

Section 1: 10-Q (FORM 10-Q)

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

FORM 10-Q

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

For the quarterly period ended September 30, 2018

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

For the transition period from _____ to _____

Commission File No. 001-37504

Provident Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of
incorporation or organization)

45-3231576

(I.R.S. Employer
Identification Number)

5 Market Street, Amesbury, Massachusetts

(Address of Principal Executive Offices)

01913

Zip Code

(978) 834-8555

(Registrant's telephone number)

N/A

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such requirements for the past 90 days.

YES NO

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). YES NO

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

Large accelerated filer
Non-accelerated filer

Accelerated filer

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 November 2, 2018, there were 9,634,368 shares of the Registrant's common stock, no par value per share, outstanding.

Provident Bancorp, Inc.
Form 10-Q

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PROVIDENT BANCORP, INC.
CONSOLIDATED BALANCE SHEETS

| <i>(Dollars in thousands)</i> | At September 30, 2018 <i>(unaudited)</i> | At December 31, 2017 |
|---|---|----------------------------|
| Assets | | |
| Cash and due from banks | \$ 9,899 | \$ 10,326 |
| Short-term investments | 16,089 | 37,363 |
| Cash and cash equivalents | 25,988 | 47,689 |
| Investments in available-for-sale securities (at fair value) | 52,476 | 61,429 |
| Federal Home Loan Bank stock, at cost | 1,925 | 1,854 |
| Loans, net | 783,292 | 742,138 |
| Assets held-for-sale | - | 3,286 |
| Bank owned life insurance | 26,055 | 25,540 |
| Premises and equipment, net | 14,943 | 10,981 |
| Accrued interest receivable | 2,584 | 2,345 |
| Deferred tax asset, net | 5,347 | 4,920 |
| Other assets | 2,561 | 2,083 |
| Total assets | \$ 915,171 | \$ 902,265 |
| Liabilities and Equity | | |
| Deposits: | | |
| Noninterest-bearing | \$ 195,641 | \$ 186,222 |
| Interest-bearing | 555,829 | 563,835 |
| Total deposits | 751,470 | 750,057 |
| Federal Home Loan Bank advances | 29,902 | 26,841 |
| Other liabilities | 11,663 | 9,590 |
| Total liabilities | 793,035 | 786,488 |
| Shareholders' equity: | | |
| Preferred stock; authorized 50,000 shares: no shares issued and outstanding | - | - |
| Common stock, no par value: 30,000,000 shares authorized; 9,662,181 shares issued, 9,634,368 shares outstanding at September 30, 2018 and 9,657,319 shares issued, 9,628,496 shares outstanding at December 31, 2017 | - | - |
| Additional paid-in capital | 45,572 | 44,592 |
| Retained earnings | 80,516 | 74,047 |
| Accumulated other comprehensive (loss) income | (700) | 589 |
| Unearned compensation - ESOP | (2,679) | (2,857) |
| Treasury stock: 27,813 and 28,823 shares at September 30, 2018 and December 31, 2017, respectively | (573) | (594) |
| Total shareholders' equity | 122,136 | 115,777 |
| Total liabilities and shareholders' equity | \$ 915,171 | \$ 902,265 |

The accompanying notes are an integral part of the consolidated financial statements.

PROVIDENT BANCORP, INC.
CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

| <i>(Dollars in thousands, except per share data)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (unaudited) | | | |
| Interest and dividend income: | | | | |
| Interest and fees on loans | \$ 10,219 | \$ 8,403 | \$ 29,420 | \$ 23,547 |
| Interest and dividends on securities | 411 | 822 | 1,256 | 2,597 |
| Interest on short-term investments | 203 | 14 | 287 | 23 |
| Total interest and dividend income | 10,833 | 9,239 | 30,963 | 26,167 |
| Interest expense: | | | | |
| Interest on deposits | 1,225 | 783 | 3,154 | 2,031 |
| Interest on Federal Home Loan Bank advances | 204 | 222 | 522 | 633 |
| Total interest expense | 1,429 | 1,005 | 3,676 | 2,664 |
| Net interest and dividend income | 9,404 | 8,234 | 27,287 | 23,503 |
| Provision for loan losses | 1,421 | 1,012 | 2,715 | 2,467 |
| Net interest and dividend income after provision for loan losses | 7,983 | 7,222 | 24,572 | 21,036 |
| Noninterest income: | | | | |
| Customer service fees on deposit accounts | 380 | 376 | 1,081 | 1,053 |
| Service charges and fees - other | 502 | 492 | 1,551 | 1,481 |
| Gain on sale of securities, net | - | 1,851 | - | 2,391 |
| Bank owned life insurance income | 172 | 167 | 515 | 468 |
| Other income | 5 | 11 | 43 | 75 |
| Total noninterest income | 1,059 | 2,897 | 3,190 | 5,468 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 4,150 | 3,948 | 12,583 | 11,361 |
| Occupancy expense | 456 | 411 | 1,323 | 1,332 |
| Equipment expense | 118 | 149 | 361 | 456 |
| FDIC assessment | 75 | 75 | 226 | 216 |
| Data processing | 200 | 177 | 597 | 543 |
| Marketing expense | 54 | 81 | 168 | 231 |
| Professional fees | 274 | 227 | 851 | 656 |
| Directors' compensation | 141 | 133 | 467 | 433 |
| Other | 755 | 713 | 2,434 | 2,182 |
| Total noninterest expense | 6,223 | 5,914 | 19,010 | 17,410 |
| Income before income tax expense | 2,819 | 4,205 | 8,752 | 9,094 |
| Income tax expense | 741 | 1,434 | 2,262 | 2,920 |
| Net income | \$ 2,078 | \$ 2,771 | \$ 6,490 | \$ 6,174 |
| Earnings per share: | | | | |
| Basic | \$ 0.22 | \$ 0.30 | \$ 0.70 | \$ 0.67 |
| Diluted | \$ 0.22 | \$ 0.30 | \$ 0.70 | \$ 0.67 |
| Weighted Average Shares: | | | | |
| Basic | 9,247,367 | 9,201,634 | 9,233,760 | 9,196,046 |
| Diluted | 9,355,410 | 9,213,056 | 9,309,712 | 9,196,046 |

The accompanying notes are an integral part of the consolidated financial statements.

PROVIDENT BANCORP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| <i>(In thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| | Net income | \$ 2,078 | \$ 2,771 | \$ 6,490 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding (losses) gains | (411) | 315 | (1,717) | 2,660 |
| Reclassification adjustment for realized gains in net income | - | (1,851) | - | (2,391) |
| Unrealized (loss) gain | (411) | (1,536) | (1,717) | 269 |
| Income tax effect | 100 | 569 | 428 | (105) |
| Net of tax amount | (311) | (967) | (1,289) | 164 |
| Total comprehensive income | \$ 1,767 | \$ 1,804 | \$ 5,201 | \$ 6,338 |

The accompanying notes are an integral part of the consolidated financial statements.

PROVIDENT BANCORP, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

| <i>(In thousands, except share data)</i> | Shares of Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) Income | Unearned Compensation ESOP | Treasury Stock | Total |
|--|------------------------------|----------------------------------|----------------------|--|----------------------------------|-------------------|-------------------|
| Balance, December 31, 2017 | 9,628,496 | \$ 44,592 | \$ 74,047 | \$ 589 | \$ (2,857) | \$ (594) | \$ 115,777 |
| Net income | - | - | 6,490 | - | - | - | 6,490 |
| Other comprehensive loss | - | - | - | (1,289) | - | - | (1,289) |
| Stock-based compensation expense | - | 695 | - | - | - | - | 695 |
| Restricted stock award grants | 4,862 | - | - | - | - | - | - |
| Exercise of stock options | 1,010 | - | (21) | - | - | 21 | - |
| ESOP shares earned | - | 285 | - | - | 178 | - | 463 |
| Balance, September 30, 2018 | <u>9,634,368</u> | <u>\$ 45,572</u> | <u>\$ 80,516</u> | <u>\$ (700)</u> | <u>\$ (2,679)</u> | <u>\$ (573)</u> | <u>\$ 122,136</u> |
| Balance, December 31, 2016 | 9,652,448 | \$ 43,393 | \$ 66,229 | \$ 2,622 | \$ (3,095) | \$ - | \$ 109,149 |
| Net income | - | - | 6,174 | - | - | - | 6,174 |
| Other comprehensive income | - | - | - | 164 | - | - | 164 |
| Stock-based compensation expense | - | 691 | - | - | - | - | 691 |
| Treasury stock acquired | (24,460) | - | - | - | - | (492) | (492) |
| ESOP shares earned | - | 190 | - | - | 178 | - | 368 |
| Balance, September 30, 2017 | <u>9,627,988</u> | <u>\$ 44,274</u> | <u>\$ 72,403</u> | <u>\$ 2,786</u> | <u>\$ (2,917)</u> | <u>\$ (492)</u> | <u>\$ 116,054</u> |

The accompanying notes are an integral part of the consolidated financial statements.

PROVIDENT BANCORP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| <i>(In thousands)</i> | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net income | \$ 6,490 | \$ 6,174 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of securities premiums, net of accretion | 215 | 618 |
| ESOP expense | 463 | 368 |
| Gain on sale of securities, net | - | (2,391) |
| Change in deferred loan fees, net | 101 | 382 |
| Provision for loan losses | 2,715 | 2,467 |
| Depreciation and amortization | 550 | 626 |
| Increase in accrued interest receivable | (239) | (315) |
| Share-based compensation expense | 695 | 691 |
| Increase in cash surrender value of life insurance | (515) | (467) |
| Increase in other assets | (478) | (324) |
| Increase in other liabilities | 2,073 | 333 |
| Net cash provided by operating activities | 12,070 | 8,162 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale securities | - | (13,120) |
| Proceeds from sales of available-for-sale securities | - | 11,915 |
| Proceeds from pay downs, maturities and calls of available-for-sale securities | 7,022 | 11,430 |
| Purchase of Federal Home Loan Bank stock, net of redemptions | (71) | (950) |
| Loan originations and purchases, net of paydowns | (43,970) | (126,961) |
| Additions to premises and equipment | (1,079) | (3,410) |
| Purchase of bank owned life insurance | - | (5,500) |
| Additions to assets held-for-sale | (147) | - |
| Net cash used in investing activities | (38,245) | (126,596) |

The accompanying notes are an integral part of the consolidated financial statements.

PROVIDENT BANCORP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Unaudited)

| <i>(In thousands)</i> | Nine Months Ended September 30, | |
|--|------------------------------------|------------------|
| | 2018 | 2017 |
| Cash flows from financing activities: | | |
| Net increase in demand deposits, NOW and savings accounts | 12,189 | 55,621 |
| Net (decrease) increase in time deposits | (10,776) | 41,670 |
| Proceeds from advances from Federal Home Loan Bank | 10,000 | 7,000 |
| Net change in Federal Home Loan Bank short-term advances | (6,939) | 21,507 |
| Purchase of treasury stock | - | (492) |
| Net cash provided by financing activities | 4,474 | 125,306 |
| Net (decrease) increase in cash and cash equivalents | (21,701) | 6,872 |
| Cash and cash equivalents at beginning of period | 47,689 | 10,705 |
| Cash and cash equivalents at end of period | \$ 25,988 | \$ 17,577 |
| Supplemental disclosures: | | |
| Interest paid | \$ 3,716 | \$ 2,653 |
| Income taxes paid | 2,520 | 3,219 |
| Assets held-for-sale transferred to premises and equipment | 3,433 | - |
| Fixed assets transferred to assets held-for-sale | - | 3,213 |

The accompanying notes are an integral part of the consolidated financial statements.

PROVIDENT BANCORP, INC.
Notes to Consolidated Financial Statements

(Unaudited)

(1) Basis of Presentation

The accompanying unaudited financial statements of Provident Bancorp, Inc., a Massachusetts corporation (the “Company”), were prepared in accordance with the instructions for Form 10-Q and with Regulation S-X and do not include information or footnotes necessary for a complete presentation of the financial condition, results of operations, and cash flows in conformity with U.S. generally accepted accounting principles (“GAAP”). However, in the opinion of management, all adjustments (consisting only of normal and recurring adjustments) necessary for a fair presentation of the financial statements have been included. The results of operations for the three- and nine-month periods ended September 30, 2018 are not necessarily indicative of the results that may be expected for future periods, including the entire fiscal year. Certain amounts in 2017 have been reclassified to be consistent with the 2018 consolidated financial statement presentation, and had no effect on the net income reported in the consolidated statement of income. These financial statements should be read in conjunction with the annual financial statements and notes thereto included in the annual report on Form 10-K the Company filed with the Securities and Exchange Commission on March 15, 2018.

