MidWestOne Financial Group, Inc.
Form 10-Q
August 02, 2018

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended 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 001-35968

MIDWEST*ONE* FINANCIAL GROUP, INC.
(Exact name of Registrant as specified in its charter)

Iowa	**42-1206172**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

102 South Clinton Street
Iowa City, IA 52240
(Address of principal executive offices, including zip code)
319-356-5800
(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 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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. (Check one):

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

As of July 31, 2018, there were 12,221,107 shares of common stock, $1.00 par value per share, outstanding.

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MIDWEST*ONE* FINANCIAL GROUP, INC.
Form 10-Q Quarterly Report
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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements.

MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(dollars in thousands)	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Cash and due from banks	$41,547	$44,818
Interest-earning deposits in banks	1,717	5,474
Federal funds sold	—	680
Cash and cash equivalents	43,264	50,972
Investment securities:		
Equity securities, at fair value	2,809	2,336
Debt securities available for sale, at fair value	438,312	445,324
Debt securities held to maturity (fair value of $188,407 as of June 30, 2018 and $194,343 as of December 31, 2017)	192,896	195,619
Loans held for sale	1,528	856
Loans held for investment, net of unearned income	2,364,035	2,286,695
Allowance for loan losses	(30,800)	(28,059)
Loans held for investment, net	2,333,235	2,258,636
Premises and equipment, net	78,106	75,969
Interest receivable	13,636	14,732
Goodwill	64,654	64,654
Other intangible assets, net	10,925	12,046
Bank-owned life insurance	60,209	59,831
Other real estate owned	676	2,010
Deferred income taxes, net	9,014	6,525
Other assets	27,013	22,761
Total assets	$3,276,277	$3,212,271
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest-bearing demand	$469,862	$461,969
Interest-bearing checking	1,183,384	1,228,112
Savings	216,866	213,430
Certificates of deposit under $100,000	341,584	324,681
Certificates of deposit $100,000 and over	392,505	377,127
Total deposits	2,604,201	2,605,319
Federal funds purchased	52,421	1,000
Securities sold under agreements to repurchase	75,046	96,229
Federal Home Loan Bank borrowings	143,000	115,000
Junior subordinated notes issued to capital trusts	23,841	23,793
Long-term debt	10,000	12,500
Deferred compensation liability	5,267	5,199
Interest payable	1,744	1,428
Other liabilities	14,556	11,499
Total liabilities	2,930,076	2,871,967
Shareholders' equity:		
Preferred stock, no par value; authorized 500,000 shares; no shares issued and outstanding at June 30, 2018 and December 31, 2017	$—	$—

Common stock, $1.00 par value; authorized 30,000,000 shares at June 30, 2018 and December 31, 2017; issued 12,463,481 shares at June 30, 2018 and December 31, 2017; outstanding 12,221,107 shares at June 30, 2018 and 12,219,611 shares at December 31, 2017	12,463	12,463
Additional paid-in capital	187,304	187,486
Treasury stock at cost, 242,374 shares as of June 30, 2018 and 243,870 shares as of December 31, 2017	(5,474)	(5,121)
Retained earnings	159,315	148,078
Accumulated other comprehensive income (loss)	(7,407)	(2,602)
Total shareholders' equity	346,201	340,304
Total liabilities and shareholders' equity	$ 3,276,277	$ 3,212,271

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(unaudited) (dollars in thousands, except per share amounts)	2018	2017	2018	2017
Interest income:				
Loans	$27,486	$25,650	$54,053	$49,929
Bank deposits	18	26	26	31
Federal funds sold	1	1	1	1
Taxable securities	2,940	2,590	5,828	5,308
Tax-exempt securities	1,528	1,587	3,057	3,152
Total interest income	31,973	29,854	62,965	58,421
Interest expense:				
Interest on deposits:				
Interest-bearing checking	1,291	912	2,376	1,710
Savings	63	51	126	102
Certificates of deposit under $100,000	1,134	886	2,129	1,745
Certificates of deposit $100,000 and over	1,521	995	2,914	1,912
Total interest expense on deposits	4,009	2,844	7,545	5,469
Federal funds purchased	211	25	336	71
Securities sold under agreements to repurchase	144	34	278	72
Federal Home Loan Bank borrowings	615	404	1,132	847
Other borrowings	4	3	6	6
Junior subordinated notes issued to capital trusts	307	240	565	461
Long-term debt	102	113	209	223
Total interest expense	5,392	3,663	10,071	7,149
Net interest income	26,581	26,191	52,894	51,272
Provision for loan losses	1,250	1,240	3,100	2,281
Net interest income after provision for loan losses	25,331	24,951	49,794	48,991
Noninterest income:				
Trust, investment, and insurance fees	1,537	1,528	3,177	3,140
Service charges and fees on deposit accounts	1,158	1,257	2,326	2,540
Loan origination and servicing fees	906	718	1,847	1,520
Other service charges and fees	1,582	1,497	2,962	2,955
Bank-owned life insurance income	397	318	830	646
Gain on sale or call of debt securities available for sale	—	20	9	20
Gain (loss) on sale or call of debt securities held to maturity	(4)	—	(4)	43
Gain (loss) on sale of premises and equipment	(17)	8	(18)	6
Other gain (loss)	(72)	37	30	50
Total noninterest income	5,487	5,383	11,159	10,920
Noninterest expense:				
Salaries and employee benefits	12,225	11,789	24,596	23,673
Occupancy and equipment, net	3,238	3,033	6,489	6,337
Professional fees	959	1,036	1,753	2,058
Data processing	691	548	1,379	1,259
FDIC insurance	392	352	711	719
Amortization of intangibles	589	804	1,246	1,653

Other	2,437	2,402	4,715	4,600
Total noninterest expense	20,531	19,964	40,889	40,299
Income before income tax expense	10,287	10,370	20,064	19,612
Income tax expense	2,131	3,136	4,115	5,665
Net income	$ 8,156	$ 7,234	$ 15,949	$ 13,947
Per share information:				
Earnings per common share - basic	$ 0.67	$ 0.59	$ 1.31	$ 1.18
Earnings per common share - diluted	0.67	0.59	1.30	1.17
Dividends paid per common share	0.195	0.165	0.390	0.330

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(unaudited) (dollars in thousands, except per share amounts)	**2018**	**2017**	**2018**	**2017**
Net income	$ 8,156	$ 7,234	$ 15,949	$ 13,947
Other comprehensive income, available for sale debt securities:				
Unrealized holding gains (losses) arising during period	(1,628)	2,745	(6,416)	4,312
Reclassification adjustment for gains included in net income	—	(20)	(9)	(20)
Income tax (expense) benefit	425	(1,070)	1,677	(1,686)
Other comprehensive income (loss) on available for sale debt securities	(1,203)	1,655	(4,748)	2,606
Other comprehensive income (loss), net of tax	(1,203)	1,655	(4,748)	2,606
Comprehensive income	$ 6,953	$ 8,889	$ 11,201	$ 16,553

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(unaudited) (dollars in thousands, except per share amounts)	Preferred Stock	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2016	$ —	$ 11,713	$ 163,667	$ (5,766)	$ 136,975	$ (1,133)	$ 305,456
Net income	—	—	—	—	13,947	—	13,947
Issuance of common stock (750,000 shares), net of expenses of $1,328	—	750	23,610	—	—	—	24,360
Dividends paid on common stock ($0.33 per share)	—	—	—	—	(3,907)	—	(3,907)
Stock options exercised (8,250 shares)	—	—	(81)	172	—	—	91
Release/lapse of restriction on RSUs (26,875 shares)	—	—	(560)	453	—	—	(107)
Stock compensation	—	—	426	—	—		426
Other comprehensive income, net of tax	—	—	—	—	—	2,606	2,606
Balance at June 30, 2017	$ —	$ 12,463	$ 187,062	$ (5,141)	$ 147,015	$ 1,473	$ 342,872
Balance at December 31, 2017	$ —	$ 12,463	$ 187,486	$ (5,121)	$ 148,078	$ (2,602)	$ 340,304
Cumulative effect of changes in accounting principles(1)	—	—	—	—	57	(57)	—
Net income	—	—	—	—	15,949	—	15,949
Dividends paid on common stock ($0.39 per share)	—	—	—	—	(4,769)	—	(4,769)
Stock options exercised (9,700 shares)	—	—	(69)	204	—	—	135
Release/lapse of restriction on RSUs (28,525 shares)	—	—	(609)	525	—	—	(84)
Repurchase of common stock (33,998 shares)	—	—	—	(1,082)	—	—	(1,082)
Stock compensation	—	—	496	—	—	—	496
Other comprehensive loss, net of tax	—	—	—	—	—	(4,748)	(4,748)
Balance at June 30, 2018	$ —	$ 12,463	$ 187,304	$ (5,474)	$ 159,315	$ (7,407)	$ 346,201

(1) Impact from adoption on January 1, 2018 of ASU 2016-01, 'Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities."

