

FIDELITY D & D BANCORP INC

Form 10-Q

November 08, 2018

Table Of Contents

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

OR

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

For the transition period from _____ to _____

Commission file number: 001-38229

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA

23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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 subjected to such filing 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 (§232.405 of this chapter) 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 <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>
	Emerging growth company <input type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

YES NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on October 31, 2018, the latest practicable date, was 3,759,426 shares.

Table Of Contents

FIDELITY D & D BANCORP, INC.

Form 10-Q September 30, 2018

Index

<u>Part I. Financial Information</u>		Page
Item 1.	<u>Financial Statements (unaudited):</u>	
	<u>Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	3
	<u>Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017</u>	4
	<u>Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017</u>	5
	<u>Consolidated Statements of Changes in Shareholders' Equity for the three and nine months ended September 30, 2018 and 2017</u>	6
	<u>Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017</u>	8
	<u>Notes to Consolidated Financial Statements (Unaudited)</u>	10
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	34
Item 3.	<u>Quantitative and Qualitative Disclosure about Market Risk</u>	53
Item 4.	<u>Controls and Procedures</u>	58
<u>Part II. Other Information</u>		
Item 1.	<u>Legal Proceedings</u>	60
Item 1A.	<u>Risk Factors</u>	60
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	60
Item 3.	<u>Defaults upon Senior Securities</u>	60
Item 4.	<u>Mine Safety Disclosures</u>	60
Item 5.	<u>Other Information</u>	60
Item 6.	<u>Exhibits</u>	60
	<u>Signatures</u>	62

Table Of Contents

PART I – Financial Information

Item 1: Financial Statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Balance Sheets
(Unaudited)

	September 30, 2018	December 31, 2017
(dollars in thousands)		
Assets:		
Cash and due from banks	\$ 14,336	\$ 14,143
Interest-bearing deposits with financial institutions	2,608	1,682
Total cash and cash equivalents	16,944	15,825
Available-for-sale securities	171,451	157,385
Federal Home Loan Bank stock	4,717	2,832
Loans and leases, net (allowance for loan losses of \$9,944 in 2018; \$9,193 in 2017)	690,944	628,767
Loans held-for-sale (fair value \$4,068 in 2018, \$2,221 in 2017)	3,998	2,181
Foreclosed assets held-for-sale	577	973
Bank premises and equipment, net	16,204	16,576
Cash surrender value of bank owned life insurance	20,464	20,017
Accrued interest receivable	3,300	2,786
Goodwill	209	209
Other assets	21,046	16,086
Total assets	\$ 949,854	\$ 863,637
Liabilities:		
Deposits:		
Interest-bearing	\$ 572,473	\$ 551,515
Non-interest-bearing	206,588	178,631
Total deposits	779,061	730,146
Accrued interest payable and other liabilities	8,768	6,402
Short-term borrowings	40,269	18,502
FHLB advances	31,704	21,204
Total liabilities	859,802	776,254
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 3,757,491 in 2018; and 3,734,478 in 2017)	29,520	28,361
Retained earnings	63,075	57,218
Accumulated other comprehensive (loss) income	(2,543)	1,804
Total shareholders' equity	90,052	87,383
Total liabilities and shareholders' equity	\$ 949,854	\$ 863,637

See notes to unaudited consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary
 Consolidated Statements of Income
 (Unaudited)

(dollars in thousands except per share data)

	Three months ended		Nine months ended	
	September	September	September	September
	30, 2018	30, 2017	30, 2018	30, 2017
Interest income:				
Loans and leases:				
Taxable	\$ 7,524	\$ 6,672	\$ 21,251	\$ 19,398
Nontaxable	256	220	689	647
Interest-bearing deposits with financial institutions	10	12	94	22
Restricted regulatory securities	44	40	122	96
Investment securities:				
U.S. government agency and corporations	799	610	2,377	1,887
States and political subdivisions (nontaxable)	395	368	1,162	1,081
Other securities	-	6	11	17
Total interest income	9,028	7,928	25,706	23,148
Interest expense:				
Deposits	981	742	2,671	1,971
Securities sold under repurchase agreements	3	3	13	15
Other short-term borrowings and other	260	60	324	197
FHLB advances	73	77	205	174
Total interest expense	1,317	882	3,213	2,357
Net interest income	7,711	7,046	22,493	20,791
Provision for loan losses	400	375	1,125	925
Net interest income after provision for loan losses	7,311	6,671	21,368	19,866
Other income:				
Service charges on deposit accounts	573	582	1,666	1,674
Interchange fees	506	431	1,480	1,256
Fees from trust fiduciary activities	305	253	1,032	756
Fees from financial services	187	169	559	434
Service charges on loans	136	201	443	597
Fees and other revenue	252	222	731	661
Earnings on bank-owned life insurance	150	158	448	422
Gain on sale or disposal of:				
Loans	168	232	522	684
Available-for-sale debt securities	4	-	10	-
Equity securities	-	-	44	-
Premises and equipment	2	-	2	-
Total other income	2,283	2,248	6,937	6,484
Other expenses:				
Salaries and employee benefits	3,454	3,235	10,241	9,559
Premises and equipment	918	919	2,815	2,816
Advertising and marketing	250	270	872	850
Professional services	355	404	1,237	1,330

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Data processing and communication	377	297	1,099	880
Automated transaction processing	202	185	580	543
Office supplies and postage	85	109	293	339
FDIC assessment	70	68	203	201
PA shares tax	196	183	432	394
Loan collection	31	84	82	191
Other real estate owned	63	37	127	183
Other	171	244	561	597
Total other expenses	6,172	6,035	18,542	17,883
Income before income taxes	3,422	2,884	9,763	8,467
Provision for income taxes	559	658	1,604	2,078
Net income	\$ 2,863	\$ 2,226	\$ 8,159	\$ 6,389
Per share data :				
Net income - basic	\$ 0.76	\$ 0.60	\$ 2.17	\$ 1.72
Net income - diluted	\$ 0.75	\$ 0.60	\$ 2.15	\$ 1.72
Dividends	\$ 0.24	\$ 0.21	\$ 0.72	\$ 0.62

See notes to unaudited consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income (Unaudited) (dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Net income	\$ 2,863	\$ 2,226	\$ 8,159	\$ 6,389
Other comprehensive (loss) income, before tax:				
Unrealized holding (loss) gain on available-for-sale debt securities	(1,591)	104	(4,960)	818
Reclassification adjustment for net gains realized in income	(4)	-	(10)	-
Net unrealized (loss) gain	(1,595)	104	(4,970)	818
Tax effect	335	(35)	1,044	(278)
Unrealized (loss) gain, net of tax	(1,260)	69	(3,926)	540
Other comprehensive (loss) income, net of tax	(1,260)	69	(3,926)	540
Total comprehensive income, net of tax	\$ 1,603	\$ 2,295	\$ 4,233	\$ 6,929

See notes to unaudited consolidated financial statements

Table Of Contents

Fidelity D & D Bancorp, Inc. and Subsidiary
 Consolidated Statements of Changes in Shareholders' Equity
 For the nine months ended September, 2018 and 2017
 (Unaudited)

