FIRST NORTHERN COMMUNITY BANCORP
Form 10-Q
August 01, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark one)
S QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2018

OR

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

For the transition period from _______________ to _______________

Commission File Number 000-30707

First Northern Community Bancorp
(Exact name of registrant as specified in its charter)

California	68-0450397
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

195 N. First Street, Dixon, California	95620
(Address of principal executive offices)	(Zip Code)

707-678-3041
(Registrant's telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or Section 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Emerging growth company
If an emerging growth company, indicate by check mark if the registrant has elected 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.

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

Yes No

The number of shares of Common Stock outstanding as of July 30, 2018 was 11,661,857.
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PART I – FINANCIAL INFORMATION

FIRST NORTHERN COMMUNITY BANCORP

ITEM I. – FINANCIAL STATEMENTS (UNAUDITED)

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in thousands, except share amounts)	June 30, 2018	December 31, 2017
Assets		
Cash and cash equivalents	$121,220	$152,892
Certificates of deposit	4,165	1,984
Investment securities – available-for-sale	285,909	280,741
Loans, net of allowance for loan losses of $11,807 at June 30, 2018 and $11,133 at December 31, 2017	730,831	739,112
Loans held-for-sale	1,436	1,040
Stock in Federal Home Loan Bank and other equity securities, at cost	6,019	5,567
Premises and equipment, net	5,991	6,248
Interest receivable and other assets	30,953	30,074
Total Assets	$1,186,524	$1,217,658
Liabilities and Stockholders' Equity		
Liabilities:		
Demand deposits	$386,083	$382,157
Interest-bearing transaction deposits	307,523	312,569
Savings and MMDA's	310,515	336,592
Time, $250,000 or less	50,307	54,531
Time, over $250,000	17,200	18,891
Total deposits	1,071,628	1,104,740
Interest payable and other liabilities	11,322	12,874
Total Liabilities	1,082,950	1,117,614
Stockholders' Equity:		
Common stock, no par value; 16,000,000 shares authorized; 11,661,857 shares issued and outstanding at June 30, 2018 and 11,630,129 shares issued and outstanding at December 31, 2017	86,048	85,583
Additional paid-in capital	977	977
Retained earnings	23,367	17,881
Accumulated other comprehensive loss, net	(6,818)	(4,397)
Total Stockholders' Equity	103,574	100,044
Total Liabilities and Stockholders' Equity	$1,186,524	$1,217,658

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(in thousands, except per share amounts)	Three months ended June 30, 2018	Three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Interest and dividend income:				
Loans	$9,146	$8,211	$17,952	$16,172
Due from banks interest bearing accounts	427	291	944	623
Investment securities				
Taxable	1,314	1,191	2,622	2,293
Non-taxable	34	73	73	148
Other earning assets	98	83	203	191
Total interest and dividend income	11,019	9,849	21,794	19,427
Interest expense:				
Deposits	281	255	544	520
Total interest expense	281	255	544	520
Net interest income	10,738	9,594	21,250	18,907
Provision for loan losses	525	—	1,050	600
Net interest income after provision for loan losses	10,213	9,594	20,200	18,307
Non-interest income:				
Service charges on deposit accounts	490	495	978	913
Gains on sales of loans held-for-sale	85	148	154	295
Investment and brokerage services income	159	145	320	288
Mortgage brokerage income	6	30	12	43
Loan servicing income	100	116	206	266
Fiduciary activities income	155	118	311	243
Debit card income	536	501	1,038	968
Gains (losses) on sales of available-for-sale securities	—	—	—	(16)
Gain on sale-leaseback of real estate	—	—	—	1,187
Other income	214	202	530	413
Total non-interest income	1,745	1,755	3,549	4,600
Non-interest expenses:				
Salaries and employee benefits	5,063	4,453	10,380	9,204
Occupancy and equipment	697	693	1,412	1,389
Data processing	489	437	1,019	839
Stationery and supplies	106	108	205	178
Advertising	97	80	185	146
Directors' fees	75	76	140	135
Other real estate owned expense	—	—	—	(1)
Other expense	1,292	1,373	2,472	2,833
Total non-interest expenses	7,819	7,220	15,813	14,723
Income before provision for income taxes	4,139	4,129	7,936	8,184
Provision for income taxes	1,136	1,581	2,200	3,123
Net income	$3,003	$2,548	$5,736	$5,061

