinarily, special mention credits have characteristics which corrective management action would remedy.

Substandard (6): Loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful (7): Loans classified as doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current known facts, conditions and values, highly questionable and improbable.

Loss (8): Loans are considered uncollectable and of such little value that continuing to carry them as assets on the Company's financial statement is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

The following tables present the Company's loan portfolio aging analysis as of September 30, 2016 and December 31, 2015.

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
<u>September 30, 2016</u>						
Commercial & Industrial	\$ -	\$-	\$ 110	\$ 110	\$ 100,841	\$ 100,951
Commercial RE & Construction	56	909	1,135	2,100	266,308	268,408
Agricultural & Farmland	-	-	-	-	54,609	54,609
Residential Real Estate	-	55	233	288	139,469	139,757
Consumer & Other	17	51	181	249	55,084	55,333
Total Loans	\$ 73	\$ 1,015	\$ 1,659	\$ 2,747	\$ 616,311	\$ 619,058

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
<u>December 31, 2015</u>						
Commercial & Industrial	\$ -	\$ 60	\$ 188	\$ 248	\$ 86,294	\$ 86,542
Commercial RE & Construction	99	-	5,280	5,379	236,829	242,208
Agricultural & Farmland	-	-	-	-	43,835	43,835
Residential Real Estate	98	198	156	452	130,354	130,806
Consumer & Other	64	-	2	66	54,158	54,224
Total Loans	\$ 261	\$ 258	\$ 5,626	\$ 6,145	\$ 551,470	\$ 557,615

All loans past due 90 days are systematically placed on nonaccrual status.

A loan is considered impaired, in accordance with the impairment accounting guidance (ASC 310-10-35-16), when based on current information and events, it is probable State Bank will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans but also include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection.

The following tables present impaired loan information as of and for the three and nine months ended September 30, 2016 and 2015, and for the twelve months ended December 31, 2015:

Nine Months Ended September 30, 2016 (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial RE & Construction	637	637	-	658	16
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	987	1,031	-	1,195	51
Consumer & Other	20	78	-	94	6
All Impaired Loans < \$100,000	398	398	-	398	-
With a specific allowance recorded:					
Commercial & Industrial	-	-	-	-	-
Commercial RE & Construction	1,135	1,385	127	1,404	-
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	887	887	148	957	29
Consumer & Other	268	268	19	272	11
Totals:					
Commercial & Industrial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial RE & Construction	\$ 1,772	\$ 2,022	\$ 127	\$ 2,062	\$ 16
Agricultural & Farmland	\$ -	\$ -	\$ -	\$ -	\$ -
Residential Real Estate	\$ 1,874	\$ 1,918	\$ 148	\$ 2,152	\$ 80
Consumer & Other	\$ 346	\$ 346	\$ 19	\$ 366	\$ 17
All Impaired Loans < \$100,000	\$ 398	\$ 398	\$ -	\$ 398	\$ -

Three Months Ended September 30, 2016 (\$'s in thousands)	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:		
Commercial & Industrial	\$ -	\$ -
Commercial RE & Construction	647	6
Agricultural & Farmland	-	-
Residential Real Estate	1,186	17
Consumer & Other	89	2
All Impaired Loans < \$100,000	438	-
With a specific allowance recorded:		
Commercial & Industrial	-	-
Commercial RE & Construction	1,404	-
Agricultural & Farmland	-	-
Residential Real Estate	945	10
Consumer & Other	267	2
Totals:		
Commercial & Industrial	\$ -	\$ -

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Commercial RE & Construction	\$ 2,051	\$ 6
Agricultural & Farmland	\$ -	\$ -
Residential Real Estate	\$ 2,131	\$ 27
Consumer & Other	\$ 356	\$ 4
All Impaired Loans < \$100,000	\$ 438	\$ -