The consolidated financial statements include the accounts of Provident Bancorp, Inc., its wholly owned subsidiary, The Provident Bank (the “Bank”), and the Bank’s wholly owned subsidiaries, Provident Security Corporation and 5 Market Street Security Corporation. Provident Security Corporation and 5 Market Street Security Corporation were established to buy, sell, and hold investments for their own account. All significant inter-company balances and transactions have been eliminated in consolidation.

(2) Corporate Structure

On July 15, 2015, the Company issued 4,274,425 shares of common stock to the public at \$10.00 per share, including 357,152 shares purchased by The Provident Bank Employee Stock Ownership Plan. In addition, the Company issued 5,034,323 shares to Provident Bancorp, the Company’s mutual holding company (the “MHC”), and 189,974 shares to The Provident Community Charitable Organization, Inc., a charitable foundation that was formed in connection with the stock offering and is dedicated to supporting charitable organizations operating in the Bank’s local community.

Upon the completion of the stock offering, a special “liquidation account” was established for the benefit of certain depositors of the Bank in an amount equal to the percentage ownership interest in the equity of the Company to be held by persons other than the MHC as of the date of the latest balance sheet contained in the prospectus utilized in connection with the offering. The Company is not permitted to pay dividends on its capital stock if the Company’s shareholders’ equity would be reduced below the amount of the liquidation account. The liquidation account is reduced annually to the extent that eligible account holders have reduced their qualifying deposits. Subsequent increases will not restore an eligible account holder’s interest in the liquidation account.

(3) Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update (ASU) No. 2014-09 – Revenue from Contracts with Customers (Topic 606)*. This ASU supersedes the revenue recognition requirements in ASC 605. This ASU requires an entity to recognize revenue for the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendment includes a five-step process to assist an entity in achieving the main principle(s) of revenue recognition under ASC 605. In March 2016, the FASB also issued ASU 2016-08, an amendment to the guidance in ASU 2014-09, which reframed the structure of the indicators of when an entity is acting as an agent and focused on evidence that an entity is acting as the principal or agent in a revenue transaction. ASU 2016-08 also eliminated two of the indicators (the entity's consideration is in the form of a commission, and the entity is not exposed to credit risk) in making that determination. This amendment also clarifies that each indicator may be more or less relevant to the assessment depending on the terms and conditions of the contract. In May 2016, the FASB issued ASU 2016-12, an amendment to ASU 2014-09, which provided practical expedients related to disclosures of remaining performance obligations, as well as other amendments to guidance on transition, collectability, non-cash consideration and presentation of sales and other similar taxes. The amendments, collectively, should be applied retrospectively to each prior reporting period presented or as a cumulative effect adjustment as of the date of adoption (modified retrospective approach).

This ASU was effective for the Company on January 1, 2018. Because the ASU does not apply to revenue associated with leases and financial instruments (including loans and securities), the Company concluded that the new guidance did not impact the elements of its consolidated statements of income most closely associated with leases and financial instruments (such as interest income, interest expense and securities gains). The Company completed its identification of all revenue streams included in its financial statements and has identified its deposit-related fees, service charges, debit and prepaid card interchange income and other fee income to be within the scope of the standard. The Company has also completed its review of the related contracts. The Company's overall assessment indicates that adoption of this ASU did not materially change its current method and timing of recognizing revenue for the identified revenue streams and therefore, the adoption of this ASU as of January 1, 2018, did not have a significant impact to the Company's financial condition, results of operations and consolidated financial statements.

In January 2016, the FASB issued *ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10): “Recognition and Measurement of Financial Assets and Financial Liabilities.”* The ASU has been issued to improve the recognition and measurement of financial instruments by requiring 1) equity investments (except those accounted for under the equity method of accounting, those without readily determinable fair values, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; 2) separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; 3) the use of the exit price notion when measuring fair value of financial instruments for disclosure purposes; and 4) separate presentation by the reporting organization in other comprehensive income for the portion of the total change in the fair value of a liability resulting from the change in the instrument-specific credit risk (also referred to as “own credit”) when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The standard was effective for the Company on January 1, 2018. The Company evaluated the impact of this pronouncement and divested its entire marketable equity securities portfolio in 2017. The Company's investment in Federal Home Loan Bank Stock is not included in the scope of this pronouncement. Upon adoption, the fair value of the Company's loan portfolio is now presented using an exit price method. Also, the Company is no longer required to disclose the methodologies used for estimating fair value of financial assets and liabilities that are not measured at fair value on a recurring or nonrecurring basis. The remaining requirements of this update did not have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued *ASU 2016-02, Leases (Topic 842)*. The amendments in this update require lessees to recognize, on the balance sheet, assets and liabilities for the rights and obligations created by leases. Accounting by lessors will remain largely unchanged. The guidance will be effective for the Company on January 1, 2019, with early adoption permitted. In July 2018, the FASB issued 2018-11, which allows a modified retrospective transition where the lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented or as a cumulative effect adjustment as of the date of adoption. Management is currently evaluating the impact of its pending adoption of this guidance on the Company's financial statements.

In June 2016, the FASB issued *ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): “Measurement of Credit Losses on Financial Instruments.”* The ASU changes the impairment model for most financial assets and certain other instruments. For trade and other receivables, held-to-maturity debt securities, loans and other instruments, entities will be required to use a new forward-looking “expected loss” model that will replace today's “incurred loss” model and can result in the earlier recognition of credit losses. For available-for-sale debt securities with unrealized losses, entities will measure credit losses in a manner similar to current practice, except that the losses will be recognized as an allowance. The amendments in this update will be effective for the Company on January 1, 2020. Early adoption is permitted as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Management is currently evaluating the impact of its pending adoption of this guidance on the Company's financial statements.

In August 2016, the FASB issued *ASU No. 2016-15, Statement of Cash Flows (Topic 230): “Classification of Certain Cash Receipts and Cash Payments.”* This ASU changes how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, Statement of Cash Flows, and other Topics. The amendments address the classification of the following eight items in the statement of cash flows: debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, distributions received from equity method investees, beneficial interests in securitization transactions and separately identifiable cash flows and application of the Predominance Principle. The amendments in this update were effective for the Company on January 1, 2018. As the guidance only affects the classification within the statement of cash flows, the adoption of this guidance did not have a material impact on the Company's financial statements.

In March 2017, the FASB issued *ASU No. 2017-08, Receivables – Nonrefundable Fees and Other Costs (subtopic 310-20): “Premium Amortization on Purchased Callable Debt Securities.”* This ASU shortens the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments will be effective for the Company on January 1, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The Company does not expect the application of this guidance will have a material impact on the Company's financial statements.

In August 2018, the FASB issued *ASU No. 2018-13, Fair Value Measurement (Topic 820): “Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.”* This ASU eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. This ASU will be effective for the Company on January 1, 2020. As the guidance only revises disclosure requirements, the adoption of this guidance did not have a material impact on the Company's financial statements.

(4) Investment Securities

The following summarizes the amortized cost of investment securities classified as available-for-sale and their approximate fair values at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | Amortized Cost Basis | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------------|----------------------------|------------------------------|-------------------------------|------------------|
| September 30, 2018 | | | | |
| State and municipal securities | \$ 20,145 | \$ 207 | \$ 313 | \$ 20,039 |
| Asset-backed securities | 6,754 | - | 209 | 6,545 |
| Government mortgage-backed securities | 26,535 | 136 | 779 | 25,892 |
| Total available-for-sale securities | <u>\$ 53,434</u> | <u>\$ 343</u> | <u>\$ 1,301</u> | <u>\$ 52,476</u> |
| December 31, 2017 | | | | |
| State and municipal securities | \$ 20,726 | \$ 745 | \$ 17 | \$ 21,454 |
| Asset-backed securities | 7,524 | 30 | 37 | 7,517 |
| Government mortgage-backed securities | 32,421 | 317 | 280 | 32,458 |
| Total available-for-sale securities | <u>\$ 60,671</u> | <u>\$ 1,092</u> | <u>\$ 334</u> | <u>\$ 61,429</u> |

The scheduled maturities of debt securities were as follows at September 30, 2018:

| <i>(In thousands)</i> | Available-for-Sale | |
|--|--------------------|------------------|
| | Amortized Cost | Fair Value |
| Due in one year or less | \$ 95 | \$ 95 |
| Due after one year through five years | 604 | 610 |
| Due after five years through ten years | 2,118 | 2,144 |
| Due after ten years | 17,328 | 17,190 |
| Government mortgage-backed securities | 26,535 | 25,892 |
| Asset-backed securities | 6,754 | 6,545 |
| | <u>\$ 53,434</u> | <u>\$ 52,476</u> |

The aggregate fair value and unrealized losses of securities that have been in a continuous unrealized loss position for less than twelve months and for twelve months or longer are as follows at September 30, 2018 and December 31, 2017:

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---------------------------------------|---------------------|-------------------|---------------------|-------------------|------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| <i>(In thousands)</i> | | | | | | |
| September 30, 2018 | | | | | | |
| Temporarily impaired securities: | | | | | | |
| State and municipal securities | \$ 11,352 | \$ 277 | \$ 584 | \$ 36 | \$ 11,936 | \$ 313 |
| Asset-backed securities | 4,051 | 121 | 2,494 | 88 | 6,545 | 209 |
| Government mortgage-backed securities | 7,750 | 208 | 12,042 | 571 | 19,792 | 779 |
| Total temporarily impaired securities | <u>\$ 23,153</u> | <u>\$ 606</u> | <u>\$ 15,120</u> | <u>\$ 695</u> | <u>\$ 38,273</u> | <u>\$ 1,301</u> |

| | | | | | | |
|---------------------------------------|-----------------|--------------|------------------|---------------|------------------|---------------|
| December 31, 2017 | | | | | | |
| Temporarily impaired securities: | | | | | | |
| State and municipal securities | \$ - | \$ - | \$ 611 | \$ 17 | \$ 611 | \$ 17 |
| Asset-backed securities | 1,745 | 13 | 1,335 | 24 | 3,080 | 37 |
| Government mortgage-backed securities | 5,231 | 20 | 13,584 | 260 | 18,815 | 280 |
| Total temporarily impaired securities | <u>\$ 6,976</u> | <u>\$ 33</u> | <u>\$ 15,530</u> | <u>\$ 301</u> | <u>\$ 22,506</u> | <u>\$ 334</u> |

Government mortgage-backed securities, state and municipal securities and asset-backed securities: Management believes that no individual unrealized loss at September 30, 2018 represents an other-than-temporary impairment (OTTI) because the decline in fair value of these securities is primarily attributable to changes in market interest rates and not credit quality, and because the Company has the intent and ability to hold these investments until market price recovery or maturity.