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
(unaudited) (dollars in thousands)	**2018**	**2017**
Cash flows from operating activities:		
Net income	$ 15,949	$ 13,947
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,100	2,281
Depreciation of premises and equipment	2,105	2,058
Amortization of other intangibles	1,246	1,653
Amortization of premiums and discounts on investment securities, net	492	650
(Gain) loss on sale of premises and equipment	18	(6)
Deferred income taxes	(803)	(554)
Excess tax benefit from share-based award activity	—	(91)
Stock-based compensation	496	426
Net losses on equity securities	23	—
Net gain on sale or call of debt securities available for sale	(9)	(20)
Net (gain) loss on sale or call of debt securities held to maturity	4	(43)
Net gain on sale of other real estate owned	(50)	(30)
Net gain on sale of loans held for sale	(802)	(799)
Writedown of other real estate owned	5	23
Origination of loans held for sale	(30,140)	(41,284)
Proceeds from sales of loans held for sale	30,270	44,688
Decrease in interest receivable	1,096	1,265
Increase in cash surrender value of bank-owned life insurance	(830)	(646)
Decrease in other assets	(4,252)	(935)
Increase in deferred compensation liability	68	44
Increase in interest payable, accounts payable, accrued expenses, and other liabilities	3,373	568
Net cash provided by operating activities	21,359	23,195
Cash flows from investing activities:		
Purchases of equity securities	(505)	(2)
Proceeds from sales of debt securities available for sale	496	9,999
Proceeds from maturities and calls of debt securities available for sale	30,942	41,162
Purchases of debt securities available for sale	(31,194)	(12,839)
Proceeds from sales of debt securities held to maturity	—	1,153
Proceeds from maturities and calls of debt securities held to maturity	3,132	2,998
Purchase of debt securities held to maturity	(553)	(18,292)
Net increase in loans	(78,203)	(34,188)
Purchases of premises and equipment	(4,212)	(1,697)
Proceeds from sale of other real estate owned	1,883	825
Proceeds from sale of premises and equipment	—	28
Proceeds of principal and earnings from bank-owned life insurance	452	—
Payments to acquire intangible assets	(125)	—
Net cash used in investing activities	(77,887)	(10,853)
Cash flows from financing activities:		
Net increase (decrease) in deposits	(1,118)	13,261
Increase in federal funds purchased	51,421	9,635
Decrease in securities sold under agreements to repurchase	(21,183)	(22,005)
Proceeds from Federal Home Loan Bank borrowings	85,000	50,000
Repayment of Federal Home Loan Bank borrowings	(57,000)	(75,000)
Proceeds from stock options exercised	135	1

Excess tax benefit from share-based award activity	—	91
Taxes paid relating to net share settlement of equity awards	(84)	(108)
Payments on long-term debt	(2,500)	(2,500)
Dividends paid	(4,769)	(3,907)
Proceeds from issuance of common stock	—	25,688
Payment of stock issuance costs	—	(1,328)
Repurchase of common stock	(1,082)	—
Net cash provided by (used in) financing activities	48,820	(6,172)
Net increase (decrease) in cash and cash equivalents	(7,708)	6,170
Cash and cash equivalents at beginning of period	50,972	43,228
Cash and cash equivalents at end of period	$43,264	$49,398

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(unaudited) (dollars in thousands)	**Six Months Ended June 30,**	
	2018	**2017**
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	$9,755	$7,070
Cash paid during the period for income taxes	$1,710	$5,975
Supplemental schedule of non-cash investing activities:		
Transfer of loans to other real estate owned	$504	$207
Transfer due to adoption of ASU 2016-01, equity securities fair value adjustment, reclassification from AOCI to Retained Earnings, net of tax	$57	$—

See accompanying notes to consolidated financial statements.

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MidWest*One* Financial Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

1. Principles of Consolidation and Presentation

MidWest*One* Financial Group, Inc. (the "Company," which is also referred to herein as "we," "our" or "us") is an Iowa corporation incorporated in 1983, a bank holding company under the Bank Holding Company Act of 1956, as amended, and a financial holding company under the Gramm-Leach-Bliley Act of 1999. Our principal executive offices are located at 102 South Clinton Street, Iowa City, Iowa 52240.

The Company owns all of the common stock of MidWest*One* Bank, an Iowa state non-member bank chartered in 1934 with its main office in Iowa City, Iowa (the "Bank"), and all of the common stock of MidWest*One* Insurance Services, Inc., Oskaloosa, Iowa. We operate primarily through MidWest*One* Bank, our bank subsidiary, and MidWest*One* Insurance Services, Inc., our wholly-owned subsidiary that operates an insurance agency business through six offices located in central and east-central Iowa.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all the information and notes necessary for complete financial statements in conformity with U.S. generally accepted accounting principles ("GAAP"). The information in this Quarterly Report on Form 10-Q is written with the presumption that the users of the interim financial statements have read or have access to the most recent Annual Report on Form 10-K of the Company, filed with the Securities and Exchange Commission (SEC) on March 1, 2018, which contains the latest audited financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2017 and for the year then ended. Management believes that the disclosures in this Form 10-Q are adequate to make the information presented not misleading. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the Company's financial position as of June 30, 2018 and December 31, 2017, and the results of operations and cash flows for the three and six months ended June 30, 2018 and 2017. All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect: (1) the reported amounts of assets and liabilities, (2) the disclosure of contingent assets and liabilities at the date of the financial statements, and (3) the reported amounts of revenues and expenses during the reporting period. These estimates are based on information available to management at the time the estimates are made. Actual results could differ from those estimates. The results for the three and six months ended June 30, 2018 may not be indicative of results for the year ending December 31, 2018, or for any other period.

All significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the Annual Report on Form 10-K for the year ended December 31, 2017.

In the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits in banks, and federal funds sold.

Certain reclassifications have been made to prior periods' consolidated financial statements to present them on a basis comparable with the current period's consolidated financial statements.

2. Effect of New Financial Accounting Standards

Accounting Guidance Adopted in 2018

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contract with Customers (Topic 606).* Subsequent to the issuance of ASU 2014-09, the FASB issued targeted updates to clarify specific implementation issues including ASU No. 2016-08, "Principal versus Agent Considerations (Reporting Revenue Gross versus Net)," ASU No. 2016-10, "*Identifying Performance Obligations and Licensing,*" ASU No. 2016-12, "*Narrow-Scope Improvements and Practical Expedients,*" and ASU No. 2016-20 "*Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.*" For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, service charges on deposit accounts, sales of other real estate, and debit card interchange fees. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross versus net). Based on its evaluation, the Company determined that ASU 2014-09 also did not materially change the method in which the Company currently recognizes costs for these revenue streams. The Company adopted this update on January 1, 2018, utilizing the modified retrospective transition method. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary. See Note 14 "Revenue Recognition" for more information.

In January 2016, the FASB issued Accounting Standards Update No. 2016-01, *Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities.* The guidance in this update makes changes to the current GAAP model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The treatment of gains and losses for all equity securities, including those without a readily determinable market value, is expected to result in additional volatility in the income statement, with the loss of mark to market via equity for these investments. Additionally, changes in the allowable method for determining the fair value of financial instruments in the financial statement footnotes ("exit price" only) require changes to current methodologies of determining these values, and how they are disclosed in the financial statement footnotes. The new standard applies to public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this update on January 1, 2018. With the elimination of the classification of available for sale equity securities, the net unrealized gain or loss on these securities that had been included in accumulated other comprehensive income at December 31, 2017, in the amount of $57,000, has been transferred to retained earnings, as shown in the Consolidated Statement of Shareholders' Equity. Changes in the fair value of equity securities with readily determinable fair values are now reflected in the noninterest income portion of the Consolidated Statements of Income, in the other gains (losses) line item. In accordance with the ASU requirements, the Company measured the fair value of its loan portfolio as of June 30, 2018 using an exit price notion. See Note 13. "Estimated Fair Value of Financial Instruments and Fair Value Measurements" to our consolidated financial statements.

Accounting Guidance Pending Adoption at June 30, 2018

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842)*. The guidance in this update is meant to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases. Disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To meet that objective, qualitative disclosures along with specific quantitative disclosures are required. The new standard applies to public business entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore not recognized on the Company's consolidated balance sheets. The Company expects the new guidance will require these lease agreements to now be recognized on the consolidated balance sheets as right-of-use assets and a corresponding lease liability. However, the Company continues to evaluate the extent of the potential impact the new guidance will have on the Company's consolidated financial statements and the availability of outside vendor products to assist in the implementation, and does not expect to early adopt the standard.

In June 2016, the FASB issued Accounting Standards Update No. 2016-13, *Financial Instruments-Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments*. The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination. The amendment requires the use of a new model covering current expected credit losses (CECL), which will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. Upon initial recognition of the exposure, the CECL model requires an entity to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses (ECL) should consider historical information, current information, and reasonable and supportable forecasts,

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including estimates of prepayments. The new guidance also amends the current available for sale (AFS) security other-than-temporary impairment (OTTI) model for debt securities. The new model will require an estimate of ECL only when the fair value is below the amortized cost of the asset. The length of time the fair value of an AFS debt security has been below the amortized cost will no longer impact the determination of whether a credit loss exists. As such, it is no longer an other-than-temporary model. Finally, the purchased financial assets with credit deterioration (PCD) model applies to purchased financial assets (measured at amortized cost or AFS) that have experienced more than insignificant credit deterioration since origination. This represents a change from the scope of what are considered purchased credit-impaired assets under today's model. Different than the accounting for originated or purchased assets that do not qualify as PCD, the initial estimate of expected credit losses for a PCD would be recognized through an allowance for loan and lease losses with an offset to the cost basis of the related financial asset at acquisition. The new standard applies to public business entities that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, with early adoption permitted for fiscal years beginning after December 31, 2018, including interim periods within those fiscal years, and is expected to increase the allowance for loan losses upon adoption. The Company has formed a working group to evaluate the impact of the standard's adoption on the Company's consolidated financial statements, and has completed viewing demonstrations of the capabilities of outside vendor software systems, and is currently evaluating the ability of these systems to meet the processing necessary to support the data collection, retention, and disclosure requirements of the Company in implementation of the new standard.

3. Investment Securities

The amortized cost and fair value of debt securities available for sale, with gross unrealized gains and losses, were as follows:

	As of June 30, 2018			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies and corporations	$5,594	$ —	$ 51	$5,543
State and political subdivisions	140,935	1,321	541	141,715
Mortgage-backed securities	55,864	128	1,622	54,370
Collateralized mortgage obligations	179,862	7	7,859	172,010
Corporate debt securities	66,080	17	1,423	64,674
Total	$448,335	$ 1,473	$ 11,496	$438,312

	As of December 31, 2017			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies and corporations	$15,716	$ —	$ 90	$15,626
State and political subdivisions	139,561	2,475	197	141,839
Mortgage-backed securities	48,744	181	428	48,497
Collateralized mortgage obligations	173,339	29	5,172	168,196
Corporate debt securities	71,562	31	427	71,166
Total	$448,922	$ 2,716	$ 6,314	$445,324

The amortized cost and fair value of debt securities held to maturity, with gross unrealized gains and losses, were as follows:

	As of June 30, 2018			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
State and political subdivisions	$125,948	$ 289	$ 3,063	$123,174

Mortgage-backed securities	11,586	2	472	11,116
Collateralized mortgage obligations	20,243	—	1,020	19,223
Corporate debt securities	35,119	264	489	34,894
Total	$ 192,896	$ 555	$ 5,044	$ 188,407

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(in thousands)	As of December 31, 2017 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies and corporations	$ 10,049	$ —	$ —	$ 10,049
State and political subdivisions	126,413	804	1,631	125,586
Mortgage-backed securities	1,906	4	13	1,897
Collateralized mortgage obligations	22,115	—	707	21,408
Corporate debt securities	35,136	548	281	35,403
Total	$ 195,619	$ 1,356	$ 2,632	$ 194,343

Investment securities with a carrying value of $235.2 million and $237.4 million at June 30, 2018 and December 31, 2017, respectively, were pledged on public deposits, securities sold under agreements to repurchase and for other purposes, as required or permitted by law.

