# Farm Credit Southeast Missouri, ACA

**Quarterly Report**
**September 30, 2018**

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following commentary reviews the consolidated financial condition and consolidated results of operations of Farm Credit Southeast Missouri, ACA and its subsidiaries Farm Credit Southeast Missouri, FLCA and Farm Credit Southeast Missouri, PCA. This discussion should be read in conjunction with both the unaudited consolidated financial information and related notes included in this Quarterly Report as well as Management's Discussion and Analysis included in our Annual Report for the year ended December 31, 2017 (2017 Annual Report).

Due to the nature of our financial relationship with AgriBank, FCB (AgriBank), the financial condition and results of operations of AgriBank materially impact our members' investment. To request free copies of the AgriBank or the AgriBank District financial reports or additional copies of our report, contact us at:


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### FORWARD-LOOKING INFORMATION

Any forward-looking statements in this Quarterly Report are based on current expectations and are subject to uncertainty and changes in circumstances. Actual results may differ materially from expectations due to a number of risks and uncertainties. More information about these risks and uncertainties is contained in our 2017 Annual Report. We undertake no duty to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

### AGRICULTURAL AND ECONOMIC CONDITIONS

**Land Values:** The average benchmark farm land value change in 2018 was 1.6%, compared to 0.2% and 2.1% in 2017 and 2016, respectively. The more moderate land value changes the past three years are indicative of lower commodity prices to more historical levels.

**Commodity Prices:** Prices continue to trend slightly downward, corn and soybeans down 10-15% compared to a year ago, and remain well below the historic highs of 2012-2013 time period.

**Crop Conditions:** Yields are reported to be average to above average for all crops across much of the area. Cotton and soybeans that have not yet been harvested appear to have excellent yield potential as well. Higher volume production will help mitigate lower prices.

### LOAN PORTFOLIO

#### Loan Portfolio

Total loans were $734.8 million at September 30, 2018, an increase of $104.9 million from December 31, 2017. The increase was primarily due to normal seasonal loan disbursements.

#### Portfolio Credit Quality

The credit quality of our portfolio improved from December 31, 2017. Adversely classified loans decreased to 0.8% of the portfolio at September 30, 2018, from 1.0% of the portfolio at December 31, 2017. Adversely classified loans are loans we have identified as showing some credit weakness outside our credit standards. We have considered portfolio credit quality in assessing the reasonableness of our allowance for loan losses.

In certain circumstances, government guarantee programs are used to reduce the risk of loss. At September 30, 2018, $74.8 million of our loans were, to some level, guaranteed under these government programs.

## Risk Assets

**Components of Risk Assets**

| (dollars in thousands) As of: | | September 30 2018 | | December 31 2017 |
|---|---|---|---|---|
| Loans: | | | | |
| Nonaccrual | **$** | **389** | $ | 2,988 |
| Accruing restructured | | **446** | | 482 |
| Accruing loans 90 days or more past due | | **3,177** | | 1,368 |
| Total risk loans | | **4,012** | | 4,838 |
| Other property owned | | **--** | | -- |
| Total risk assets | **$** | **4,012** | $ | 4,838 |
| Total risk loans as a percentage of total loans | | **0.5%** | | 0.8% |
| Nonaccrual loans as a percentage of total loans | | **0.1%** | | 0.5% |
| Current nonaccrual loans as a percentage of total nonaccrual loans | | **96.9%** | | 69.5% |
| Total delinquencies as a percentage of total loans | | **0.8%** | | 0.9% |

Note: Accruing loans include accrued interest receivable.

Our risk assets have decreased from December 31, 2017, and have remained at acceptable levels. Total risk loans as a percentage of total loans were well within our established risk management guidelines.

The decrease in nonaccrual loans was primarily due to the payoff of seven nonaccrual local credits to four customers and the reinstatement to accrual status of five local credits to one customer. Nonaccrual loans remained at an acceptable level at September 30, 2018, and December 31, 2017.

The increase in accruing loans 90 days or more past due was primarily due to six fully guaranteed United States Department of Agriculture (USDA) loans becoming over 90 days past due during the nine months ended September 30, 2018. The principal and accruing interest on these loans are guaranteed by the USDA and are therefore eligible to remain in accruing status. Our accounting policy requires loans past due 90 days or more to be transferred into nonaccrual status unless adequately secured and in the process of collection. Based on our analysis, accruing loans 90 days or more past due were eligible to remain in accruing status.