(5) Loans

A summary of loans is as follows:

| | At September 30, 2018 | | At December 31, 2017 | |
|-----------------------------------|-----------------------------|----------------|----------------------------|----------------|
| | Amount | Percent | Amount | Percent |
| Commercial real estate | \$ 361,765 | 45.48% | \$ 371,510 | 49.35% |
| Commercial | 300,584 | 37.79% | 240,223 | 31.91% |
| Residential real estate | 60,034 | 7.55% | 67,724 | 9.00% |
| Construction and land development | 52,870 | 6.64% | 55,828 | 7.42% |
| Consumer | 20,119 | 2.53% | 17,455 | 2.32% |
| | <u>795,372</u> | <u>100.00%</u> | <u>752,740</u> | <u>100.00%</u> |
| Allowance for loan losses | (11,134) | | (9,757) | |
| Deferred loan fees, net | (946) | | (845) | |
| Net loans | <u>\$ 783,292</u> | | <u>\$ 742,138</u> | |

The following tables set forth information regarding the activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2018 and 2017:

| | For the three months ended September 30, | | | | | | |
|--------------------------------------|--|-----------------|----------------------------|---|---------------|--------------|------------------|
| | Commercial Real Estate | Commercial | Residential Real Estate | Construction and Land Development | Consumer | Unallocated | Total |
| <i>(In thousands)</i> | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at June 30, 2018 | \$ 4,106 | \$ 4,512 | \$ 282 | \$ 968 | \$ 735 | \$ 27 | \$ 10,630 |
| Charge-offs | (790) | (50) | - | - | (128) | - | (968) |
| Recoveries | - | 26 | 2 | - | 23 | - | 51 |
| Provision (credit) | 969 | 272 | (22) | 25 | 200 | (23) | 1,421 |
| Balance at September 30, 2018 | <u>\$ 4,285</u> | <u>\$ 4,760</u> | <u>\$ 262</u> | <u>\$ 993</u> | <u>\$ 830</u> | <u>\$ 4</u> | <u>\$ 11,134</u> |
| Balance at June 30, 2017 | \$ 4,640 | \$ 3,281 | \$ 318 | \$ 1,141 | \$ 472 | \$ 100 | \$ 9,952 |
| Charge-offs | - | (2) | - | - | (80) | - | (82) |
| Recoveries | - | 45 | - | - | 5 | - | 50 |
| Provision (credit) | 1,029 | 60 | (22) | (177) | 172 | (50) | 1,012 |
| Balance at September 30, 2017 | <u>\$ 5,669</u> | <u>\$ 3,384</u> | <u>\$ 296</u> | <u>\$ 964</u> | <u>\$ 569</u> | <u>\$ 50</u> | <u>\$ 10,932</u> |

| | For the nine months ended September 30, | | | | | | |
|--------------------------------------|---|-----------------|----------------------------|---|---------------|--------------|------------------|
| | Commercial Real Estate | Commercial | Residential Real Estate | Construction and Land Development | Consumer | Unallocated | Total |
| <i>(In thousands)</i> | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at December 31, 2017 | \$ 4,483 | \$ 3,280 | \$ 300 | \$ 965 | \$ 649 | \$ 80 | \$ 9,757 |
| Charge-offs | (790) | (101) | - | - | (526) | - | (1,417) |
| Recoveries | - | 27 | 2 | - | 50 | - | 79 |
| Provision (credit) | 592 | 1,554 | (40) | 28 | 657 | (76) | 2,715 |
| Balance at September 30, 2018 | <u>\$ 4,285</u> | <u>\$ 4,760</u> | <u>\$ 262</u> | <u>\$ 993</u> | <u>\$ 830</u> | <u>\$ 4</u> | <u>\$ 11,134</u> |
| Balance at December 31, 2016 | \$ 4,503 | \$ 2,513 | \$ 328 | \$ 882 | \$ 279 | \$ 85 | \$ 8,590 |
| Charge-offs | (6) | (63) | - | - | (106) | - | (175) |
| Recoveries | - | 45 | - | - | 5 | - | 50 |
| Provision (credit) | 1,172 | 889 | (32) | 82 | 391 | (35) | 2,467 |
| Balance at September 30, 2017 | <u>\$ 5,669</u> | <u>\$ 3,384</u> | <u>\$ 296</u> | <u>\$ 964</u> | <u>\$ 569</u> | <u>\$ 50</u> | <u>\$ 10,932</u> |

The following table sets forth information regarding the allowance for loan losses and related loan balances by segment at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | Commercial Real Estate | Commercial | Residential Real Estate | Construction and Land Development | Consumer | Unallocated | Total |
|---|---------------------------|-------------------|----------------------------|---|------------------|--------------|-------------------|
| September 30, 2018 | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Ending balance: | | | | | | | |
| Individually evaluated | | | | | | | |
| for impairment | \$ - | \$ 765 | \$ - | \$ - | \$ - | \$ - | \$ 765 |
| Ending balance: | | | | | | | |
| Collectively evaluated | | | | | | | |
| for impairment | 4,285 | 3,995 | 262 | 993 | 830 | 4 | 10,369 |
| Total allowance for loan losses ending balance | \$ 4,285 | \$ 4,760 | \$ 262 | \$ 993 | \$ 830 | \$ 4 | \$ 11,134 |
| Loans: | | | | | | | |
| Ending balance: | | | | | | | |
| Individually evaluated | | | | | | | |
| for impairment | \$ 4,342 | \$ 4,070 | \$ 392 | \$ - | \$ - | | \$ 8,804 |
| Ending balance: | | | | | | | |
| Collectively evaluated | | | | | | | |
| for impairment | 357,423 | 296,514 | 59,642 | 52,870 | 20,119 | | 786,568 |
| Total loans ending balance | \$ 361,765 | \$ 300,584 | \$ 60,034 | \$ 52,870 | \$ 20,119 | | \$ 795,372 |
| December 31, 2017 | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Ending balance: | | | | | | | |
| Individually evaluated | | | | | | | |
| for impairment | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Ending balance: | | | | | | | |
| Collectively evaluated | | | | | | | |
| for impairment | 4,483 | 3,280 | 300 | 965 | 649 | 80 | 9,757 |
| Total allowance for loan losses ending balance | \$ 4,483 | \$ 3,280 | \$ 300 | \$ 965 | \$ 649 | \$ 80 | \$ 9,757 |
| Loans: | | | | | | | |
| Ending balance: | | | | | | | |
| Individually evaluated | | | | | | | |
| for impairment | \$ 8,623 | \$ 3,202 | \$ 404 | \$ - | \$ - | | \$ 12,229 |
| Ending balance: | | | | | | | |
| Collectively evaluated | | | | | | | |
| for impairment | 362,887 | 237,021 | 67,320 | 55,828 | 17,455 | | 740,511 |
| Total loans ending balance | \$ 371,510 | \$ 240,223 | \$ 67,724 | \$ 55,828 | \$ 17,455 | | \$ 752,740 |

The following tables set forth information regarding non-accrual loans and loan delinquencies by portfolio segment at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | <u>30 - 59 Days</u> | <u>60 - 89 Days</u> | <u>90 Days or More Past Due</u> | <u>Total Past Due</u> | <u>Total Current</u> | <u>Total Loans</u> | <u>90 Days or More Past Due and Accruing</u> | <u>Non-accrual Loans</u> |
|--------------------------------------|-------------------------|-------------------------|---|-------------------------------|--------------------------|------------------------|--|------------------------------|
| September 30, 2018 | | | | | | | | |
| Commercial real estate | \$ - | \$ 519 | \$ 2,879 | \$ 3,398 | \$ 358,367 | \$ 361,765 | \$ - | \$ 2,879 |
| Commercial | 248 | 2,731 | 248 | 3,227 | 297,357 | 300,584 | - | 3,552 |
| Residential real estate | 565 | 131 | - | 696 | 59,338 | 60,034 | - | 855 |
| Construction and land development | - | - | - | - | 52,870 | 52,870 | - | - |
| Consumer | 62 | 71 | 65 | 198 | 19,921 | 20,119 | - | 68 |
| Total | <u>\$ 875</u> | <u>\$ 3,452</u> | <u>\$ 3,192</u> | <u>\$ 7,519</u> | <u>\$ 787,853</u> | <u>\$ 795,372</u> | <u>\$ -</u> | <u>\$ 7,354</u> |
| December 31, 2017 | | | | | | | | |
| Commercial real estate | \$ - | \$ 3,669 | \$ - | \$ 3,669 | \$ 367,841 | \$ 371,510 | \$ - | \$ 7,102 |
| Commercial | 12 | - | - | 12 | 240,211 | 240,223 | - | 1,505 |
| Residential real estate | 699 | 178 | 81 | 958 | 66,766 | 67,724 | - | 364 |
| Construction and land development | - | - | - | - | 55,828 | 55,828 | - | - |
| Consumer | 63 | 45 | 60 | 168 | 17,287 | 17,455 | - | 62 |
| Total | <u>\$ 774</u> | <u>\$ 3,892</u> | <u>\$ 141</u> | <u>\$ 4,807</u> | <u>\$ 747,933</u> | <u>\$ 752,740</u> | <u>\$ -</u> | <u>\$ 9,033</u> |

Information about the Company's impaired loans by portfolio segment was as follows at and for the nine months ended September 30, 2018 and at and for the year ended December 31, 2017:

| <i>(In thousands)</i> | <u>Recorded Investment</u> | <u>Unpaid Principal Balance</u> | <u>Related Allowance</u> | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> |
|---|--------------------------------|---|------------------------------|--|---|
| September 30, 2018 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | \$ 4,342 | \$ 6,645 | \$ - | \$ 6,684 | \$ 51 |
| Commercial | 2,474 | 2,474 | - | 3,328 | 30 |
| Residential real estate | 392 | 392 | - | 398 | 15 |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total impaired with no related allowance | <u>7,208</u> | <u>9,511</u> | <u>-</u> | <u>10,410</u> | <u>96</u> |
| With an allowance recorded: | | | | | |
| Commercial real estate | - | - | - | - | - |
| Commercial | 1,596 | 1,596 | 765 | 1,599 | 52 |
| Residential real estate | - | - | - | - | - |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total impaired with an allowance recorded | <u>1,596</u> | <u>1,596</u> | <u>765</u> | <u>1,599</u> | <u>52</u> |
| Total | | | | | |
| Commercial real estate | 4,342 | 6,645 | - | 6,684 | 51 |
| Commercial | 4,070 | 4,070 | 765 | 4,927 | 82 |
| Residential real estate | 392 | 392 | - | 398 | 15 |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total impaired loans | <u>\$ 8,804</u> | <u>\$ 11,107</u> | <u>\$ 765</u> | <u>\$ 12,009</u> | <u>\$ 148</u> |
| December 31, 2017 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial real estate | \$ 8,623 | \$ 10,139 | \$ - | \$ 4,562 | \$ 70 |
| Commercial | 3,202 | 3,202 | - | 2,054 | 123 |
| Residential real estate | 404 | 404 | - | 412 | 20 |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total impaired with no related allowance | <u>12,229</u> | <u>13,745</u> | <u>-</u> | <u>7,028</u> | <u>213</u> |
| With an allowance recorded: | | | | | |
| Commercial real estate | - | - | - | - | - |
| Commercial | - | - | - | - | - |
| Residential real estate | - | - | - | - | - |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total impaired with an allowance recorded | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Total | | | | | |
| Commercial real estate | 8,623 | 10,139 | - | 4,562 | 70 |
| Commercial | 3,202 | 3,202 | - | 2,054 | 123 |
| Residential real estate | 404 | 404 | - | 412 | 20 |
| Construction and land development | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total impaired loans | <u>\$ 12,229</u> | <u>\$ 13,745</u> | <u>\$ -</u> | <u>\$ 7,028</u> | <u>\$ 213</u> |

There were no troubled debt restructurings during the nine months ended September 30, 2018.

The following summarizes troubled debt restructurings entered into during the nine months ended September 30, 2017:

(Dollars in thousands)

| | Number of Contracts | Pre- Modification Outstanding Recorded Investment | Post- Modification Outstanding Recorded Investment |
|-------------------------------|------------------------|---|--|
| September 30, 2017 | | | |
| Troubled debt restructurings: | | | |
| Commercial | 1 | \$ 249 | \$ 249 |
| | 1 | \$ 249 | \$ 249 |

In the nine months ended September 30, 2017, the Company approved one troubled debt restructure totaling \$249,000, with no specific reserve required based on an analysis of the borrower's collateral coverage. The term of this commercial loan was extended to a three-year term.

The following tables present the Company's loans by risk rating and portfolio segment at September 30, 2018 and December 31, 2017:

(In thousands)

| | Commercial Real Estate | Commercial | Residential Real Estate | Construction and Land Development | Consumer | Total |
|---------------------------|---------------------------|-------------------|----------------------------|---|------------------|-------------------|
| September 30, 2018 | | | | | | |
| Grade: | | | | | | |
| Pass | \$ 350,705 | \$ 279,072 | \$ - | \$ 52,870 | \$ - | \$ 682,647 |
| Special mention | 6,248 | 11,748 | - | - | - | 17,996 |
| Substandard | 4,812 | 8,168 | 579 | - | - | 13,559 |
| Doubtful | - | 1,596 | - | - | - | 1,596 |
| Not formally rated | - | - | 59,455 | - | 20,119 | 79,574 |
| Total | <u>\$ 361,765</u> | <u>\$ 300,584</u> | <u>\$ 60,034</u> | <u>\$ 52,870</u> | <u>\$ 20,119</u> | <u>\$ 795,372</u> |
| December 31, 2017 | | | | | | |
| Grade: | | | | | | |
| Pass | \$ 355,623 | \$ 224,190 | \$ - | \$ 55,828 | \$ - | \$ 635,641 |
| Special mention | 6,852 | 9,155 | - | - | - | 16,007 |
| Substandard | 9,035 | 6,878 | 679 | - | - | 16,592 |
| Not formally rated | - | - | 67,045 | - | 17,455 | 84,500 |
| Total | <u>\$ 371,510</u> | <u>\$ 240,223</u> | <u>\$ 67,724</u> | <u>\$ 55,828</u> | <u>\$ 17,455</u> | <u>\$ 752,740</u> |

Credit Quality Information

The Company utilizes a seven grade internal loan risk rating system for commercial real estate, construction and land development, and commercial loans as follows:

Loans rated 1-3: Loans in these categories are considered “pass” rated loans with low to average risk.