As of June 30, 2018, the Company owned $0.4 million of equity securities in banks and financial service-related companies, and $2.4 million of mutual funds invested in debt securities and other debt instruments that will cause units of the fund to be deemed to be qualified under the Community Reinvestment Act. Prior to January 1, 2018, we accounted for our marketable equity securities at fair value with unrealized gains and losses recognized in accumulated other comprehensive income on the balance sheet. Realized gains and losses on marketable equity securities sold or impaired were recognized in noninterest income. Effective with the January 1, 2018 adoption of ASU 2016-01, both the realized and unrealized net gains and losses on equity securities are required to be recognized in the statement of income. A breakdown between net realized and unrealized gains and losses is provided later in this financial statement footnote. These net changes are included in the other gains line item in the noninterest income section of the Consolidated Statements of Income.

The summary of investment securities shows that some of the securities in the available for sale and held to maturity investment portfolios had unrealized losses, or were temporarily impaired, as of June 30, 2018 and December 31, 2017. This temporary impairment represents the estimated amount of loss that would be realized if the securities were sold on the valuation date.

The following tables present information pertaining to securities with gross unrealized losses as of June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position:

		As of June 30, 2018					
	Number of Securities	Less than 12 Months		12 Months or More		Total	
Available for Sale		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
U.S. Government agencies and corporations	2	$ 5,543	$ 51	$ —	$ —	$ 5,543	$ 51
State and political subdivisions	73	35,538	471	2,757	70	38,295	541
Mortgage-backed securities	27	53,518	1,447	6,176	175	59,694	1,622
Collateralized mortgage obligations	43	46,904	958	120,274	6,901	167,178	7,859
Corporate debt securities	12	54,441	1,183	8,440	240	62,881	1,423
Total	157	$ 195,944	$ 4,110	$ 137,647	$ 7,386	$ 333,591	$ 11,496

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	As of December 31, 2017						
	Number of Securities	Less than 12 Months		12 Months or More		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
U.S. Government agencies and corporations	3	$15,626	$ 90	$—	$ —	$15,626	$ 90
State and political subdivisions	34	11,705	167	1,800	30	13,505	197
Mortgage-backed securities	20	37,964	359	3,961	69	41,925	428
Collateralized mortgage obligations	35	37,881	489	122,757	4,683	160,638	5,172
Corporate debt securities	12	55,340	298	8,778	129	64,118	427
Other equity securities	1	—	—	1,944	56	1,944	56
Total	105	$158,516	$ 1,403	$139,240	$ 4,967	$297,756	$ 6,370

	As of June 30, 2018						
Held to Maturity	Number of Securities	Less than 12 Months		12 Months or More		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
State and political subdivisions	224	$49,218	$ 1,135	$27,690	$ 1,928	$76,908	$ 3,063
Mortgage-backed securities	6	10,203	438	841	34	11,044	472
Collateralized mortgage obligations	7	4,690	187	14,520	833	19,210	1,020
Corporate debt securities	7	12,882	318	2,724	171	15,606	489
Total	244	$76,993	$ 2,078	$45,775	$ 2,966	$122,768	$ 5,044

	As of December 31, 2017						
	Number of Securities	Less than 12 Months		12 Months or More		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
State and political subdivisions	167	$33,237	$ 393	$25,843	$ 1,238	$59,080	$ 1,631
Mortgage-backed securities	4	349	2	887	11	1,236	13
Collateralized mortgage obligations	7	5,221	90	16,168	617	21,389	707
Corporate debt securities	3	3,093	4	2,617	277	5,710	281
Total	181	$41,900	$ 489	$45,515	$ 2,143	$87,415	$ 2,632

The Company's assessment of OTTI is based on its reasonable judgment of the specific facts and circumstances impacting each individual debt security at the time such assessments are made. The Company reviews and considers factual information, including expected cash flows, the structure of the debt security, the creditworthiness of the issuer, the type of underlying assets and the current and anticipated market conditions.

At June 30, 2018 and December 31, 2017, the Company’s mortgage-backed securities and collateralized mortgage obligations portfolios consisted of securities predominantly backed by one- to four-family mortgage loans and underwritten to the standards of and guaranteed by the following government-sponsored agencies: the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Government National Mortgage Association. The receipt of principal, at par, and interest on mortgage-backed securities is guaranteed by the respective government-sponsored agency guarantor, such that the Company believes that its mortgage-backed securities and collateralized mortgage obligations do not expose the Company to credit-related losses.
At June 30, 2018, approximately 55% of the municipal bonds held by the Company were Iowa-based, and approximately 22% were Minnesota-based. The Company does not intend to sell these municipal obligations, and it is more likely than not that the Company will not be required to sell them until the recovery of their cost. Due to the issuers’ continued satisfaction of their obligations under the securities in accordance with their contractual terms and

the expectation that they will continue to do so, management's intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value, as well as the evaluation of the fundamentals of the issuers' financial conditions

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and other objective evidence, the Company believed that the municipal obligations identified in the tables above were temporarily impaired as of June 30, 2018 and December 31, 2017.

At June 30, 2018 and December 31, 2017, all but one of the Company's corporate bonds held an investment grade rating from Moody's, S&P or Kroll, or carried a guarantee from an agency of the US government. We have evaluated financial statements of the company issuing the non-investment grade bond and found the company's earnings and equity position to be satisfactory and in line with industry norms. Therefore, we expect to receive all contractual payments. The internal evaluation of the non-investment grade bond along with the investment grade ratings on the remainder of the corporate portfolio lead us to conclude that all of the corporate bonds in our portfolio will continue to pay according to their contractual terms. Since the Company has the ability and intent to hold securities until price recovery, we believe that there is no other-than-temporary-impairment in the corporate bond portfolio.

It is reasonably possible that the fair values of the Company's investment securities could decline in the future if interest rates increase or the overall economy or the financial conditions of the issuers deteriorate. As a result, there is a risk that OTTI may be recognized in the future, and any such amounts could be material to the Company's consolidated statements of income.

Unless certain conditions are met, investment securities classified as held to maturity may not be sold without calling into question the Company's intent to hold other debt securities so classified ("tainting"). One acceptable condition, outlined in Accounting Standards Codification 320-10-25-6(a), is the significant deterioration of an issuer's creditworthiness. During the first quarter of 2017, $1.2 million of debt securities from a single issuer in the state and political subdivisions category were identified by the Company as having an elevated level of credit risk and were internally classified as "watch." Given the significant deterioration of the issuer's creditworthiness, the Company sold the debt securities in March 2017. The Company believes the sale was in accordance with applicable accounting guidance and did not taint the remainder of the held to maturity portfolio.

The contractual maturity distribution of investment debt securities at June 30, 2018, is summarized as follows:

	Available For Sale		**Held to Maturity**	
(in thousands)	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**
Due in one year or less	$39,542	$39,518	$520	$521
Due after one year through five years	107,415	106,371	23,357	23,016
Due after five years through ten years	62,298	62,685	94,804	93,529
Due after ten years	3,354	3,358	42,386	41,002
Debt securities without a single maturity date	235,726	226,380	31,829	30,339
Total	$448,335	$438,312	$192,896	$188,407

Mortgage-backed securities and collateralized mortgage obligations are collateralized by mortgage loans and guaranteed by U.S. government agencies. Our experience has indicated that principal payments will be collected sooner than scheduled because of prepayments. Therefore, these securities are not scheduled in the maturity categories indicated above.

Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Realized gains (losses) on investments due to sale or call, including impairment losses for the three and six months ended June 30, 2018 and 2017, were as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2018**	**2017**	**2018**	**2017**
Debt securities available for sale:				
Gross realized gains	$—	$20	9	20
Gross realized gain	$—	$20	$9	$20
Debt securities held to maturity:				
Gross realized gains	$—	$—	$—	$43

Gross realized losses	(4)	—	(4)	—
Gross realized gain (loss)	$(4)	$—	$(4)	$43

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The following tables present the net gains and losses on equity investments during the three and six months ended June 30, 2018, disaggregated into realized and unrealized gains and losses:

(in thousands)	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Net losses recognized	$ (7)	$ (23)
Less: Net gains and losses recognized due to sales	—	—
Unrealized losses on securities still held at the reporting date	$ (7)	$ (23)

4. Loans Receivable and the Allowance for Loan Losses

The composition of allowance for loan losses and loans by portfolio segment and based on impairment method are as follows:

	Allowance for Loan Losses and Recorded Investment in Loan Receivables					
	As of June 30, 2018 and December 31, 2017					
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
June 30, 2018						
Allowance for loan losses:						
Individually evaluated for impairment	$ 287	$ 3,093	$ 3,950	$ 163	$ —	$ 7,493
Collectively evaluated for impairment	2,369	5,464	12,053	2,353	256	22,495
Purchased credit impaired loans	—	—	338	474	—	812
Total	$ 2,656	$ 8,557	$ 16,341	$ 2,990	$ 256	$ 30,800
Loans receivable						
Individually evaluated for impairment	$ 8,056	$ 12,865	$ 20,477	$ 3,756	$ —	$ 45,154
Collectively evaluated for impairment	95,373	499,438	1,209,911	459,045	36,936	2,300,703
Purchased credit impaired loans	—	54	13,506	4,618	—	18,178
Total	$ 103,429	$ 512,357	$ 1,243,894	$ 467,419	$ 36,936	$ 2,364,035

(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
December 31, 2017						
Allowance for loan losses:						
Individually evaluated for impairment	$ 140	$ 1,126	$ 2,157	$ 226	$ —	$ 3,649
Collectively evaluated for impairment	2,650	7,392	11,144	2,182	244	23,612
Purchased credit impaired loans	—	—	336	462	—	798
Total	$ 2,790	$ 8,518	$ 13,637	$ 2,870	$ 244	$ 28,059
Loans receivable						
Individually evaluated for impairment	$ 2,969	$ 9,734	$ 10,386	$ 3,722	$ —	$ 26,811
Collectively evaluated for impairment	102,543	493,844	1,147,133	460,475	36,158	2,240,153
Purchased credit impaired loans	—	46	14,452	5,233	—	19,731
Total	$ 105,512	$ 503,624	$ 1,171,971	$ 469,430	$ 36,158	$ 2,286,695

As of June 30, 2018, the gross purchased credit impaired loans included above were $19.3 million, with a discount of $1.1 million.