## Allowance for Loan Losses

The allowance for loan losses is an estimate of losses on loans in our portfolio as of the financial statement date. We determine the appropriate level of allowance for loan losses based on periodic evaluation of factors such as loan loss history, estimated probability of default, estimated loss severity, portfolio quality, and current economic and environmental conditions.

**Allowance Coverage Ratios**

| As of: | September 30 2018 | December 31 2017 |
|---|---|---|
| Allowance as a percentage of: | | |
| Loans | **0.1%** | 0.1% |
| Nonaccrual loans | **134.4%** | 17.9% |
| Total risk loans | **13.0%** | 11.0% |

In our opinion, the allowance for loan losses was reasonable in relation to the risk in our loan portfolio at September 30, 2018.

## RESULTS OF OPERATIONS

**Profitability Information**

| (dollars in thousands) For the nine months ended September 30 | | 2018 | | 2017 |
|---|---|---|---|---|
| Net income | **$** | **10,691** | $ | 10,239 |
| Return on average assets | | **2.1%** | | 2.1% |
| Return on average members' equity | | **9.7%** | | 9.9% |

Changes in the chart above relate directly to:

- Changes in income discussed below
- Changes in assets discussed in the Loan Portfolio section
- Changes in capital discussed in the Funding, Liquidity, and Capital section

**Changes in Significant Components of Net Income**

| (in thousands)<br>For the nine months ended September 30 | | 2018 | | 2017 | | Increase (decrease) in net income |
|---|---|---|---|---|---|---|
| Net interest income | $ | **15,185** | $ | 14,799 | $ | **386** |
| Provision for credit losses | | **7** | | 484 | | **477** |
| Patronage income | | **1,338** | | 1,601 | | **(263)** |
| Other income, net | | **925** | | 445 | | **480** |
| Operating expenses | | **6,709** | | 6,171 | | **(538)** |
| Provision for (benefit from) income taxes | | **41** | | (49) | | **(90)** |
| Net income | $ | **10,691** | $ | 10,239 | $ | **452** |

**Changes in Net Interest Income**

| (in thousands)<br>For the nine months ended September 30 | | 2018 vs 2017 |
|---|---|---|
| Changes in volume | $ | **196** |
| Changes in interest rates | | **(5)** |
| Changes in nonaccrual income and other | | **195** |
| Net change | $ | **386** |

The change in the provision for credit losses was primarily related to a specific reserve reversal and a partial loan recovery on a nonaccrual local credit in the first quarter of 2018. In addition, we had a $90 thousand provision for credit losses to establish a reserve for unfunded commitments on our loan portfolio during the first quarter of 2018.

The change in patronage income was primarily related to a lower accrual rate and a slight decrease in average balance on our note payable.

The change in other income was primarily due to our share of the Allocated Insurance Reserve Accounts (AIRA) distributions received from the Farm Credit System Insurance Corporation (FCSIC) of $352 thousand. The AIRA was established by the FCSIC when premiums collected increased the level of the Insurance Fund beyond the required 2 percent of insured debt. There was no distribution in 2017. Refer to the 2017 Annual Report for additional information about the FCSIC.

The change in operating expenses was primarily related to an increase in salaries and benefits expense, an increase in purchased and vendor services expense as well as an increase in public and member relations expense. These increases were partially offset by a decrease in FCSIC expense primarily due to a lower premium rate charged by FCSIC on accrual loans from 15 basis points in 2017 to 9 basis points in 2018. The FCSIC Board meets periodically throughout the year to review premium rates and has the ability to change these rates at any time.

The change in provision for (benefit from) income taxes was primarily related to a higher reserve for 2018 patronage compared to the third quarter of 2017.

## FUNDING, LIQUIDITY, AND CAPITAL

We borrow from AgriBank, under a note payable, in the form of a line of credit. Our note payable matures on June 30, 2020, at which time the note will be renegotiated. The repricing attributes of our line of credit generally correspond to the repricing attributes of our loan portfolio which significantly reduces our market interest rate risk. Due to the cooperative structure of the Farm Credit System and as we are a stockholder of AgriBank, we expect this borrowing relationship to continue into the foreseeable future. Our other source of lendable funds is from unallocated surplus.

The components of cost of funds associated with our note payable include:

- A marginal cost of debt component
- A spread component, which includes cost of servicing, cost of liquidity, and bank profit
- A risk premium component, if applicable

We were not subject to a risk premium at September 30, 2018, or December 31, 2017.