Loans rated 4: Loans in this category are considered “special mention.” These loans are starting to show signs of potential weakness and are being closely monitored by management.

Loans rated 5: Loans in this category are considered “substandard.” Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.

Loans rated 6: Loans in this category are considered “doubtful.” Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.

Loans rated 7: Loans in this category are considered uncollectible “loss” and of such little value that their continuance as loans is not warranted.

On an annual basis, or more often if needed, the Company formally reviews the ratings on all commercial real estate, construction and land development, and commercial loans.

For residential real estate and consumer loans, the Company initially assesses credit quality based upon the borrower’s ability to pay and rates such loans as pass. Subsequent risk rating downgrades are based upon the borrower’s payment activity.

(6) Deposits

A summary of deposit balances, by type is as follows:

| <i>(In thousands)</i> | September 30, 2018 | December 31, 2017 |
|---|--------------------------|----------------------|
| NOW and demand | \$ 318,962 | \$ 309,514 |
| Regular savings | 116,692 | 112,610 |
| Money market deposits | <u>224,394</u> | <u>225,735</u> |
| Total non-certificate accounts | <u>660,048</u> | <u>647,859</u> |
| Certificate accounts of \$250,000 or more | 14,096 | 5,061 |
| Certificate accounts less than \$250,000 | <u>77,326</u> | <u>97,137</u> |
| Total certificate accounts | <u>91,422</u> | <u>102,198</u> |
| Total deposits | <u>\$ 751,470</u> | <u>\$ 750,057</u> |

(7) Federal Home Loan Bank Advances

Borrowings from the Federal Home Loan Bank (the “FHLB”) are secured by a blanket lien on qualified collateral, consisting primarily of loans with first mortgages secured by one to four family properties, certain commercial real estate loans and other qualified assets.

Maturities of advances from the FHLB as of September 30, 2018 are summarized as follows:

(In thousands)

| Fiscal Year-End | Dollar Amount |
|------------------------|----------------------|
| 2019 | 4,962 |
| 2020 | 11,440 |
| 2021 | 5,000 |
| 2023 | 8,500 |
| Total | <u>\$ 29,902</u> |

(8) Fair Value Measurements

The Company reports certain assets at fair value in accordance with GAAP, which defines fair value and establishes a framework for measuring fair value in accordance with generally accepted accounting principles. Fair value is defined as 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. The guidance establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair values:

Basis of Fair Value Measurements

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

An asset’s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Fair Values of Assets Measured on a Recurring Basis

The Company’s investments in state and municipal, asset-backed and government mortgage-backed available-for-sale securities are generally classified within Level 2 of the fair value hierarchy. For these investments, the Company obtains fair value measurements from independent pricing services. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trading levels, market consensus prepayment speeds, credit information and the instrument’s terms and conditions.

The following summarizes financial instruments measured at fair value on a recurring basis at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | Fair Value Measurements at Reporting Date Using | | | |
|--------------------------------|---|---|--|--|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| September 30, 2018 | | | | |
| State and municipal securities | \$ 20,039 | \$ - | \$ 20,039 | \$ - |
| Asset-backed securities | 6,545 | - | 6,545 | - |
| Mortgage-backed securities | 25,892 | - | 25,892 | - |
| Totals | \$ 52,476 | \$ - | \$ 52,476 | \$ - |
| December 31, 2017 | | | | |
| State and municipal securities | \$ 21,454 | \$ - | \$ 21,454 | \$ - |
| Asset-backed securities | 7,517 | - | 7,517 | - |
| Mortgage-backed securities | 32,458 | - | 32,458 | - |
| Totals | \$ 61,429 | \$ - | \$ 61,429 | \$ - |

Fair Values of Assets Measured on a Non-Recurring Basis

The Company's impaired loans are reported at the fair value of the underlying collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based upon appraisals of similar properties obtained from a third party. However, the Company generally discounts appraisals to arrive at fair value, and therefore classifies such loans as Level 3 because the discounts are a significant input that is not observable.

The following summarizes assets measured at fair value on a nonrecurring basis at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | Fair Value Measurements at Reporting Date Using: | | | |
|---------------------------|--|---|--|--|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| September 30, 2018 | | | | |
| Impaired loans | \$ 3,710 | \$ - | \$ - | \$ 3,710 |
| December 31, 2017 | | | | |
| Impaired loan | \$ 3,670 | \$ - | \$ - | \$ 3,670 |

The following is a summary of the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a nonrecurring basis at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | Fair Value | Valuation Technique | Unobservable Input |
|---------------------------|------------|--|--|
| September 30, 2018 | | | |
| Impaired loans | \$ 3,710 | Real estate appraisals and business evaluation | Discount for dated appraisals and comparable company evaluations |
| December 31, 2017 | | | |
| Impaired loan | \$ 3,670 | Real estate appraisals | Discount for dated appraisals |

(9) Fair Value of Financial Instruments

GAAP requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. Certain financial instruments and all nonfinancial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and estimated fair values of the Company's financial instruments, all of which are held or issued for purposes other than trading, are as follows at September 30, 2018 and December 31, 2017:

| <i>(In thousands)</i> | Carrying Amount | Fair Value | | | Total |
|--|-----------------|------------|---------|---------|-----------|
| | | Level 1 | Level 2 | Level 3 | |
| September 30, 2018 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 25,988 | \$ 25,988 | \$ - | \$ - | \$ 25,988 |
| Available-for-sale securities | 52,476 | - | 52,476 | - | 52,476 |
| Federal Home Loan Bank of Boston stock | 1,925 | 1,925 | - | - | 1,925 |
| Loans, net | 783,292 | - | - | 774,229 | 774,229 |
| Accrued interest receivable | 2,584 | - | 2,584 | - | 2,584 |
| Financial liabilities: | | | | | |
| Deposits | 751,470 | - | - | 751,427 | 751,427 |
| Federal Home Loan Bank advances | 29,902 | - | 29,499 | - | 29,499 |
| December 31, 2017 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 47,689 | \$ 47,689 | \$ - | \$ - | \$ 47,689 |
| Available-for-sale securities | 61,429 | - | 61,429 | - | 61,429 |
| Federal Home Loan Bank of Boston stock | 1,854 | 1,854 | - | - | 1,854 |
| Loans, net | 742,138 | - | - | 745,637 | 745,637 |
| Accrued interest receivable | 2,345 | - | 2,345 | - | 2,345 |
| Financial liabilities: | | | | | |
| Deposits | 750,057 | - | - | 749,898 | 749,898 |
| Federal Home Loan Bank advances | 26,841 | - | 26,655 | - | 26,655 |

(10) Regulatory Capital

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Effective January 1, 2015 (with a phase-in period of two to four years for certain components), the Bank became subject to capital regulations adopted by the FDIC, which implement the Basel III regulatory capital reforms and the changes required by the Dodd-Frank Act. The new regulations require a new Common Equity Tier 1 ("CET1") capital ratio of 4.5%, a minimum Tier 1 capital to risk-weighted assets ratio of 6.0%, a minimum total capital to risk-weighted assets ratio of 8.0% and a minimum Tier 1 leverage ratio of 4.0%. CET1 generally consists of common stock and retained earnings, subject to applicable adjustments and deductions. Under new prompt corrective action regulations, in order to be considered "well capitalized," the Bank must maintain a CET1 capital ratio of 6.5% and a Tier 1 ratio of 8.0%, a total risk based capital ratio of 10% and a Tier 1 leverage ratio of 5.0%. In addition, the regulations establish a capital conservation buffer above the required capital ratios that started phasing in on January 1, 2016 at 0.625% of risk-weighted assets and increases each year by 0.625% until it is fully phased in at 2.5% effective January 1, 2019. At September 30, 2018, the Bank exceeded the fully phased in regulatory requirement for the capital conservation buffer. Failure to maintain the capital conservation buffer limits the ability of the Bank and the Company to pay dividends, repurchases shares or pay discretionary bonuses.

As of September 30, 2018 and December 31, 2017, the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

The Bank's actual capital amounts and ratios are presented in the following table.

| <i>(dollars in thousands)</i> | Actual | | For Capital Adequacy Purposes | | | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|------------|-------|-------------------------------|---|-------|-----------|--|-------|
| | Amount | Ratio | Amount | | Ratio | Amount | Ratio | |
| September 30, 2018 | | | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$ 125,071 | 15.0% | \$ 66,636 | ≥ | 8.0% | \$ 83,294 | ≥ | 10.0% |
| Tier 1 Capital (to Risk Weighted Assets) | 114,651 | 13.8 | 49,977 | ≥ | 6.0 | 66,636 | ≥ | 8.0 |
| Common Equity Tier 1 Capital (to Risk Weighted Assets) | 114,651 | 13.8 | 37,482 | ≥ | 4.5 | 54,141 | ≥ | 6.5 |
| Tier 1 Capital (to Average Assets) | 114,651 | 12.4 | 36,916 | ≥ | 4.0 | 46,146 | ≥ | 5.0 |
| December 31, 2017 | | | | | | | | |
| Total Capital (to Risk Weighted Assets) | \$ 116,869 | 15.0% | \$ 62,514 | ≥ | 8.0% | \$ 78,142 | ≥ | 10.0% |
| Tier 1 Capital (to Risk Weighted Assets) | 107,112 | 13.7 | 46,885 | ≥ | 6.0 | 62,514 | ≥ | 8.0 |
| Common Equity Tier 1 Capital (to Risk Weighted Assets) | 107,112 | 13.7 | 35,164 | ≥ | 4.5 | 50,792 | ≥ | 6.5 |
| Tier 1 Capital (to Average Assets) | 107,112 | 11.8 | 36,299 | ≥ | 4.0 | 45,374 | ≥ | 5.0 |

As a result of the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act, the federal banking agencies are required to develop a "Community Bank Leverage Ratio" (the ratio of a bank's tangible equity capital to average total consolidated assets) for financial institutions with assets of less than \$10 billion. A "qualifying community bank" that exceeds this ratio will be deemed to be in compliance with all other capital and leverage requirements, including the capital requirements to be considered "well capitalized" under Prompt Corrective Action statutes. The federal banking agencies may consider a financial institution's risk profile when evaluating whether it qualifies as a community bank for purposes of the capital ratio requirement. The federal banking agencies must set the minimum capital for the new Community Bank Leverage Ratio at not less than 8% and not more than 10%. A financial institution can elect to be subject to this new definition.

The Company may use capital management tools such as cash dividends and common share repurchases. In January 2017, the Company received a non-objection from the Federal Reserve Board to adopt a stock repurchase program for up to 6.6% of its common stock. As of September 30, 2018, the Company had repurchased 28,823 shares of its stock at an average price of \$20.59 per share, or 4.6% of the 625,015 shares authorized for repurchase under the Company's repurchase program.

(11) Employee Stock Ownership Plan

The Bank maintains an Employee Stock Ownership Plan ("ESOP") to provide eligible employees the opportunity to own Company stock. This plan is a tax-qualified retirement plan for the benefit of Bank employees. Contributions are allocated to eligible participants on the basis of compensation, subject to federal tax limits. The number of shares committed to be released per year through 2029 is 23,810.

The Company loaned funds to the ESOP to purchase 357,152 shares of the Company's common stock at a price of \$10.00 per share. The loan is payable annually over 15 years at a rate per annum equal to the Prime Rate as of December 31 (4.50% at December 31, 2017). Loan payments are principally funded by cash contributions from the Bank.

| | September 30, 2018 | December 31, 2017 |
|---------------------------|-----------------------|-------------------|
| Allocated | 83,334 | 47,620 |
| Committed to be allocated | 5,952 | 23,810 |
| Unallocated | 267,866 | 285,722 |
| Total | <u>357,152</u> | <u>357,152</u> |

The fair value of unallocated shares was approximately \$7.8 million at September 30, 2018.

Total compensation expense recognized in connection with the ESOP for the three months ended September 30, 2018 and 2017 was \$166,000 and \$127,000, respectively. Total compensation expense recognized for the nine months ended September 30, 2018 and 2017 was \$463,000 and \$368,000, respectively.