Twelve Months Ended December 31, 2015 (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$126	\$1,214	\$-	\$1,388	\$-
Commercial RE & Construction	1,110	1,110	-	1,206	27
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	657	657	-	862	52
Consumer & Other	90	90	-	107	9
All Impaired Loans < \$100,000	131	131	-	131	-
With a specific allowance recorded:					
Commercial & Industrial	-	-	-	-	-
Commercial RE & Construction	4,644	4,893	1,759	5,006	90
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,056	1,013	167	1,084	45
Consumer & Other	374	374	37	385	22
Totals:					
Commercial & Industrial	\$126	\$1,214	\$-	\$1,388	\$-
Commercial RE & Construction	\$5,754	\$6,003	\$1,759	\$6,212	\$117
Agricultural & Farmland	\$-	\$-	\$-	\$-	\$-
Residential Real Estate	\$1,713	\$1,670	\$167	\$1,946	\$97
Consumer & Other	\$464	\$464	\$37	\$492	\$31
All Impaired Loans < \$100,000	\$131	\$131	\$-	\$131	\$-

September 30, 2015	Nine Months Ended		Three Months Ended	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial & Industrial	\$316	\$ -	\$316	\$ -
Commercial RE & Construction	704	25	797	6
Agricultural & Farmland	-	-	-	-
Residential Real Estate	673	38	859	8
Consumer & Other	114	7	125	3
All Impaired Loans < \$100,000	344	-	344	-
With a specific allowance recorded:				
Commercial & Industrial	19	-	1,080	-
Commercial RE & Construction	4,949	13	1,954	3
Agricultural & Farmland	-	-	-	-
Residential Real Estate	1,025	33	1,080	10
Consumer & Other	337	17	362	5
Totals:				
Commercial & Industrial	\$335	\$ -	\$1,396	\$ -
Commercial RE & Construction	\$5,653	\$ 38	\$2,751	\$ 9
Agricultural & Farmland	\$-	\$ -	\$-	\$ -
Residential Real Estate	\$1,698	\$ 71	\$1,939	\$ 18

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Consumer & Other	\$451	\$ 24	\$487	\$ 8
All Impaired Loans < \$100,000	\$344	\$ -	\$344	\$ -

Impaired loans less than \$100,000 are included in groups of homogenous loans. These loans are evaluated based on delinquency status.

Interest income recognized on a cash basis does not materially differ from interest income recognized on an accrual basis.

Troubled Debt Restructured (TDR) Loans

TDRs are modified loans where a concession was provided to a borrower experiencing financial difficulties. Loan modifications are considered TDRs when the concessions provided are not available to the borrower through either normal channels or other sources. However, not all loan modifications are TDRs.

TDR Concession Types

The Company's standards relating to loan modifications consider, among other factors, minimum verified income requirements, cash flow analysis, and collateral valuations. Each potential loan modification is reviewed individually and the terms of the loan are modified to meet a borrower's specific circumstances at a point in time. All loan modifications, including those classified as TDRs, are reviewed and approved. The types of concessions provided to borrowers include:

Interest rate reduction: A reduction of the stated interest rate to a nonmarket rate for the remaining original life of the loan. The Company also may grant interest rate concessions for a limited timeframe on a case by case basis.

Amortization or maturity date change: A change in the amortization or maturity date beyond what the collateral supports, including a concession that does any of the following:

Lengthens the amortization period of the amortized principal beyond market terms. This concession reduces the (1) minimum monthly payment and increases the amount of the balloon payment at the end of the term of the loan. Principal is generally not forgiven.

Reduces the amount of loan principal to be amortized. This concession also reduces the minimum monthly (2) payment and increases the amount of the balloon payment at the end of the term of the loan. Principal is generally not forgiven.

Extends the maturity date or dates of the debt beyond what the collateral supports. This concession generally (3) applies to loans without a balloon payment at the end of the term of the loan. In addition, there may be instances where renewing loans potentially require non-market terms and would then be reclassified as TDRs.

Other: A concession that is not categorized as one of the concessions described above. These concessions include, but are not limited to: principal forgiveness, collateral concessions, covenant concessions, and reduction of accrued interest. Principal forgiveness may result from any TDR modification of any concession type.

The following presents the activity of TDRs during the three and nine months ended September 30, 2016 and 2015.

