UNION BANKSHARES INC
Form 10-Q
May 10, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: March 31, 2018

Commission file number: 001-15985

UNION BANKSHARES, INC.
VERMONT 03-0283552

P.O. BOX 667
20 LOWER MAIN STREET
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

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

Common Stock, $2.00 par value	Nasdaq Stock Market
(Title of class)	(Exchanges registered on)

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 [X] 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 [X] No [ ]

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

Large accelerated filer [ ]	Accelerated filer [X]
Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [ ]
	Emerging growth company [ ]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of April 30, 2018.

Common Stock, $2 par value	4,465,661 shares

UNION BANKSHARES, INC.
TABLE OF CONTENTS

PART I FINANCIAL INFORMATION
Item 1. Financial Statements
UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	March 31, 2018 (Unaudited)	December 31, 2017
Assets	(Dollars in thousands)	
Cash and due from banks	$3,328	$ 3,857
Federal funds sold and overnight deposits	9,918	34,651
Cash and cash equivalents	13,246	38,508
Interest bearing deposits in banks	9,601	9,352
Investment securities available-for-sale	68,440	65,439
Investment securities held-to-maturity (fair value $999 thousand at December 31, 2017)	—	1,000
Other investments	502	—
Total investments	68,942	66,439
Loans held for sale	2,938	7,947
Loans	591,660	586,615
Allowance for loan losses	(5,405)	(5,408)
Net deferred loan costs	797	795
Net loans	587,052	582,002
Accrued interest receivable	2,468	2,500
Premises and equipment, net	14,298	14,255
Core deposit intangible	540	583
Goodwill	2,223	2,223
Investment in real estate limited partnerships	3,028	3,166
Company-owned life insurance	8,865	8,861
Other assets	9,530	9,995
Total assets	$722,731	$ 745,831
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	$128,951	$ 127,824
Interest bearing	392,027	418,621
Time	102,865	101,129
Total deposits	623,843	647,574
Borrowed funds	31,265	31,581
Accrued interest and other liabilities	8,459	8,015
Total liabilities	663,567	687,170
Commitments and Contingencies		
Stockholders' Equity		
Common stock, $2.00 par value; 7,500,000 shares authorized; 4,940,961 shares issued at March 31, 2018 and December 31, 2017	9,882	9,882
Additional paid-in capital	803	755
Retained earnings	58,604	57,197
Treasury stock at cost; 475,304 shares at March 31, 2018 and 475,385 shares at December 31, 2017	(4,079)	(4,077)
Accumulated other comprehensive loss	(6,046)	(5,096)
Total stockholders' equity	59,164	58,661

Total liabilities and stockholders' equity	$722,731	$ 745,831

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands, except per share data)	
Interest and dividend income		
Interest and fees on loans	$6,999	$ 6,322
Interest on debt securities:		
Taxable	289	242
Tax exempt	145	165
Dividends	40	45
Interest on federal funds sold and overnight deposits	53	30
Interest on interest bearing deposits in banks	45	35
Total interest and dividend income	7,571	6,839
Interest expense		
Interest on deposits	533	422
Interest on borrowed funds	114	115
Total interest expense	647	537
Net interest income	6,924	6,302
Provision for loan losses	—	—
Net interest income after provision for loan losses	6,924	6,302
Noninterest income		
Trust income	193	178
Service fees	1,487	1,440
Net gains on sales of loans held for sale	295	508
Other income	496	107
Total noninterest income	2,471	2,233
Noninterest expenses		
Salaries and wages	2,649	2,568
Pension and employee benefits	958	879
Occupancy expense, net	395	390
Equipment expense	535	534
Other expenses	1,598	1,570
Total noninterest expenses	6,135	5,941
Income before provision for income taxes	3,260	2,594
Provision for income taxes	513	664
Net income	$2,747	$ 1,930
Earnings per common share	$0.62	$ 0.43
Weighted average number of common shares outstanding	4,465,600	4,462,057
Dividends per common share	$0.30	$ 0.29

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Net income	$2,747	$1,930
Other comprehensive (loss) income, net of tax:		
Investment securities available-for-sale:		
Net unrealized holding (losses) gains arising during the period on investment securities available-for-sale	(950)	225
Total other comprehensive (loss) income	(950)	225
Total comprehensive income	$1,797	$2,155

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Three Months Ended March 31, 2018 and 2017 (Unaudited)