Loans with unpaid principal in the amount of $476.8 million and $477.6 million at June 30, 2018 and December 31, 2017, respectively, were pledged to the Federal Home Loan Bank (the “FHLB”) as collateral for borrowings.

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The changes in the allowance for loan losses by portfolio segment were as follows:

	Allowance for Loan Loss Activity					
	For the Three Months Ended June 30, 2018 and 2017					
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
2018						
Beginning balance	$3,153	$ 8,362	$ 14,997	$ 2,877	$ 282	$29,671
Charge-offs	(268)	(3)	—	(3)	(17)	(291)
Recoveries	9	103	40	15	3	170
Provision	(238)	95	1,304	101	(12)	1,250
Ending balance	$2,656	$ 8,557	$ 16,341	$ 2,990	$ 256	$30,800
2017						
Beginning balance	$2,460	$ 6,021	$ 9,751	$ 3,764	$ 221	$22,217
Charge-offs	(347)	(464)	(45)	(52)	(135)	(1,043)
Recoveries	4	83	5	—	4	96
Provision	549	2,319	(698)	(1,062)	132	1,240
Ending balance	$2,666	$ 7,959	$ 9,013	$ 2,650	$ 222	$22,510

	Allowance for Loan Loss Activity					
	For the Six Months Ended June 30, 2018 and 2017					
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
2018						
Beginning balance	$2,790	$ 8,518	$ 13,637	$ 2,870	$ 244	$28,059
Charge-offs	(268)	(90)	(264)	(107)	(38)	(767)
Recoveries	15	182	116	77	18	408
Provision	119	(53)	2,852	150	32	3,100
Ending balance	$2,656	$ 8,557	$ 16,341	$ 2,990	$ 256	$30,800
2017						
Beginning balance	$2,003	$ 6,274	$ 9,860	$ 3,458	$ 255	$21,850
Charge-offs	(884)	(529)	(106)	(80)	(160)	(1,759)
Recoveries	14	102	15	—	7	138
Provision	1,533	2,112	(756)	(728)	120	2,281
Ending balance	$2,666	$ 7,959	$ 9,013	$ 2,650	$ 222	$22,510

Loan Portfolio Segment Risk Characteristics

Agricultural - Agricultural loans, most of which are secured by crops, livestock, and machinery, are provided to finance capital improvements and farm operations as well as acquisitions of livestock and machinery. The ability of the borrower to repay may be affected by many factors outside of the borrower’s control including adverse weather conditions, loss of livestock due to disease or other factors, declines in market prices for agricultural products and the impact of government regulations. The ultimate repayment of agricultural loans is dependent upon the profitable operation or management of the agricultural entity. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial and Industrial - Commercial and industrial loans are primarily made based on the reported cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The collateral support provided by the borrower for most of these loans and the probability of repayment are based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists. The primary repayment risks of commercial and industrial loans are that the cash flows of the borrower may be unpredictable, and the collateral securing these loans may fluctuate in value. The size of the loans the Company can offer to commercial customers is less than the size of the loans that competitors with larger lending limits can offer. This may limit the Company's ability to establish relationships with the largest businesses in the areas in which the Company operates. As a result, the Company may assume greater lending risks than financial institutions that have a lesser concentration of such loans and tend to make loans to larger businesses. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. In addition, a decline in the U.S. economy could harm or continue to harm the businesses of the Company's commercial and industrial customers and reduce the value of the collateral securing these loans.

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Commercial Real Estate - The Company offers mortgage loans to commercial and agricultural customers for the acquisition of real estate used in their businesses, such as offices, warehouses and production facilities, and to real estate investors for the acquisition of apartment buildings, retail centers, office buildings and other commercial buildings. The market value of real estate securing commercial real estate loans can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in one or more of the Company's markets could increase the credit risk associated with its loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts than other loans, and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the Company's control or that of the borrower could negatively impact the future cash flow and market values of the affected properties.

Residential Real Estate - The Company generally retains short-term residential mortgage loans that are originated for its own portfolio but sells most long-term loans to other parties while retaining servicing rights on the majority of those loans. The market value of real estate securing residential real estate loans can fluctuate as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in one or more of the Company's markets could increase the credit risk associated with its loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts than other loans, and the repayment of the loans generally is dependent, in large part, on the borrower's continuing financial stability, and is therefore more likely to be affected by adverse personal circumstances.

Consumer - Consumer loans typically have shorter terms, lower balances, higher yields and higher risks of default than real estate-related loans. Consumer loan collections are dependent on the borrower's continuing financial stability, and are therefore more likely to be affected by adverse personal circumstances. Collateral for these loans generally includes automobiles, boats, recreational vehicles, mobile homes, and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to recover and may fluctuate in value based on condition. In addition, a decline in the United States economy could result in reduced employment, impacting the ability of customers to repay their obligations.

Purchased Loans Policy

All purchased loans (nonimpaired and impaired) are initially measured at fair value as of the acquisition date in accordance with applicable authoritative accounting guidance. Credit discounts are included in the determination of fair value. An allowance for loan losses is not recorded at the acquisition date for loans purchased.

Individual loans acquired through the completion of a transfer, including loans that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments receivable, are referred to herein as "purchased credit impaired loans." In determining the acquisition date fair value and estimated credit losses of purchased credit impaired loans, and in subsequent accounting, the Company accounts for loans individually. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the "nonaccretable difference," are not recognized as a yield adjustment or as a loss accrual or valuation allowance. Expected cash flows at the purchase date in excess of the fair value of loans, if any, are recorded as interest income over the expected life of the loans if the timing and amount of future cash flows are reasonably estimable. Subsequent to the purchase date, increases in cash flows over those expected at the purchase date are recognized as interest income prospectively. The present value of any decreases in expected cash flows after the purchase date is recognized by recording an allowance for loan losses and a provision for loan losses. If the Company does not have the information necessary to reasonably estimate cash flows to be expected, it may use the cost-recovery method or cash-basis method of income recognition.

Charge-off Policy

The Company requires a loan to be charged-off, in whole or in part, as soon as it becomes apparent that some loss will be incurred, or when its collectability is sufficiently questionable that it no longer is considered a bankable asset. The primary considerations when determining if and how much of a loan should be charged-off are as follows: (1) the potential for future cash flows; (2) the value of any collateral; and (3) the strength of any co-makers or guarantors.

When it is determined that a loan requires a partial or full charge-off, a request for approval of a charge-off is submitted to the Company's President, Executive Vice President and Chief Credit Officer, and the Senior Regional Loan officer. The Bank's board of directors formally approves all loan charge-offs. Once a loan is charged-off, it cannot be restructured and returned to the Company's books.

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Allowance for Loan and Lease Losses

The Company requires the maintenance of an adequate allowance for loan and lease losses ("ALLL") in order to cover estimated probable losses without eroding the Company's capital base. Calculations are done at each quarter end, or more frequently if warranted, to analyze the collectability of loans and to ensure the adequacy of the allowance. In line with FDIC directives, the ALLL calculation does not include consideration of loans held for sale or off-balance-sheet credit exposures (such as unfunded letters of credit). Determining the appropriate level for the ALLL relies on the informed judgment of management, and as such, is subject to inexactness. Given the inherently imprecise nature of calculating the necessary ALLL, the Company's policy permits the actual ALLL to be between 20% above and 5% below the "indicated reserve."

Loans Reviewed Individually for Impairment

The Company identifies loans to be reviewed and evaluated individually for impairment based on current information and events and the probability that the borrower will be unable to repay all amounts due according to the contractual terms of the loan agreement. Specific areas of consideration include: size of credit exposure, risk rating, delinquency, nonaccrual status, and loan classification.

The level of individual impairment is measured using one of the following methods: (1) the fair value of the collateral less costs to sell; (2) the present value of expected future cash flows, discounted at the loan's effective interest rate; or (3) the loan's observable market price. Loans that are deemed fully collateralized or have been charged down to a level corresponding with any of the three measurements require no assignment of reserves from the ALLL.

A loan modification is a change in an existing loan contract that has been agreed to by the borrower and the Bank, which may or may not be a troubled debt restructure or "TDR." All loans deemed TDR are considered impaired. A loan is considered a TDR when, for economic or legal reasons related to a borrower's financial difficulties, a concession is granted to the borrower that would not otherwise be considered. Both financial distress on the part of the borrower and the Bank's granting of a concession, which are detailed further below, must be present in order for the loan to be considered a TDR.

All of the following factors are indicators that the debtor is experiencing financial difficulties (one or more items may be present):

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- There is significant doubt as to whether the debtor will continue to be a going concern.
- Currently, the debtor has securities being held as collateral that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled debtor.

The following factors are potential indicators that a concession has been granted (one or multiple items may be present):

- The borrower receives a reduction of the stated interest rate for the remaining original life of the debt.
- The borrower receives an extension of the maturity date or dates at a stated interest rate lower that the current market interest rate for new debt with similar risk characteristics.
- The borrower receives a reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
- The borrower receives a deferral of required payments (principal and/or interest).
- The borrower receives a reduction of the accrued interest.

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The following table sets forth information on the Company's TDRs by class of loan occurring during the stated periods:

	Three Months Ended June 30,					
	2018			2017		
(dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings[1]:						
Commercial real estate:						
Farmland						
Extended maturity date	1	$ 86	$ 86	2	$ 176	$ 176
Commercial real estate-other						
Other	—	—	—	1	10,546	10,923
Total	1	$ 86	$ 86	3	$ 10,722	$ 11,099

	Six Months Ended June 30,					
	2018			2017		
(dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings[1]:						
Commercial and industrial						
Extended maturity date	—	$ —	$ —	6	$ 2,037	$ 2,083
Commercial real estate:						
Farmland						
Extended maturity date	1	86	86	2	176	176
Commercial real estate-other						
Extended maturity date	—	—	—	1	968	968
Other	—	—	—	1	10,546	10,923
Total	1	$ 86	$ 86	10	$ 13,727	$ 14,150

(1) TDRs may include multiple concessions, and the disclosure classifications are based on the primary concession provided to the borrower.