(\$ in thousands)	Three Months ended Sep. 30, 2016			
	Pre-Modification of Recorded Loans Balance	Post-Modification Recorded Balance		
Residential Real Estate	-	\$ -	\$ -	
Commercial	1	309	309	
Consumer & Other	-	-	-	
Total Modifications	1	\$ 309	\$ 309	

	Interest Only	Term	Combination	Total Modification
Residential Real Estate	\$ -	\$ -	\$ -	\$ -
Commercial	-	309	-	309
Consumer & Other	-	-	-	-
Total Modifications	\$-	\$ 309	\$-	\$ 309

There was no increase in the allowance for loan losses due to TDR's in the three month period ended Sep. 30, 2016.

(\$ in thousands)	Nine Months ended Sep. 30, 2016			
	Pre-Modification of Recorded Loans Balance	Post-Modification Recorded Balance		
Residential Real Estate	-	\$ -	\$ -	
Commercial	1	309	309	
Consumer & Other	1	221	221	
Total Modifications	2	\$ 530	\$ 530	

	Interest Only	Term	Combination	Total Modification
Residential Real Estate	\$ -	\$ -	\$ -	\$ -
Commercial	-	309	-	309
Consumer & Other	-	221	-	221
Total Modifications	\$-	\$ 530	\$-	\$ 530

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Residential Real Estate	\$	-	\$-	\$	-	\$	-
Commercial	-		309	-		309	
Consumer & Other	-		221	-		221	
Total Modifications	\$-		\$ 530	\$-		\$ 530	

21

There was no increase in the allowance for loan losses due to TDR's in the nine month period ended Sep. 30, 2016.

(\$ in thousands)	Three Months ended Sep. 30, 2015		
	Number of Loans	Pre- Modification Recorded Balance	Post Modification Recorded Balance
Residential Real Estate	-	\$ -	\$ -
Commercial	-	-	-
Consumer & Other	-	-	-
Total Modifications	-	\$-	\$-

	Interest Only	Term	Combination	Total Modification
Residential Real Estate	\$-	\$-	\$ -	\$ -
Consumer & Other	-	-	-	-
Total Modifications	\$-	\$-	\$-	\$-

There was no increase in the allowance for loan losses due to TDR's in the three month period ended Sep. 30, 2015.

(\$ in thousands)	Nine Months ended Sep. 30, 2015		
	Number of Loans	Pre- Modification Recorded Balance	Post Modification Recorded Balance
Residential Real Estate	1	\$ 24	\$ 24
Consumer & Other	-	-	-
Total Modifications	1	\$ 24	\$ 24

	Interest Only	Term	Combination	Total Modification
Residential Real Estate	\$ -	\$ 24	\$ -	\$ 24
Consumer & Other	-	-	-	-
Total Modifications	\$-	\$ 24	\$-	\$ 24

There was no increase in the allowance for loan losses due to TDR's in the nine month period ended Sep. 30, 2015. TDR's modified in 2016 that have subsequently defaulted

(\$ in thousands)	Number of Contracts	Recorded Balance
Consumer & Other	1	\$ 221
	1	221

There were no TDR's modified during 2015 that have subsequently defaulted.

NOTE 5 – DERIVATIVE FINANCIAL INSTRUMENTS AND REPURCHASE AGREEMENTS

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company manages its exposures to a wide variety of business and operational risks primarily through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing and duration of the Company's known or expected cash payments principally related to certain variable-rate assets.

Non-designated Hedges

The Company does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously offset by interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2016 and December 31, 2015, the notional amount of customer-facing swaps was approximately \$30.1 million and \$17.6 million, respectively. The same amounts were offset with third party counterparties, as described above.

The Company has minimum collateral posting thresholds with its derivative counterparties. As of September 30, 2016 and December 31, 2015, the Company had posted cash as collateral in the amount of \$1.6 million and \$0.7 million, respectively.

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the Balance Sheet, as of September 30, 2016 and December 31, 2015.