	Common Stock						
	Shares, net of treasury	Amount	Additional paid-in capital	Retained earnings	Treasury stock	Accumulated other comprehensive loss	Total stockholders' equity
	(Dollars in thousands, except per share data)						
Balances December 31, 2017	4,465,576	$ 9,882	$ 755	$ 57,197	$ (4,077)	$ (5,096)	$ 58,661
Net income	—	—	—	2,747	—	—	2,747
Other comprehensive loss	—	—	—	—	—	(950)	(950)
Dividend reinvestment plan	141	—	7	—	1	—	8
Cash dividends declared ($0.30 per share)	—	—	—	(1,340)	—	—	(1,340)
Stock based compensation expense	—	—	41	—	—	—	41
Purchase of treasury stock	(60)	—	—	—	(3)	—	(3)
Balances March 31, 2018	4,465,657	$ 9,882	$ 803	$ 58,604	$ (4,079)	$ (6,046)	$ 59,164
Balances, December 31, 2016	4,462,135	$ 9,874	$ 620	$ 53,086	$ (4,022)	$ (3,279)	$ 56,279
Net income	—	—	—	1,930	—	—	1,930
Other comprehensive income	—	—	—	—	—	225	225
Dividend reinvestment plan	117	—	4	—	1	—	5
Cash dividends declared ($0.29 per share)	—	—	—	(1,294)	—	—	(1,294)
Stock based compensation expense	—	—	34	—	—	—	34
Purchase of treasury stock	(225)	—	—	—	(9)	—	(9)
Balances, March 31, 2017	4,462,027	$ 9,874	$ 658	$ 53,722	$ (4,030)	$ (3,054)	$ 57,170

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Three Months Ended March 31,	
	2018	2017
	(Dollars in thousands)	
Cash Flows From Operating Activities		
Net income	$2,747	$1,930
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	301	307
Deferred income tax provision	41	333
Net amortization of investment securities	93	113
Equity in losses of limited partnerships	140	157
Stock based compensation expense	41	34
Net (increase) decrease in unamortized loan costs	(2)	5
Proceeds from sales of loans held for sale	23,384	29,041
Origination of loans held for sale	(18,080)	(23,577)
Net gains on sales of loans held for sale	(295)	(508)
Net (gain) loss on disposals of premises and equipment	(191)	13
Net gain on sales of other real estate owned	(11)	—
Decrease in accrued interest receivable	32	217
Amortization of core deposit intangible	43	43
Increase in other assets	403	80
Contribution to defined benefit pension plan	—	(750)
Increase in other liabilities	474	419
Net cash provided by operating activities	9,120	7,857
Cash Flows From Investing Activities		
Interest bearing deposits in banks		
Proceeds from maturities and redemptions	996	2,988
Purchases	(1,245)	(1,992)
Investment securities held-to-maturity		
Proceeds from maturities, calls and paydowns	1,000	—
Investment securities available-for-sale		
Proceeds from maturities, calls and paydowns	1,539	1,696
Purchases	(6,358)	(3,551)
Other Investments		
Proceeds from sales	44	—
Purchases	(24)	—
Purchase of nonmarketable stock	(105)	—
Net increase in loans	(5,051)	(4,298)
Recoveries of loans charged off	3	6
Purchases of premises and equipment	(357)	(67)
Proceeds from Company-owned life insurance death benefit	307	—
Investments in limited partnerships	—	(186)
Proceeds from sales of premises and equipment	204	—
Proceeds from sales of other real estate owned	47	—
Net cash used in investing activities	(9,000)	(5,404)

Cash Flows From Financing Activities		
Advances on long-term borrowings	7,000	—
Repayment of long-term debt	(6,072)	(70)
Net (decrease) increase in short-term borrowings outstanding	(1,244)	202
Net increase (decrease) in noninterest bearing deposits	1,127	(2,297)
Net decrease in interest bearing deposits	(26,594)	(12,632)
Net increase (decrease) in time deposits	1,736	(666)
Purchase of treasury stock	(3)	(9)
Dividends paid	(1,332)	(1,289)
Net cash used in financing activities	(25,382)	(16,761)
Net decrease in cash and cash equivalents	(25,262)	(14,308)
Cash and cash equivalents		
Beginning of period	38,508	39,275
End of period	$13,246	$24,967
Supplemental Disclosures of Cash Flow Information		
Interest paid	$647	$540
Dividends paid on Common Stock:		
Dividends declared	$1,340	$1,294
Dividends reinvested	(8)	(5)
	$1,332	$1,289

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
Note 1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements of Union Bankshares, Inc. and Subsidiary (together, the Company) as of March 31, 2018, and for the three months ended March 31, 2018 and 2017, have been prepared in conformity with GAAP for interim financial information, general practices within the banking industry, and the accounting policies described in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 (2017 Annual Report). The Company's sole subsidiary is Union Bank. In the opinion of the Company’s management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein, have been made. This information should be read in conjunction with the Company’s 2017 Annual Report. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2018, or any interim period.