Total members' equity increased $5.8 million from December 31, 2017, primarily due to net income for the period partially offset by patronage distribution accruals.

The Farm Credit Administration (FCA) Regulations require us to maintain minimums for our common equity tier 1, tier 1 capital, total capital, and permanent capital risk-based capital ratios. In addition, the FCA requires us to maintain minimums for our non-risk-adjusted ratios of tier 1 leverage and unallocated retained earnings and equivalents. Refer to Note 7 in our 2017 Annual Report for a more complete description of these ratios.

**Regulatory Capital Requirements and Ratios**

| As of: | **September 30 2018** | December 31 2017 | Regulatory Minimums | Capital Conservation Buffer | Total |
|---|---|---|---|---|---|
| Risk-adjusted: | | | | | |
| Common equity tier 1 ratio | **19.6%** | 20.2% | 4.5% | 2.5%* | 7.0% |
| Tier 1 capital ratio | **19.6%** | 20.2% | 6.0% | 2.5%* | 8.5% |
| Total capital ratio | **19.7%** | 20.3% | 8.0% | 2.5%* | 10.5% |
| Permanent capital ratio | **19.6%** | 20.2% | 7.0% | N/A | 7.0% |
| Non-risk-adjusted: | | | | | |
| Tier 1 leverage ratio | **19.1%** | 19.6% | 4.0% | 1.0% | 5.0% |
| Unallocated retained earnings and equivalents leverage ratio | **19.1%** | 19.6% | 1.5% | N/A | 1.5% |

*The 2.5% capital conservation buffer over risk-adjusted ratio minimums is being phased in through 2020 under the FCA capital requirements.

The capital adequacy ratios are directly impacted by the changes in capital as more fully explained in this section and the changes in assets as discussed in the Loan Portfolio section.

## RELATIONSHIP WITH AGRIBANK

### Purchased Services

During 2016, District associations and AgriBank conducted research related to repositioning many business services offered by AgriBank into a separate entity jointly owned by AgriBank and participating associations. The long-term strategic objective of this initiative is to increase scale, improve operating efficiency, and enhance technology and business services. The proposed service entity will be named SunStream Business Services. An application to form the service entity was submitted to the FCA for approval in May 2017, and the FCA continues its due diligence on the charter request.

## REGULATORY MATTERS

### Investment Securities Eligibility

In May 2018, the FCA Board approved a final rule to revise the requirements governing the eligibility of investment securities for System Banks and associations. The new regulation revises the eligibility purpose, type, and amount of investments that a System association may hold. The regulation is effective January 1, 2019. We are currently working to update policies, procedures, and other documentation to ensure compliance by the effective date. We do not expect the regulation to have a material impact on our financial statements.

## CERTIFICATION

The undersigned have reviewed the September 30, 2018, Quarterly Report of Farm Credit Southeast Missouri, ACA, which has been prepared under the oversight of the Audit Committee and in accordance with all applicable statutory or regulatory requirements. The information contained herein is true, accurate, and complete to the best of our knowledge and belief.

Markel D. Yarbro
Chairperson of the Board
Farm Credit Southeast Missouri, ACA

Robert E. Smith
President / Chief Executive Officer
Farm Credit Southeast Missouri, ACA

Vernon D. Griffith
Executive Vice President / Chief Financial Officer
Farm Credit Southeast Missouri, ACA

November 8, 2018

# CONSOLIDATED STATEMENTS OF CONDITION

*Farm Credit Southeast Missouri, ACA*
*(in thousands)*
*(Unaudited)*

| As of: | | September 30 2018 | | December 31 2017 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Loans | **$** | **734,798** | $ | 629,942 |
| Allowance for loan losses | | **523** | | 534 |
| Net loans | | **734,275** | | 629,408 |
| Investment in AgriBank, FCB | | **13,106** | | 12,865 |
| Investment securities | | **894** | | 1,509 |
| Accrued interest receivable | | **17,544** | | 11,142 |
| Deferred tax assets, net | | **60** | | 100 |
| Other assets | | **5,690** | | 5,424 |
| Total assets | **$** | **771,569** | $ | 660,448 |
| **LIABILITIES** | | | | |
| Note payable to AgriBank, FCB | **$** | **612,280** | $ | 504,826 |
| Accrued interest payable | | **3,774** | | 2,890 |
| Patronage distribution payable | | **4,900** | | 7,000 |
| Other liabilities | | **1,375** | | 2,305 |
| Total liabilities | | **622,329** | | 517,021 |
| Contingencies and commitments (Note 4) | | | | |
| **MEMBERS' EQUITY** | | | | |
| Capital stock and participation certificates | | **1,724** | | 1,713 |
| Unallocated surplus | | **147,516** | | 141,714 |
| Total members' equity | | **149,240** | | 143,427 |
| Total liabilities and members' equity | **$** | **771,569** | $ | 660,448 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