Loans by class modified as TDRs within 12 months of modification and for which there was a payment default during the stated periods were as follows:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
(dollars in thousands)	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Troubled Debt Restructurings[1] That Subsequently Defaulted:								
Commercial and industrial								
Extended maturity date	—	$ —	1	$ 550	—	$ —	4	$ 1,504
Commercial real estate:								
Commercial real estate-other								
Extended maturity date	—	—	1	968	1	2,657	1	968
Total	—	$ —	2	$ 1,518	1	$ 2,657	5	$ 2,472

(1) TDRs may include multiple concessions, and the disclosure classifications are based on the primary concession provided to the borrower.

Loans Reviewed Collectively for Impairment

All loans not evaluated individually for impairment will be separated into homogeneous pools to be collectively evaluated. Loans will be first grouped into the various loan types (i.e. commercial, agricultural, consumer, etc.) and further segmented within each subset by risk classification (i.e. pass, special mention/watch, and substandard). Homogeneous loans past due 60-89 days and 90 days or more are classified special mention/watch and substandard, respectively, for allocation purposes.

The Company’s historical loss experience for each group segmented by loan type is calculated for the prior 20 quarters as a starting point for estimating losses. In addition, other prevailing qualitative or environmental factors likely to cause

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probable losses to vary from historical data are incorporated in the form of adjustments to increase or decrease the loss rate applied to each group. These adjustments are documented and fully explain how the current information, events, circumstances, and conditions impact the historical loss measurement assumptions.

Although not a comprehensive list, the following are considered key factors and are evaluated with each calculation of the ALLL to determine if adjustments to historical loss rates are warranted:

- Changes in national and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments.
- Changes in the quality and experience of lending staff and management.
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses.
- Changes in the volume and severity of past due loans, classified loans and non-performing loans.
- The existence and potential impact of any concentrations of credit.
- Changes in the nature and terms of loans such as growth rates and utilization rates.
- Changes in the value of underlying collateral for collateral-dependent loans, considering the Company’s disposition bias.
- The effect of other external factors such as the legal and regulatory environment.

The Company may also consider other qualitative factors for additional allowance allocations, including changes in the Company’s loan review process. Changes in the criteria used in this evaluation or the availability of new information could cause the allowance to be increased or decreased in future periods. In addition, bank regulatory agencies, as part of their examination process, may require adjustments to the allowance for loan losses based on their judgments and estimates.

The items listed above are used to determine the pass percentage for loans evaluated under ASC 450, and as such, are applied to the loans risk rated pass. Due to the inherent risks associated with special mention/watch risk-rated loans (i.e. early stages of financial deterioration, technical exceptions, etc.), this subset is reserved at a level that will cover losses above a pass allocation for loans that had a loss in the last 20 quarters in which the loan was risk-rated special mention/watch at the time of the loss. Substandard loans carry greater risk than special mention/watch loans, and as such, this subset is reserved at a level that will cover losses above a pass allocation for loans that had a loss in the last 20 quarters in which the loan was risk-rated substandard at the time of the loss. Ongoing analysis is performed to support these factor multiples.

The following tables set forth the risk category of loans by class of loans and credit quality indicator based on the most recent analysis performed, as of June 30, 2018 and December 31, 2017:

(in thousands)	**Pass**	**Special Mention/ Watch**	**Substandard**	**Doubtful**	**Loss**	**Total**
June 30, 2018						
Agricultural	$76,987	$ 17,723	$ 8,719	$ —	$ —	$103,429
Commercial and industrial	473,717	21,118	17,517	5	—	512,357
Commercial real estate:						
Construction and development	203,880	1,216	1,173	—	—	206,269
Farmland	70,237	8,514	10,010	—	—	88,761
Multifamily	127,072	1,406	1,181	—	—	129,659
Commercial real estate-other	754,866	45,300	19,039	—	—	819,205
Total commercial real estate	1,156,055	56,436	31,403	—	—	1,243,894
Residential real estate:						
One- to four- family first liens	340,610	3,104	6,567	—	—	350,281
One- to four- family junior liens	115,160	706	1,272	—	—	117,138
Total residential real estate	455,770	3,810	7,839	—	—	467,419
Consumer	36,772	133	3	28	—	36,936
Total	$2,199,301	$ 99,220	$ 65,481	$ 33	$ —	$2,364,035

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(in thousands)	Pass	Special Mention/ Watch	Substandard	Doubtful	Loss	Total
December 31, 2017						
Agricultural	$ 80,377	$ 21,989	$ 3,146	$ —	$ —	$ 105,512
Commercial and industrial	453,363	23,153	27,102	6	—	503,624
Commercial real estate:						
Construction and development	162,968	1,061	1,247	—	—	165,276
Farmland	76,740	10,357	771	—	—	87,868
Multifamily	131,507	2,498	501	—	—	134,506
Commercial real estate-other	731,231	34,056	19,034	—	—	784,321
Total commercial real estate	1,102,446	47,972	21,553	—	—	1,171,971
Residential real estate:						
One- to four- family first liens	340,446	2,776	9,004	—	—	352,226
One- to four- family junior liens	114,763	952	1,489	—	—	117,204
Total residential real estate	455,209	3,728	10,493	—	—	469,430
Consumer	36,059	—	68	31	—	36,158
Total	$ 2,127,454	$ 96,842	$ 62,362	$ 37	$ —	$ 2,286,695

Included within the special mention/watch, substandard, and doubtful categories at June 30, 2018 and December 31, 2017 are purchased credit impaired loans totaling $11.4 million and $12.6 million, respectively.
Below are descriptions of the risk classifications of our loan portfolio.
Special Mention/Watch - A special mention/watch asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Company’s credit position at some future date. Special mention/watch assets are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.
Substandard - Substandard loans are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
Doubtful - Loans classified as doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.
Loss - Loans classified as loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

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The following table presents loans individually evaluated for impairment, excluding purchased credit impaired loans, by class of loan, as of June 30, 2018 and December 31, 2017:

	June 30, 2018			December 31, 2017		
(in thousands)	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**
With no related allowance recorded:						
Agricultural	$ 6,307	$ 6,807	$ —	$ 1,523	$ 2,023	$ —
Commercial and industrial	4,162	4,528	—	7,588	7,963	—
Commercial real estate:						
Construction and development	84	84	—	84	84	—
Farmland	6,532	6,532	—	287	287	—
Multifamily	823	823	—	—	—	—
Commercial real estate-other	6,602	7,111	—	5,746	6,251	—
Total commercial real estate	14,041	14,550	—	6,117	6,622	—
Residential real estate:						
One- to four- family first liens	2,488	2,540	—	2,449	2,482	—
One- to four- family junior liens	302	302	—	26	26	—
Total residential real estate	2,790	2,842	—	2,475	2,508	—
Consumer	—	—	—	—	—	—
Total	$ 27,300	$ 28,727	$ —	$ 17,703	$ 19,116	$ —
With an allowance recorded:						
Agricultural	$ 1,749	$ 1,754	$ 287	$ 1,446	$ 1,446	$ 140
Commercial and industrial	8,703	8,810	3,093	2,146	2,177	1,126
Commercial real estate:						
Construction and development	—	—	—	—	—	—
Farmland	2,123	2,123	648	—	—	—
Multifamily	—	—	—	—	—	—
Commercial real estate-other	4,313	11,980	3,302	4,269	11,536	2,157
Total commercial real estate	6,436	14,103	3,950	4,269	11,536	2,157
Residential real estate:						
One- to four- family first liens	966	966	163	979	979	185
One- to four- family junior liens	—	—	—	268	268	41
Total residential real estate	966	966	163	1,247	1,247	226
Consumer	—	—	—	—	—	—
Total	$ 17,854	$ 25,633	$ 7,493	$ 9,108	$ 16,406	$ 3,649
Total:						
Agricultural	$ 8,056	$ 8,561	$ 287	$ 2,969	$ 3,469	$ 140
Commercial and industrial	12,865	13,338	3,093	9,734	10,140	1,126
Commercial real estate:						
Construction and development	84	84	—	84	84	—
Farmland	8,655	8,655	648	287	287	—
Multifamily	823	823	—	—	—	—
Commercial real estate-other	10,915	19,091	3,302	10,015	17,787	2,157
Total commercial real estate	20,477	28,653	3,950	10,386	18,158	2,157
Residential real estate:						
One- to four- family first liens	3,454	3,506	163	3,428	3,461	185
One- to four- family junior liens	302	302	—	294	294	41
Total residential real estate	3,756	3,808	163	3,722	3,755	226
Consumer	—	—	—	—	—	—

Total	$45,154	$ 54,360	$ 7,493	$26,811	$ 35,522	$ 3,649

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The following table presents the average recorded investment and interest income recognized for loans individually evaluated for impairment, excluding purchased credit impaired loans, by class of loan, during the stated periods:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
(in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:								
Agricultural	$ 6,037	$ 296	$ 1,192	$ 66	$ 4,422	$ 363	$ 1,216	$ 79
Commercial and industrial	3,954	98	4,787	67	3,465	144	4,143	90
Commercial real estate:								
Construction and development	84	—	360	—	84	—	360	—
Farmland	5,242	185	1,686	36	3,494	234	2,073	69
Multifamily	825	20	—	—	550	30	—	—
Commercial real estate-other	5,693	130	3,118	71	5,394	177	3,040	103
Total commercial real estate	11,844	335	5,164	107	9,522	441	5,473	172
Residential real estate:								
One- to four- family first liens	2,438	20	2,409	46	1,757	11	2,417	70
One- to four- family junior liens	297	—	13	—	288	—	13	—
Total residential real estate	2,735	20	2,422	46	2,045	11	2,430	70
Consumer	—	—	—	—	—	—	—	—
Total	$ 24,570	$ 749	$ 13,565	$ 286	$ 19,454	$ 959	$ 13,262	$ 411
With an allowance recorded:								
Agricultural	$ 1,622	$ 57	$ 1,855	$ 53	$ 1,610	$ 71	$ 1,875	$ 67
Commercial and industrial	7,797	53	4,444	14	7,457	37	3,495	37
Commercial real estate:								
Construction and development	—	—	809	—	—	—	832	—
Farmland	2,107	26	—	—	1,405	54	—	—
Multifamily	—	—	—	—	—	—	—	—
Commercial real estate-other	4,360	—	6,294	16	4,586	—	4,410	—
Total commercial real estate	6,467	26	7,103	16	5,991	54	5,242	—
Residential real estate:								
One- to four- family first liens	969	18	1,372	17	972	27	1,389	26
One- to four- family junior liens	—	—	—	—	—	—	—	—
Total residential real estate	969	18	1,372	17	972	27	1,389	26
Consumer	—	—	—	—	—	—	—	—
Total	$ 16,855	$ 154	$ 14,774	$ 100	$ 16,030	$ 189	$ 12,001	$ 130
Total:								
Agricultural	$ 7,659	$ 353	$ 3,047	$ 119	$ 6,032	$ 434	$ 3,091	$ 146
Commercial and industrial	11,751	151	9,231	81	10,922	181	7,638	127
Commercial real estate:								
Construction and development	84	—	1,169	—	84	—	1,192	—
Farmland	7,349	211	1,686	36	4,899	288	2,073	69
Multifamily	825	20	—	—	550	30	—	—
Commercial real estate-other	10,053	130	9,412	87	9,980	177	7,450	103
Total commercial real estate	18,311	361	12,267	123	15,513	495	10,715	172
Residential real estate:								
One- to four- family first liens	3,407	38	3,781	63	2,729	38	3,806	96
One- to four- family junior liens	297	—	13	—	288	—	13	—
Total residential real estate	3,704	38	3,794	63	3,017	38	3,819	96