Basic earnings per common share	$0.26	$0.22	$0.50	$0.44
Diluted earnings per common share	$0.26	$0.22	$0.49	$0.43

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(in thousands)	Three months ended June 30, 2018	Three months ended June 30, 2017	Six months ended June 30, 2018	Six months ended June 30, 2017
Net income	$ 3,003	$ 2,548	$ 5,736	$ 5,061
Other comprehensive (loss) income, net of tax:				
Unrealized holding (loss) gains arising during the period, net of tax effect of $(246) and $64 for the three months ended June 30, 2018 and June 30, 2017, respectively, and $(977) and $70 for the six months ended June 30, 2018 and June 30, 2017, respectively	(610)	93	(2,421)	103
Less: reclassification adjustment due to losses realized on sales of securities, net of tax effect of $0 for each of the three months ended June 30, 2018 and June 30, 2017 and $0 and $6 for the six months ended June 30, 2018 and June 30, 2017, respectively	—	—	—	10
Directors' and officers' retirement plan equity adjustments, net of tax effect of $0 for the three months ended June 30, 2018 and June 30, 2017, and $0 and $(31) for the six months ended June 30, 2018 and June 30, 2017, respectively	—	—	—	(46)
Other comprehensive (loss) income, net of tax	$ (610)	$ 93	$ (2,421)	$ 67
Comprehensive income	$ 2,393	$ 2,641	$ 3,315	$ 5,128

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)

(in thousands, except share data)

	Common Stock					
	Shares	Amounts	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, net	Total
Balance at December 31, 2016	11,148,446	$79,114	$ 977	$14,557	$ (2,350)	$92,298
Net income				8,748		8,748
Other comprehensive loss, net of taxes					(1,448)	(1,448)
Stock dividend adjustment	289	207		(207)		—
Tax rate change reclassification				599	(599)	—
4% stock dividend declared in 2018	447,312	5,806		(5,806)		—
Cash in lieu of fractional shares	(129)			(10)		(10)
Stock-based compensation		378				378
Common shares issued related to restricted stock grants and ESPP, net of restricted stock reversals	34,211	78				78
Balance at December 31, 2017	11,630,129	$85,583	$ 977	$17,881	$ (4,397)	$100,044
Net income				5,736		5,736
Other comprehensive loss, net of taxes					(2,421)	(2,421)
Stock dividend adjustment	628	240		(240)		—
Cash in lieu of fractional shares	(159)			(10)		(10)
Stock-based compensation		225				225
Common shares issued related to restricted stock grants, net of restricted stock reversals	25,281	—				—
Stock options exercised, net	5,978	—				—
Balance at June 30, 2018	11,661,857	$86,048	$ 977	$23,367	$ (6,818)	$103,574

See notes to unaudited condensed consolidated financial statements.

FIRST NORTHERN COMMUNITY BANCORP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	(in thousands)	
	Six months ended June 30, 2018	Six months ended June 30, 2017
Cash Flows From Operating Activities		
Net income	$5,736	$5,061
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	285	295
Accretion and amortization of investment securities premiums and discounts, net	1,393	1,853
Valuation adjustment on mortgage servicing rights	—	(21)
Increase in deferred loan origination fees and costs, net	70	133
Provision for loan losses	1,050	600
Stock-based compensation	225	165
Losses on sales of available-for-sale securities	—	16
Gain on sale-leaseback of real estate	—	(1,187)
Gains on sales of loans held-for-sale	(154)	(295)
Proceeds from sales of loans held-for-sale	10,194	15,699
Originations of loans held-for-sale	(10,436)	(12,886)
Changes in assets and liabilities:		
Decrease (increase) in interest receivable and other assets	98	(673)
Decrease in interest payable and other liabilities	(1,552)	(517)
Net cash provided by operating activities	6,909	8,243
Cash Flows From Investing Activities		
Proceeds from calls or maturities of available-for-sale securities	14,580	2,275
Proceeds from sales of available-for-sale securities	—	462
Principal repayments on available-for-sale securities	25,081	23,694
Purchase of available-for-sale securities	(49,620)	(55,419)
Net (increase) decrease in certificates of deposit	(2,181)	12,245
Net decrease (increase) in loans	7,161	(5,980)
Net increase in stock in Federal Home Loan Bank and other equity securities, at cost	(452)	(1,158)
Proceeds from sale of bank premises and equipment	—	2,868
Purchases of bank premises and equipment, net	(28)	(930)
Net cash used in investing activities	(5,459)	(21,943)
Cash Flows From Financing Activities		
Net decrease in deposits	(33,112)	(14,423)
Cash dividends paid in lieu of fractional shares	(10)	(10)
Net cash provided by financing activities	(33,122)	(14,433)
Net decrease in Cash and Cash Equivalents	(31,672)	(28,133)
Cash and Cash Equivalents, beginning of period	152,892	159,643
Cash and Cash Equivalents, end of period	$121,220	$131,510