Asset Derivatives

Liability Derivatives

(\$ in thousands)	September 30, 2016		September 30, 2016	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$ 1,396	Other Liabilities	\$ 1,396

(\$ in thousands)	Asset Derivatives		Liability Derivatives	
	December 31, 2015 Balance Sheet Location	Fair Value	December 31, 2015 Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$ 490	Other Liabilities	\$ 490

The Company's derivative financial instruments had no net effect on the Income Statements for the three and nine months ended September 30, 2016 and 2015.

Securities Sold Under Repurchase Agreements

State Bank has retail repurchase agreements to facilitate cash management transactions with commercial customers. These obligations are secured by agency and mortgage-backed securities and such collateral is held by the Federal Home Loan Bank. The agreements mature within one month. These repurchase agreements are secured by agency securities and mortgage-backed securities with corresponding liabilities of \$5.7 million and of \$14.9 million. These securities have various maturity dates beyond 2017.

NOTE 6 – FAIR VALUE OF ASSETS AND LIABILITIES

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

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

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis, recognized in the accompanying balance sheets, as well as the general classifications of such assets pursuant to the valuation hierarchy.

Available-for-Sale Securities

The fair values of available-for-sale securities are determined by various valuation methodologies. Level 1 securities include money market mutual funds. Level 1 inputs include quoted prices in an active market. Level 2 securities include U.S. treasury and government agencies, mortgage-backed securities, obligations of political and state subdivisions and equity securities. Level 2 inputs do not include quoted prices for individual securities in active markets; however, they do include inputs that are either directly or indirectly observable for the individual security being valued. Such observable inputs include interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, credit risks and default rates. Also included are inputs derived principally from or corroborated by observable market data by correlation or other means.

Interest Rate Contracts

The fair values of interest rate contracts are based upon the estimated amount the Company would receive or pay to terminate the contracts or agreements, taking into account underlying interest rates, creditworthiness of underlying customers for credit derivatives and, when appropriate, the creditworthiness of the counterparties.

The following table presents the fair value measurements of assets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2016 and December 31, 2015.

Fair Value Measurements Using:

(\$ in thousands)	Fair Values at	(Level	(Level	(Level
Available-for-Sale Securities:	9/30/16	1)	2)	3)
U.S. Treasury and Government Agencies	\$ 14,033	\$ -	\$14,033	\$ -
Mortgage-backed securities	62,760	-	62,760	-
State and political subdivisions	15,873	-	15,873	-
Equity securities	23	-	23	-
Interest rate contracts - assets	1,396	-	1,396	-
Interest rate contracts - liabilities	(1,396)	-	(1,396)	-

Fair Value Measurements Using:

(\$ in thousands)	Fair Values at	(Level	(Level	(Level
Available-for-Sale Securities:	12/31/2015	1)	2)	3)
U.S. Treasury and Government Agencies	\$ 10,905	\$ -	\$10,905	\$ -
Mortgage-backed securities	61,343	-	61,343	-
State and political subdivisions	17,518	-	17,518	-
Equity securities	23	-	23	-
Interest rate contracts - assets	490	-	490	-
Interest rate contracts - liabilities	(490)	-	(490)	-

Level 1 – Quoted Prices in Active Markets for Identical Assets

Level 2 – Significant Other Observable Inputs

Level 3 – Significant Unobservable Inputs

The following is a description of the valuation methodologies and inputs used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

Collateral-dependent Impaired Loans, NET of ALLL

Loans for which it is probable the Company will not collect all principal and interest due according to contractual terms are measured for impairment. The estimated fair value of collateral-dependent impaired loans is based on the appraised value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy. This method requires obtaining an independent appraisal of the collateral, which is reviewed for accuracy and consistency by Credit Administration. These appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by applying a discount factor to the value based on the Company's loan review policy. All impaired loans held by the Company were collateral dependent at June 30, 2016 and December 31, 2015.

Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees; miscellaneous income and float; marginal costs of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements.