(12) Earnings Per Common Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed in a manner similar to that of basic earnings per share except that the weighted-average number of common shares outstanding is increased to include the number of incremental common shares (computed using the treasury method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. Unallocated ESOP shares, treasury stock and unvested restricted stock is not deemed outstanding for earnings per share calculations.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| <i>(Dollars in thousands, except per share amounts)</i> | | | | |
| Net Income attributable to common shareholders | \$ 2,078 | \$ 2,771 | \$ 6,490 | \$ 6,174 |
| Average number of common shares issued | 9,660,543 | 9,652,448 | 9,658,405 | 9,652,448 |
| Less: | | | | |
| average unallocated ESOP shares | (274,452) | (296,398) | (280,274) | (301,342) |
| average unvested restricted stock | (110,230) | (133,258) | (115,659) | (140,869) |
| average treasury stock acquired | (28,494) | (21,158) | (28,712) | (14,191) |
| Average number of common shares outstanding to calculate basic earnings per common share | 9,247,367 | 9,201,634 | 9,233,760 | 9,196,046 |
| Effect of dilutive unvested restricted stock and stock option awards | 108,043 | 11,422 | 75,952 | - |
| Average number of common shares outstanding to calculate diluted earnings per common share | 9,355,410 | 9,213,056 | 9,309,712 | 9,196,046 |
| Earnings per common share: | | | | |
| Basic | \$ 0.22 | \$ 0.30 | \$ 0.70 | \$ 0.67 |
| Diluted | \$ 0.22 | \$ 0.30 | \$ 0.70 | \$ 0.67 |

(13) Share-Based Compensation

Under the Provident Bancorp, Inc. 2016 Equity Incentive Plan (the "Equity Plan"), the Company may grant options, restricted stock, restricted units or performance awards to its directors, officers and employees. Both incentive stock options and non-qualified stock options may be granted under the Equity Plan, with the total shares reserved for options equaling 446,440. The exercise price of each option equals the market price of the Company's stock on the date of grant and the term of each option is generally ten years. The total number of shares reserved for restricted stock or restricted units is 178,575. Options and other awards vest ratably over five years.

Expense related to options and restricted stock granted to directors is recognized in directors' compensation within non-interest expense.

Stock Options

The fair value of each option is estimated on the date of the grant using the Black-Scholes option-pricing model with the following assumptions:

- Volatility is based on peer group volatility because the Company does not have a sufficient trading history.
- Expected life represents the period of time that the option is expected to be outstanding, taking into account the contractual term, and the vesting period.
- The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for a period equivalent to the expected life of the option.

A summary of the status of the Company's stock option grants for the nine months ended September 30, 2018, is presented in the table below:

| | Stock Option Awards | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|--|---------------------|---------------------------------|---|---------------------------|
| Outstanding at December 31, 2017 | 396,443 | \$ 17.61 | | |
| Granted | 12,170 | 27.20 | | |
| Forfeited | (9,740) | 17.40 | | |
| Exercised | (2,435) | 17.40 | | |
| Outstanding at September 30, 2018 | 396,438 | \$ 17.89 | 8.24 | \$ 4,496,000 |
| Outstanding and expected to vest at September 30, 2018 | 396,438 | \$ 17.89 | 8.24 | \$ 4,496,000 |
| Vested and Exercisable at September 30, 2018 | 74,419 | \$ 17.40 | 8.13 | \$ 681,000 |
| Unrecognized compensation cost | \$ 1,343,000 | | | |
| Weighted average remaining recognition period (years) | 3.13 | | | |

For the three months ended September 30, 2018 and 2017, total expense for the stock options was \$94,000 and \$97,000, respectively. For the nine months ended September 30, 2018 and 2017, total expense for the stock options was \$295,000 and \$290,000, respectively.

Restricted Stock

Shares issued upon the granting of restricted stock may be either authorized but unissued shares or reacquired shares held by the Company. Any shares forfeited because vesting requirements are not met will again be available for issuance under the Equity Plan. The fair market value of shares awarded, based on the market prices at the date of grant, is recorded as unearned compensation and amortized over the applicable vesting period.

The following table presents the activity in restricted stock awards under the Equity Plan for the nine months ended September 30, 2018:

| | Unvested Restricted Stock Awards | Weighted Average Grant Date Price |
|--|----------------------------------|-----------------------------------|
| Unvested restricted stock awards at December 31, 2017 | 127,852 | \$ 17.59 |
| Granted | 4,862 | 27.20 |
| Forfeited | (3,896) | 17.40 |
| Unvested restricted stock awards at September 30, 2018 | 128,818 | \$ 17.89 |
| Unrecognized compensation cost | \$ 1,851,000 | |
| Weighted average remaining recognition period (years) | 3.13 | |

For the three months ended September 30, 2018 and 2017, total expense for the restricted stock awards was \$121,000 and \$134,000, respectively. For the nine months ended September 30, 2018 and 2017, total expense for the restricted stock awards was \$400,000 and \$401,000, respectively.

(14) Commitments and Contingencies

U.S. Small Bus. Admin. v. The Provident Bank, No. 1:18-cv-00746 (D.N.H.) (filed Aug. 23, 2018)

As previously disclosed, on April 3, 2018, the Bank conducted a foreclosure sale of certain real and personal property which secured four non-accruing loans originally made by the Bank. The aggregate outstanding principal balance of these loans was approximately \$7.5 million, of which (a) approximately \$4.9 million was due and owing to the Bank and (b) approximately \$2.6 million was due and owing to another financial institution who purchased participation interests in certain of these loans (the “Participant”). The Bank received \$8.3 in proceeds from this foreclosure sale. The U.S. Small Business Administration (SBA) which also made a secured loan to the same obligors has since disputed the Bank’s retention of and claimed priority to a portion of the proceeds generated from this foreclosure sale, alleging a breach of contract and seeking monetary damages in the approximate amount of \$2.0 million. The Bank has partially denied liability, and in addition to its defenses, has asserted a counterclaim against the SBA and its assignee, Granite State Economic Development Corporation, seeking equitable reformation of the contract at issue on the basis of a mutual mistake of fact. This case is in the preliminary pretrial stage. Pending the outcome of this lawsuit, and as previously disclosed, the Bank has segregated into a separate deposit account the entire amount in dispute, consisting of \$1.4 million that would be retained by the Bank, and \$543,000 that would be provided to the participating institution. Management does not believe that the ultimate resolution of this matter will have a significant impact on the Bank’s financial condition or the results of operations.

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

Management’s discussion and analysis of financial condition and results of operations at September 30, 2018 and December 31, 2017 and for the three and nine months ended September 30, 2018 and 2017 is intended to assist in understanding our financial condition and results of operations. Operating results for the three and nine month period ended September 30, 2018 may not be indicative of results for all of 2018 or any other period. The information contained in this section should be read in conjunction with the Unaudited Consolidated Financial Statements and the notes thereto, appearing in Part 1, Item 1 of this report.

Forward-Looking Statements

This document may contain certain forward-looking statements, such as statements of the Company’s or the Bank’s plans, objectives, expectations, estimates and intentions. Forward-looking statements may be identified by the use of words such as “expects,” “subject,” “believes,” “will,” “intends,” “may,” “will be,” “would” or similar expressions. Readers should not place undue reliance on any forward-looking statements, which reflect management’s analysis of factors only as of the date of which they are given. These statements are subject to change based on various important factors (some of which are beyond the Company’s or the Bank’s control) and actual results may differ materially. These factors include general economic conditions, including trends and levels of interest rates; the ability of our borrowers to repay their loans; the ability of the Company or the Bank to effectively manage its growth; real estate values in the market area; loan demand; competition; changes in accounting policies; changes in laws and regulations; our success in introducing new products or entering new markets; our ability to retain key employees; failures or breaches of our IT systems; and results of regulatory examinations, among other factors. The foregoing list of important factors is not exclusive. Readers should carefully review the factors described in other documents the Company files from time to time with the Securities and Exchange Commission, including Current Reports on Form 8-K.

Except as required by applicable law and regulation, the Company does not undertake — and specifically disclaims any obligation — to update any forward-looking statements after the date of this quarterly report.

Critical Accounting Policies

Critical accounting estimates are necessary in the application of certain accounting policies and procedures and are particularly susceptible to significant change. Critical accounting policies are defined as those involving significant judgments and assumptions by management that could have a material impact on the carrying value of certain assets or on income under different assumptions or conditions. Management believes that the most critical accounting policies, which involve the most complex or subjective decisions or assessments, are as follows:

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

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

The Company classifies a loan as impaired when, based on current information and events, it is probable that it will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, we do not separately identify individual consumer and residential loans for impairment disclosures.

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following loan segments: residential real estate, commercial real estate, construction and land development, commercial and consumer. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in our policies or methodology pertaining to the general component of the allowance for loan losses during the nine months ended September 30, 2018 or during the year ended December 31, 2017.

The qualitative factors are determined based on the various risk characteristics of each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

Residential real estate: We generally do not originate loans with a loan-to-value ratio greater than 80% and do not grant subprime loans. Loans with loan to value ratios greater than 80% require the purchase of private mortgage insurance. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment.

Commercial real estate: Loans in this segment are primarily income-producing properties throughout Massachusetts and New Hampshire. The underlying cash flows generated by the properties are adversely impacted by a downturn in the economy as evidenced by increased vacancy rates, which in turn, will have an effect on the credit quality in this segment. Management periodically obtains rent rolls and continually monitors the cash flows of these loans.

Construction and land development: Loans in this segment primarily include speculative and pre-sold real estate development loans for which payment is derived from sale of the property and a conversion of the construction loans to permanent loans for which payment is then derived from cash flows of the property. Credit risk is affected by cost overruns, time to sell at an adequate price, and market conditions.

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

Consumer: Loans in this segment are generally unsecured and repayment is dependent on the credit quality of the individual borrower.

The allocated component relates to loans that are classified as impaired. Impairment is measured on a loan by loan basis for commercial, commercial real estate and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows (or collateral value) of the impaired loan is lower than the carrying value of that loan.

We periodically may agree to modify the contractual terms of loans. When a loan is modified and a concession is made to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring. All troubled debt restructurings are initially classified as impaired.

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

Stock-based Compensation Plans. The Company measures and recognizes compensation cost relating to stock-based payment transactions based on the grant-date fair value of the equity instruments issued. Stock-based compensation is recognized over the period the employee is required to provide services for the award. The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options granted. The determination of fair value involves a number of significant estimates, which require a number of assumptions to determine the model inputs. The fair value of restricted stock is recorded based on the grant date value of the equity instrument issued.

Income Taxes. The Company recognizes income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are established for the temporary differences between the accounting basis and the tax basis of our assets and liabilities at enacted tax rates expected to be in effect when the amounts related to such temporary differences are realized or settled. A tax valuation allowance is established, as needed, to reduce net deferred tax assets to the amount expected to be realized.

The Company examines its significant income tax positions quarterly to determine whether a tax benefit is more likely than not to be sustained upon examination by tax authorities.

Balance Sheet Analysis

Assets. Total assets were \$915.2 million at September 30, 2018, an increase of \$12.9 million, or 1.4%, from \$902.3 million at December 31, 2017. The increase resulted primarily from an increase in net loans of \$41.2 million. The increase was partially offset by a decrease in cash and cash equivalents of \$21.7 million and available-for-sale investment securities of \$9.0 million.

Cash and Cash Equivalents. Cash and cash equivalents decreased \$21.7 million, or 45.5%, to \$26.0 million at September 30, 2018 from \$47.7 million at December 31, 2017. The decrease is primarily due to utilizing funds for loan growth.

Securities. Investments in available-for-sale securities decreased \$9.0 million, or 14.6%, to \$52.5 million at September 30, 2018 from \$61.4 million at December 31, 2017. The decrease is primarily due to principal paydowns on government mortgage-backed securities and a change in the fair value of the securities.

Loans. At September 30, 2018, net loans were \$783.3 million, or 85.6% of total assets, compared to \$742.1 million, or 82.3% of total assets, at December 31, 2017. Increases in commercial loans of \$60.4 million, or 25.1%, and in consumer loans of \$2.7 million, or 15.3%, were partially offset by decreases in residential real estate loans of \$7.7 million, or 11.4%, construction and land development loans of \$3.0 million, or 5.3%, and commercial real estate of \$9.7 million, or 2.6%. Our commercial loan growth is attributed to adding commercial lenders and a continued focus on our niche lending of senior secured cash flow loans. Senior secured cash flow loans increased \$61.3 million, or 148.5%, to \$102.6 million at September 30, 2018 from \$41.3 million at December 31, 2017. The consumer loan growth is primarily due to loan purchases through the BancAlliance Lending Club Program that the Bank entered into an agreement with in 2016.