Consumer	—	—	—	—	—	—	—	—
Total	$41,425	$ 903	$28,339	$ 386	$35,484	$ 1,148	$25,263	$ 541

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The following table presents the contractual aging of the recorded investment in past due loans by class of loans at June 30, 2018 and December 31, 2017:

(in thousands)	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable
June 30, 2018						
Agricultural	$503	$—	$280	$783	$102,646	$103,429
Commercial and industrial	1,144	185	6,006	7,335	505,022	512,357
Commercial real estate:						
Construction and development	11	—	83	94	206,175	206,269
Farmland	515	—	141	656	88,105	88,761
Multifamily	—	—	—	—	129,659	129,659
Commercial real estate-other	189	62	3,646	3,897	815,308	819,205
Total commercial real estate	715	62	3,870	4,647	1,239,247	1,243,894
Residential real estate:						
One- to four- family first liens	1,412	1,170	872	3,454	346,827	350,281
One- to four- family junior liens	120	67	440	627	116,511	117,138
Total residential real estate	1,532	1,237	1,312	4,081	463,338	467,419
Consumer	56	23	19	98	36,838	36,936
Total	$3,950	$1,507	$11,487	$16,944	$2,347,091	$2,364,035
Included in the totals above are the following purchased credit impaired loans	$203	$160	$—	$363	$17,815	$18,178
December 31, 2017						
Agricultural	$95	$118	$168	$381	$105,131	$105,512
Commercial and industrial	1,434	1,336	1,576	4,346	499,278	503,624
Commercial real estate:						
Construction and development	57	97	82	236	165,040	165,276
Farmland	217	—	373	590	87,278	87,868
Multifamily	—	25	—	25	134,481	134,506
Commercial real estate-other	74	—	1,852	1,926	782,395	784,321
Total commercial real estate	348	122	2,307	2,777	1,169,194	1,171,971
Residential real estate:						
One- to four- family first liens	3,854	756	1,019	5,629	346,597	352,226
One- to four- family junior liens	325	770	271	1,366	115,838	117,204
Total residential real estate	4,179	1,526	1,290	6,995	462,435	469,430
Consumer	79	15	29	123	36,035	36,158
Total	$6,135	$3,117	$5,370	$14,622	$2,272,073	$2,286,695
Included in the totals above are the following purchased credit impaired loans	$164	$756	$553	$1,473	$18,258	$19,731

Non-accrual and Delinquent Loans

Loans are placed on non-accrual when (1) payment in full of principal and interest is no longer expected or (2) principal or interest has been in default for 90 days or more (unless the loan is both well secured with marketable collateral and in the process of collection). All loans rated doubtful or worse, and certain loans rated substandard, are placed on non-accrual.

A non-accrual asset may be restored to an accrual status when (1) all past due principal and interest has been paid

(excluding renewals and modifications that involve the capitalizing of interest) or (2) the loan becomes well secured with marketable collateral and is in the process of collection. An established track record of performance is also considered when determining accrual status.
Delinquency status of a loan is determined by the number of days that have elapsed past the loan’s payment due date, using the following classification groupings: 30-59 days, 60-89 days and 90 days or more. Once a TDR has gone 90 days or more past due or is placed on nonaccrual status, it is included in the 90 days or more past due or nonaccrual totals.

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The following table sets forth the composition of the Company's recorded investment in loans on nonaccrual status and past due 90 days or more and still accruing by class of loans, excluding purchased credit impaired loans, as of June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
(in thousands)	Non-Accrual	Loans Past Due 90 Days or More and Still Accruing	Non-Accrual	Loans Past Due 90 Days or More and Still Accruing
Agricultural	$255	$ 52	$168	$ —
Commercial and industrial	6,790	—	7,124	—
Commercial real estate:				
Construction and development	102	—	188	—
Farmland	278	—	386	—
Multifamily	—	—	—	—
Commercial real estate-other	4,001	—	5,279	—
Total commercial real estate	4,381	—	5,853	—
Residential real estate:				
One- to four- family first liens	1,085	60	1,228	205
One- to four- family junior liens	493	39	346	2
Total residential real estate	1,578	99	1,574	207
Consumer	63	—	65	—
Total	$13,067	$ 151	$14,784	$ 207

Not included in the loans above as of June 30, 2018 and December 31, 2017 were purchased credit impaired loans with an outstanding balance of $0.3 million and $0.7 million, net of a discount of $0.1 million and $0.1 million, respectively.

As of June 30, 2018, the Company had $0.3 million in commitments to lend additional funds to borrowers who have a TDR.

Purchased Loans

Purchased loans acquired in a business combination are recorded and initially measured at their estimated fair value as of the acquisition date. Credit discounts are included in the determination of fair value. An allowance for loan losses is not carried over. These purchased loans are segregated into two types: purchased credit impaired loans and purchased non-credit impaired loans.

- Purchased non-credit impaired loans are accounted for in accordance with ASC 310-20 "*Nonrefundable Fees and Other Costs*" as these loans do not have evidence of significant credit deterioration since origination and it is probable all contractually required payments will be received from the borrower.
- Purchased credit impaired loans are accounted for in accordance with ASC 310-30 "*Loans and Debt Securities Acquired with Deteriorated Credit Quality*" as they display significant credit deterioration since origination and it is probable, as of the acquisition date, that the Company will be unable to collect all contractually required payments from the borrower.

For purchased non-credit impaired loans the accretable discount is the discount applied to the expected cash flows of the portfolio to account for the differences between the interest rates at acquisition and rates currently expected on similar portfolios in the marketplace. As the accretable discount is accreted to interest income over the expected average life of the portfolio, the result will be interest income on loans at the estimated current market rate. We record a provision for the acquired portfolio as the loans acquired in the Central Bancshares, Inc. ("Central") merger renew and the discount is accreted.

For purchased credit impaired loans the difference between contractually required payments at acquisition and the cash flows expected to be collected is referred to as the non-accretable difference. Further, any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the expected remaining life of the loan if the timing and amount of the future cash flows are reasonably estimable. This discount includes an adjustment on loans that are not accruing or paying contractual interest so that interest income will be recognized at the estimated current market rate.

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Subsequent to the purchase date, increases in cash flows over those expected at the purchase date are recognized as interest income prospectively. The present value of any decreases in expected cash flows after the purchase date is recognized by recording an allowance for credit losses and a provision for loan losses.
Changes in the accretable yield for loans acquired and accounted for under ASC 310-30 were as follows for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	**2018**	**2017**	**2018**	**2017**
Balance at beginning of period	$608	$1,633	$840	$1,961
Accretion	(373)	(475)	(650)	(891)
Reclassification from nonaccretable difference	76	213	121	301
Balance at end of period	$311	$1,371	$311	$1,371

5. Derivatives and Hedging Activities

FASB ASC 815, *Derivatives and Hedging* (“ASC 815”), provides the disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how the entity accounts for derivative instruments and related hedged items, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. Further, qualitative disclosures are required that explain the Company’s objectives and strategies for using derivatives, as well as quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.
As required by ASC 815, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.
The Company does not use derivatives for trading or speculative purposes.
In accordance with the FASB’s fair value measurement guidance, the Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.
The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its assets and liabilities and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company’s derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company’s known or expected cash receipts and its known or expected cash payments principally related to the Company’s loans and borrowings.

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The following table presents the total notional and gross fair value of the Company's derivatives as of June 30, 2018 and December 31, 2017. The derivative asset and liability balances are presented on a gross basis, prior to the application of master netting agreements, as included in other assets and other liabilities, respectively, on the Consolidated Balance Sheets.

	As of June 30, 2018			As of December 31, 2017		
		Fair Value			Fair Value	
(in thousands)	**Notional Amount**	**Derivative Assets**	**Derivative Liabilities**	**Notional Amount**	**Derivative Assets**	**Derivative Liabilities**
Derivatives designated as hedging instruments:						
Fair value hedges:						
Interest rate swaps	$ 5,605	$ —	$ 26	$ —	$ —	$ —
Derivatives not designated as hedging instruments:						
Interest rate swaps	10,720	113	132	—	—	—

Derivatives Designated as Hedging Instruments

The Company is exposed to changes in the fair value of certain of its fixed-rate assets due to changes in benchmark interest rates. The Company uses interest rate swaps to manage its exposure to changes in fair value on these instruments attributable to changes in the designated benchmark interest rate, LIBOR. Interest rate swaps designated as fair value hedges involve the payment of fixed-rate amounts to a counterparty in exchange for the Company receiving variable-rate payments over the life of the agreements without the exchange of the underlying notional amount. For derivatives designated and that qualify as fair value hedges, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in interest income.