Supplemental Disclosures of Cash Flow Information:

Cash paid during the period for:		
Interest	$536	$518
Income taxes	$1,655	$3,265
Supplemental disclosures of non-cash investing and financing activities:		
Stock dividend distributed	$6,046	$5,295
Decrease in directors' and officers' retirement plan equity adjustment, net of tax	$—	$(46)
Change in unrealized holding (losses) gains on available for sale securities, net of taxes	$(2,421)	$113

See notes to unaudited condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018 and 2017 and December 31, 2017

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of First Northern Community Bancorp (the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Articles 9 and 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The results of operations for any interim period are not necessarily indicative of results expected for the full year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 as filed with the Securities and Exchange Commission. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. All material intercompany balances and transactions have been eliminated in consolidation.

2. ACCOUNTING POLICIES

The most significant accounting policies followed by the Company are presented in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, Management has identified the allowance for loan losses accounting to be the accounting area requiring the most subjective or complex judgments, and as such the accounting area that could be most subject to revision as new information becomes available. A discussion of the factors affecting accounting for the allowance for loan losses is included in the "Asset Quality" and "Allowance for Loan Loss" discussions below. Certain amounts in prior periods have been reclassified to conform to the current presentation.

Application of these principles requires the Company to make certain estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain accounting policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment writedown or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

Recently Adopted Accounting Standards:

In May 2014, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 specifies a standardized approach for revenue recognition across industries and transactions. The scope of this ASU does not include revenue streams covered by other ASU topics. Our revenue is comprised of net interest income on financial assets and financial liabilities and non-interest income. All of our net interest income and a portion of our non-interest income is excluded from the scope of Topic 606. The contracts that are in scope are primarily related to service charges and fees on deposit accounts, debit card income, investment and brokerage income and fiduciary activities income. We adopted the requirements of ASU 2014-09 on January 1, 2018. We have analyzed all revenue streams and determined our revenue recognition practices in scope of Topic 606 did not change in any material regard upon adoption of this ASU. See Note 11, Revenue from Contracts with Customers, for a description of the Company's sources of Non-interest income within the scope of ASC 606.

In January 2016, FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in ASU 2016-01, among other things:

Require equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income.
Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables).
Eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost.

We adopted the requirements of ASU 2016-01 effective January 1, 2018. The fair value of our loans held for investment, which is recorded at amortized cost, now incorporates the exit price notion. See Note 6, Fair Value Measurements.

Recently Issued Accounting Standards:

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The amendments in ASU 2016-02, among other things, require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and
A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

The amendments in this ASU are effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The Company currently leases ten properties. This ASU will result in the recording of a lease liability and a related right-of-use asset on the Company's financial statements. Management has not yet quantified the lease liability and right-of-use asset and is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

In June 2016, FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The amendments in ASU 2016-13, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments are effective for public companies for annual periods beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Management is currently gathering data required to measure expected credit losses in accordance with this ASU and will then evaluate the impact of this ASU on the Company's consolidated financial statements. While the Company has not quantified the impact of this ASU, it does expect changing from the current loss model to an expected loss model will result in an earlier recognition of losses.