The following table sets forth the composition of our loan portfolio by type of loan at the dates indicated.

| <i>(Dollars in thousands)</i> | At September 30, 2018 | | At December 31, 2017 | |
|-----------------------------------|-----------------------------|---------|----------------------------|---------|
| | Amount | Percent | Amount | Percent |
| Commercial real estate | \$ 361,765 | 45.48% | \$ 371,510 | 49.35% |
| Commercial | 300,584 | 37.79% | 240,223 | 31.91% |
| Residential real estate | 60,034 | 7.55% | 67,724 | 9.00% |
| Construction and land development | 52,870 | 6.64% | 55,828 | 7.42% |
| Consumer | 20,119 | 2.53% | 17,455 | 2.32% |
| | 795,372 | 100.00% | 752,740 | 100.00% |
| Allowance for loan losses | (11,134) | | (9,757) | |
| Deferred loan fees, net | (946) | | (845) | |
| Net loans | \$ 783,292 | | \$ 742,138 | |

Assets Held-for-Sale. The Company purchased a building in Portsmouth, New Hampshire in January 2017 with the intention of using a majority of the space for banking operations. The cost of this building and the related improvements was \$3.3 million as of December 31, 2017. During 2017, the Company entered into an agreement to sell the building for \$3.3 million, with the building to be developed into a mixed used commercial building, and transferred the building into the held-for-sale category. During the first quarter of 2018, the Company transferred the assets back into the premises and equipment category as the Company terminated the agreement to sell the building, and entered into a new agreement with a third party to construct the commercial building, in which the Company will occupy space. The Company will then sell any unused units.

Deposits. Total deposits increased \$1.4 million, or 0.2%, to \$751.5 million at September 30, 2018 from \$750.1 million at December 31, 2017. The primary reason for the increase in deposits was an increase of \$9.4 million, or 3.1%, in NOW and demand deposits and an increase in savings deposits of \$4.1 million, or 3.6%. The increases were partially offset by a decrease of \$10.8 million, or 10.5%, in time deposits. The increase in the NOW and demand deposits and savings deposits occurred primarily due to new account relationships. Time deposits decreased primarily due to the roll-off of brokered certificates of deposit.

Borrowings. Borrowings at both September 30, 2018 and December 31, 2017 consisted entirely of Federal Home Loan Bank advances. Borrowings increased \$3.1 million, or 11.4%, to \$29.9 million at September 30, 2018 from \$26.8 million at December 31, 2017. The increase was primarily due to funding loan growth.

Shareholders' Equity. Total shareholders' equity increased \$6.4 million, or 5.5%, to \$122.1 million at September 30, 2018, from \$115.8 million at December 31, 2017. The increase was primarily due to year-to-date net income of \$6.5 million, stock-based compensation expense of \$695,000, and ESOP shares earned of \$463,000, partially offset by decreases of \$1.3 million in accumulated other comprehensive income, reflecting a decrease in the fair value of available-for-sale securities. Book value per share increased to \$12.68 at September 30, 2018 from \$12.02 at December 31, 2017.

Asset Quality.

The following table sets forth information regarding our non-performing assets at the dates indicated.

| | At September 30, 2018 | At December 31, 2017 |
|---|-----------------------------|----------------------------|
| <i>(Dollars in thousands)</i> | | |
| Non-accrual loans: | | |
| Real estate: | | |
| Commercial | \$ 2,879 | \$ 7,102 |
| Residential | 855 | 364 |
| Construction and land development | - | - |
| Commercial | 3,552 | 1,505 |
| Consumer | 68 | 62 |
| Total non-accrual loans | <u>7,354</u> | <u>9,033</u> |
| Accruing loans past due 90 days or more | | |
| Real estate owned | - | - |
| Total non-performing assets | <u>\$ 7,354</u> | <u>\$ 9,033</u> |
| Total loans (1) | \$ 794,426 | \$ 751,895 |
| Total assets | \$ 915,171 | \$ 902,265 |
| Total non-performing loans to total loans (1) | 0.93% | 1.20% |
| Total non-performing assets to total assets | 0.80% | 1.00% |

(1) Loans are presented before the allowance for loan losses but include deferred fees/costs

The decrease in non-performing assets at September 30, 2018 compared to December 31, 2017 was primarily due to the Company's foreclosure sale of certain real and personal property which secured four non-accruing loans originally made by the Bank. The aggregate outstanding principal balance of these loans was approximately \$7.5 million, of which (a) approximately \$4.9 million was due and owing to the Bank and (b) approximately \$2.6 million was due and owing to another financial institution who purchased participation interests in certain of these loans (the "Participant"). The Bank received \$8.3 in proceeds from this foreclosure sale. The U.S. Small Business Administration (SBA) which also made a secured loan to the same obligors has since disputed the Bank's retention of and claimed priority to a portion of the proceeds generated from this foreclosure sale, alleging a breach of contract and seeking monetary damages in the approximate amount of \$2.0 million. The Bank has partially denied liability, and in addition to its defenses, has asserted a counterclaim against the SBA and its assignee, Granite State Economic Development Corporation, seeking equitable reformation of the contract at issue on the basis of a mutual mistake of fact. This case is in the preliminary pretrial stage. Pending the outcome of this lawsuit, and as previously disclosed, the Bank has segregated into a separate deposit account the entire amount in dispute, consisting of \$1.4 million that would be retained by the Bank, and \$543,000 that would be provided to the participating institution. Management does not believe that the ultimate resolution of this matter will have a significant impact on the Bank's financial condition or the results of operations.

The Company has cooperative relationships with the vast majority of its non-performing loan customers. Repayment of non-performing loans is largely dependent on the return of such loans to performing status or the liquidation of the underlying collateral. The Company pursues the resolution of all non-performing loans through collections, restructures, voluntary liquidation of collateral by the borrower and, where necessary, legal action. When attempts to work with a customer to return a loan to performing status, including restructuring the loan, are unsuccessful, the Company will initiate appropriate legal action seeking to acquire property by deed in lieu of foreclosure or through foreclosure, or to liquidate business assets.

Allowance for Loan Losses. The allowance for loan losses is maintained at levels considered adequate by management to provide for probable loan losses inherent in the loan portfolio as of the consolidated balance sheet reporting dates. The allowance for loan losses is based on management's assessment of various factors affecting the loan portfolio, including portfolio size and composition, amount of and trend regarding delinquent net non-accrual loans and charge-offs, national and local business conditions, loss experience and an overall evaluation of the quality of the underlying collateral.

The following table sets forth activity in our allowance for loan losses for the periods indicated:

| <i>(Dollars in thousands)</i> | Nine Months Ended September 30, | |
|---|---------------------------------|------------------|
| | 2018 | 2017 |
| Allowance at beginning of period | \$ 9,757 | \$ 8,590 |
| Provision for loan losses | 2,715 | 2,467 |
| Charge offs: | | |
| Real estate: | | |
| Commercial | 790 | 6 |
| Residential | - | - |
| Construction and land development | - | - |
| Commercial | 101 | 63 |
| Consumer | 526 | 106 |
| Total charge-offs | <u>1,417</u> | <u>175</u> |
| Recoveries: | | |
| Real estate: | | |
| Commercial | - | - |
| Residential | 2 | - |
| Construction and land development | - | - |
| Commercial | 27 | 45 |
| Consumer | 50 | 5 |
| Total recoveries | <u>79</u> | <u>50</u> |
| Net charge-offs | <u>1,338</u> | <u>125</u> |
| Allowance at end of period | <u>\$ 11,134</u> | <u>\$ 10,932</u> |
| Non-performing loans at end of period | \$ 7,354 | \$ 5,647 |
| Total loans outstanding at end of period (1) | 794,426 | 759,469 |
| Average loans outstanding during the period (1) | 772,839 | 681,034 |
| Allowance to non-performing loans | 151.40% | 193.59% |
| Allowance to total loans outstanding at end of period | 1.40% | 1.44% |
| Net charge-offs to average loans outstanding during the during the period (annualized) | 0.23% | 0.02% |

(1) Loans are presented before the allowance for loan losses but include deferred fees/costs

Results of Operations for the Three Months Ended September 30, 2018 and 2017

General. Net income decreased \$693,000 to \$2.1 million for the three months ended September 30, 2018 from \$2.8 million for the three months ended September 30, 2017. The decrease was related to a decrease of \$1.8 million in noninterest income and an increase in provision for loan losses of \$409,000, partially offset by an increase in net interest and dividend income of \$1.2 million and a decrease in income tax expense of \$693,000.

Interest and Dividend Income. Interest and dividend income increased \$1.6 million, or 17.3%, to \$10.8 million for the three months ended September 30, 2018 from \$9.2 million for the three months ended September 30, 2017. This increase was primarily attributable to an increase in interest and fees on loans, which increased \$1.8 million, or 21.6%, to \$10.2 million for the three months ended September 30, 2018 from \$8.4 million for the three months ended September 30, 2017. The increase in interest and fees on loans was partially offset by a decrease in interest and dividends on securities, which decreased \$411,000, or 50.0%, to \$411,000 for the three months ended September 30, 2017 from \$822,000 for the three months ended September 30, 2017.

The increase in interest income on loans was due to an increase in the average balance of loans of \$59.5 million, or 8.3%, to \$778.6 million for the three months ended September 30, 2018 from \$719.1 million for the three months ended September 30, 2017. In addition, interest income increased due to the yield on loans increasing 58 basis points to 5.25% for the three months ended September 30, 2018 due to our continued focus on higher-yielding commercial lending. The decrease in interest and dividends on securities was due to the Company selling \$30.6 million of state and municipal securities and divesting of all equity securities during the third and fourth quarters of 2017.

Interest Expense. Interest expense increased \$424,000, or 42.2%, to \$1.4 million for the three months ended September 30, 2018 from \$1.0 million for the three months ended September 30, 2017, caused by an increase in interest expense on deposits. Interest expense on deposits increased \$442,000, or 56.4%, to \$1.2 million for the three months ended September 30, 2018 from \$783,000 for the three months ended September 30, 2017, due to an increase in the average rate paid on interest-bearing deposits of 28 basis points to 0.86% for the three months ended September 30, 2018 from 0.58% for the three months ended September 30, 2017. The increase in the average rate was primarily the result of increases in the average rate paid on money market accounts and certificates of deposit. The average rate paid on money market accounts and certificates of deposit increased due to changes in the market rate environment. Interest expense on deposits also increased due to an increase in the average balance of interest-bearing deposits of \$25.1 million, or 4.6%, to \$567.4 million for the three months ended September 30, 2018 from \$542.2 million for the three months ended September 30, 2017. The increase resulted primarily from an increase in the average balance of money market accounts, which increased \$50.8 million, or 28.1%.

Net Interest and Dividend Income. Net interest and dividend income increased \$1.2 million, or 14.2%, to \$9.4 million for the three months ended September 30, 2018 from \$8.2 million for the three months ended September 30, 2017. The increase was due to both higher balances of interest-earning assets and expanding margins. Our net interest rate spread increased 30 basis points to 4.00% for the three months ended September 30, 2018 from 3.70% for the three months ended September 30, 2017. Our net interest margin increased 42 basis points to 4.31% for the three months ended September 30, 2018 from 3.89% for the three months ended September 30, 2017.

Provision for Loan Losses. The provision for loan losses was \$1.4 million for the three months ended September 30, 2018 compared to \$1.0 million for the three months ended September 30, 2017. The provision recorded resulted in an allowance for loan losses of \$11.1 million, or 1.40% of total loans at September 30, 2018, compared to \$9.8 million, or 1.30% of total loans, at December 31, 2017 and \$10.9 million, or 1.44% of total loans, at September 30, 2017. The changes in the provision and allowance for loan losses were based on management's assessment of loan portfolio growth and composition trends, historical charge-off trends, levels of problem loans and other asset quality trends. Non-accrual loans as of September 30, 2018 were primarily comprised of three commercial and industrial relationships with a total carrying value of \$3.1 million and one commercial real estate relationship with a carrying value of \$2.9 million.

Noninterest Income. Noninterest income decreased \$1.8 million, or 63.4%, to \$1.1 million for the three months ended September 30, 2018 from \$2.9 million for the three months ended September 30, 2017. The decrease was primarily caused by a decrease in the gain on sales of securities. Gain on sales of securities was zero for the three months ended September 30, 2018 compared to \$1.9 million for the three months ended September 30, 2017.

Noninterest Expense. Noninterest expense increased \$309,000, or 5.2%, to \$6.2 million for the three months ended September 30, 2018 from \$5.9 million for the three months ended September 30, 2017. The largest increases were related to salaries and employee benefits expense, professional fees, and occupancy expense. The increase in salary and employee benefits of \$202,000, or 5.1%, to \$4.2 million for the three months ended September 30, 2018 from \$3.9 million for the three months ended September 30, 2017 was primarily related to hiring additional lenders. The increase in professional fees of \$47,000, or 20.7%, to \$274,000 for the three months ended September 30, 2018 from \$227,000 for the three months ended September 30, 2017 was primarily related to increased legal expenses related to certain subordinated lienholders that are disputing the priority of the Bank's liens and the right of the Bank to retain proceeds from a foreclosure sale, discussed in Note 14 to the interim financial statements. The increase in occupancy expense of \$45,000, or 10.9%, to \$456,000 for the three months ended September 30, 2018 from \$411,000 for the three months ended September 30, 2017 was primarily related to one-time building maintenance expenses.