(\$ in thousands) Description	Fair Values at 9/30/2016	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 1,188	\$ -	\$ -	\$1,188
Mortgage Servicing Rights	7,125	\$ -	\$ -	7,125

(\$ in thousands) Description	Fair Values at 12/31/2015	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 3,011	\$ -	\$ -	\$3,011
Mortgage Servicing Rights	2,585	\$ -	\$ -	2,585

Level 1 - Quoted Prices in Active Markets for Identical Assets

Level 2 - Significant Other Observable Inputs

Level 3 - Significant Unobservable Inputs

(\$'s in thousands)	Fair Value at 9/30/2016	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
Collateral-dependent impaired loans	\$ 1,188	Market comparable properties	Comparability adjustments (%)	Not available
Mortgage servicing rights	7,125	Discounted cash flow	Discount Rate	9.03 %
			Constant prepayment rate	14.45 %
			P&I earnings credit	0.53 %
			T&I earnings credit	1.14 %
			Inflation for cost of servicing	1.50 %

(\$'s in thousands)	Fair Value at 12/31/2015	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
Collateral-dependent impaired loans	\$ 3,011	Market comparable properties	Comparability adjustments (%)	Not available

Edgar Filing: SB FINANCIAL GROUP, INC. - Form 10-Q

Mortgage servicing rights	2,585	Discounted cash flow	Discount Rate	9.75	%
			Constant prepayment rate	8.90	%
			P&I earnings credit	0.42	%
			T&I earnings credit	1.54	%
			Inflation for cost of servicing	1.50	%

There were no changes in the inputs or methodologies used to determine fair value at September 30, 2016 as compared to December 31, 2015.

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying balance sheets at amounts other than fair value.

Cash and Due From Banks, Federal Reserve and Federal Home Loan Bank Stock and Accrued Interest Receivable and Payable

The carrying amount approximates the fair value.

Loans Held for Sale

The fair value of loans held for sale is based upon quoted market prices, where available, or is determined by discounting estimated cash flows using interest rates approximating the Company's current origination rates for similar loans and adjusted to reflect the inherent credit risk.

Loans

The estimated fair value for loans receivable is based on estimates of the rate State Bank would charge for similar loans at September 30, 2016 and December 31, 2015, applied for the time period until the loans are assumed to re-price or be paid.

Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees, miscellaneous income and float; marginal costs of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

Deposits, FHLB advances & Repurchase agreements

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount approximates the fair value. The estimated fair value for fixed-maturity time deposits, as well as borrowings, is based on estimates of the rate State Bank could pay on similar instruments with similar terms and maturities at September 30, 2016 and December 31, 2015.

Loan Commitments

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The estimated fair values for other financial instruments and off-balance-sheet loan commitments approximate cost at September 30, 2016 and December 31, 2015 and are not considered significant to this presentation.

Trust Preferred Securities

The fair value for Trust Preferred Securities is estimated by discounting the cash flows using an appropriate discount rate.

The following table presents estimated fair values of the Company's other financial instruments carried at other than fair value. The fair values of certain of these instruments were calculated by discounting expected cash flows, which involves significant judgments by management and uncertainties. Fair value is the estimated amount at which financial assets or liabilities could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Because no market exists for certain of these financial instruments, and because management does not intend to sell these financial instruments, the Company does not know whether the fair values shown below represent values at which the respective financial instruments could be sold individually or in the aggregate.

	September 30, 2016 Carrying Amount	Fair Value Measurements Using		
		(Level 1)	(Level 2)	(Level 3)
Financial assets				
Cash and cash equivalents	\$ 25,167	\$25,167	\$-	\$-
Loans held for sale	5,865	-	6,053	-
Loans, net of allowance for loan losses	612,032	-	-	612,961
Federal Reserve and FHLB Bank stock	3,748	-	3,748	-
Mortgage Servicing Rights	6,887	-	-	6,947
Accrued interest receivable	1,641	-	1,641	-
Financial liabilities				
Deposits	\$ 662,144	\$116,976	\$548,360	\$-
FHLB Advances	23,000	-	23,143	-
Short-term borrowings	11,363	-	11,363	-
Trust preferred securities	10,310	-	8,015	-
Accrued interest payable	427	-	427	-
	December 31, 2015 Carrying Amount	Fair Value Measurements Using		
		(Level 1)	(Level 2)	(Level 3)
Financial assets				
Cash and due from banks	\$ 20,459	\$20,459	\$-	\$-
Loans held for sale	7,516	-	7,779	-
Loans, net of allowance for loan losses	550,669	-	-	548,154
Federal Reserve and FHLB Bank stock, at cost	3,748	-	3,748	-
Mortgage Servicing Rights	7,152	-	-	7,760
Accrued interest receivable	1,260	-	1,260	-
Financial liabilities				
Deposits	\$ 586,453	\$113,113	\$475,468	\$-
FHLB advances	35,000	-	34,870	-
Short-term borrowings	12,406	-	12,406	-
Trust preferred securities	10,310	-	7,165	-
Accrued interest payable	264	-	264	-