(dollars in thousands)	Capital stock		Retained	Accumulated other comprehensive	Total
	Shares	Amount	earnings	income (loss)	
Balance, December 31, 2016	2,453,805	\$ 27,155	\$ 52,095	\$ 1,381	\$ 80,631
Net income			6,389		6,389
Other comprehensive income				540	540
Issuance of common stock through Employee Stock Purchase Plan	4,085	126			126
Issuance of common stock through Dividend Reinvestment Plan	7,744	331			331
Issuance of common stock from vested restricted share grants through stock compensation plans	9,657				
Issuance of common stock through exercise of stock options	11,500	332			332
Stock-based compensation expense		256			256
Issuance of common stock from stock split	1,243,187				
Cash in lieu of fractional shares paid due to the stock split			(11)		(11)
Cash dividends declared			(2,310)		(2,310)
Balance, September 30, 2017	3,729,978	\$ 28,200	\$ 56,163	\$ 1,921	\$ 86,284
Balance, December 31, 2017	3,734,478	\$ 28,361	\$ 57,218	\$ 1,804	\$ 87,383
Net income			8,159		8,159
Other comprehensive loss				(3,926)	(3,926)
Effect of adopting ASU 2016-01			421	(421)	-
Issuance of common stock through Employee Stock Purchase Plan	6,783	149			149
Issuance of common stock through Dividend Reinvestment Plan	5,486	311			311
Issuance of common stock from vested restricted share grants through stock compensation plans	9,994				
Issuance of common stock through exercise of stock options	750	14			14
Stock-based compensation expense		685			685
Cash dividends declared			(2,723)		(2,723)

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Balance, September 30, 2018	3,757,491	\$ 29,520	\$ 63,075	\$ (2,543)	\$ 90,052
-----------------------------	-----------	-----------	-----------	------------	-----------

6

Table Of Contents

For the three months ended September, 2018 and 2017
(Unaudited)

(dollars in thousands)	Capital stock		Retained	Accumulated other comprehensive	Total
	Shares	Amount	earnings	income (loss)	
Balance, June 30, 2017	2,470,544	\$ 27,565	\$ 54,719	\$ 1,852	\$ 84,136
Net income			2,226		2,226
Other comprehensive income				69	69
Issuance of common stock through Dividend Reinvestment Plan	5,266	241			241
Issuance of common stock through exercise of stock options	10,981	317			317
Stock-based compensation expense		77			77
Issuance of common stock from stock split	1,243,187				
Cash in lieu of fractional shares paid due to the stock split			(11)		(11)
Cash dividends declared			(771)		(771)
Balance, September 30, 2017	3,729,978	\$ 28,200	\$ 56,163	\$ 1,921	\$ 86,284
Balance, June 30, 2018	3,752,005	\$ 29,016	\$ 61,119	\$ (1,283)	\$ 88,852
Net income			2,863		2,863
Other comprehensive loss				(1,260)	(1,260)
Issuance of common stock through Dividend Reinvestment Plan	5,486	311			311
Stock-based compensation expense		193			193
Cash dividends declared			(907)		(907)
Balance, September 30, 2018	3,757,491	\$ 29,520	\$ 63,075	\$ (2,543)	\$ 90,052

See notes to unaudited consolidated financial statements

Table Of ContentsFidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows

(Unaudited)

(dollars in thousands)

Nine months ended
September 30,
2018 2017

Cash flows from operating activities:

Net income	\$ 8,159	\$ 6,389
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	2,252	2,324
Provision for loan losses	1,125	925
Deferred income tax expense	779	1,070
Stock-based compensation expense	590	419
Excess tax benefit from exercise of stock options	4	66
Proceeds from sale of loans held-for-sale	25,509	33,498
Originations of loans held-for-sale	(25,622)	(29,342)
Earnings from bank-owned life insurance	(448)	(422)
Net gain from sales of loans	(522)	(684)
Net gain from sales of investment securities	(54)	-
Net loss from sale and write-down of foreclosed assets held-for-sale	52	83
Net gain from disposal of equipment	(2)	-
Change in:		
Accrued interest receivable	(514)	(519)
Other assets	(2,244)	(4,262)
Accrued interest payable and other liabilities	1,205	1,928
Net cash provided by operating activities	10,269	11,473

Cash flows from investing activities:

Available-for-sale securities:

Proceeds from sales	13,514	-
Proceeds from maturities, calls and principal pay-downs	15,579	14,795
Purchases	(48,931)	(36,786)
(Increase) decrease in FHLB stock	(1,885)	63
Net increase in loans and leases	(65,624)	(39,271)
Purchase of life insurance policies	-	(8,000)
Purchases of bank premises and equipment	(1,869)	(747)
Net cash acquired in acquisition of bank branch	-	11,817
Proceeds from sale of bank premises and equipment	8	6
Proceeds from sale of foreclosed assets held-for-sale	1,125	511
Net cash used in investing activities	(88,083)	(57,612)

Cash flows from financing activities:

Net increase in deposits	48,915	31,308
--------------------------	--------	--------

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Net increase in short-term borrowings	21,767	8,697
Proceeds from issuance of FHLB advances	15,000	25,704
Repayment of FHLB advances	(4,500)	(2,000)
Proceeds from employee stock purchase plan participants	149	126
Exercise of stock options	14	332
Dividends paid, net of dividends reinvested	(2,412)	(1,979)
Cash paid in lieu of fractional shares	-	(11)
Net cash provided by financing activities	78,933	62,177
Net increase in cash and cash equivalents	1,119	16,038
Cash and cash equivalents, beginning	15,825	25,843
Cash and cash equivalents, ending	\$ 16,944	\$ 41,881

See notes to consolidated financial statements

Table Of ContentsFidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows (continued)

(Unaudited)

Nine months ended

September 30,

2018 2017

(dollars in thousands)

Supplemental Disclosures of Cash Flow Information

Cash payments for:

Interest \$ 3,150 \$ 2,219

Income tax 300 1,300

Supplemental Disclosures of Non-cash Investing Activities:

Net change in unrealized gains on available-for-sale securities (4,970) 818

Transfers from loans to foreclosed assets held-for-sale 781 216

Transfers from loans to loans held-for-sale 1,541 2,752

Acquisition of West Scranton Branch from Wayne Bank

Non-cash assets acquired:

Loans \$ 1,574

Bank premises and equipment 264

Goodwill 209

Accrued interest receivable and other assets 4

Total non-cash assets acquired \$ 2,051

Liabilities assumed:

Deposits \$ 13,809

Accrued interest payable and other liabilities 59

Total liabilities assumed \$ 13,868

See notes to unaudited consolidated financial statements

Table Of Contents

FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered under the law of the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne Counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company's assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of September 30, 2018 and December 31, 2017 and the related consolidated statements of income and consolidated statements of comprehensive income for the three and nine months ended September 30, 2018 and 2017, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the nine months ended September 30, 2018 and 2017 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2017 financial statements to conform to the 2018 presentation.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after September 30, 2018 through the date these consolidated financial statements were issued.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2017, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at September 30, 2018 is adequate and reasonable to cover incurred losses. Given the subjective nature of identifying and estimating loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance amount. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Fair values of investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. All of the Company's debt securities are classified as available-for-sale (AFS). AFS debt securities are carried at fair value on the

Table Of Contents

consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (AOCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the residential mortgage loans are transferred at the lower of cost or market value and simultaneously sold. For other loans transferred to HFS, pricing may be obtained from other entities or modeled and the other loans are transferred at the lower of cost or market value and then sold. As of September 30, 2018 and December 31, 2017, loans classified as HFS consisted of residential mortgage loans.

Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest income on automobile direct finance leasing is determined using the interest method to arrive at a level effective yield over the life of the lease.