Income Tax Provision. We recorded a provision for income taxes of \$741,000 for the three months ended September 30, 2018, reflecting an effective tax rate of 26.3%, compared to a provision of \$1.4 million for the three months ended September 30, 2017, reflecting an effective tax rate of 34.1%. The changes in the income tax provision were primarily due to a reduction of the federal corporate income tax rate from 35% to 21% effective beginning in 2018.

Average Balance Sheet and Related Yields and Rates

The following tables set forth the average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. No tax-equivalent yield adjustments have been made, as the amount of tax free interest-earning assets is immaterial. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances. The yields set forth below include the effect of deferred fees, discounts, and premiums that are amortized or accreted to interest income or interest expense.

| | For the Three Months Ended September 30, | | | | | |
|---|--|--------------------------|----------------|-----------------|--------------------------|----------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Earned/ Paid | Yield/ Rate | Average Balance | Interest Earned/ Paid | Yield/ Rate |
| <i>(Dollars in thousands)</i> | | | | | | |
| Assets: | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans | \$ 778,646 | \$ 10,219 | 5.25% | \$ 719,116 | \$ 8,403 | 4.67% |
| Short-term investments | 38,307 | 203 | 2.12% | 4,897 | 14 | 1.14% |
| Investment securities | 54,405 | 381 | 2.80% | 118,672 | 793 | 2.67% |
| Federal Home Loan Bank stock | 1,945 | 30 | 6.17% | 3,028 | 29 | 3.83% |
| Total interest-earning assets | 873,303 | 10,833 | 4.96% | 845,713 | 9,239 | 4.37% |
| Non-interest earning assets | 49,289 | | | 45,951 | | |
| Total assets | \$ 922,592 | | | \$ 891,664 | | |
| Interest-bearing liabilities: | | | | | | |
| Savings accounts | \$ 123,178 | 97 | 0.31% | \$ 117,049 | 51 | 0.17% |
| Money market accounts | 231,896 | 630 | 1.09% | 181,064 | 234 | 0.52% |
| NOW accounts | 119,821 | 150 | 0.50% | 118,469 | 172 | 0.58% |
| Certificates of deposit | 92,475 | 348 | 1.51% | 125,645 | 326 | 1.04% |
| Total interest-bearing deposits | 567,370 | 1,225 | 0.86% | 542,227 | 783 | 0.58% |
| Federal Home Loan Bank advances | 30,467 | 204 | 2.68% | 57,446 | 222 | 1.55% |
| Total interest-bearing liabilities | 597,837 | 1,429 | 0.96% | 599,673 | 1,005 | 0.67% |
| Noninterest-bearing liabilities: | | | | | | |
| Noninterest-bearing deposits | 191,802 | | | 168,129 | | |
| Other noninterest-bearing liabilities | 11,162 | | | 8,230 | | |
| Total liabilities | 800,801 | | | 776,032 | | |
| Total equity | 121,791 | | | 115,632 | | |
| Total liabilities and equity | \$ 922,592 | | | \$ 891,664 | | |
| Net interest income | | \$ 9,404 | | | \$ 8,234 | |
| Interest rate spread (1) | | | 4.00% | | | 3.70% |
| Net interest-earning assets (2) | \$ 275,466 | | | \$ 246,040 | | |
| Net interest margin (3) | | | 4.31% | | | 3.89% |
| Average interest-earning assets to interest-bearing liabilities | 146.08% | | | 141.03% | | |

- (1) Net interest rate spread represents the difference between the weighted average yield on interest-bearing assets and the weighted average rate of interest-bearing liabilities.
- (2) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
- (3) Net interest margin represents net interest income divided by average total interest-earning assets

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effect attributable to changes in volume (changes in volume multiplied by prior rate). The total column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

| | For the Three Months Ended September 30, 2018 Compared to the Three Months Ended September 30, 2017 | | |
|---|---|---------------|------------------------|
| | Increase (Decrease) Due to | | Total |
| | Rate | Volume | Increase (Decrease) |
| <i>(In thousands)</i> | | | |
| Interest-earning assets: | | | |
| Loans | \$ 1,086 | \$ 730 | \$ 1,816 |
| Interest-earning deposits | 21 | 168 | 189 |
| Investment securities | 36 | (448) | (412) |
| Federal Home Loan Bank stock | 14 | (13) | 1 |
| Total interest-earning assets | 1,157 | 437 | 1,594 |
| Interest-bearing liabilities: | | | |
| Savings accounts | 43 | 3 | 46 |
| Money Market accounts | 316 | 80 | 396 |
| Now accounts | (24) | 2 | (22) |
| Certificates of deposit | 122 | (100) | 22 |
| Total interest-bearing deposits | 457 | (15) | 442 |
| Federal Home Loan Bank advances | 116 | (134) | (18) |
| Total interest-bearing liabilities | 573 | (149) | 424 |
| Change in net interest income | \$ 584 | \$ 586 | \$ 1,170 |

Results of Operations for the Nine Months Ended September 30, 2018 and 2017

General. Net income increased \$316,000 to \$6.5 million for the nine months ended September 30, 2018 from \$6.2 million for the nine months ended September 30, 2017. The increase was related to an increase of \$3.8 million in net interest and dividend income and a decrease in income tax expense of \$658,000, partially offset by a \$2.3 million decrease in noninterest income and an increase in noninterest expense of \$1.6 million.

Interest and Dividend Income. Interest and dividend income increased \$4.8 million, or 18.3%, to \$31.0 million for the nine months ended September 30, 2018 from \$26.2 million for the nine months ended September 30, 2017. This increase was primarily attributable to an increase in interest and fees on loans, which increased \$5.9 million, or 24.9%, to \$29.4 million for the nine months ended September 30, 2018 from \$23.5 million for the nine months ended September 30, 2017. The increase in interest and fees on loans was partially offset by a decrease in interest and dividends on securities, which decreased \$1.3 million, or 51.6%, to \$1.3 million for the nine months ended September 30, 2018 from \$2.6 million for the nine months ended September 30, 2017.

The increase in interest income on loans was due to an increase in the average balance of loans of \$91.8 million, or 13.5%, to \$772.8 million for the nine months ended September 30, 2018 from \$681.0 million for the nine months ended September 30, 2017. In addition, interest income increased due to the yield on loans increasing 47 basis points to 5.08% for the nine months ended September 30, 2018 due to our continued focus on higher-yielding commercial lending. The decrease in interest and dividends on securities was due to the Company selling \$30.6 million of state and municipal securities and divesting of all equity securities during the third and fourth quarters of 2017.

Interest Expense. Interest expense increased \$1.0 million, or 38.0%, to \$3.7 million for the nine months ended September 30, 2018 from \$2.7 million for the nine months ended September 30, 2017, caused by an increase in interest expense on deposits, partially offset by a decrease in interest expense on borrowings. Interest expense on deposits increased \$1.1 million, or 55.3%, to \$3.2 million for the nine months ended September 30, 2018 from \$2.0 million for the nine months ended September 30, 2017, due to an increase in the average rate paid on interest-bearing deposits of 23 basis points to 0.76% for the nine months ended September 30, 2018 from 0.53% for the nine months ended September 30, 2017. The increase in the average rate was primarily the result of increases in the average rate paid on money market accounts and certificates of deposit. The average rate paid on money market accounts and certificates of deposit increased due to changes in the market rate environment. Interest expense on deposits also increased due to an increase in the average balance of interest-bearing deposits of \$40.9 million, or 8.0%, to \$554.2 million for the nine months ended September 30, 2018 from \$513.3 million for the nine months ended September 30, 2017. The increase resulted primarily from an increase in the average balance of money market accounts, which increased \$62.9 million, or 38.8%.

Interest expense on borrowings decreased \$111,000, or 17.5%, to \$522,000 for the nine months ended September 30, 2018 from \$633,000 for the nine months ended September 30, 2017. The interest expense on borrowings decreased due to the decrease in the average outstanding balance of \$27.4 million, or 47.6% to \$30.1 million for the nine months ended September 30, 2018. The decrease in the average outstanding balance was partially offset by a 84 basis point increase in the cost of borrowings to 2.31% for the nine months ended September 30, 2018.

Net Interest and Dividend Income. Net interest and dividend income increased \$3.8 million, or 16.1%, to \$27.3 million for the nine months ended September 30, 2018 from \$23.5 million for the nine months ended September 30, 2017. The increase was due to both higher balances of interest-earning assets and expanding margins. Our net interest rate spread increased 32 basis points to 4.01% for the nine months ended September 30, 2018 from 3.69% for the nine months ended September 30, 2017. Our net interest margin increased 40 basis points to 4.27% for the nine months ended September 30, 2018 from 3.87% for the nine months ended September 30, 2017.

Provision for Loan Losses. The provision for loan losses was \$2.7 million for the nine months ended September 30, 2018 compared to \$2.5 million for the nine months ended September 30, 2017. The provision recorded resulted in an allowance for loan losses of \$11.1 million, or 1.40% of total loans at September 30, 2018, compared to \$9.8 million, or 1.30% of total loans, at December 31, 2017 and \$10.9 million, or 1.44% of total loans, at September 30, 2017. The changes in the provision and allowance for loan losses were based on management's assessment of loan portfolio growth and composition trends, historical charge-off trends, levels of problem loans and other asset quality trends. Non-accrual loans as of September 30, 2018 were primarily comprised of three commercial and industrial relationships with a total carrying value of \$3.1 million and one commercial real estate relationship with a carrying value of \$2.9 million.

Noninterest Income. Noninterest income decreased \$2.3 million, or 41.7%, to \$3.2 million for the nine months ended September 30, 2018 from \$5.5 million for the nine months ended September 30, 2017. The decrease was primarily caused by a decrease in the gain on sales of securities. Gain on sales of securities was zero for the nine months ended September 30, 2018 compared to \$2.4 million for the nine months ended September 30, 2017.

Noninterest Expense. Noninterest expense increased \$1.6 million, or 9.2%, to \$19.0 million for the nine months ended September 30, 2018 from \$17.4 million for the nine months ended September 30, 2017. The largest increases were related to salaries and employee benefits expense, professional fees, and other expense. The increase in salary and employee benefits of \$1.2 million, or 10.8%, to \$12.6 million for the nine months ended September 30, 2018 from \$11.4 million for the nine months ended September 30, 2017 was primarily related to an increased number of lenders. The increase in professional fees of \$195,000, or 29.7%, was primarily due to increased legal expenses related to certain subordinated lienholders that are disputing the priority of the Bank's liens and the right of the Bank to retain proceeds from a foreclosure sale, discussed in Note 14 to the interim financial statements. The increase in other expense of \$252,000, or 11.5%, to \$2.4 million for the nine months ended September 30, 2018 from \$2.2 million for the nine months ended September 30, 2017 was primarily related to costs incurred working out non-performing loans.

Income Tax Provision. We recorded a provision for income taxes of \$2.3 million for the nine months ended September 30, 2018, reflecting an effective tax rate of 25.8%, compared to a provision of \$2.9 million for the nine months ended September 30, 2017, reflecting an effective tax rate of 32.1%. The changes in the income tax provision were primarily due to a reduction of the federal corporate income tax rate from 35% to 21% effective beginning in 2018.