In March 2018, FASB issued ASU 2018-05, Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118. These amendments add SEC guidance, among other things, to the FASB Accounting Standards Codification regarding the Tax Cuts and Jobs Act. The amendments are effective upon addition to the FASB Codification. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

3. INVESTMENT SECURITIES

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at June 30, 2018 are summarized as follows:

(in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
Investment securities available-for-sale:				
U.S. Treasury Securities	$ 30,433	$ —	$ (242)	$ 30,191
Securities of U.S. government agencies and corporations	38,318	—	(360)	37,958
Obligations of states and political subdivisions	18,414	124	(167)	18,371
Collateralized mortgage obligations	66,296	—	(2,659)	63,637
Mortgage-backed securities	140,052	33	(4,333)	135,752
Total debt securities	$ 293,513	$ 157	$ (7,761)	$ 285,909

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2017 are summarized as follows:

(in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Estimated fair value
Investment securities available-for-sale:				
U.S. Treasury Securities	$ 18,589	$ —	$ (125)	$ 18,464
Securities of U.S. government agencies and corporations	21,353	—	(244)	21,109
Obligations of states and political subdivisions	23,138	216	(146)	23,208
Collateralized mortgage obligations	67,724	—	(1,641)	66,083
Mortgage-backed securities	154,143	95	(2,361)	151,877
Total debt securities	$ 284,947	$ 311	$ (4,517)	$ 280,741

The Company had $3,465,000 and $14,580,000 in proceeds from sales, calls and maturities of available-for-sale securities for the three and six months ended June 30, 2018, respectively. The Company had $0 and $2,737,000 in proceeds from sales, calls and maturities of available-for-sale securities for the three and six months ended June 30, 2017, respectively. There were no gross realized gains on sales of available-for-sale securities for the three and six months ended June 30, 2018 and June 30, 2017. There were no gross realized losses from sales of available-for-sale securities for the three and six months ended June 30, 2018. Gross realized losses from sales of available-for-sale securities were $0 and $(16,000) for the three and six months ended June 30, 2017, respectively.

The amortized cost and estimated market value of debt and other securities at June 30, 2018, by contractual and expected maturity, are shown in the following table:

(in thousands)	Amortized cost	Estimated fair value
Maturity in years:		
Due in one year or less	$ 36,120	$ 36,000
Due after one year through five years	47,010	46,380

Due after five years through ten years	4,035	4,140
Subtotal	87,165	86,520
MBS & CMO	206,348	199,389
Total	$ 293,513	$ 285,909

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. In addition, factors such as prepayments and interest rates may affect the yield on the carrying value of mortgage-related securities.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of June 30, 2018, follows:

	Less than 12 months		12 months or more		Total	
(in thousands)	Fair Value	Unrealized losses	Fair Value	Unrealized losses	Fair Value	Unrealized losses
U.S. Treasury securities	$21,788	$ (80)	$8,403	$ (162)	$30,191	$ (242)
Securities of U.S. government agencies and corporations	20,841	(132)	17,117	(228)	37,958	(360)
Obligations of states and political subdivisions	6,179	(54)	6,075	(113)	12,254	(167)
Collateralized mortgage obligations	19,502	(576)	44,135	(2,083)	63,637	(2,659)
Mortgage-backed securities	45,840	(1,120)	84,797	(3,213)	130,637	(4,333)
Total	$114,150	$ (1,962)	$160,527	$ (5,799)	$274,677	$ (7,761)

No decline in value was considered "other-than-temporary" during the first six months of 2018. One hundred two securities, all considered investment grade, which had a fair value of $114,150,000 and a total unrealized loss of $1,962,000, have been in an unrealized loss position for less than twelve months as of June 30, 2018. One hundred forty-five securities, all considered investment grade, which had a fair value of $160,527,000 and a total unrealized loss of $5,799,000, have been in an unrealized loss position for more than twelve months as of June 30, 2018. The unrealized losses on the Company's investment securities were caused by market conditions for these types of investments, particularly changes in risk-free interest rates. The Company does not intend to sell the securities and has concluded it is not more likely than not that we will be required to sell these securities prior to recovery of their anticipated cost basis. Therefore, the Company does not consider these investments to be other than temporarily impaired as of June 30, 2018.