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value, any rental income received and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

Goodwill is recorded on the consolidated balance sheets as the excess of liabilities assumed over identifiable assets acquired on the acquisition date. Goodwill is recorded at its net carrying value which represents estimated fair value. The goodwill is deductible for tax purposes over a 15 year period.

The Company holds separate supplemental executive retirement (SERP) agreements for certain officers and an amount is credited to each participant's SERP account monthly while they are actively employed by the bank until retirement. A deferred tax asset is provided for the non-deductible SERP expense. The Company also entered into separate split dollar life insurance arrangements with three executives providing post-retirement benefits and accrues monthly expense for this benefit. The split dollar life insurance expense is not deductible for tax purposes. Monthly expenses for the SERP and post-retirement split dollar life benefit are recorded as components of salaries and employee benefit expense on the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

Revenue Recognition

As of January 1, 2018, the Company adopted ASU 2014-09, Revenue from Contracts with Customers (Topic 606) and all subsequent ASUs that modified Topic 606. The Company has elected to use the modified retrospective approach with prior period financial statements unadjusted and presented with historical revenue recognition methods. The implementation of the new standard had no material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

The majority of the Company's revenues are generated through interest earned on securities and loans, which is explicitly excluded from the scope of the guidance. In addition, certain non-interest income streams such as fees associated with mortgage servicing rights, loan service charges, life insurance earnings, rental income and gains/losses on the sale of loans and securities are not in the scope of the new guidance. The main types of contracts with customers that are in the scope of the new guidance are:

- Service charges on deposit accounts – Deposit service charges represent fees charged by the Company for the performance obligation of providing services to a customer's deposit account. The transaction price for deposit services includes both fixed and variable amounts based on the Company's fee schedules. Revenue is recognized and payment is received either at a point in time for transactional fees or on a monthly basis for non-transactional fees.
- Interchange fees – Interchange fees represent fees charged by the Company for customers using debit cards. The contract is between the Company and the processor and the performance obligation is the ability of customers to use debit cards to make purchases at a point in time. The transaction price is a percentage of debit card usage and the processor pays the Company and revenue is recorded throughout the month as the performance obligations are being met.
- Fees from trust fiduciary activities – Trust fees represent fees charged by the Company for the management, custody and/or administration of trusts. These are mostly monthly fees based on the market value of assets in the trust account at the prior month end. Payment is generally received a few weeks after month end through a direct charge to customers' accounts. Estate fees are recognized and charged as the Company reaches each of six different stages of the estate administration process.

Table Of Contents

- Fees from financial services – Financial service fees represent fees charged by the Company for the performance obligation of providing various services for an investment account. Revenue is recognized twice monthly for fees on sales transactions and on a monthly basis for advisory fees and quarterly for trail fees.
- Gain/loss on ORE sales – Gain/loss on the sale of ORE is recognized at the closing date when the sales proceeds are received. In seller-financed ORE transactions, the contract is made subject to our normal underwriting standards and pricing. The Company does not have any obligation or right to repurchase any sales of ORE.

Contract balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before the payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity already received payment (or payment is due) from the customer. The Company's non-interest income streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company typically does not enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.

Remaining performance obligations

The Company's performance obligations have an original expected duration of less than one year and follow the relevant guidance for recognizing revenue over time. There is no variable consideration subject to constraint that is not included in information about transaction price.

Contract acquisition costs

In connection with the adoption of Topic 606, an entity is required to capitalize and subsequently amortize into expense, certain incremental costs of obtaining a contract if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition costs.

2. New accounting pronouncements

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2016-13, Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments. The amendments in this update require financial assets measured at amortized cost basis to be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. Previously, when credit losses were measured under GAAP, an entity only considered past events and current conditions when measuring the incurred loss. The amendments in this update broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgement in determining the relevant information and estimation methods that are appropriate under the circumstances. The amendments in this update also require that credit losses on available-for-sale debt securities be presented as an allowance for credit losses rather than a writedown. The amendments in this update are effective for fiscal years, including interim periods within those fiscal years, beginning

after December 15, 2019 for public companies. Early adoption is permitted beginning after December 15, 2018, including interim periods within those fiscal years. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption (modified-retrospective approach). Upon adoption, the change in this accounting guidance could result in an increase in the Company's allowance for loan losses and require the Company to record loan losses more rapidly. The Company is currently evaluating the impact of ASU 2016-13 on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation.

The Company adopted this guidance on January 1, 2018 using the modified retrospective approach. The adoption of ASU 2014-09 did not materially change the method in which the Company recognizes revenue. As a result, the Company changed the process for recognizing revenue for estate fees within fees from trust fiduciary services. The Company concluded the cumulative adjustment to

Table Of Contents

retained earnings for estates in process was immaterial and the income was recognized during the first quarter of 2018. See “Revenue Recognition” in footnote 1 for more information.

In January 2016, the FASB issued ASU 2016-01 related to Financial Instruments - Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities. The update applies to all entities that hold financial assets or owe financial liabilities. The amendments in this update make targeted improvements to U.S. GAAP as follows:

- Require equity investments to be measured at fair value with changes in fair value recognized in net income;
- Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
- Require public business entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes;
- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset;
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities.

The Company adopted this guidance on January 1, 2018. The adoption did not have a material impact on the consolidated financial statements. As a result of this guidance, the Company reclassified \$0.4 million in net unrealized gains on equity securities from accumulated other comprehensive income to retained earnings on January 1, 2018 and the Company measured the fair value of its loan portfolio using the exit price notion. See “Fair Value Measurements” in footnote 8 for more information about the fair value measurement of the loan portfolio.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU 2016-02 requires the recognition of a right-of-use asset and related lease liability by lessees for leases classified as operating leases under GAAP. The Company is expected to make an election to exclude leases less than 12 months from the provisions of this ASU. The amendments in this update are effective for the Company for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption of the amendments in this update is permitted. A modified retroactive approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore not recognized on the Company’s consolidated balance sheets. Therefore, the adoption of ASU 2016-02 is expected to impact the Company’s consolidated balance sheets, along with our regulatory capital ratios. Upon adoption, this change in accounting guidance could also potentially impact debt covenant agreements with our customers. The Company estimated approximately \$8 million will be added to the consolidated balance sheets as a right-of-use-asset and lease liability. As we finalize our assessment, this amount may change. There is not expected to be any significant effect on the consolidated statements of income.

In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, Leases and ASU 2018-11, Leases (Topic 842) Targeted Improvements to clarify how to apply certain aspects of ASU 2016-02 and to simplify adoption and reduce costs. ASU 2018-11 allows companies the option to apply the provisions of the new lease standard prospectively as of the effective date, without adjusting comparative periods, and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company anticipates using this additional transition method. The amendments in this update are effective upon adoption of Topic 842.

In August 2016, the FASB released ASU 2016-15, Statement of Cash Flows (Topic 230) to clarify the presentation of certain cash receipts and payments on the statement of cash flows. The update addressed eight specific cash flow

issues with the objective of reducing the existing diversity in practice. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments in this update should be applied using a retrospective transition method to each period presented. The Company adopted ASU 2016-15 on January 1, 2018 and it did not have a significant impact on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles-Goodwill and Other (Topic 350) to simplify the test for goodwill impairment. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. Under the amendments in this update, an entity should perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting units fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity should apply the amendments in his update on a prospective basis. The amendments in this update are effective for the Company for its annual goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company adopted this standard in 2017 and it did not have an impact on its consolidated financial statements. The Company did not have any goodwill prior to adoption of this update.