# CONSOLIDATED STATEMENTS OF INCOME

*Farm Credit Southeast Missouri, ACA*

*(in thousands)*
*(Unaudited)*

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| *For the period ended September 30* | **2018** | 2017 | **2018** | 2017 |
| **Interest income** | **$ 9,421** | $ 8,506 | **$ 24,710** | $ 22,472 |
| **Interest expense** | **3,774** | 3,038 | **9,525** | 7,673 |
| Net interest income | **5,647** | 5,468 | **15,185** | 14,799 |
| **Provision for credit losses** | **33** | 9 | **7** | 484 |
| Net interest income after provision for credit losses | **5,614** | 5,459 | **15,178** | 14,315 |
| **Other income** | | | | |
| Patronage income | **506** | 796 | **1,338** | 1,601 |
| Financially related services income | **471** | 307 | **614** | 442 |
| Fee income, net | **(16)** | (18) | **(47)** | (51) |
| Allocated Insurance Reserve Accounts distribution | **--** | -- | **352** | -- |
| Miscellaneous (loss) income, net | **(12)** | 13 | **6** | 54 |
| Total other income | **949** | 1,098 | **2,263** | 2,046 |
| **Operating expenses** | | | | |
| Salaries and employee benefits | **1,458** | 1,247 | **4,078** | 3,836 |
| Other operating expenses | **885** | 863 | **2,631** | 2,335 |
| Total operating expenses | **2,343** | 2,110 | **6,709** | 6,171 |
| Income before income taxes | **4,220** | 4,447 | **10,732** | 10,190 |
| **Provision for (benefit from) income taxes** | **1** | (27) | **41** | (49) |
| Net income | **$ 4,219** | $ 4,474 | **$ 10,691** | $ 10,239 |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

# CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY

*Farm Credit Southeast Missouri, ACA*
*(in thousands)*
*(Unaudited)*

| | Capital Stock and Participation Certificates | Unallocated Surplus | Total Members' Equity |
|---|---|---|---|
| Balance at December 31, 2016 | $ 1,715 | $ 133,866 | $ 135,581 |
| Net income | -- | 10,239 | 10,239 |
| Unallocated surplus designated for patronage distributions | -- | (3,750) | (3,750) |
| Capital stock and participation certificates issued | 80 | -- | 80 |
| Capital stock and participation certificates retired | (64) | -- | (64) |
| Balance at September 30, 2017 | $ 1,731 | $ 140,355 | $ 142,086 |
| Balance at December 31, 2017 | $ 1,713 | $ 141,714 | $ 143,427 |
| Net income | **--** | **10,691** | **10,691** |
| Unallocated surplus designated for patronage distributions | **--** | **(4,889)** | **(4,889)** |
| Capital stock and participation certificates issued | **91** | **--** | **91** |
| Capital stock and participation certificates retired | **(80)** | **--** | **(80)** |
| **Balance at September 30, 2018** | **$ 1,724** | **$ 147,516** | **$ 149,240** |

*The accompanying notes are an integral part of these Consolidated Financial Statements.*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1: ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

The Consolidated Financial Statements contain all adjustments necessary for a fair presentation of the interim consolidated financial condition and consolidated results of operations. Our accounting policies conform to accounting principles generally accepted in the United States of America (GAAP) and the prevailing practices within the financial services industry. This interim Quarterly Report is prepared based upon statutory and regulatory requirements and in accordance with GAAP. However, certain disclosures required by GAAP are omitted. The results of the nine months ended September 30, 2018, are not necessarily indicative of the results to be expected for the year ending December 31, 2018. The interim financial statements and the related notes in this Quarterly Report should be read in conjunction with the Consolidated Financial Statements and related notes included in our Annual Report for the year ended December 31, 2017 (2017 Annual Report).