The fair value of investment securities could decline in the future if the general economy deteriorates, inflation increases, credit ratings decline, the issuer's financial condition deteriorates, or the liquidity for securities declines. As a result, other than temporary impairments may occur in the future.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2017, follows:

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized losses	Fair Value	Unrealized losses	Fair Value	Unrealized losses
U.S. Treasury Securities	$10,004	$ (2)	$8,460	$ (123)	$18,464	$ (125)
Securities of U.S. government agencies and corporations	6,049	(50)	15,060	(194)	21,109	(244)
Obligations of states and political subdivisions	7,677	(34)	7,116	(112)	14,793	(146)
Collateralized mortgage obligations	31,679	(576)	34,404	(1,065)	66,083	(1,641)
Mortgage-backed securities	62,320	(650)	76,478	(1,711)	138,798	(2,361)
Total	$117,729	$ (1,312)	$141,518	$ (3,205)	$259,247	$ (4,517)

Investment securities carried at $36,084,000 and $32,399,000 at June 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

4. LOANS

The composition of the Company's loan portfolio, by loan class, as of June 30, 2018 and December 31, 2017, was as follows:

($ in thousands)	June 30, 2018	December 31, 2017
Commercial	$131,471	$135,015
Commercial Real Estate	392,073	398,346
Agriculture	112,457	113,555
Residential Mortgage	45,767	42,081
Residential Construction	22,694	21,299
Consumer	37,197	38,900
	741,659	749,196
Allowance for loan losses	(11,807)	(11,133)
Net deferred origination fees and costs	979	1,049
Loans, net	$730,831	$739,112

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans and delinquencies, with particular attention to portfolio dynamics and loan mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of collectability and current collateral values and to maintain an adequate allowance for loan losses at all times. Asset quality reviews of loans and other non-performing assets are administered using credit risk rating standards and criteria similar to those employed by state and federal banking regulatory agencies.

Commercial loans, whether secured or unsecured, generally are made to support the short-term operations and other needs of small businesses. These loans are generally secured by the receivables, equipment, and other real property of the business and are susceptible to the related risks described above. Problem commercial loans are generally identified by periodic review of financial information that may include financial statements, tax returns, and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner-occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to Commercial loans whether secured by equipment, receivables or other personal property or unsecured. Problem commercial real estate loans are generally identified by periodic review of financial information that may include financial statements, tax returns, payment history of the borrower, and site inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resulting over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or service. Agricultural loans are generally secured by inventory, receivables, equipment, and other real property. Agricultural loans primarily are susceptible to changes in market demand for specific commodities. This may be exacerbated by, among other things, industry changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles, as well as adverse weather conditions such as drought or floods. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history, and crop inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary.

Residential mortgage loans, which are secured by real estate, are primarily susceptible to four risks: non-payment due to diminished or lost income; over-extension of credit; a lack of borrower's cash flow to sustain payments; and shortfalls in collateral value. In general, non-payment is usually due to loss of employment and follows general economic trends, particularly the upward movement in the unemployment rate, loss of collateral value, and demand shifts.

Construction loans, whether owner-occupied or non-owner occupied residential development loans, are not only susceptible to the related risks described above but the added risks of construction, including cost over-runs, mismanagement of the project, or lack of demand and market changes experienced at time of completion. Losses are primarily related to underlying collateral value and changes therein as described above. Problem construction loans are generally identified by periodic review of financial information that may include financial statements, tax returns and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors, or repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation.

Consumer loans, whether unsecured or secured, are primarily susceptible to four risks: non-payment due to diminished or lost income; over-extension of credit; a lack of borrower's cash flow to sustain payments; and shortfall in collateral value for secured loans. In general, non-payment is usually due to loss of employment and will follow general economic trends, particularly the upward movements in the unemployment rate, loss of collateral value, and demand shifts.

Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally annually but may be more frequent depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

As of June 30, 2018, approximately 18% in principal amount of the Company's loans were for general commercial uses including professional, retail and small businesses. Approximately 53% in principal amount of the Company's loans were secured by commercial real estate, consisting primarily of loans secured by commercial properties and construction and land development loans. Approximately 15% in principal amount of the Company's loans were for agriculture, approximately 6% in principal amount of the Company's loans were residential mortgage loans, approximately 3% in principal amount of the Company's loans were residential construction loans and approximately 5% in principal amount of the Company's loans were consumer loans.