In March 2017, the FASB issued ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20) Premium Amortization on Purchased Callable Debt Securities to amend the amortization period for certain purchased callable debt securities held at a premium. The amendments in this update shorten the amortization period for the premium to the earliest call date. The

Table Of Contents

amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. An entity should apply the amendments in this update on a modified retrospective basis through a cumulative effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company adopted this standard in 2017 and it did not have an effect on its consolidated financial statements.

In February 2018, the FASB released ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220) to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Act. The amendments in this update also require certain disclosures about stranded tax effects. The guidance is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or available for issuance, including in the period the Act was enacted. The Company elected to early adopt and reclassify the stranded income tax effects of the Act from accumulated other comprehensive income to retained earnings during the fourth quarter of 2017. The reclassification increased AOCI and decreased retained earnings by \$0.3 million, with zero net effect on total shareholders' equity.

3. Accumulated other comprehensive income

The following tables illustrate the changes in accumulated other comprehensive income by component and the details about the components of accumulated other comprehensive income as of and for the periods indicated:

As of and for the nine months ended September 30, 2018

(dollars in thousands)	Unrealized gains (losses) on available-for-sale debt securities
Beginning balance	\$ 1,804
Other comprehensive loss before reclassifications, net of tax	(3,918)
Amounts reclassified from accumulated other comprehensive income, net of tax	(8)
Effect of adopting ASU 2016-01, net of tax*	(421)
Net current-period other comprehensive loss	(4,347)
Ending balance	\$ (2,543)

*The Company adopted ASU 2016-01 on January 1, 2018. As a result, unrealized gains on equity securities were reclassified from accumulated other comprehensive income to retained earnings.

As of and for the three months ended September 30, 2018

(dollars in thousands)	Unrealized gains (losses) on available-for-sale debt securities
Beginning balance	\$ (1,283)

Other comprehensive loss before reclassifications, net of tax	(1,257)
Amounts reclassified from accumulated other comprehensive income, net of tax	(3)
Net current-period other comprehensive loss	(1,260)
Ending balance	\$ (2,543)

As of and for the nine months ended September 30, 2017

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities
Beginning balance	\$ 1,381
Other comprehensive income before reclassifications, net of tax	540
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	540
Ending balance	\$ 1,921

Table Of Contents

As of and for the three months ended September 30, 2017

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities
Beginning balance	\$ 1,852
Other comprehensive income before reclassifications, net of tax	69
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	69
Ending balance	\$ 1,921

Details about accumulated other

comprehensive income components	Amount reclassified from accumulated other comprehensive income				Affected line item in the statement
(dollars in thousands)					where net income is presented
	For the three months ended September 30, 2018	For the nine months ended September 30, 2017	For the three months ended September 30, 2018	For the nine months ended September 30, 2017	
Unrealized gains on AFS debt securities	\$ 4	\$ -	\$ 10	\$ -	Gain on sale of investment securities
Income tax effect	(1)	-	(2)	-	Provision for income taxes
Total reclassifications for the period	\$ 3	\$ -	\$ 8	\$ -	Net income

4. Investment securities

Agency – Government-sponsored enterprise (GSE) and Mortgage-backed securities (MBS) - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- to long-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), FNMA, FHLB and Government National Mortgage Association (GNMA). These

securities have interest rates that are fixed and adjustable, have varying short to long-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

Obligations of states and political subdivisions

The municipal securities are bank qualified or bank eligible, general obligation and revenue bonds rated as investment grade by various credit rating agencies and have fixed rates of interest with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

The amortized cost and fair value of investment securities at September 30, 2018 and December 31, 2017 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
September 30, 2018				
Available-for-sale debt securities:				
Agency - GSE	\$ 5,922	\$ -	\$ (89)	\$ 5,833
Obligations of states and political subdivisions	44,579	1,030	(523)	45,086
MBS - GSE residential	124,169	159	(3,796)	120,532
Total available-for-sale debt securities	\$ 174,670	\$ 1,189	\$ (4,408)	\$ 171,451

Table Of Contents

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2017				
Available-for-sale securities:				
Agency - GSE	\$ 9,120	\$ 3	\$ (24)	\$ 9,099
Obligations of states and political subdivisions	42,300	2,036	(30)	44,306
MBS - GSE residential	103,386	519	(753)	103,152
Total debt securities	154,806	2,558	(807)	156,557
Equity securities - financial services	294	534	-	828
Total available-for-sale securities	\$ 155,100	\$ 3,092	\$ (807)	\$ 157,385

The Company adopted ASU 2016-01, Financial Instruments – Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities effective January 1, 2018. The Company sold all of its equity securities during the first half of 2018.

The amortized cost and fair value of debt securities at September 30, 2018 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Available-for-sale securities:		
Debt securities:		
Due in one year or less	\$ -	\$ -
Due after one year through five years	3,825	3,841
Due after five years through ten years	7,599	7,596
Due after ten years	39,077	39,482
MBS - GSE residential	124,169	120,532
Total available-for-sale debt securities	\$ 174,670	\$ 171,451

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total. Most of the securities have fixed rates or have predetermined scheduled rate changes and many have call features that allow the issuer to call the security at par before its stated maturity without penalty.

Table Of Contents

The following table presents the fair value and gross unrealized losses of debt securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of September 30, 2018 and December 31, 2017:

(dollars in thousands)	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
September 30, 2018						
Agency - GSE	\$ 5,833	\$ (89)	\$ -	\$ -	\$ 5,833	\$ (89)
Obligations of states and political subdivisions	16,463	(334)	1,942	(189)	18,405	(523)
MBS - GSE residential	68,881	(1,650)	47,161	(2,146)	116,042	(3,796)
Total	\$ 91,177	\$ (2,073)	\$ 49,103	\$ (2,335)	\$ 140,280	\$ (4,408)
Number of securities	79		37		116	
December 31, 2017						
Agency - GSE	\$ 6,020	\$ (14)	\$ 1,008	\$ (10)	\$ 7,028	\$ (24)
Obligations of states and political subdivisions	425	(1)	2,109	(29)	2,534	(30)
MBS - GSE residential	61,349	(437)	15,309	(316)	76,658	(753)
Total	\$ 67,794	\$ (452)	\$ 18,426	\$ (355)	\$ 86,220	\$ (807)
Number of securities	45		14		59	

The Company had 116 debt securities in an unrealized loss position at September 30, 2018, including six agency securities, seventy-four mortgage-backed securities and thirty-six municipal securities. The severity of these unrealized losses based on their underlying cost basis was as follows at September 30, 2018: 1.50% for agencies; 3.17% for total MBS-GSE; and 2.76% for municipals. Of these securities, thirty-three mortgage-backed securities and four municipal securities had been in an unrealized loss position in excess of 12 months. The changes in the prices on these securities in an unrealized loss position in excess of 12 months are the result of interest rate movement and management believes they are temporary in nature.

Management believes the cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to illiquid conditions in the debt market and is not directly related to credit quality. Quarterly, management conducts a formal review of investment securities for the presence of other than temporary impairment (OTTI). The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost as of the balance sheet date. Under those circumstances, OTTI is considered to have occurred if: (1) the entity has intent to sell the security; (2) more likely than not the entity will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost. The accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (OCI). Non-credit-related OTTI is based on other factors affecting market value, including illiquidity.

The Company's OTTI evaluation process also follows the guidance set forth in topics related to debt securities. The guidance set forth in the pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts' evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be to maturity and other factors when evaluating for the existence of OTTI. The guidance requires that credit-related OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder's expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt securities.