The table below presents the effect of the Company's derivative financial instruments designated as hedging instruments on the Consolidated Statements of Income for the three and six months ended June 30, 2018 and June 30, 2017:

	Location and Amount of Gain or Loss Recognized in Income on Fair Value Hedging Relationships							
	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2018		2017		2018		2017	
(in thousands)	**Interest Income (Expense)**	**Other Gain (Loss)**	**Interest Income (Expense)**	**Other Gain (Loss)**	**Interest Income (Expense)**	**Other Gain (Loss)**	**Interest Income (Expense)**	**Other Gain (Loss)**
Total amounts of income and expense line items presented in the Consolidated Statements of Income in which the effects of fair value hedges are recorded	$ (1)	$ —	$ —	$ —	$ (1)	$ —	$ —	$ —
The effects of fair value hedging:								
Loss on fair value hedging relationships in subtopic 815-20:								
Interest contracts:								
Hedged items	135	—	—	—	135	—	—	—
Derivative designated as hedging instruments	(136)	—	—	—	(136)	—	—	—

As of June 30, 2018, the following amounts were recorded on the balance sheet related to cumulative basis adjustment for fair value hedges:

Line Item in the Balance Sheet in Which the Hedged Item is Included	Carrying Amount of the Hedged Assets	Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of

(in thousands)		the Hedged Asset
Loans	$ 5,630	$ 25

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Derivatives Not Designated as Hedging Instruments

The Company enters into interest rate derivatives, including interest rate swaps with its customers, to allow them to hedge against the risk of rising interest rates by providing fixed rate loans. To economically hedge against the interest rate risks in the products offered to its customers, the Company enters into mirrored interest rate contracts with institutional counterparties, with one designated as a central counterparty. As of June 30, 2018, the total amount of interest rate swaps, including mirrored transactions with institutional counterparties and the Company's customers, totaled $5.4 million for derivatives that were in an asset valuation position, and $5.4 million for derivatives that were in a liability valuation position. As of December 31, 2017, the total notional amounts of interest rate swaps, including mirrored transactions with institutional counterparties and the Company's customers, totaled zero for derivatives that were in an asset valuation position, and zero for derivatives that were in a liability valuation position. The fair value of interest rate swaps with institutional counterparties and the Company's customers amounted to a $0.1 million asset and a $0.1 million liability, as of June 30, 2018. The fair value of interest rate swaps with institutional counterparties and the Company's customers amounted to a zero asset and a zero liability, as of December 31, 2017.

The following table presents the net gains (losses) recognized on the Consolidated Statements of Income related to the derivatives not designated as hedging instruments for the three and six months ended June 30, 2018 and June 30, 2017:

	Location in the Consolidated Statements of Income	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
(in thousands)		2018	2017	2018	2017
Interest rate swaps	Other gain (loss)	$(19)	$ —	$(19)	$ —

Offsetting of Derivatives

The table below presents a gross presentation, the effects of offsetting, and a net presentation of the Company's derivatives as of June 30, 2018 and December 31, 2017. The net amounts of derivative assets or liabilities can be reconciled to the tabular disclosure of fair value. The tabular disclosure of fair value provides the location that derivative assets and liabilities are presented on the Consolidated Balance Sheets.

				Gross Amounts Not Offset in the Balance Sheet		
(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets (Liabilities) presented in the Balance Sheet	Financial Instruments	Cash Collateral Received (Paid)	Net Assets (Liabilities)
As of June 30, 2018						
Asset Derivatives	$ 113	$ —	$ 113	$ —	$ —	$ 113
Liability Derivatives	(158)	—	(158)	—	—	(158)
As of December 31, 2017						
Derivatives	—	—	—	—	—	—
Liability Derivatives	—	—	—	—	—	—

Credit-risk-related Contingent Features

The Company has an unsecured federal funds line with its derivative counterparty.The Company has an agreement with its derivative counterparty that contains a provision under which if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations. The Company also has an agreement with its derivative counterparty that contains a provision under which the Company could be declared in default on its derivative obligations if repayment of the underlying indebtedness is accelerated by the lender due to the Company's default on the indebtedness.

As of June 30, 2018, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was $163,000. As of June 30, 2018, the Company has minimum collateral posting thresholds with certain of its derivative counterparties, and has not posted any collateral related to these agreements. If the Company had breached any of these provisions at June 30, 2018, it could have been required to settle its obligations under the agreements at their termination value of $163,000.

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6. Goodwill and Intangible Assets

The excess of the cost of an acquisition over the fair value of the net assets acquired, including core deposit, trade name, and client relationship intangibles, consists of goodwill. Under ASC Topic 350, goodwill and the non-amortizing portion of the trade name intangible are subject to at least annual assessments for impairment by applying a fair value based test. The Company reviews goodwill and the non-amortizing portion of the trade name intangible at the reporting unit level to determine potential impairment annually on October 1, or more frequently if events or changes in circumstances indicate that the carrying value may not be recoverable, by comparing the carrying value of the reporting unit with the fair value of the reporting unit. No impairment was recorded on either the goodwill or the trade name intangible assets during the six months ended June 30, 2018. The carrying amount of goodwill was $64.7 million at June 30, 2018, the same as at December 31, 2017.

During the second quarter of 2018, the Company recognized a $125,000 customer list intangible due to the purchase of a registered investment adviser in the Denver, Colorado, area.

The following table presents the changes in the carrying amount of intangibles (excluding goodwill), gross carrying amount, accumulated amortization, and net book value as of and for the six months ended June 30, 2018:

(in thousands)	Insurance Agency Intangible	Core Deposit Intangible	Indefinite-Lived Trade Name Intangible	Finite-Lived Trade Name Intangible	Customer List Intangible	Total
June 30, 2018						
Balance, beginning of period	$ 148	$ 4,011	$ 7,040	$ 744	$ 103	$ 12,046
Finite-lived intangible assets acquired	—	—	—	—	125	125
Amortization expense	(19)	(1,119)	—	(97)	(11)	(1,246)
Balance at end of period	$ 129	$ 2,892	$ 7,040	$ 647	$ 217	$ 10,925
Gross carrying amount	$ 1,320	$ 18,206	$ 7,040	$ 1,380	$ 455	$ 28,401
Accumulated amortization	(1,191)	(15,314)	—	(733)	(238)	(17,476)
Net book value	$ 129	$ 2,892	$ 7,040	$ 647	$ 217	$ 10,925

7. Other Assets

The components of the Company’s other assets were as follows:

(in thousands)	June 30, 2018	December 31, 2017
Federal Home Loan Bank Stock	$ 14,748	$ 11,324
Prepaid expenses	1,954	2,992
Mortgage servicing rights	2,589	2,316
Federal & state income taxes receivable, current	—	3,120
Accounts receivable & other miscellaneous assets	7,722	3,009
	$ 27,013	$ 22,761

The Bank is a member of the FHLB of Des Moines, and ownership of FHLB stock is a requirement for such membership. The amount of FHLB stock the Bank is required to hold is directly related to the amount of FHLB advances borrowed. Because this security is not readily marketable and there are no available market values, this security is carried at cost and evaluated for potential impairment each quarter. Redemption of this investment is at the option of the FHLB. No impairment was recorded on FHLB stock in the six months ended June 30, 2018 or in the year ended December 31, 2017.

Mortgage servicing rights are recorded at fair value based on assumptions provided by a third-party valuation service. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the servicing cost per loan, the discount rate, the escrow float rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.

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8. Short-Term Borrowings

Short-term borrowings were as follows as of June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
(in thousands)	Weighted Average Cost	Balance	Weighted Average Cost	Balance
Federal funds purchased	2.10 %	$ 52,421	1.77 %	$ 1,000
Securities sold under agreements to repurchase	0.91	75,046	0.71	96,229
Total	1.40 %	$ 127,467	0.73 %	$ 97,229

At June 30, 2018 and December 31, 2017, the Company had no borrowings through the Federal Reserve Discount Window, while the borrowing capacity was $11.4 million as of June 30, 2018 and December 31, 2017. As of June 30, 2018 and December 31, 2017, the Bank had municipal securities pledged with a market value of $12.7 million and $12.8 million, respectively, to the Federal Reserve to secure potential borrowings. The Company also has various other unsecured federal funds agreements with correspondent banks as well as the FHLB. As of June 30, 2018 and December 31, 2017, there were $52.4 million and $1.0 million of borrowings through these correspondent bank federal funds agreements, respectively.

Securities sold under agreements to repurchase are agreements in which the Company acquires funds by selling assets to another party under a simultaneous agreement to repurchase the same assets at a specified price and date. The Company enters into repurchase agreements and also offers a demand deposit account product to customers that sweeps their balances in excess of an agreed upon target amount into overnight repurchase agreements. All securities sold under agreements to repurchase are recorded on the face of the balance sheet.

On April 30, 2015, the Company entered into a $5.0 million unsecured line of credit with a correspondent bank. Interest is payable at a rate of one-month LIBOR plus 2.00%. The line was renewed in May 2018, and matures on April 30, 2019. The Company had no balance outstanding under this agreement as of June 30, 2018.

9. Junior Subordinated Notes Issued to Capital Trusts

The Company has established three statutory business trusts under the laws of the state of Delaware: Central Bancshares Capital Trust II, Barron Investment Capital Trust I, and MidWestOne Statutory Trust II. The trusts exist for the exclusive purposes of (i) issuing trust securities representing undivided beneficial interests in the assets of the respective trust; (ii) investing the gross proceeds of the trust securities in junior subordinated deferrable interest debentures (junior subordinated notes); and (iii) engaging in only those activities necessary or incidental thereto. For regulatory capital purposes, these trust securities qualify as a component of Tier 1 capital.

The table below summarizes the outstanding junior subordinated notes and the related trust preferred securities issued by each trust as of June 30, 2018 and December 31, 2017:

(in thousands)	Face Value	Book Value	Interest Rate	Interest Rate at 6/30/2018	Maturity Date	Callable Date
June 30, 2018						
Central Bancshares Capital Trust II[(1) (2)]	$ 7,217	$ 6,702	Three-month LIBOR + 3.50%	5.84 %	03/15/2038	03/15/2013
Barron Investment Capital Trust I[(1) (2)]	2,062	1,675	Three-month LIBOR + 2.15%	4.49 %	09/23/2036	09/23/2011
MidWestOne Statutory Trust II[(1)]	15,464	15,464	Three-month LIBOR + 1.59%	3.93 %	12/15/2037	12/15/2012
Total	$ 24,743	$ 23,841				

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(in thousands)	Face Value	Book Value	Interest Rate	Interest Rate at 12/31/2017		Maturity Date	Callable Date
December 31, 2017							
Central Bancshares Capital Trust II(1) (2)	$7,217	$6,674	Three-month LIBOR + 3.50%	5.09	%	03/15/2038	03/15/2013
Barron Investment Capital Trust I(1) (2)	2,062	1,655	Three-month LIBOR + 2.15%	3.82	%	09/23/2036	09/23/2011
MidWestOne Statutory Trust II(1)	15,464	15,464	Three-month LIBOR + 1.59%	3.18	%	12/15/2037	12/15/2012
Total	$24,743	$23,793					

(1) All distributions are cumulative and paid in cash quarterly.
(2) Central Bancshares Capital Trust II and Barron Investment Capital Trust I were established by Central prior to the Company's merger with Central, and the junior subordinated notes issued by Central were assumed by the Company.