Once a loan becomes delinquent or repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not forthcoming and payment of principal and interest in accordance with the contractual terms of the loan agreement becomes unlikely, the Company will consider the loan to be impaired and will estimate its probable loss, using the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. For collateral dependent loans, the Company will utilize a recent valuation of the underlying collateral less estimated costs of sale, and charge-off the loan down to the estimated net realizable amount. Depending on the length of time until final collection, the Company may periodically revalue the estimated loss and take additional charge-offs or specific reserves as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when the collateral is liquidated and the actual loss is confirmed. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

At June 30, 2018 and December 31, 2017, all loans were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank ("FHLB") and the Federal Reserve Bank.

Non-accrual and Past Due Loans

The Company's loans by delinquency and non-accrual status, as of June 30, 2018 and December 31, 2017, were as follows:

($ in thousands)	Current & Accruing	30-59 Days Past Due & Accruing	60-89 Days Past Due & Accruing	90 Days or more Past Due & Accruing	Nonaccrual	Total Loans
June 30, 2018						
Commercial	$131,064	$ —	$ —	$ 12	$ 395	$131,471
Commercial Real Estate	390,325	93	—	—	1,655	392,073
Agriculture	112,448	9	—	—	—	112,457
Residential Mortgage	45,311	—	345	—	111	45,767
Residential Construction	22,694	—	—	—	—	22,694
Consumer	36,922	38	—	—	237	37,197
Total	$738,764	$ 140	$ 345	$ 12	$ 2,398	$741,659
December 31, 2017						
Commercial	$133,913	$ —	$ —	$ 45	$ 1,057	$135,015
Commercial Real Estate	396,521	101	—	—	1,724	398,346
Agriculture	113,555	—	—	—	—	113,555
Residential Mortgage	40,354	349	597	—	781	42,081
Residential Construction	21,299	—	—	—	—	21,299
Consumer	38,656	1	38	—	205	38,900
Total	$744,298	$ 451	$ 635	$ 45	$ 3,767	$749,196

Non-accrual loans amounted to $2,398,000 at June 30, 2018 and were comprised of three commercial loans totaling $395,000, three commercial real estate loans totaling $1,655,000, two residential mortgage loans totaling $111,000, and two consumer loans totaling $237,000. Non-accrual loans amounted to $3,767,000 at December 31, 2017 and were comprised of three commercial loans totaling $1,057,000, three commercial real estate loans totaling $1,724,000, three residential mortgage loans totaling $781,000, and one consumer loan totaling $205,000. All non-accrual loans are measured for impairment based upon the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of collateral, if the loan is collateral dependent. If the measurement of the non-accrual loan is less than the recorded investment in the loan, an impairment is recognized through the establishment of a specific reserve sufficient to cover expected losses and/or a charge-off against the allowance for loan losses. If the loan is considered to be collateral dependent, it is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral. There were no commitments to lend additional funds to borrowers whose loans were on non-accrual status at June 30, 2018.

Impaired Loans

A loan is considered 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, including scheduled interest payments. Loans to be considered for impairment include non-accrual loans, troubled debt restructurings and loans with a risk rating of 5 (special mention) or worse and an aggregate exposure of $500,000 or more. Once identified, impaired loans are measured individually for impairment using one of three methods: present value of expected cash flows discounted at the loan's effective interest rate; the loan's observable market price; or fair value of collateral if the loan is collateral dependent. In general, any portion of the recorded investment in a collateral dependent loan in excess of the fair value of the collateral that can be identified as uncollectible, and is, therefore, deemed a confirmed loss, is promptly charged-off against the allowance for loan losses.

Impaired loans, segregated by loan class, as of June 30, 2018 and December 31, 2017 were as follows:

($ in thousands)	Unpaid Contractual Principal Balance	Recorded Investment with no Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
June 30, 2018					
Commercial	$ 3,241	$ 395	$ 2,140	$ 2,535	$ 45
Commercial Real Estate	2,074	1,655	267	1,922	35
Agriculture	—	—	—	—	—
Residential Mortgage	1,819	111	1,474	1,585	304
Residential Construction	637	—	637	637	58
Consumer	455	237	209	446	4
Total	$ 8,226	$ 2,398	$ 4,727	$ 7,125	$ 446
December 31, 2017					
Commercial	$ 3,882	$ 1,057	$ 2,603	$ 3,660	$ 53
Commercial Real Estate	2,114	1,724	272	1,996	36
Agriculture	—	—	—	—	—
Residential Mortgage	2,628	781	1,496	2,277	302
Residential Construction	651	—	650	650	76
Consumer	418	205	213	418	3
Total	$ 9,693	$ 3,767	$ 5,234	$ 9,001	$ 470