For all debt securities, as of September 30, 2018, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that, more likely than not, would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's security portfolio. In addition, management believes the change in fair value is attributable to changes in interest rates.

Table Of Contents

5. Loans and leases

The classifications of loans and leases at September 30, 2018 and December 31, 2017 are summarized as follows:

(dollars in thousands)	September 30, 2018	December 31, 2017
Commercial and industrial	\$ 121,788	\$ 113,601
Commercial real estate:		
Non-owner occupied	89,568	92,851
Owner occupied	121,144	109,383
Construction	7,510	6,228
Consumer:		
Home equity installment	31,511	27,317
Home equity line of credit	52,936	53,273
Auto loans and leases	113,643	83,510
Other	5,292	5,604
Residential:		
Real estate	145,711	136,901
Construction	12,754	9,931
Total	701,857	638,599
Less:		
Allowance for loan losses	(9,944)	(9,193)
Unearned lease revenue	(969)	(639)
Loans and leases, net	\$ 690,944	\$ 628,767

Net deferred loan costs of \$2.5 million and \$2.1 million have been included in the carrying values of loans at September 30, 2018 and December 31, 2017, respectively.

Unearned lease revenue represents the difference between the lessor's investment in the property and the gross investment in the lease. Unearned revenue is accrued over the life of the lease using the effective interest method. The residual value of leases is fully guaranteed by the dealerships. Residual values, a component of other assets on the balance sheet, amounted to \$10.5 million and \$9.4 million at September 30, 2018 and December 31, 2017, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate unpaid principal balance of mortgages serviced amounted to \$304.9 million as of September 30, 2018 and \$299.3 million as of December 31, 2017. Mortgage servicing rights amounted to \$1.2 million and \$1.3 million as of September 30, 2018 and December 31, 2017, respectively.

Management is responsible for conducting the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the board of directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. C&I and CRE loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. The Company considers all non-accrual loans to be impaired loans.

Table Of Contents

Non-accrual loans, segregated by class, at September 30, 2018 and December 31, 2017, were as follows:

(dollars in thousands)	September 30, 2018	December 31, 2017
Commercial and industrial	\$ 169	\$ 36
Commercial real estate:		
Non-owner occupied	538	649
Owner occupied	911	942
Construction	46	161
Consumer:		
Home equity installment	462	15
Home equity line of credit	43	559
Auto loans and leases	62	5
Residential:		
Real estate	1,546	1,074
Total	\$ 3,777	\$ 3,441

Troubled Debt Restructuring

A modification of a loan constitutes a TDR when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company considers all TDRs to be impaired loans. The Company typically considers the following concessions when modifying a loan, which may include lowering interest rates below the market rate, temporary interest-only payment periods, term extensions at interest rates lower than the current market rate for new debt with similar risk and/or converting revolving credit lines to term loans. The Company typically does not consider forgiveness of principal when granting a TDR modification. Of the TDRs outstanding as of September 30, 2018 and 2017, when modified, the concessions granted consisted of temporary interest-only payments, extensions of maturity date, or a reduction in the rate of interest to a below-market rate for a contractual period of time. Other than the TDRs that were placed on non-accrual status, the TDRs were performing in accordance with their modified terms.

There were no loans modified in a TDR for the three months ended September 30, 2018 and 2017. The following presents by class, information related to loans modified in a TDR:

(dollars in thousands)	Loans modified as TDRs for the nine months ended:					
	September 30, 2018			September 30, 2017		
	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

			period end)			period end)
Commercial real estate - non-owner occupied	-	\$ -	\$ -	1	\$ 119	\$ 4
Commercial real estate - owner occupied	-	-	-	5	926	187
Consumer home equity installment	1	413	356	-	-	-
Residential real estate	1	316	-	-	-	-
Total	2	\$ 729	\$ 356	6	\$ 1,045	\$ 191

In the above tables, the period end balance is inclusive of all partial pay downs and charge-offs since the modification date. For all loans modified in a TDR, the pre-modification recorded investment was the same as the post-modification recorded investment.

The following presents by class, loans modified as a TDR that subsequently defaulted (i.e. 90 days or more past due following modification) during the periods indicated:

Loans modified as a TDR within the previous twelve months that subsequently defaulted during the nine months ended:

(dollars in thousands)	September 30, 2018		September 30, 2017	
	Number of contracts	Recorded investment	Number of contracts	Recorded investment
Commercial real estate - owner occupied	-	\$ -	1	\$ 142
Consumer home equity installment	1	413	-	-
Residential real estate	1	316	-	-
	2	\$ 729	1	\$ 142

In the above table, the period end balances are inclusive of all partial pay downs and charge-offs since the modification date.

Table Of Contents

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment.

The allowance for loan losses (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge-offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral is used to establish the allowance. As of September 30, 2018 and 2017, respectively, the allowance for impaired loans that have been modified in a TDR was \$0.8 million and \$0.8 million, respectively.

Past due loans

Loans are considered past due when the contractual principal and/or interest is not received by the due date. An aging analysis of past due loans, segregated by class, as of the period indicated is as follows (dollars in thousands):

September 30, 2018	30 - 59 Days past due	60 - 89 Days past due	Past due		Current	Total loans (3)	Recorded investment past due ≥ 90 days and accruing
			90 days or more (1)	Total past due			
Commercial and industrial	\$ 340	\$ 112	\$ 169	\$ 621	\$ 121,167	\$ 121,788	\$ -
Commercial real estate:							
Non-owner occupied	176	-	538	714	88,854	89,568	-
Owner occupied	1,461	395	911	2,767	118,377	121,144	-
Construction	-	-	46	46	7,464	7,510	-
Consumer:							
Home equity installment	252	41	462	755	30,756	31,511	-
Home equity line of credit	86	9	43	138	52,798	52,936	-
Auto loans and leases	308	15	76	399	112,275	112,674 (2)	14
Other	13	33	-	46	5,246	5,292	-
Residential:							
Real estate	560	212	1,546	2,318	143,393	145,711	-
Construction	-	-	-	-	12,754	12,754	-
Total	\$ 3,196	\$ 817	\$ 3,791	\$ 7,804	\$ 693,084	\$ 700,888	\$ 14

(1) Includes \$3.8 million of non-accrual loans. (2) Net of unearned lease revenue of \$1.0 million. (3) Includes net deferred loan costs of \$2.5 million.

	30 - 59 Days	60 - 89 Days	Past due		Current	Total loans (3)	Recorded investment past due ≥ 90 days and accruing
			90 days or more (1)	Total past due			
December 31, 2017	past due	past due	(1)	past due	Current	loans (3)	
Commercial and industrial	\$ 286	\$ -	\$ 36	\$ 322	\$ 113,279	\$ 113,601	\$ -
Commercial real estate:							
Non-owner occupied	51	1,018	649	1,718	91,133	92,851	-
Owner occupied	52	85	942	1,079	108,304	109,383	-
Construction	-	-	161	161	6,067	6,228	-
Consumer:							
Home equity installment	130	30	15	175	27,142	27,317	-
Home equity line of credit	276	-	559	835	52,438	53,273	-
Auto loans and leases	449	85	11	545	82,326	82,871 (2)	6
Other	42	-	-	42	5,562	5,604	-
Residential:							
Real estate	38	351	1,074	1,463	135,438	136,901	-
Construction	-	-	-	-	9,931	9,931	-
Total	\$ 1,324	\$ 1,569	\$ 3,447	\$ 6,340	\$ 631,620	\$ 637,960	\$ 6

(1) Includes \$3.4 million of non-accrual loans. (2) Net of unearned lease revenue of \$0.6 million. (3) Includes net deferred loan costs of \$2.1 million.