In addition to the definitions set forth elsewhere in this report, the acronyms, abbreviations and capitalized terms identified below are used throughout this Form 10-Q, including Part I. "Financial Information" and Part II. "Other Information". The following is provided to aid the reader and provide a reference page when reviewing this Form 10-Q.

AFS:	Available-for-sale	IRS:	Internal Revenue Service
ALCO:	Asset Liability Committee	MBS:	Mortgage-backed security
ALL:	Allowance for loan losses	MSRs:	Mortgage servicing rights
ASC:	Accounting Standards Codification	OAO:	Other assets owned
ASU:	Accounting Standards Update	OCI:	Other comprehensive income (loss)
Board:	Board of Directors	OFAC:	U.S. Office of Foreign Assets Control
bp or bps:	Basis point(s)	OREO:	Other real estate owned
Branch Acquisition:	The acquisition of three New Hampshire branches in May 2011	OTTI:	Other-than-temporary impairment
CDARS:	Certificate of Deposit Accounts Registry Service of the Promontory Interfinancial Network	OTT:	Other-than-temporary
Company:	Union Bankshares, Inc. and Subsidiary	Plan:	The Union Bank Pension Plan
DRIP:	Dividend Reinvestment Plan	RD:	USDA Rural Development
FASB:	Financial Accounting Standards Board	RSU:	Restricted Stock Unit
FDIC:	Federal Deposit Insurance Corporation	SBA:	U.S. Small Business Administration
FHA:	U.S. Federal Housing Administration	SEC:	U.S. Securities and Exchange Commission
FHLB:	Federal Home Loan Bank of Boston	TDR:	Troubled-debt restructuring
FRB:	Federal Reserve Board	Union:	Union Bank, the sole subsidiary of Union Bankshares, Inc
FHLMC/Freddie Mac:	Federal Home Loan Mortgage Corporation	USDA:	U.S. Department of Agriculture
GAAP:	Generally Accepted Accounting Principles in the United States	VA:	U.S. Veterans Administration
HTM:	Held-to-maturity	2008 ISO Plan:	2008 Incentive Stock Option Plan of the Company
HUD:	U.S. Department of Housing and Urban Development	2014 Equity Plan:	2014 Equity Incentive Plan
ICS:	Insured Cash Sweeps of the Promontory Interfinancial Network	2017 Annual Report	Annual Report of Form 10-K for the year ended December 31, 2017
			Tax Cut and Jobs Act of 2017

2017 Tax Act:

Note 2. Legal Contingencies

In the normal course of business, the Company is involved in various legal and other proceedings. In the opinion of management, any liability resulting from such proceedings is not expected to have a material adverse effect on the Company's consolidated financial condition or results of operations.

Note 3. Per Share Information

Earnings per common share are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed exercise of outstanding exercisable stock options and vesting of RSUs does not result in material dilution and is not included in the calculation.

Note 4. Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and liabilities (including operating leases) on the balance sheet and disclosing key information about leasing arrangements. Previous lease accounting did not require the inclusion of operating leases in the balance sheet. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. The Company is evaluating the potential impact of the ASU on its consolidated financial statements by reviewing its lease contracts.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Under the new guidance, which will replace the existing incurred loss model for recognizing credit losses, banks and other lending institutions will be required to recognize the full amount of expected credit losses. The new guidance, which is referred to as the current expected credit loss model ("CECL"), requires that expected credit losses for financial assets held at the reporting date that are accounted for at amortized cost be measured and recognized based on historical experience and current and reasonably supportable forecasted conditions to reflect the full amount of expected credit losses. A modified version of these requirements also applies to debt securities classified as AFS. The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within such years. The Company has established a CECL implementation team and developed a transition project plan. The team members have evaluated CECL implementation software providers and have selected Sageworks. The Company has entered into an agreement with Sageworks and has been compiling data to run parallel calculations during 2018. This will facilitate the implementation process and management's evaluation of the potential impact of the ASU on the Company's consolidated financial statements.