NOTE 7 – GENERAL LITIGATION

The Company is subject to claims and lawsuits that arise primarily in the ordinary course of business. Additionally, the Company is subject to periodic examinations by various regulatory agencies. It is the opinion of management that the disposition or ultimate resolution of such claims, lawsuits and examinations will not have a material adverse effect on the consolidated financial position, results of operations and cash flow of the Company.

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

Cautionary Statement Regarding Forward-Looking Information

This Quarterly Report on Form 10-Q, including Management’s Discussion and Analysis of Financial Condition and Results of Operations, contains certain forward-looking statements that are provided to assist in the understanding of anticipated future financial performance. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance. Examples of forward-looking statements include: (a) projections of income or expense, earnings per share, the payment or non-payment of dividends, capital structure and other financial items; (b) statements of plans and objectives of the Company or our management or Board of Directors, including those relating to products or services; (c) statements of future economic performance; (d) statements regarding future customer attraction or retention; and (e) statements of assumptions underlying such statements. Words such as “anticipates”, “believes”, “plans”, “intends”, “expects”, “projects”, “estimates”, “should”, “may”, “will allow”, “will likely result”, “will continue”, “will remain”, or other similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying those statements. Forward-looking statements are based on management’s expectations and are subject to a number of risks and uncertainties. Although management believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from those expressed or implied in such statements. Risks and uncertainties that could cause actual results to differ materially include, without limitation, risks and uncertainties inherent in the national and regional banking industry, changes in economic conditions in the market areas in which the Company and its subsidiaries operate, changes in policies by regulatory agencies, changes in accounting standards and policies, changes in tax laws, fluctuations in interest rates, demand for loans in the market areas in which the Company and its subsidiaries operate, increases in FDIC insurance premiums, changes in the competitive environment, losses of significant customers, geopolitical events and the loss of key personnel. Additional detailed information concerning a number of important factors which could cause actual results to differ materially from the forward-looking statements contained in Management’s Discussion and Analysis of Financial Condition and Results of Operations is available in the Company’s filings with the Securities and Exchange Commission, including the risks identified under the heading “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2015. Undue reliance should not be placed on the forward-looking statements, which speak only as of the date hereof. Except as may be required by law, the Company undertakes no obligation to update any forward-looking statement to reflect unanticipated events or circumstances after the date on which the statement is made.

Overview of SB Financial

SB Financial Group, Inc. (“SB Financial” or the “Company”) is a bank holding company registered with the Federal Reserve Board. SB Financial’s wholly-owned subsidiary, The State Bank and Trust Company (“State Bank”), is an Ohio-chartered bank engaged in commercial banking. SB Financial’s technology subsidiary, Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”), provides item processing services to community banks and businesses.

Rurban Statutory Trust II (“RST II”) was established in August 2005. In September 2005, RST II completed a pooled private offering of 10,000 Trust Preferred Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures of the Company with terms substantially similar to the Trust Preferred Securities. The sole assets of RST II are the junior subordinated debentures, and the back-up obligations, in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST II.

RFCBC, Inc. (“RFCBC”) is an Ohio corporation and wholly-owned subsidiary of the Company that was incorporated in August 2004. RFCBC operates as a loan subsidiary in servicing and working out problem loans.

State Bank Insurance, LLC (“SBI”) is an Ohio corporation and a wholly-owned subsidiary of State Bank that was incorporated in June of 2010. SBI is an insurance company that engages in the sale of insurance products to retail and commercial customers of State Bank.