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the three months ended June 30, 2018 and June 30, 2017 was as follows:

($ in thousands)	Three Months Ended June 30, 2018		Three Months Ended June 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$2,863	$ 45	$4,542	$ 8
Commercial Real Estate	1,934	4	1,164	4
Agriculture	—	—	—	—
Residential Mortgage	1,888	15	2,736	23
Residential Construction	641	9	808	10

Consumer	484	3	592	9
Total	$7,810	$ 76	$9,842	$ 54

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the six months ended June 30, 2018 and June 30, 2017 was as follows:

($ in thousands)	Six Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$3,129	$ 91	$4,887	$ 17
Commercial Real Estate	1,955	7	1,050	8
Agriculture	—	—	—	—
Residential Mortgage	2,018	30	2,835	54
Residential Construction	644	19	812	19
Consumer	462	6	630	17
Total	$8,208	$ 153	$10,214	$ 115

Troubled Debt Restructurings

The Company's loan portfolio includes certain loans that have been modified in a Troubled Debt Restructuring ("TDR"), which are loans on which concessions in terms have been granted because of the borrowers' financial difficulties and, as a result, the Company receives less than the current market-based compensation for the loan. These concessions may include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are placed on non-accrual status at the time of restructure and may be returned to accruing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

When a loan is modified, it is measured based upon the present value of future cash flows discounted at the contractual interest rate of the original loan agreement, or the fair value of collateral less selling costs if the loan is collateral dependent. If the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through a specific allowance or a charge-off of the loan.

The Company had $4,727,000 and $5,896,000 in TDR loans as of June 30, 2018 and December 31, 2017, respectively. Specific reserves for TDR loans totaled $446,000 and $470,000 as of June 30, 2018 and December 31, 2017, respectively. TDR loans performing in compliance with modified terms totaled $4,727,000 and $5,234,000 as of June 30, 2018 and December 31, 2017, respectively. There were no commitments to advance additional funds on existing TDR loans as of June 30, 2018.

There were no loans modified as TDRs during the three and six months ended June 30, 2018 and 2017.

Loan modifications generally involve reductions in the interest rate, payment extensions, forgiveness of principal, or forbearance. There were no loans modified as a TDR within the previous 12 months and for which there was a payment default during the three and six months ended June 30, 2018 and June 30, 2017.

Credit Quality Indicators

All loans are rated using the credit risk ratings and criteria adopted by the Company. Risk ratings are adjusted as current and expected future circumstances warrant. All credits risk rated 1, 2, 3 or 4 equate to a Pass as indicated by Federal and State bank regulatory agencies; a 5 equates to a Special Mention; a 6 equates to Substandard; a 7 equates to Doubtful; and an 8 equates to a Loss. For the definitions of each risk rating, see Note 4 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2017.

The following table presents the risk ratings by loan class as of June 30, 2018 and December 31, 2017:

($ in thousands)	Pass	Special Mention	Substandard	Doubtful	Loss	Total
June 30, 2018						
Commercial	$128,183	$845	$ 2,443	$ —	$ —	$131,471
Commercial Real Estate	369,512	7,071	15,490	—	—	392,073
Agriculture	107,254	5,203	—	—	—	112,457
Residential Mortgage	45,414	228	125	—	—	45,767
Residential Construction	22,694	—	—	—	—	22,694
Consumer	36,639	—	558	—	—	37,197
Total	$709,696	$13,347	$ 18,616	$ —	$ —	$741,659
December 31, 2017						
Commercial	$132,846	$1,050	$ 1,119	$ —	$ —	$135,015
Commercial Real Estate	378,632	16,101	3,613	—	—	398,346
Agriculture	110,370	3,140	45	—	—	113,555
Residential Mortgage	39,142	2,147	792	—	—	42,081
Residential Construction	21,299	—	—	—	—	21,299
Consumer	38,157	500	243	—	—	38,900
Total	$720,446	$22,938	$ 5,812	$ —	$ —	$749,196

Allowance for Loan Losses

The following tables detail activity in the allowance for loan losses by loan class for the three and six months ended June 30, 2018.