The Company adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) using a modified-retrospective transition method, as of January 1, 2018. The ASU requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. While the guidance replaces most existing revenue recognition guidance in GAAP, the ASU is not applicable to financial instruments and, therefore, did not impact a majority of the Company’s revenues, including net interest income. Through the Company's assessment, it was determined that there will be no cumulative-effect adjustment to beginning stockholders' equity under the modified retrospective transition method within the consolidated financial statements as there was no change in revenue recognition upon adoption of ASU2014-09.

Note 5. Goodwill and Other Intangible Assets

As a result of the 2011 Branch Acquisition, the Company recorded goodwill amounting to $2.2 million. The goodwill is not amortizable. Goodwill is evaluated for impairment annually, in accordance with current authoritative accounting guidance. Management assesses qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of the Company, in total, is less than its carrying amount. Management is not aware of any such events or circumstances that would cause it to conclude that the fair value of the Company is less than its carrying amount.

The Company also initially recorded $1.7 million of acquired identifiable intangible assets in connection with the 2011 Branch Acquisition, representing the core deposit intangible which is subject to straight-line amortization over the estimated 10 year average life of the core deposit base, absent any future impairment. Management will evaluate the core deposit intangible for impairment if conditions warrant.

Amortization expense for the core deposit intangible was $43 thousand for the three months ended March 31, 2018 and 2017. The amortization expense is included in other expenses on the consolidated statements of income and is deductible for tax purposes. As of March 31, 2018, the remaining amortization expense related to the core deposit intangible, absent any future impairment, is expected to be as follows:

	(Dollars in thousands)
2018	$ 128
2019	171
2020	171
2021	70
Total	$ 540

Note 6. Investment Securities

AFS and HTM investment securities as of the balance sheet dates consisted of the following:

March 31, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Available-for-sale				
Debt securities:				
U.S. Government-sponsored enterprises	$7,437	$ 2	$ (178)	$7,261
Agency mortgage-backed	33,356	—	(796)	32,560
State and political subdivisions	24,820	126	(624)	24,322
Corporate	4,411	1	(115)	4,297
Total	$70,024	$ 129	$ (1,713)	$68,440

December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Available-for-sale				
Debt securities:				
U.S. Government-sponsored enterprises	$7,805	$ 12	$ (122)	$7,695
Agency mortgage-backed	28,378	12	(274)	28,116
State and political subdivisions	24,704	249	(239)	24,714
Corporate	4,412	48	(67)	4,393
Total debt securities	65,299	321	(702)	64,918
Mutual funds (1)	521	—	—	521
Total	$65,820	$ 321	$ (702)	$65,439
Held-to-maturity				
U.S. Government-sponsored enterprises	$1,000	$ —	$ (1)	$999

(1) As of December 31, 2017, mutual funds were classified as AFS investment securities. Effective January 1, 2018, these investments were reclassified to other investments on the consolidated balance sheets as they are no longer eligible to be classified as AFS upon adoption of ASU 2016-01.

There were no investment securities HTM at March 31, 2018. Investment securities AFS with a carrying amount of $2.7 million and $4.6 million at March 31, 2018 and December 31, 2017, respectively, were pledged as collateral for public deposits and for other purposes as required or permitted by law.

The amortized cost and estimated fair value of debt securities by contractual scheduled maturity as of March 31, 2018 were as follows:

Available-for-sale	Amortized Cost	Fair Value
	(Dollars in thousands)	
Due from one to five years	$4,302	$4,325
Due from five to ten years	16,319	15,978
Due after ten years	16,047	15,577
	36,668	35,880
Agency mortgage-backed	33,356	32,560
Total debt securities available-for-sale	$70,024	$68,440

Actual maturities may differ for certain debt securities that may be called by the issuer prior to the contractual maturity. Actual maturities usually differ from contractual maturities on agency MBS because the mortgages underlying the securities may be prepaid, usually without any penalties. Therefore, these agency MBS are shown separately and are not included in the contractual maturity categories in the above maturity summary.

As of March 31, 2018, other investments consisted of mutual funds with a fair value of $502 thousand, a cost basis of $459 thousand and unrealized gains of $43 thousand.