Impaired loans

A loan is considered impaired when, based on current information and events; it is probable that the Company will be unable to collect the payments in accordance with the contractual terms of the loan. Factors considered in determining impairment include payment status, collateral value and the probability of collecting payments when due. The significance of payment delays and/or shortfalls is determined on a case-by-case basis. All circumstances surrounding the loan are taken into account. Such factors include the length of

Table Of Contents

the delinquency, the underlying reasons and the borrower's prior payment record. Impairment is measured on these loans on a loan-by-loan basis. Impaired loans include non-accrual loans, TDRs and other loans deemed to be impaired based on the aforementioned factors.

At September 30, 2018, impaired loans totaled \$7.0 million consisting of \$1.8 million in accruing TDRs, \$3.8 million in non-accrual loans and \$1.4 million in accruing impaired loans. At December 31, 2017, impaired loans totaled \$6.9 million consisting of \$1.9 million in accruing TDRs, \$3.4 million in non-accrual loans and \$1.6 million in accruing impaired loans. As of September 30, 2018, the non-accrual loans included four TDRs to three unrelated borrowers totaling \$1.9 million compared with three TDRs totaling \$1.6 million to three unrelated borrowers as of December 31, 2017.

Impaired loans, segregated by class, as of the period indicated are detailed below:

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance
September 30, 2018					
Commercial and industrial	\$ 265	\$ 70	\$ 123	\$ 193	\$ 30
Commercial real estate:					
Non-owner occupied	2,374	1,831	361	2,192	415
Owner occupied	2,696	1,584	863	2,447	504
Construction	269	-	46	46	-
Consumer:					
Home equity installment	495	413	49	462	356
Home equity line of credit	82	27	16	43	27
Auto loans and leases	89	27	35	62	12
Other	-	-	-	-	-
Residential:					
Real estate	1,880	76	1,470	1,546	47
Construction	-	-	-	-	-
Total	\$ 8,150	\$ 4,028	\$ 2,963	\$ 6,991	\$ 1,391

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance
December 31, 2017					
Commercial and industrial	\$ 281	\$ 225	\$ 24	\$ 249	\$ 196
Commercial real estate:					
Non-owner occupied	2,426	1,975	363	2,338	488
Owner occupied	2,742	1,768	725	2,493	433

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Construction	384	-	161	161	-
Consumer:					
Home equity installment	48	-	15	15	-
Home equity line of credit	878	32	527	559	25
Auto	13	-	5	5	-
Other	-	-	-	-	-
Residential:					
Real estate	1,350	131	943	1,074	37
Construction	-	-	-	-	-
Total	\$ 8,122	\$ 4,131	\$ 2,763	\$ 6,894	\$ 1,179

The following table presents the average recorded investments in impaired loans and related amount of interest income recognized during the periods indicated below. The average balances are calculated based on the quarter-end balances of impaired loans. Payments received from non-accruing impaired loans are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income. Payments received from accruing impaired loans are applied to principal and interest, as contractually agreed upon.

Table Of Contents

(dollars in thousands)	For the nine months ended September 30, 2018			September 30, 2017		
	Average recorded investment	Interest income recognized	Cash basis interest income recognized	Average recorded investment	Interest income recognized	Cash basis interest income recognized
Commercial and industrial	\$ 202	\$ 2	\$ -	\$ 232	\$ 7	\$ -
Commercial real estate:						
Non-owner occupied	2,236	89	-	3,054	114	-
Owner occupied	2,534	62	-	4,393	223	-
Construction	140	-	-	184	-	-
Consumer:						
Home equity installment	283	5	-	19	-	-
Home equity line of credit	236	8	-	722	5	-
Auto	27	-	-	21	4	-
Other	4	-	-	4	1	-
Residential:						
Real estate	1,303	31	-	1,428	77	-
Construction	-	-	-	-	-	-
Total	\$ 6,965	\$ 197	\$ -	\$ 10,057	\$ 431	\$ -

(dollars in thousands)	For the three months ended September 30, 2018			September 30, 2017		
	Average recorded investment	Interest income recognized	Cash basis interest income recognized	Average recorded investment	Interest income recognized	Cash basis interest income recognized
Commercial and industrial	\$ 158	\$ 1	\$ -	\$ 223	\$ 3	\$ -
Commercial real estate:						
Non-owner occupied	2,179	26	-	2,588	52	-
Owner occupied	2,455	21	-	3,521	152	-
Construction	103	-	-	173	-	-
Consumer:						
Home equity installment	479	-	-	15	-	-
Home equity line of credit	37	-	-	659	5	-
Auto	57	-	-	-	-	-
Other	-	-	-	3	-	-
Residential:						
Real estate	1,389	-	-	1,421	54	-

Construction	-	-	-	-	-	-
Total	\$ 6,857	\$ 48	\$ -	\$ 8,603	\$ 266	\$ -

Credit Quality Indicators

Commercial and industrial and commercial real estate

The Company utilizes a loan grading system and assigns a credit risk grade to its loans in the C&I and CRE portfolios. The grading system provides a means to measure portfolio quality and aids in the monitoring of the credit quality of the overall loan portfolio. The credit risk grades are arrived at using a risk rating matrix to assign a grade to each of the loans in the C&I and CRE portfolios.

The following is a description of each risk rating category the Company uses to classify each of its C&I and CRE loans:

Pass

Loans in this category have an acceptable level of risk and are graded in a range of one to five. Secured loans generally have good collateral coverage. Current financial statements reflect acceptable balance sheet ratios, sales and earnings trends. Management is considered to be competent, and a reasonable succession plan is evident. Payment experience on the loans has been good with minor or no delinquency experience. Loans with a grade of one are of the highest quality in the range. Those graded five are of marginally acceptable quality.

Table Of Contents

Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the Company, but have not yet reached the point of adverse classification. Some of the following conditions may exist: little or no collateral coverage; lack of current financial information; delinquency problems; highly leveraged; available financial information reflects poor balance sheet ratios and profit and loss statements reflect uncertain trends; and document exceptions. Cash flow may not be sufficient to support total debt service requirements.

Substandard

Loans in this category are graded a seven and have a well-defined weakness which may jeopardize the ultimate collectability of the debt. The collateral pledged may be lacking in quality or quantity. Financial statements may indicate insufficient cash flow to service the debt; and/or do not reflect a sound net worth. The payment history indicates chronic delinquency problems. Management is considered to be weak. There is a distinct possibility that the Company may sustain a loss. All loans on non-accrual are rated substandard. Other loans that are included in the substandard category can be accruing, as well as loans that are current or past due. Loans 90 days or more past due, unless otherwise fully supported, are classified substandard. Also, borrowers that are bankrupt or have loans categorized as TDRs can be graded substandard.

Doubtful

Loans in this category are graded an eight and have a better than 50% possibility of the Company sustaining a loss, but the loss cannot be determined because of specific reasonable factors which may strengthen credit in the near-term. Many of the weaknesses present in a substandard loan exist. Liquidation of collateral, if any, is likely. Any loan graded lower than an eight is considered to be uncollectible and charged-off.

Consumer and residential

The consumer and residential loan segments are regarded as homogeneous loan pools and as such are not risk rated. For these portfolios, the Company utilizes payment activity and history in assessing performance. Non-performing loans are comprised of non-accrual loans and loans past due 90 days or more and accruing. All loans not classified as non-performing are considered performing.