Average Balance Sheet and Related Yields and Rates

The following tables set forth the average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. No tax-equivalent yield adjustments have been made, as the amount of tax free interest-earning assets is immaterial. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances. The yields set forth below include the effect of deferred fees, discounts, and premiums that are amortized or accreted to interest income or interest expense.

| | For the Nine Months Ended September 30, | | | | | |
|---|---|--------------------------|----------------|-----------------|--------------------------|----------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Earned/ Paid | Yield/ Rate | Average Balance | Interest Earned/ Paid | Yield/ Rate |
| (dollars in thousands) | | | | | | |
| Assets: | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans | \$ 772,839 | \$ 29,420 | 5.08% | \$ 681,034 | \$ 23,547 | 4.61% |
| Short-term investments | 19,345 | 287 | 1.98% | 3,406 | 23 | 0.90% |
| Investment securities | 56,993 | 1,176 | 2.75% | 121,377 | 2,507 | 2.75% |
| Federal Home Loan Bank stock | 1,892 | 80 | 5.64% | 3,108 | 90 | 3.86% |
| Total interest-earning assets | 851,069 | 30,963 | 4.85% | 808,925 | 26,167 | 4.31% |
| Non-interest earning assets | 49,406 | | | 45,916 | | |
| Total assets | \$ 900,475 | | | \$ 854,841 | | |
| Interest-bearing liabilities: | | | | | | |
| Savings accounts | \$ 117,533 | 224 | 0.25% | \$ 116,481 | 160 | 0.18% |
| Money market accounts | 225,144 | 1,537 | 0.91% | 162,204 | 511 | 0.42% |
| NOW accounts | 115,000 | 450 | 0.52% | 115,038 | 506 | 0.59% |
| Certificates of deposit | 96,563 | 943 | 1.30% | 119,571 | 854 | 0.95% |
| Total interest-bearing deposits | 554,240 | 3,154 | 0.76% | 513,294 | 2,031 | 0.53% |
| Federal Home Loan Bank advances | 30,104 | 522 | 2.31% | 57,500 | 633 | 1.47% |
| Total interest-bearing liabilities | 584,344 | 3,676 | 0.84% | 570,794 | 2,664 | 0.62% |
| Noninterest-bearing liabilities: | | | | | | |
| Noninterest-bearing deposits | 186,497 | | | 161,043 | | |
| Other noninterest-bearing liabilities | 10,447 | | | 8,052 | | |
| Total liabilities | 781,288 | | | 739,889 | | |
| Total equity | 119,187 | | | 114,952 | | |
| Total liabilities and equity | \$ 900,475 | | | \$ 854,841 | | |
| Net interest income | | \$ 27,287 | | | \$ 23,503 | |
| Interest rate spread (1) | | | 4.01% | | | 3.69% |
| Net interest-earning assets (2) | \$ 266,725 | | | \$ 238,131 | | |
| Net interest margin (3) | | | 4.27% | | | 3.87% |
| Average interest-earning assets to interest-bearing liabilities | 145.65% | | | 141.72% | | |

(1) Net interest rate spread represents the difference between the weighted average yield on interest-bearing assets and the weighted average rate of interest-bearing liabilities.

(2) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.

(3) Net interest margin represents net interest income divided by average total interest-earning assets

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effect attributable to changes in volume (changes in volume multiplied by prior rate). The total column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

| | For the Nine Months Ended September 30, 2018 Compared to the Nine Months Ended September 30, 2017 | | |
|---|---|-----------------|------------------------|
| | Increase (Decrease) Due to | | Total |
| | Rate | Volume | Increase (Decrease) |
| <i>(in thousands)</i> | | | |
| Interest-earning assets: | | | |
| Loans | \$ 2,516 | \$ 3,357 | \$ 5,873 |
| Interest-earning deposits | 54 | 210 | 264 |
| Investment securities | (2) | (1,329) | (1,331) |
| Federal Home Loan Bank stock | 33 | (43) | (10) |
| Total interest-earning assets | 2,599 | 2,197 | 4,796 |
| Interest-bearing liabilities: | | | |
| Savings accounts | 63 | 1 | 64 |
| Money Market Accounts | 770 | 256 | 1,026 |
| Now Accounts | (56) | (0) | (56) |
| Certificates of deposit | 274 | (185) | 89 |
| Total interest-bearing deposits | 1,051 | 72 | 1,123 |
| Federal Home Loan Bank advances | 269 | (380) | (111) |
| Total interest-bearing liabilities | 1,320 | (308) | 1,012 |
| Change in net interest income | \$ 1,280 | \$ 2,504 | \$ 3,784 |

Management of Market Risk

Net Interest Income Simulation. We analyze our sensitivity to changes in interest rates through a net interest income simulation model. Net interest income is the difference between the interest income we earn on our interest-earning assets, such as loans and securities, and the interest we pay on our interest-bearing liabilities, such as deposits and borrowings. We estimate what our net interest income would be for a 12-month period in the current interest rate environment. We then calculate what the net interest income would be for the same period under the assumption that interest rates increase 200 basis points from current market rates and under the assumption that interest rates decrease 100 basis points from current market rates, with changes in interest rates representing immediate and permanent, parallel shifts in the yield curve.

The following table presents the estimated changes in net interest income of The Provident Bank, calculated on a bank-only basis, that would result from changes in market interest rates over twelve-month periods beginning September 30, 2018.

| <i>(Dollars in thousands)</i> Changes in Interest Rates (Basis Points) | At September 30, 2018 | |
|---|--|---------|
| | Estimated | |
| | Net Interest Income Over Next 12 Months | Change |
| 200 | \$ 40,454 | (0.70%) |
| 0 | 40,737 | - |
| -200 | 39,845 | (2.19%) |

Economic Value of Equity Simulation. We also analyze our sensitivity to changes in interest rates through an economic value of equity (“EVE”) model. EVE represents the present value of the expected cash flows from our assets less the present value of the expected cash flows arising from our liabilities adjusted for the value of off-balance sheet contracts. The EVE ratio represents the dollar amount of our EVE divided by the present value of our total assets for a given interest rate scenario. EVE attempts to quantify our economic value using a discounted cash flow methodology while the EVE ratio reflects that value as a form of capital ratio. We estimate what our EVE would be as of a specific date. We then calculate what EVE would be as of the same date throughout a series of interest rate scenarios representing immediate and permanent, parallel shifts in the yield curve. We currently calculate EVE under the assumptions that interest rates increase 100, 200, 300 and 400 basis points from current market rates, and under the assumption that interest rates decrease 100 basis points from current market rates.

The following table presents the estimated changes in EVE of The Provident Bank, calculated on a bank-only basis, that would result from changes in market interest rates as of September 30, 2018.

| <i>(Dollars in thousands)</i> Changes in Interest Rates (Basis Points) | At September 30, 2018 | |
|---|--------------------------|----------|
| | Economic | |
| | Value of Equity | Change |
| 400 | \$ 147,454 | (1.60%) |
| 300 | 149,051 | (0.50%) |
| 200 | 150,282 | 0.30% |
| 100 | 151,199 | 0.90% |
| 0 | 149,831 | - |
| -100 | 144,344 | (3.70%) |
| -200 | 130,461 | (12.90%) |

Certain shortcomings are inherent in the methodologies used in the above interest rate risk measurements. Modeling changes require making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the tables presented above assume that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assume that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although the tables provide an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations of a short-term nature. Our primary sources of funds consist of deposit inflows, loan repayments and maturities, FHLB advances, and sales of securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

We regularly review the need to adjust our investments in liquid assets based upon our assessment of: (1) expected loan demand, (2) expected deposit flows, (3) yields available on interest-earning deposits and securities, and (4) the objectives of our asset/liability management program. Excess liquid assets are invested generally in interest-earning deposits and short- and intermediate-term securities.

Our most liquid assets are cash and cash equivalents. The levels of these assets are dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2018, cash and cash equivalents totaled \$26.0 million. Securities classified as available-for-sale, which provide additional sources of liquidity, totaled \$52.5 million at September 30, 2018.

At September 30, 2018, we had the ability to borrow a total of \$195.4 million from the Federal Home Loan Bank of Boston. On that date, we had \$29.9 million in advances outstanding. At September 30, 2018, we also had an available line of credit with the Federal Reserve Bank of Boston's borrower-in-custody program of \$198.3 million, none of which was outstanding as of that date.

We have no material commitments or demands that are likely to affect our liquidity other than set forth below. In the event loan demand were to increase faster than expected, or any unforeseen demand or commitment were to occur, we could access our borrowing capacity with the Federal Home Loan Bank of Boston or obtain additional funds through brokered certificates of deposit.

At September 30, 2018 and December 31, 2017, we had \$29.2 million and \$18.6 million in loan commitments outstanding, respectively. In addition to commitments to originate loans, at September 30, 2018 and December 31, 2017, we had \$185.2 million and \$166.0 million in unadvanced funds to borrowers, respectively. We also had \$1.7 million and \$2.0 million in outstanding letters of credit at September 30, 2018 and December 31, 2017, respectively.

Certificates of deposit due within one year of September 30, 2018 totaled \$66.0 million, or 8.8% of total deposits. If these deposits do not remain with us, we will be required to seek other sources of funds, including other certificates of deposit and Federal Home Loan Bank of Boston advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit. We believe, however, based on past experience that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

Our primary investing activities are the origination of loans and the purchase of securities. During the nine months ended September 30, 2018, we originated \$195.7 million of loans, all of which were intended to be held in our portfolio and we purchased \$3.0 million in loans. We did not purchase any securities. During the nine months ended September 30, 2017, we originated \$208.5 million of loans, all of which were intended to be held in our portfolio. We also purchased \$13.1 million in loans and \$13.1 million in securities.

Financing activities consist primarily of activity in deposit accounts and Federal Home Loan Bank advances. We experienced net increases in total deposits of \$1.4 million and \$97.3 million for the nine months ended September 30, 2018 and 2017, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors and other factors. We generally manage the pricing of our deposits to be competitive. Federal Home Loan Bank advances increased \$3.1 million and \$28.5 million during the nine months ended September 30, 2018 and 2017, respectively.

The Provident Bank is subject to various regulatory capital requirements administered by the Massachusetts Commissioner of Banks and the Federal Deposit Insurance Corporation. At September 30, 2018, The Provident Bank exceeded all applicable regulatory capital requirements, and was considered “well capitalized” under regulatory guidelines. See Note 10 of the Notes to the Unaudited Consolidated Financial Statements for additional information.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

See Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operation”.

Item 4. Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company’s management, including the President and Chief Executive Officer and the Executive Vice President and Chief Financial Officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 30, 2018. Based on that evaluation, the Company’s management, including the President and Chief Executive Officer and the Executive Vice President and Chief Financial Officer, concluded that the Company’s disclosure controls and procedures were effective.

During the quarter ended September 30, 2018, there have been no changes in the Company’s internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Part II – Other Information

Item 1. Legal Proceedings

Not applicable.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

- (a) Not applicable.
- (b) Not applicable.
- (c) On January 26, 2017, the Company announced a repurchase program under which it would repurchase up to 6.6% of the then-outstanding shares of the Company's common stock (625,015 shares) from time to time, depending on market conditions. The repurchase program will continue until it is completed or terminated by the Company's Board of Directors. For the three months ended September 30, 2018, there were no repurchases of Provident Bancorp, Inc. stock.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

[3.1](#) [Amended and Restated Articles of Organization of Provident Bancorp, Inc. \(1\)](#)

[3.2](#) [By-Laws of Provident Bancorp, Inc. \(1\)](#)

[31.1](#) [Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#)

[31.2](#) [Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#)

[32](#) [Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002](#)

101 The following financial statements from the Provident Bancorp, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Comprehensive Income; (iv) Consolidated Statements of Changes in Shareholders' Equity; (v) Consolidated Statements of Cash Flows; and (vi) Notes to Unaudited Consolidated Financial Statements.

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- (1) Incorporated by reference to the Company's Registration Statement on Form S-1 (file no. 333-202716), initially filed with the Securities and Exchange Commission on March 13, 2015.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PROVIDENT BANCORP, INC.

Date: November 8, 2018

/s/ David P. Mansfield

David P. Mansfield

President and Chief Executive Officer

Date: November 8, 2018

/s/ Carol L. Houle

Carol L. Houle

Executive Vice President and Chief Financial Officer

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Section 2: EX-31.1 (EXHIBIT 31.1)

Exhibit 31.1

Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, David P. Mansfield, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Provident Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2018

/s/ David P. Mansfield

David P. Mansfield

President and Chief Executive Officer

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Section 3: EX-31.2 (EXHIBIT 31.2)

Exhibit 31.2

Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Carol L. Houle, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Provident Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2018

/s/ Carol L. Houle

Carol L. Houle

Executive Vice President and Chief Financial Officer

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Section 4: EX-32 (EXHIBIT 32)

Exhibit 32

Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

David P. Mansfield, President and Chief Executive Officer of Provident Bancorp, Inc. (the "Company"), and Carol L. Houle, Executive Vice President and Chief Financial Officer of the Company, each certify in his or her capacity as an officer of the Company that they have reviewed the quarterly report on Form 10-Q for the quarter ended September 30, 2018 (the "Report") and that to the best of their knowledge:

1. the Report fully complies with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 8, 2018

/s/ David P. Mansfield

David P. Mansfield

President and Chief Executive Officer

Date: November 8, 2018

/s/ Carol L. Houle

Carol L. Houle

Executive Vice President and Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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