Information pertaining to all investment securities with gross unrealized losses as of the balance sheet dates, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

March 31, 2018	Less Than 12 Months			12 Months and over			Total		
	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses
	(Dollars in thousands)								
Debt securities:									
U.S. Government-sponsored enterprises	5	$2,381	$ (19)	9	$4,216	$ (159)	14	$6,597	$ (178)
Agency mortgage-backed	38	27,583	(580)	7	4,977	(216)	45	32,560	(796)
State and political subdivisions	25	9,982	(189)	18	7,657	(435)	43	17,639	(624)
Corporate	6	2,826	(86)	2	971	(29)	8	3,797	(115)
Total	74	$42,772	$ (874)	36	$17,821	$ (839)	110	$60,593	$ (1,713)

December 31, 2017	Less Than 12 Months			12 Months and over			Total		
	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses	Number of Securities	Fair Value	Gross Unrealized Losses
	(Dollars in thousands)								
Debt securities:									
U.S. Government-sponsored enterprises	3	$1,824	$ (7)	9	$4,374	$ (116)	12	$6,198	$ (123)
Agency mortgage-backed	26	19,315	(143)	7	5,222	(131)	33	24,537	(274)
State and political subdivisions	8	3,803	(22)	18	7,899	(217)	26	11,702	(239)
Corporate	2	870	(31)	2	964	(36)	4	1,834	(67)
Total	39	$25,812	$ (203)	36	$18,459	$ (500)	75	$44,271	$ (703)

The Company evaluates all investment securities on a quarterly basis, and more frequently when economic conditions warrant, to determine if an OTTI exists. A security is considered impaired if the fair value is lower than its amortized cost basis at the report date. If impaired, management then assesses whether the unrealized loss is OTT.

An unrealized loss on a debt security is generally deemed to be OTT and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of OTTI write-down is recorded, net of tax effect, through net income as a component of net OTTI losses in the consolidated statements of income, while the remaining portion of the impairment loss is recognized in OCI, provided the Company does not intend to sell the underlying debt security and it is "more likely than not" that the Company will not have to sell the debt security prior to recovery. Declines in the fair values of individual equity securities that are deemed by management to be OTT are reflected in noninterest income when identified.

Management considers the following factors in determining whether OTTI exists and the period over which the security is expected to recover:

- The length of time, and extent to which, the fair value has been less than the amortized cost;
- Adverse conditions specifically related to the security, industry, or geographic area;
- The historical and implied volatility of the fair value of the security;

- The payment structure of the debt security and the likelihood of the issuer being able to make payments that may increase in the future;
- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency;
- Recoveries or additional declines in fair value subsequent to the balance sheet date; and
- The nature of the issuer, including whether it is a private company, public entity or government-sponsored enterprise, and the existence or likelihood of any government or third party guaranty.

The Company has the ability to hold the investment securities that had unrealized losses at March 31, 2018 and December 31, 2017 for the foreseeable future and no declines were deemed by management to be OTT.

There were no sales of AFS securities for the three months ended March 31, 2018 and March 31, 2017.

Note 7. Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their unpaid principal balances, adjusted for any charge-offs, the ALL, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

Loan interest income is accrued daily on outstanding balances. The following accounting policies, related to accrual and nonaccrual loans, apply to all portfolio segments and loan classes, which the Company considers to be the same. The accrual of interest is normally discontinued when a loan is specifically determined to be impaired and/or management believes, after considering collection efforts and other factors, that the borrower's financial condition is such that collection of interest is doubtful. Generally, any unpaid interest previously accrued on those loans is reversed against current period interest income. A loan may be restored to accrual status when its financial status has significantly improved and there is no principal or interest past due. A loan may also be restored to accrual status if the borrower makes six consecutive monthly payments or the lump sum equivalent. Income on nonaccrual loans is generally not recognized unless a loan is returned to accrual status or after all principal has been collected. Interest income generally is not recognized on impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are generally applied as a reduction of the loan principal balance. Delinquency status is determined based on contractual terms for all portfolio segments and loan classes. Loans past due 30 days or more are considered delinquent. Loans are considered in process of foreclosure when a judgment of foreclosure has been issued by the court.

Loan origination fees and direct loan origination costs are deferred and amortized as an adjustment of the related loan's yield using methods that approximate the interest method. The Company generally amortizes these amounts over the estimated average life of the related loans.

The composition of Net loans as of the balance sheet dates were as follows:

	March 31, 2018	December 31, 2017
	(Dollars in thousands)	
Residential real estate	$181,850	$ 178,999
Construction real estate	43,379	42,935
Commercial real estate	260,695	254,291
Commercial	46,885	50,719
Consumer	3,525	3,894
Municipal	55,326	55,777
Gross loans	591,660	586,615
Allowance for loan losses	(5,405)	(5,408)
Net deferred loan costs	797	795
Net loans	$587,052	$ 582,002

Qualifying residential first mortgage loans and certain commercial real estate loans with a carrying value of $165.0 million and $164.5 million were pledged as collateral for borrowings from the FHLB under a blanket lien at March 31, 2018 and December 31, 2017, respectively.