The Consolidated Financial Statements present the consolidated financial results of Farm Credit Southeast Missouri, ACA (the Association) and its subsidiaries Farm Credit Southeast Missouri, FLCA and Farm Credit Southeast Missouri, PCA (the subsidiaries). All material intercompany transactions and balances have been eliminated in consolidation.

**Recently Issued or Adopted Accounting Pronouncements**

We have assessed the potential impact of accounting standards that have been issued by the Financial Accounting Standards Board (FASB) and have determined the following standards to be applicable to our business. While we are a nonpublic entity, we generally adopt on the public entity required date to align with other Farm Credit System institutions. For recently issued and adopted accounting pronouncements disclosed, we plan to adopt on the public entity effective date.

| Standard and effective date | Description | Adoption status and financial statement impact |
|---|---|---|
| In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09 “Revenue from Contracts with Customers." This guidance was effective for public entities on January 1, 2018. | The guidance governs revenue recognition from contracts with customers and requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Financial instruments and other contractual rights within the scope of other guidance issued by the FASB are excluded from the scope of this guidance. The guidance sets forth the requirement for new and enhanced disclosures. | We adopted this guidance on January 1, 2018, using the modified retrospective approach, as the majority of our revenues are not subject to the new guidance. The adoption of the guidance did not have a material impact on the financial condition, results of operations, or cash flows. |
| In March 2017, the FASB issued ASU 2017-07 “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Cost.” This guidance was effective for public entities on January 1, 2018. | This guidance requires that an employer disaggregate the service cost component from the other components of net benefit cost. Specifically, the guidance requires non-service cost components of net benefit cost to be recognized in a non-operating income line item of the income statement and allow only the service cost component of net benefit cost to be eligible for capitalization. | The adoption of the guidance did not impact the Association’s financial condition, results of operations, cash flows, or financial statement disclosures. |
| In January 2016, the FASB issued ASU 2016-01 “Recognition and Measurement of Financial Assets and Financial Liabilities.” This guidance was effective for public business entities on January 1, 2018. | The guidance is intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The amendments address certain aspects of recognition, measurement, presentation, and disclosure of financial statements. | We adopted this guidance on January 1, 2018. The adoption of this guidance did not impact our financial condition, results of operations, or cash flows, but did impact our fair value disclosures. |
| In February 2016, the FASB issued ASU 2016-02 “Leases.” In July 2018, the FASB issued ASU 2018-11 “Leases (Topic 842): Targeted Improvements.” The guidance is effective for public entities in its first quarter of 2019 and early adoption is permitted. | The guidance modifies the recognition and accounting for lessees and lessors and requires expanded disclosures regarding assumptions used to recognize revenue and expenses related to leases. When this guidance is adopted, a liability for lease obligations and a corresponding right-of-use asset will be recognized on the Consolidated Statements of Condition for all lease arrangements spanning more than 12 months. The guidance includes an optional transition method where an entity is permitted to apply the guidance as of the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings. | We have no plans to early adopt this guidance. We are in the process of system selection, drafting accounting policies, and designing processes and controls to implement this standard. The necessary disclosures will be determined during 2018. We have determined after preliminary review, this guidance will not have a material impact on our financial condition, results of operations, and financial statement disclosures, and will have no impact on cash flows. |

| Standard and effective date | Description | Adoption status and financial statement impact |
|---|---|---|
| In August 2018, the FASB issued ASU 2018-15 "Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract." The guidance is effective for our first quarter of 2020 and early adoption is permitted. | The guidance clarifies that implementation costs incurred in a hosting arrangement that is a service contract should be accounted for in the same manner as implementation costs incurred to develop or obtain internal-use software. | We are in the process of reviewing the accounting standard. Based on our preliminary review and analysis, this new guidance will not have a material impact on our financial condition, results of operations, cash flows and financial statement disclosures. |
| In June 2016, the FASB issued ASU 2016-13 "Financial Instruments – Credit Losses." This guidance is effective for public business entities for non-U.S. Securities Exchange Commission filers for the first quarter of 2021 and early adoption is permitted. | The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. | We have no plans to early adopt this guidance. We are in the process of reviewing the standard. Significant implementation matters yet to be addressed include system selection, drafting of accounting policies and disclosures, and designing processes and controls. We are currently unable to estimate the impact on the financial statements. |

## NOTE 2: LOANS AND ALLOWANCE FOR LOAN LOSSES

**Loans by Type**

(dollars in thousands)

| As of: | **September 30, 2018** | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| | | Amount | % | | Amount | % |
| Real estate mortgage | **$** | **373,530** | **50.9%** | $ | 353,371 | 56.1% |
| Production and intermediate-term | | **307,991** | **41.9%** | | 218,676 | 34.7% |
| Agribusiness | | **4,714** | **0.6%** | | 7,444 | 1.2% |
| Other | | **48,563** | **6.6%** | | 50,451 | 8.0% |
| Total | **$** | **734,798** | **100.0%** | $ | 629,942 | 100.0% |

The other category is primarily comprised of certain assets originated under the mission related investment authority as well as rural residential real estate loans.