The trust preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the junior subordinated notes at the stated maturity date or upon redemption of the junior subordinated notes. Each trust's ability to pay amounts due on the trust preferred securities is solely dependent upon the Company making payment on the related junior subordinated notes. The Company's obligation under the junior subordinated notes and other relevant trust agreements, in aggregate, constitutes a full and unconditional guarantee by the Company of each trust's obligations under the trust preferred securities issued by each trust. The Company has the right to defer payment of interest on the junior subordinated notes and, therefore, distributions on the trust preferred securities, for up to five years, but not beyond the stated maturity date in the table above. During any such deferral period the Company may not pay cash dividends on its stock and generally may not repurchase its stock.

10. Federal Home Loan Bank Borrowings and Long-Term Debt

Federal Home Loan Bank borrowings and long-term debt were as follows as of June 30, 2018 and December 31, 2017:

	June 30, 2018		December 31, 2017	
(in thousands)	Weighted Average Cost	Balance	Weighted Average Cost	Balance
FHLB Borrowings	2.12%	$143,000	1.72%	$115,000
Note payable to unaffiliated bank	3.75	10,000	3.32	12,500
Total	2.23%	$153,000	1.88%	$127,500

The Company utilizes FHLB borrowings as a supplement to customer deposits to fund interest-earning assets and to assist in managing interest rate risk. As a member of the Federal Home Loan Bank of Des Moines, the Bank may borrow funds from the FHLB in amounts up to 35% of the Bank's total assets, provided the Bank is able to pledge an adequate amount of qualified assets to secure the borrowings. Advances from the FHLB are collateralized primarily by one- to four-family residential, commercial and agricultural real estate first mortgages equal to various percentages of the total outstanding notes. See Note 4 "Loans Receivable and the Allowance for Loan Losses" of the notes to the consolidated financial statements.

On April 30, 2015, the Company entered into a $35.0 million unsecured note payable with a correspondent bank with a maturity date of June 30, 2020. The Company drew $25.0 million on the note prior to June 30, 2015, at which time the ability to obtain additional advances ceased. Payments of principal and interest are payable quarterly, which began on September 30, 2015. As of June 30, 2018, $10.0 million of that note was outstanding.

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11. Income Taxes

Income tax expense for the three and six months ended June 30, 2018 and 2017 was less than the amount computed by applying the maximum effective federal income tax rate of 21% and 35%, respectively, to the income before income taxes, because of the following items:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2018		2017		2018		2017	
(in thousands)	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income
Income tax based on statutory rate	$2,160	21.0 %	$3,629	35.0 %	$4,213	21.0 %	$6,864	35.0 %
Tax-exempt interest	(501)	(4.9)	(795)	(7.7)	(991)	(4.9)	(1,581)	(8.1)
Bank-owned life insurance	(82)	(0.8)	(110)	(1.1)	(173)	(0.9)	(225)	(1.1)
State income taxes, net of federal income tax benefit	566	5.5	443	4.3	1,095	5.4	848	4.3
General business credits	7	(1.0)	(19)	(0.2)	(40)	(0.7)	(40)	(0.2)
Other	(19)	0.9	(12)	(0.1)	11	0.6	(201)	(1.0)
Total income tax expense	$2,131	20.7 %	$3,136	30.2 %	$4,115	20.5 %	$5,665	28.9 %

In December 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118), which provides guidance regarding how a company is to reflect provisional amounts when necessary information is not yet available, prepared or analyzed sufficiently to complete its accounting for the effect of the changes in Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). During the first quarter of 2018, the income tax expense recorded during the fourth quarter of 2017 was determined to be final.

12. Earnings per Share

Basic per-share amounts are computed by dividing net income (the numerator) by the weighted-average number of common shares outstanding (the denominator). Diluted per-share amounts assume issuance of all common stock issuable upon conversion or exercise of other securities, unless the effect is to reduce the loss or increase the income per common share from continuing operations.

The following table presents the computation of earnings per common share for the respective periods:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands, except per share amounts)	2018	2017	2018	2017
Basic earnings per common share computation				
Numerator:				
Net income	$8,156	$ 7,234	$15,949	$ 13,947
Denominator:				
Weighted average shares outstanding	12,218,241	12,200,689	12,220,451	11,855,108
Basic earnings per common share	$0.67	$ 0.59	$1.31	$ 1.18
Diluted earnings per common share computation				
Numerator:				
Net income	$8,156	$ 7,234	$15,949	$ 13,947
Denominator:				
Weighted average shares outstanding, including all dilutive potential shares	12,229,941	12,219,238	12,235,405	11,878,315
Diluted earnings per common share	$0.67	$ 0.59	$1.30	$ 1.17

13. Estimated Fair Value of Financial Instruments and Fair Value Measurements

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Market participants are defined as buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: 1) an unrelated party; 2) knowledgeable (having a reasonable understanding about the asset or liability and the transaction based on all available information; including

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information that might be obtained through due diligence efforts that are usual or customary); 3) able to transact; and 4) willing to transact (motivated but not forced or otherwise compelled to do so).

The FASB states "valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value." The valuation techniques for measuring fair value are consistent with the three traditional approaches to value: the market approach, the income approach, and the cost or asset approach.

In applying valuation techniques, the use of relevant inputs (both observable and unobservable) based on the facts and circumstances must be used. The FASB has defined a fair value hierarchy for these inputs which prioritizes the inputs into three broad levels:

- *Level 1 Inputs* – Quoted prices (unadjusted) for identical assets or liabilities in active markets.
- *Level 2 Inputs* – Inputs other than quoted prices within Level 1 that are observable for assets or liabilities, either directly or indirectly.
- *Level 3 Inputs* – Unobservable inputs for the asset or liability.

Unobservable inputs should be used only to the extent that relevant observable inputs are not available; this allows for situations where there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk.

It is the Company's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. The Company is required to use observable inputs, to the extent available, in the fair value estimation process unless that data results from forced liquidations or distressed sales. The Company used the following methods and significant assumptions to estimate fair value:

Investment Securities - The fair value for investment securities are determined by quoted market prices, if available (Level 1). The Company utilizes an independent pricing service to obtain the fair value of debt securities. On a quarterly basis, the Company selects a sample of 30 securities from its primary pricing service and compares them to a secondary independent pricing service to validate value. In addition, the Company periodically reviews the pricing methodology utilized by the primary independent service for reasonableness. Debt securities issued by the U.S. Treasury and other U.S. Government agencies and corporations, mortgage-backed securities, and collateralized mortgage obligations are priced utilizing industry-standard models that consider various assumptions, including time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace (Level 2). Municipal securities are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating (Level 2). On an annual basis, a group of selected municipal securities have their credit rating evaluated by a securities dealer and that information is used to verify the primary independent service's rating and pricing.

Loans Held for Sale - Loans held for sale are carried at the lower of cost or fair value, with fair value being based on binding contracts from third party investors (Level 2). The portfolio has historically consisted primarily of residential real estate loans.

Loans, Net - The estimated fair value of loans, net, was performed using the income approach, with the market approach used for certain nonperforming loans, resulting in a Level 3 fair value classification. The application of the income approach establishes value by methods that discount or capitalize earnings and/or cash flow, by a discount or capitalization rate that reflects market rate of return expectations, market conditions, and the relative risk of the investment. Generally, this can be accomplished by the discounted cash flow method. For loans that exhibited some characteristics of performance and where it appears that the borrower may have adequate cash flows to service the loan, a discounted cash flow analysis was used. The discounted cash flow analysis was based on the contractual maturity of the loan and market indications of rates, prepayment speeds, defaults and credit risk. For loans with balloon or interest only payment structures, the repayment was extended by assuming a renewal period beyond the current contractual maturity date. For loans analyzed using the asset approach, the fair value was determined based on the estimated values of the underlying collateral. For impaired loans, the estimated net sales proceeds was used to determine the fair value of the loans when deemed appropriate. The implied sales proceeds value provides a better

indication of value than the income stream as these loans are not performing or exhibit strong signs indicative of nonperformance.
Collateral Dependent Impaired Loans - From time to time, a loan is considered impaired and an allowance for credit losses is established. The specific reserves for collateral dependent impaired loans are based on the fair value of the

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collateral less estimated costs to sell, based on appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available for similar loans and collateral underlying such loans, and resulted in a Level 3 classification for inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower’s financial statements, or aging reports, adjusted or discounted based on management’s historical knowledge, changes in market conditions from the time of valuation, and management’s expertise and knowledge of the client and the client’s business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted in accordance with the allowance policy.

Other Real Estate Owned (“OREO”) - OREO represents property acquired through foreclosures and settlements of loans. Property acquired through or in lieu of foreclosure are initially recorded at fair value less estimated selling cost at the date of foreclosure, establishing a new cost basis. These assets are subsequently accounted for at the lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than every 18 months. These appraisals may utilize a single valuation approach or a combination of approaches, including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available for similar loans and the collateral underlying such loans, resulting in a Level 3 classification for inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Appraisals for both collateral dependent impaired loans and OREO are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Special Assets Department reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics.

Interest Rate Swaps - Interest rate swaps are valued by the Company's swap dealers using cash flow valuation techniques with observable market data inputs. The fair values estimated by the Company's swap dealers use interest rates that are observable or that can be corroborated by observable market data and, therefore, are classified within Level 2 of the valuation hierarchy. The Company has entered into collateral agreements with its swap dealers which entitle it to receive collateral to cover market values on derivatives which are in asset position, thus a credit risk adjustment on interest rate swaps is not warranted.

The following table summarizes assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017. The assets and liabilities are segregated by the level of valuation inputs within the fair value hierarchy utilized to measure fair value:

	Fair Value Measurement at June 30, 2018 Using			
(in thousands)	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:				
Available for sale debt securities:				
U.S. Government agencies and corporations	$5,543	$ —	$5,543	$ —
State and political subdivisions	141,715	—	141,715	—
Mortgage-backed securities	54,370	—	54,370	—
Collateralized mortgage obligations	172,010	—	172,010	—
Corporate debt securities	64,674	—	64,674	—
Total available for sale debt securities	$438,312	$ —	$438,312	$ —
Derivatives	$113	$ —	$113	$ —
Liabilities:				

Derivatives	$ 158	$ —	$ 158	$ —

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