A summary of current, past due and nonaccrual loans as of the balance sheet dates follows:

March 31, 2018	Current	30-59 Days	60-89 Days	90 Days and Over and Accruing	Nonaccrual	Total
	(Dollars in thousands)					
Residential real estate	$177,929	$2,453	$358	$ 293	$ 817	$181,850
Construction real estate	42,919	352	55	—	53	43,379
Commercial real estate	258,127	2,267	—	—	301	260,695
Commercial	46,625	20	10	1	229	46,885
Consumer	3,485	39	1	—	—	3,525
Municipal	55,326	—	—	—	—	55,326
Total	$584,411	$5,131	$424	$ 294	$ 1,400	$591,660

December 31, 2017	Current	30-59 Days	60-89 Days	90 Days and Over and Accruing	Nonaccrual	Total
	(Dollars in thousands)					
Residential real estate	$173,914	$3,047	$750	$ 472	$ 816	$178,999
Construction real estate	42,857	—	—	22	56	42,935
Commercial real estate	253,266	357	361	—	307	254,291
Commercial	50,675	21	11	—	12	50,719
Consumer	3,884	7	3	—	—	3,894
Municipal	55,777	—	—	—	—	55,777
Total	$580,373	$3,432	$1,125	$ 494	$ 1,191	$586,615

There was one residential real estate loan totaling $131 thousand in process of foreclosure at March 31, 2018. Aggregate interest on nonaccrual loans not recognized was $1.2 million and $1.3 million as of March 31, 2018 and 2017, respectively, and $1.2 million as of December 31, 2017.

Note 8. Allowance for Loan Losses and Credit Quality

The ALL is established for estimated losses in the loan portfolio through a provision for loan losses charged to earnings. For all loan classes, loan losses are charged against the ALL when management believes the loan balance is uncollectible or in accordance with federal guidelines. Subsequent recoveries, if any, are credited to the ALL.

The ALL is maintained at a level believed by management to be appropriate to absorb probable credit losses inherent in the loan portfolio as of the balance sheet date. The amount of the ALL is based on management's periodic evaluation of the collectability of the loan portfolio, including the nature, volume and risk characteristics of the portfolio, credit concentrations, trends in historical loss experience, estimated value of any underlying collateral, specific impaired loans and economic conditions. There was no change to the methodology used to estimate the ALL during the first quarter of 2018. While management uses available information to recognize losses on loans, future additions to the ALL may be necessary based on changes in economic conditions or other relevant factors.

In addition, various regulatory agencies, as an integral part of their examination process, regularly review the Company's ALL. Such agencies may require the Company to recognize additions to the ALL, with a corresponding charge to earnings, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

The ALL consists of specific, general and unallocated components. The specific component relates to the loans that are classified as impaired. Loans are evaluated for impairment and may be classified as impaired when management believes it is probable that the Company will not collect all the contractual interest and principal payments as scheduled in the loan agreement. Impaired loans may also include troubled loans that are restructured. A TDR occurs when the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that would otherwise not be granted. A TDR classification may result from the transfer of assets to the Company in partial satisfaction of a troubled loan, a modification of a loan's terms (such as reduction of stated interest rates below market rates, extension of maturity that does not conform to the Company's policies, reduction of the face amount of the loan, reduction of accrued interest, or reduction or deferment of loan payments), or a combination. A specific reserve amount is allocated to the ALL for individual loans that have been classified as impaired based on management's estimate of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows. The Company accounts for the change in present value attributable to the passage of time in the loan loss reserve. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, real estate or small balance commercial loans for impairment evaluation, unless such loans are subject to a restructuring agreement or have been identified as impaired as part of a larger customer relationship. Management has established the threshold for individual impairment evaluation for commercial loans with balances greater than $500 thousand, based on an evaluation of the Company's historical loss experience on substandard commercial loans.

The general component represents the level of ALL allocable to each loan portfolio segment with similar risk characteristics and is determined based on historical loss experience, adjusted for qualitative factors, for each class of loan. Management deems a five year average to be an appropriate time frame on which to base historical losses for each portfolio segment. Qualitative factors considered include underwriting, economic and market conditions, portfolio composition, collateral values, delinquencies, lender experience and legal issues. The qualitative factors are determined based on the various risk characteristics of each portfolio segment. Risk characteristics relevant to each portfolio segment are as follows:

- Residential real estate - Loans in this segment are collateralized by owner-occupied 1-4 family residential real estate, second and vacation homes, 1-4 family investment properties, home equity and second mortgage loans. Repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, could have an effect on the credit quality of this segment.