The following table presents loans including \$2.5 million and \$2.1 million of deferred costs, segregated by class, categorized into the appropriate credit quality indicator category as of September 30, 2018 and December 31, 2017, respectively:

Commercial credit exposure

Credit risk profile by creditworthiness category

(dollars in thousands)	September 30, 2018				
	Pass	Special mention	Substandard	Doubtful	Total

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Commercial and industrial	\$ 120,023	\$ 428	\$ 1,337	\$ -	\$ 121,788
Commercial real estate - non-owner occupied	84,109	1,149	4,310	-	89,568
Commercial real estate - owner occupied	113,589	2,557	4,998	-	121,144
Commercial real estate - construction	7,464	-	46	-	7,510
Total commercial	\$ 325,185	\$ 4,134	\$ 10,691	\$ -	\$ 340,010

Consumer & Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	September 30, 2018		
	Performing	Non-performing	Total
Consumer			
Home equity installment	\$ 31,049	\$ 462	\$ 31,511
Home equity line of credit	52,893	43	52,936
Auto loans and leases (1)	112,598	76	112,674
Other	5,292	-	5,292
Total consumer	\$ 201,832	\$ 581	\$ 202,413
Residential			
Real estate	\$ 144,165	\$ 1,546	\$ 145,711
Construction	12,754	-	12,754
Total residential	\$ 156,919	\$ 1,546	\$ 158,465
Total consumer & residential	\$ 358,751	\$ 2,127	\$ 360,878

(1)Net of unearned lease revenue of \$0.9 million.

Table Of Contents

Commercial credit exposure

Credit risk profile by creditworthiness category

(dollars in thousands)	December 31, 2017				
	Pass	Special mention	Substandard	Doubtful	Total
Commercial and industrial	\$ 112,398	\$ 509	\$ 694	\$ -	\$ 113,601
Commercial real estate - non-owner occupied	84,892	998	6,961	-	92,851
Commercial real estate - owner occupied	103,426	2,479	3,478	-	109,383
Commercial real estate - construction	6,067	-	161	-	6,228
Total commercial	\$ 306,783	\$ 3,986	\$ 11,294	\$ -	\$ 322,063

Consumer & Mortgage lending credit exposure

Credit risk profile based on payment activity

(dollars in thousands)	December 31, 2017		
	Performing	Non-performing	Total
Consumer			
Home equity installment	\$ 27,302	\$ 15	\$ 27,317
Home equity line of credit	52,714	559	53,273
Auto loans and leases (2)	82,860	11	82,871
Other	5,604	-	5,604
Total consumer	\$ 168,480	\$ 585	\$ 169,065
Residential			
Real estate	\$ 135,827	\$ 1,074	\$ 136,901
Construction	9,931	-	9,931
Total residential	\$ 145,758	\$ 1,074	\$ 146,832
Total consumer & residential	\$ 314,238	\$ 1,659	\$ 315,897

(2)Net of unearned lease revenue of \$0.6 million.

Allowance for loan losses

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- § identification of specific impaired loans by loan category;
- § identification of specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- § application of historical loss percentages (trailing twelve-quarter average) to pools to determine the allowance allocation;
- § application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio.
- § Qualitative factor adjustments include:
 - o levels of and trends in delinquencies and non-accrual loans;
 - o levels of and trends in charge-offs and recoveries;
 - o trends in volume and terms of loans;
 - o changes in risk selection and underwriting standards;
 - o changes in lending policies and legal and regulatory requirements;
 - o experience, ability and depth of lending management;
 - o national and local economic trends and conditions; and
 - o changes in credit concentrations.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of

Table Of Contents

individual C&I and CRE loans. C&I and CRE loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The credit risk grades for the C&I and CRE loan portfolios are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what we believe to be best practices and common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the C&I and CRE loan portfolio from period to period are based upon the credit risk grading system and from periodic reviews of the loan portfolio. An unallocated component is 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.

Each quarter, management performs an assessment of the allowance. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount, if applicable, based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered regarding not only loans considered for specific reserves, but also the collectability of loans that may be past due in payment. The assessment process also includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating.

The Company's policy is to charge-off unsecured consumer loans when they become 90 days or more past due as to principal and interest. In the other portfolio segments, amounts are charged-off at the point in time when the Company deems the balance, or a portion thereof, to be uncollectible.

Information related to the change in the allowance and the Company's recorded investment in loans by portfolio segment as of the period indicated is as follows:

As of and for the nine months ended September 30, 2018

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,374	\$ 4,060	\$ 2,063	\$ 1,608	\$ 88	\$ 9,193
Charge-offs	(106)	(166)	(275)	(117)	-	(664)
Recoveries	67	36	187	-	-	290
Provision	(1)	100	699	286	41	1,125
Ending balance	\$ 1,334	\$ 4,030	\$ 2,674	\$ 1,777	\$ 129	\$ 9,944
Ending balance: individually evaluated for impairment	\$ 30	\$ 919	\$ 395	\$ 47	\$ -	\$ 1,391

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Ending balance: collectively evaluated for impairment	\$ 1,304	\$ 3,111	\$ 2,279	\$ 1,730	\$ 129	\$ 8,553
Loans Receivables:						
Ending balance (2)	\$ 121,788	\$ 218,222	\$ 202,413 (1)	\$ 158,465	\$ -	\$ 700,888
Ending balance: individually evaluated for impairment	\$ 193	\$ 4,685	\$ 567	\$ 1,546	\$ -	\$ 6,991
Ending balance: collectively evaluated for impairment	\$ 121,595	\$ 213,537	\$ 201,846	\$ 156,919	\$ -	\$ 693,897

(1) Net of unearned lease revenue of \$1.0 million. (2) Includes \$2.5 million of net deferred loan costs.

As of and for the three months ended
September 30, 2018

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,341	\$ 3,814	\$ 2,629	\$ 1,722	\$ 21	\$ 9,527
Charge-offs	(9)	(36)	(73)	(2)	-	(120)
Recoveries	13	3	121	-	-	137
Provision	(11)	249	(3)	57	108	400
Ending balance	\$ 1,334	\$ 4,030	\$ 2,674	\$ 1,777	\$ 129	\$ 9,944

Table Of Contents

As of and for the year ended
December 31, 2017

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,075	\$ 4,706	\$ 1,834	\$ 1,622	\$ 127	\$ 9,364
Charge-offs	(143)	(635)	(658)	(309)	-	(1,745)
Recoveries	10	47	67	-	-	124
Provision	432	(58)	820	295	(39)	1,450
Ending balance	\$ 1,374	\$ 4,060	\$ 2,063	\$ 1,608	\$ 88	\$ 9,193
Ending balance: individually evaluated for impairment	\$ 196	\$ 921	\$ 25	\$ 37	\$ -	\$ 1,179
Ending balance: collectively evaluated for impairment	\$ 1,178	\$ 3,139	\$ 2,038	\$ 1,571	\$ 88	\$ 8,014
Loans Receivables:						
Ending balance (2)	\$ 113,601	\$ 208,462	\$ 169,065 (1)	\$ 146,832	\$ -	\$ 637,960
Ending balance: individually evaluated for impairment	\$ 249	\$ 4,992	\$ 579	\$ 1,074	\$ -	\$ 6,894
Ending balance: collectively evaluated for impairment	\$ 113,352	\$ 203,470	\$ 168,486	\$ 145,758	\$ -	\$ 631,066

(1) Net of unearned lease revenue of \$0.6 million. (2) Includes \$2.1 million of net deferred loan costs.