Three months ended June 30, 2018

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of March 31, 2018	$ 2,549	$ 5,414	$ 1,423	$ 643	$ 348	$ 305	$ 1,033	$11,715
Provision for loan losses	654	(30)	112	(28)	12	—	(195)	525
Charge-offs	(475)	—	—	—	—	(5)	—	(480)
Recoveries	36	—	—	4	1	6	—	47
Net (charge-offs) recoveries	(439)	—	—	4	1	1	—	(433)
Balance as of June 30, 2018	$ 2,764	$ 5,384	$ 1,535	$ 619	$ 361	$ 306	$ 838	$11,807

Six months ended June 30, 2018

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of December 31, 2017	$ 2,625	$ 5,460	$ 1,547	$ 628	$ 360	$ 342	$ 171	$11,133
Provision for loan losses	569	(76)	(12)	(29)	(1)	(68)	667	1,050
Charge-offs	(475)	—	—	—	—	(11)	—	(486)
Recoveries	45	—	—	20	2	43	—	110
Net (charge-offs) recoveries	(430)	—	—	20	2	32	—	(376)
Balance as of June 30, 2018	$ 2,764	$ 5,384	$ 1,535	$ 619	$ 361	$ 306	$ 838	$11,807

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of June 30, 2018.

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Period-end amount allocated to:								
Loans individually evaluated for impairment	$ 45	$ 35	$ —	$ 304	$ 58	$ 4	$ —	$446
Loans collectively evaluated for impairment	2,719	5,349	1,535	315	303	302	838	11,361
Ending Balance	$ 2,764	$ 5,384	$ 1,535	$ 619	$ 361	$ 306	$ 838	$11,807

The following table details activity in the allowance for loan losses by loan class for the three and six months ended June 30, 2017.

Three months ended June 30, 2017

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of March 31, 2017	$ 3,808	$ 4,723	$ 1,287	$ 701	$ 454	$ 381	$ 145	$ 11,499
Provision for loan losses	(869)	160	88	(114)	22	(12)	725	—
Charge-offs	—	—	—	—	—	(5)	—	(5)
Recoveries	121	—	—	90	1	14	—	226
Net (charge-offs) recoveries	121	—	—	90	1	9	—	221
Balance as of June 30, 2017	$ 3,060	$ 4,883	$ 1,375	$ 677	$ 477	$ 378	$ 870	$ 11,720

Six months ended June 30, 2017

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of December 31, 2016	$ 3,571	$ 3,910	$ 1,262	$ 660	$ 440	$ 498	$ 558	$ 10,899
Provision for loan losses	(634)	973	113	(73)	35	(126)	312	600
Charge-offs	—	—	—	—	—	(16)	—	(16)
Recoveries	123	—	—	90	2	22	—	237
Net (charge-offs) recoveries	123	—	—	90	2	6	—	221
Balance as of June 30, 2017	$ 3,060	$ 4,883	$ 1,375	$ 677	$ 477	$ 378	$ 870	$ 11,720

The following table details the allowance for loan losses allocated to loans individually and collectively evaluated for impairment by loan class as of June 30, 2017.

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Period-end amount allocated to:								
Loans individually evaluated for impairment	$ 827	$ 48	$ —	$ 571	$ 87	$ 25	$ —	$ 1,558
Loans collectively evaluated for impairment	2,233	4,835	1,375	106	390	353	870	10,162
Ending Balance	$ 3,060	$ 4,883	$ 1,375	$ 677	$ 477	$ 378	$ 870	$ 11,720

The following table details activity in the allowance for loan losses and the amount allocated to loans individually and collectively evaluated for impairment as of and for the year ended December 31, 2017.

Year ended December 31, 2017

($ in thousands)	Commercial	Commercial Real Estate	Agriculture	Residential Mortgage	Residential Construction	Consumer	Unallocated	Total
Balance as of December 31, 2016	$ 3,571	$ 3,910	$ 1,262	$ 660	$ 440	$ 498	$ 558	$ 10,899
Provision for loan losses	(567)	1,550	285	(7)	(85)	(189)	(387)	600
Charge-offs	(681)	—	—	(121)	—	(33)	—	(835)
Recoveries	302	—	—	96	5	66	—	469
Net (charge-offs) recoveries	(379)	—	—					