- Construction real estate - Loans in this segment include residential and commercial construction properties, commercial real estate development loans (while in the construction phase of the projects), land and land development loans. Repayment is dependent on the credit quality of the individual borrower and/or the underlying cash flows generated by the properties being constructed. The overall health of the economy, including unemployment rates, housing prices, vacancy rates and material costs, could have an effect on the credit quality of this segment.

- Commercial real estate - Loans in this segment are primarily properties occupied by businesses or income-producing properties. The underlying cash flows generated by the properties may be adversely impacted by a downturn in the economy as evidenced by a general slowdown in business or increased vacancy rates which, in turn, could have an effect on the credit quality of this segment. Management requests business financial statements at least annually and monitors the cash flows of these loans.

- Commercial - Loans in this segment are made to businesses and are generally secured by non-real estate assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer or business spending, could have an effect on the credit quality of this segment.

- Consumer - Loans in this segment are made to individuals for personal expenditures, such as an automobile purchase, and include unsecured loans. Repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment, could have an effect on the credit quality of this segment.

- Municipal - Loans in this segment are made to municipalities located within the Company's service area. Repayment is primarily dependent on taxes or other funds collected by the municipalities. Management considers there to be minimal risk surrounding the credit quality of this segment.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the ALL reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

All evaluations are inherently subjective as they require estimates that are susceptible to significant revision as more information becomes available or as changes occur in economic conditions or other relevant factors. Despite the allocation shown in the tables below, the ALL is general in nature and is available to absorb losses from any class of loan.

Changes in the ALL, by class of loans, for the three months ended March 31, 2018 and 2017 were as follows:

For The Three Months Ended March 31, 2018	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Balance, December 31, 2017	$1,361	$ 488	$ 2,707	$ 395	$ 30	$ 64	$ 363	$5,408
Provision (credit) for loan losses	14	6	68	(28)	(4)	(1)	(55)	—
Recoveries of amounts charged off	—	—	—	—	3	—	—	3
	1,375	494	2,775	367	29	63	308	5,411
Amounts charged off	—	—	(2)	—	(4)	—	—	(6)
Balance, March 31, 2018	$1,375	$ 494	$ 2,773	$ 367	$ 25	$ 63	$ 308	$5,405

For The Three Months Ended March 31, 2017	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Balance, December 31, 2016	$1,399	$ 391	$ 2,687	$ 342	$ 26	$ 40	$ 362	$5,247
Provision (credit) for loan losses	29	48	(26)	4	—	2	(57)	—
Recoveries of amounts charged off	2	3	—	—	1	—	—	6
	1,430	442	2,661	346	27	42	305	5,253
Amounts charged off	(58)	—	—	—	(3)	—	—	(61)
Balance, March 31, 2017	$1,372	$ 442	$ 2,661	$ 346	$ 24	$ 42	$ 305	$5,192

The allocation of the ALL, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

March 31, 2018	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Individually evaluated for impairment	$44	$ —	$ —	$ 6	$ —	$ —	$ —	$50
Collectively evaluated for impairment	1,331	494	2,773	361	25	63	308	5,355
Total allocated	$1,375	$ 494	$ 2,773	$ 367	$ 25	$ 63	$ 308	$5,405

December 31, 2017	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Unallocated	Total
	(Dollars in thousands)							
Individually evaluated for impairment	$47	$ —	$ 1	$ —	$ —	$ —	$ —	$48
Collectively evaluated for impairment	1,314	488	2,706	395	30	64	363	5,360
Total allocated	$1,361	$ 488	$ 2,707	$ 395	$ 30	$ 64	$ 363	$5,408

The recorded investment in loans, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

March 31, 2018	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Individually evaluated for impairment	$1,793	$ 81	$ 1,056	$ 374	$ —	$ —	$3,304
Collectively evaluated for impairment	180,057	43,298	259,639	46,511	3,525	55,326	588,356
Total	$181,850	$ 43,379	$ 260,695	$ 46,885	$ 3,525	$ 55,326	$591,660