### Delinquency

**Aging Analysis of Loans**

| (in thousands)<br>**As of September 30, 2018** | 30-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Not Past Due or Less than 30 Days Past Due | Total | Accruing Loans 90 Days or More Past Due |
|---|---|---|---|---|---|---|
| Real estate mortgage | **$ 75** | **$ --** | **$ 75** | **$ 383,390** | **$ 383,465** | **$ --** |
| Production and intermediate-term | **18** | **--** | **18** | **315,060** | **315,078** | **--** |
| Agribusiness | **2,011** | **--** | **2,011** | **2,841** | **4,852** | **--** |
| Other | **609** | **3,177** | **3,786** | **45,154** | **48,940** | **3,177** |
| Total | **$ 2,713** | **$ 3,177** | **$ 5,890** | **$ 746,445** | **$ 752,335** | **$ 3,177** |

| As of December 31, 2017 | 30-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Not Past Due or Less than 30 Days Past Due | Total | Accruing Loans 90 Days or More Past Due |
|---|---|---|---|---|---|---|
| Real estate mortgage | $ 183 | $ 499 | $ 682 | $ 358,748 | $ 359,430 | $ -- |
| Production and intermediate-term | 59 | 396 | 455 | 222,870 | 223,325 | -- |
| Agribusiness | -- | -- | -- | 7,520 | 7,520 | -- |
| Other | 2,988 | 1,369 | 4,357 | 46,441 | 50,798 | 1,368 |
| Total | $ 3,230 | $ 2,264 | $ 5,494 | $ 635,579 | $ 641,073 | $ 1,368 |

Note: Accruing loans include accrued interest receivable.

## Risk Loans

Risk loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms.

**Risk Loan Information**

| (in thousands)<br>As of: | | **September 30<br>2018** | | December 31<br>2017 |
|---|---|---|---|---|
| Volume with specific allowance | **$** | **--** | $ | 391 |
| Volume without specific allowance | | **4,012** | | 4,447 |
| Total risk loans | **$** | **4,012** | $ | 4,838 |
| Total specific allowance | **$** | **--** | $ | 42 |
| For the nine months ended September 30 | | **2018** | | 2017 |
| Income on accrual risk loans | **$** | **147** | $ | 35 |
| Income on nonaccrual loans | | **300** | | 106 |
| Total income on risk loans | **$** | **447** | $ | 141 |
| Average risk loans | **$** | **4,483** | $ | 4,699 |

Note: Accruing loans include accrued interest receivable.

We did not have any material commitments to lend additional money to borrowers whose loans were classified as risk loans at September 30, 2018.

## Troubled Debt Restructurings (TDRs)

In situations where, for economic or legal reasons related to the borrower's financial difficulties, we grant a concession for other than an insignificant period of time to the borrower that we would not otherwise consider, the related loan is classified as a troubled debt restructuring, also known as a restructured loan. A concession is generally granted in order to minimize economic loss and avoid foreclosure. Concessions vary by program and borrower and may include interest rate reductions, term extensions, payment deferrals, or an acceptance of additional collateral in lieu of payments. In limited circumstances, principal may be forgiven. Loans classified as TDRs are considered risk loans. All risk loans are analyzed within our allowance for loan losses. We record a specific allowance to reduce the carrying amount of the restructured loan to the lower of book value or net realizable value of collateral.

There were no TDRs that occurred during the nine months ended September 30, 2018, or 2017. There were no TDRs that defaulted during the nine months ended September 30, 2018, or 2017 in which the modification was within twelve months of the respective reporting period.

TDRs outstanding in the Real Estate Mortgage loan category totaled $446 thousand and $482 thousand, all of which were in accrual status at September 30, 2018, and December 31, 2017, respectively.