Unless the context indicates otherwise, all references herein to “we”, “us”, “our”, or the “Company” refer to SB Financial Group, Inc. and its consolidated subsidiaries.

Recent Regulatory Developments

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Act was enacted into law on July 21, 2010. The Dodd-Frank Act is significantly changing the regulation of financial institutions and the financial services industry. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the new law and the effects they will have on the Company will not be known for months and even years.

Among the provisions already implemented pursuant to the Dodd-Frank Act, the following provisions have or may have an effect on the business of the Company and its subsidiaries:

the CFPB has been formed with broad powers to adopt and enforce consumer protection regulations;

the federal law prohibiting the payment of interest on commercial demand deposit accounts was eliminated effective July 21, 2011;

the standard maximum amount of deposit insurance per customer was permanently increased to \$250,000;

the assessment base for determining deposit insurance premiums has been expanded from domestic deposits to average assets minus average tangible equity;

public companies in all industries are or will be required to provide shareholders the opportunity to cast a non-binding advisory vote on executive compensation;

new capital regulations for bank holding companies have been adopted, which will impose stricter requirements, and any new trust preferred securities issued after May 19, 2010, will no longer constitute Tier I capital; and

new corporate governance requirements applicable generally to all public companies in all industries require new compensation practices and disclosure requirements, including requiring companies to “claw back” incentive compensation under certain circumstances, to consider the independence of compensation advisors and to make additional disclosures in proxy statements with respect to compensation matters.

Many provisions of the Dodd-Frank Act have not yet been implemented and will require interpretation and rule making by federal regulators. As a result, the full effect of the Dodd-Frank Act on the Company cannot yet be determined. However, it is likely that the implementation of these provisions will increase compliance costs and fees paid to regulators, along with possibly restricting the operations of the Company and its subsidiaries.

The Volcker Rule

In December 2013, five federal agencies adopted a final regulation implementing the Volcker Rule provision of the Dodd-Frank Act (the “Volcker Rule”). The Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The trading activity includes a purchase or sale as principal of a security, derivative, commodity future or option on any such instrument in order to benefit from short-term price movements or to realize short-term profits. The Volcker Rule exempts specified U.S. Government, agency and/or municipal obligations, and it excepts trading conducted in certain capacities, including as a broker or other agent, through a deferred compensation or pension plan, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities.

The Volcker Rule also prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund, with a number of exceptions. The Company does not engage in any of the trading activities or have any ownership interest in or relationship with any of the types of funds regulated by the Volcker Rule.

Executive and Incentive Compensation

In June 2010, the Federal Reserve Board, the OCC and the FDIC issued joint interagency guidance on incentive compensation policies (the “Joint Guidance”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. This principles-based guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (a) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (b) be compatible with effective internal controls and risk management and (c) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Pursuant to the Joint Guidance, the Federal Reserve Board will review as part of a regular, risk-focused examination process, the incentive compensation arrangements of financial institutions such as the Company. Such reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination and deficiencies will be incorporated into the institution’s supervisory ratings, which can affect the institution’s ability to make acquisitions and take other actions. Enforcement actions may be taken against an institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization’s safety and soundness and prompt and effective measures are not being taken to correct the deficiencies.

On February 7, 2011, federal banking regulatory agencies jointly issued proposed rules on incentive-based compensation arrangements under applicable provisions of the Dodd-Frank Act (the “Proposed Rules”). The Proposed Rules generally apply to financial institutions with \$1.0 billion or more in assets that maintain incentive-based compensation arrangements for certain covered employees. The Proposed Rules (i) prohibit covered financial institutions from maintaining incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risk by providing the covered person with “excessive” compensation; (ii) prohibit covered financial institutions from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to a material financial loss, (iii) require covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with the Proposed Rules and (iv) require covered financial institutions to provide enhanced disclosure to regulators regarding their incentive-based compensation arrangements for covered person within 90 days following the end of the fiscal year.

Pursuant to rules adopted by the stock exchanges and approved by the SEC in January 2013 under the Dodd-Frank Act, public companies are