December 31, 2017	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Individually evaluated for impairment	$1,718	$ 82	$ 1,074	$ 378	$ —	$ —	$3,252
Collectively evaluated for impairment	177,281	42,853	253,217	50,341	3,894	55,777	583,363
Total	$178,999	$ 42,935	$ 254,291	$ 50,719	$ 3,894	$ 55,777	$586,615

Risk and collateral ratings are assigned to loans and are subject to ongoing monitoring by lending and credit personnel with such ratings updated annually or more frequently if warranted. The following is an overview of the Company's loan rating system:

1-3 Rating - Pass
Risk-rating grades "1" through "3" comprise those loans ranging from those with lower than average credit risk, defined as borrowers with high liquidity, excellent financial condition, strong management, favorable industry trends or loans secured by highly liquid assets, through those with marginal credit risk, defined as borrowers that, while creditworthy, exhibit some characteristics requiring special attention by the account officer.

4/M Rating - Satisfactory/Monitor
Borrowers exhibit potential credit weaknesses or downward trends warranting management's attention. While potentially weak, these borrowers are currently marginally acceptable; no loss of principal or interest is envisioned. When warranted, these credits may be monitored on the watch list.

5-7 Rating - Substandard
Borrowers exhibit well defined weaknesses that jeopardize the orderly liquidation of debt. The loan may be inadequately protected by the net worth and paying capacity of the obligor and/or the underlying collateral is inadequate.

The following tables summarize the loan ratings applied to the Company's loans by class as of the balance sheet dates:

March 31, 2018	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Pass	$167,824	$ 35,795	$ 173,160	$ 35,525	$ 3,495	$ 55,326	$471,125
Satisfactory/Monitor	11,099	7,429	84,478	10,515	28	—	113,549
Substandard	2,927	155	3,057	845	2	—	6,986

Total	$181,850	$ 43,379	$ 260,695	$ 46,885	$ 3,525	$ 55,326	$591,660

December 31, 2017	Residential Real Estate	Construction Real Estate	Commercial Real Estate	Commercial	Consumer	Municipal	Total
	(Dollars in thousands)						
Pass	$164,733	$ 33,401	$ 177,388	$ 38,877	$ 3,859	$ 55,777	$474,035
Satisfactory/Monitor	11,296	9,374	73,772	11,165	30	—	105,637
Substandard	2,970	160	3,131	677	5	—	6,943
Total	$178,999	$ 42,935	$ 254,291	$ 50,719	$ 3,894	$ 55,777	$586,615

The following tables provide information with respect to impaired loans by class of loan as of and for the three months ended March 31, 2018 and March 31, 2017:

	As of March 31, 2018			For The Three Months Ended March 31, 2018	
	Recorded Investment (1)	Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)				
Residential real estate	$235	$ 244	$ 44		
Commercial	13	13	6		
With an allowance recorded	248	257	50		
Residential real estate	1,558	2,074	—		
Construction real estate	81	81	—		
Commercial real estate	1,056	1,137	—		
Commercial	361	361	—		
With no allowance recorded	3,056	3,653	—		
Residential real estate	1,793	2,318	44	$1,755	$ 12
Construction real estate	81	81	—	82	1
Commercial real estate	1,056	1,137	—	1,065	16
Commercial	374	374	6	376	8
Total	$3,304	$ 3,910	$ 50	$3,278	$ 37

(1) Does not reflect government guaranties on impaired loans as of March 31, 2018 totaling $533 thousand.

	As of March 31, 2017			For The Three Months Ended March 31, 2017	
	Recorded Investment (1)	Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)				
Residential real estate	$1,579	$ 2,087	$ 61	$1,514	$ 11
Construction real estate	87	87	—	87	1
Commercial real estate	2,220	2,291	21	2,774	32
Commercial	417	417	—	424	7
Total	$4,303	$ 4,882	$ 82	$4,799	$ 51

(1) Does not reflect government guaranties on impaired loans as of March 31, 2017 totaling $623 thousand.

The following table provides information with respect to impaired loans as of December 31, 2017:

	December 31, 2017		
	Recorded Investment (1)	Principal Balance (1)	Related Allowance
	(Dollars in thousands)		
Residential real estate	$238	$ 247	$ 47
Commercial real estate	137	141	1
With an allowance recorded	375	388	48
Residential real estate	1,480	1,983	—
Construction real estate	82	82	—
Commercial real estate	937	1,011	—
Commercial	378	378	—
With no allowance recorded	2,877	3,454	—
Residential real estate	1,718	2,230	47
Construction real estate	82	82	—
Commercial real estate	1,074	1,152	1
Commercial	378		