## Allowance for Loan Losses

**Changes in Allowance for Loan Losses**

| (in thousands)<br>Nine months ended September 30 | | **2018** | | 2017 |
|---|---|---|---|---|
| Balance at beginning of period | **$** | **534** | $ | 482 |
| (Reversal of) provision for loan losses | | **(83)** | | 484 |
| Loan recoveries | | **96** | | 4 |
| Loan charge-offs | | **(24)** | | (1) |
| Balance at end of period | **$** | **523** | $ | 969 |

The "provision for credit losses" in the Consolidated Statements of Income includes a (reversal of) provision for loan losses as presented in the previous chart, as well as a provision for credit loss reserve on unfunded commitments. The accrued credit loss reserve on unfunded commitments are recorded in "Other liabilities" in the Consolidated Statements of Condition.

**Credit Loss Information on Unfunded Commitments**

| (in thousands)<br>For the nine months ended September 30 | | **2018** | | 2017 |
|---|---|---|---|---|
| Provision for credit losses | **$** | **90** | $ | -- |
| As of: | | **September 30<br>2018** | | December 31<br>2017 |
| Accrued credit loss reserve | **$** | **90** | $ | -- |

## NOTE 3: INVESTMENT SECURITIES

We held investment securities of $916 thousand at September 30, 2018, and $1.5 million at December 31, 2017. Our investment securities consisted of securities containing loans fully guaranteed by the Small Business Administration (SBA).

The investment securities have been classified as held-to-maturity. The investment portfolio is evaluated for other-than-temporary impairment. No investments within the portfolio were impaired as of September 30, 2018, and December 31, 2017.

**Additional Investment Securities Information**

| (dollars in thousands)<br>As of: | **September 30<br>2018** | December 31<br>2017 |
|---|---|---|
| Amortized cost | **$ 894** | $ 1,509 |
| Unrealized gains | **22** | 48 |
| Fair value | **$ 916** | $ 1,557 |
| Weighted average yield | **4.2%** | 3.8% |

Investment income is recorded in "Interest income" in the Consolidated Statements of Income and totaled $37 thousand and $61 thousand for the nine months ended September 30, 2018, and 2017, respectively.

## NOTE 4: CONTINGENCIES AND COMMITMENTS

In the normal course of business, we have various contingent liabilities and commitments outstanding, primarily commitments to extend credit, which may not be reflected in the Consolidated Financial Statements. We do not anticipate any material losses because of these contingencies or commitments.

We may be named as a defendant in certain lawsuits or legal actions in the normal course of business. At the date of these Consolidated Financial Statements, our management team was not aware of any material actions. However, management cannot ensure that such actions or other contingencies will not arise in the future.

## NOTE 5: FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or most advantageous market for the asset or liability. Accounting guidance also establishes a fair value hierarchy, with three input levels that may be used to measure fair value. Refer to Note 2 in our 2017 Annual Report for a more complete description of the three input levels.

We did not have any assets or liabilities measured at fair value on a recurring basis at September 30, 2018, or December 31, 2017.

### Non-Recurring

We may be required, from time to time, to measure certain assets at fair value on a non-recurring basis.

**Assets Measured at Fair Value on a Non-recurring Basis**

(in thousands)

| | **As of September 30, 2018** | | | |
|---|---|---|---|---|
| | Fair Value Measurement Using | | | Total Fair |
| | Level 1 | Level 2 | Level 3 | Value |
| Impaired loans | **$ --** | **$ --** | **$ --** | **$ --** |
| | As of December 31, 2017 | | | |
| | Fair Value Measurement Using | | | Total Fair |
| | Level 1 | Level 2 | Level 3 | Value |
| Impaired loans | $ -- | $ -- | $ 367 | $ 367 |

### Valuation Techniques

**Impaired loans:** Represents the carrying amount and related write-downs of loans which were evaluated for individual impairment based on the appraised value of the underlying collateral. When the value of the collateral, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established. Costs to sell represent transaction costs and are not included as a component of the asset's fair value. If the process uses independent appraisals and other observable market-based information, they are classified as Level 2. If the process requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters, they are classified as Level 3.

## NOTE 6: SUBSEQUENT EVENTS

We have evaluated subsequent events through November 8, 2018, which is the date the Consolidated Financial Statements were available to be issued.

In October 2018, a previously charged off loan was sold to a third party for $200 thousand and the Association has relinquished any further collection efforts.

There have been no other material subsequent events that would require recognition in our Quarterly Report or disclosure in the Notes to Consolidated Financial Statements.