As of and for the nine months ended
September 30, 2017

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,075	\$ 4,706	\$ 1,834	\$ 1,622	\$ 127	\$ 9,364
Charge-offs	(76)	(416)	(505)	(38)	-	(1,035)
Recoveries	5	44	53	-	-	102
Provision	395	(232)	587	215	(40)	925
Ending balance	\$ 1,399	\$ 4,102	\$ 1,969	\$ 1,799	\$ 87	\$ 9,356

As of and for the three months ended
September 30, 2017

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	\$ 1,383	\$ 4,510	\$ 1,939	\$ 1,511	\$ 63	\$ 9,406
Charge-offs	(46)	(48)	(345)	-	-	(439)
Recoveries	2	3	9	-	-	14
Provision	60	(363)	366	288	24	375
Ending balance	\$ 1,399	\$ 4,102	\$ 1,969	\$ 1,799	\$ 87	\$ 9,356

6. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but also reflects the potential dilution that could occur from the grant of stock-based compensation awards. The Company maintains two active share-based compensation plans that may generate additional potentially dilutive common shares. For granted and unexercised stock options and stock-settled stock appreciation rights (SSARs), dilution would occur if Company-issued stock options or SSARs were exercised and converted into common stock. As of the three and nine months ended September 30, 2018, there were 32,608 and 28,621 potentially dilutive shares related to issued and unexercised stock options and SSARs compared to 16,707 and 12,237 for the same 2017 periods, respectively. For restricted stock, dilution would occur from the Company's previously granted but unvested shares. There were 15,655 and 12,795 potentially dilutive shares related to unvested restricted share grants as of the three and nine months ended September 30, 2018 compared to 9,504 and 8,130 for the same 2017 periods, respectively.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options and SSARs and unvested restricted stock. Under the treasury stock method, the assumed proceeds, as defined, received from shares issued in a hypothetical stock option exercise or restricted stock grant, are assumed to be used to purchase treasury stock. Proceeds include: amounts received from the exercise of outstanding stock options and compensation cost for future service that the Company has not yet recognized in earnings. The Company does not consider awards from share-based grants in the computation of basic EPS.

Table Of Contents

The following table illustrates the data used in computing basic and diluted EPS for the periods indicated:

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
(dollars in thousands except per share data)				
Basic EPS:				
Net income available to common shareholders	\$ 2,863	\$ 2,226	\$ 8,159	\$ 6,389
Weighted-average common shares outstanding	3,753,138	3,712,297	3,750,652	3,704,859
Basic EPS	\$ 0.76	\$ 0.60	\$ 2.17	\$ 1.72
Diluted EPS:				
Net income available to common shareholders	\$ 2,863	\$ 2,226	\$ 8,159	\$ 6,389
Weighted-average common shares outstanding	3,753,138	3,712,297	3,750,652	3,704,859
Potentially dilutive common shares	48,263	26,211	41,416	20,367
Weighted-average common and potentially dilutive shares outstanding	3,801,401	3,738,508	3,792,068	3,725,226
Diluted EPS	\$ 0.75	\$ 0.60	\$ 2.15	\$ 1.72

7. Stock plans

The Company has two stock-based compensation plans (the stock compensation plans) from which it can grant stock-based compensation awards, and applies the fair value method of accounting for stock-based compensation provided under current accounting guidance. The guidelines require the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. The Company's stock compensation plans were shareholder-approved and permit the grant of share-based compensation awards to its employees and directors. The Company believes that the stock-based compensation plans will advance the development, growth and financial condition of the Company by providing incentives through participation in the appreciation in the value of the Company's common stock. In return, the Company hopes to secure, retain and motivate the employees and directors who are responsible for the operation and the management of the affairs of the Company by aligning the interest of its employees and directors with the interest of its shareholders. In the stock compensation plans, employees and directors are eligible to be awarded stock-based compensation grants which can consist of stock options (qualified and non-qualified), stock appreciation rights (SARs) and restricted stock.

At the 2012 annual shareholders' meeting, the Company's shareholders approved and the Company adopted the 2012 Omnibus Stock Incentive Plan and the 2012 Director Stock Incentive Plan (collectively, the 2012 stock incentive plans). The 2012 stock incentive plans replaced both the expired 2000 Independent Directors Stock Option Plan and the 2000 Stock Incentive Plan (collectively, the 2000 stock incentive plans). Unless terminated by the Company's board of directors, the 2012 stock incentive plans will expire on and no stock-based awards shall be granted after the year 2022.

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

In each of the 2012 stock incentive plans, the Company has reserved 750,000 shares of its no-par common stock for future issuance. The Company recognizes share-based compensation expense over the requisite service or vesting period. During 2015, the Company created a Long-Term Incentive Plan (LTIP) that awards restricted stock and stock-settled stock appreciation rights (SSARs) to senior officers based on the attainment of performance goals. The service requirement is the participant's continued employment throughout the LTIP with a three-year vesting period. The restricted stock has a two-year post vesting holding period requirement. The SSAR awards have a ten year term from the date of each grant. The Company granted restricted stock and SSARs in February 2016 based on 2015 performance, in February 2017 based on 2016 performance and in February 2018 based on 2017 performance and 2015-2017 3-year cumulative performance.

The following table summarizes the weighted-average fair value and vesting of restricted stock grants awarded during the periods ended September 30, 2018 and 2017 under the 2012 stock incentive plans:

	September 30, 2018			September 30, 2017		
	Shares	Weighted-		Shares	Weighted-	
	granted	average		granted	average	
		grant date			grant date	
		fair value			fair value	
Director plan	8,400	(3) \$	49.50	8,400	(2) \$	26.17
Omnibus plan	10,800	(3)	45.83	4,749	(3)	23.93
Omnibus plan	50	(1)	49.50	75	(1)	26.17
Total	19,250	\$	47.44	13,224	\$	25.36

(1) Vest after 1 year (2) Vest after 2 years – 50% each year (3) Vest after 3 years – 33% each year

Table Of Contents

The fair value of the 10,800 shares granted on February 6, 2018 was calculated using the grant date stock price with a discount valuation. The Chaffe model was used to calculate the discount. Since the shares vest over three years and then have a further two-year holding period, the historical volatility of the five years prior to the issue date was used to estimate volatility. The five year treasury yield was used as the interest rate. The Company does pay a dividend, but since the shareholder will receive the dividends during vesting and the post-vest restriction period, no dividend yield was used in the calculation as not to inflate the discount. The grant date stock price was \$49.50 and the discount of 7.423% was calculated using an interest rate of 2.504% and a 5 year historical volatility of 17.617%.

A summary of the status of the Company's non-vested restricted stock as of and changes during the period indicated are presented in the following table:

	2012 Stock incentive plans			Weighted- average grant date fair value
	Director	Omnibus	Total	
Non-vested balance at December 31, 2017	8,400	12,304	20,704	\$ 23.59
Granted	8,400	10,850	19,250	47.44
Vested	(4,200)	(5,794)	(9,994)	23.69
Non-vested balance at September 30, 2018	12,600	17,360	29,960	\$ 38.99

The Company granted 38,941 SSARs under the Omnibus Plan on February 6, 2018. The Company estimated the fair value of SSARs using the Black-Scholes-Merton valuation model on the grant date. The Company used the following assumptions: the risk-free interest rate is the rate equivalent to the expected term of the option interpolated from the U.S. Treasury Yield Curve on the valuation date and historical volatility is calculated by taking the standard deviation of historical returns using weekly and monthly data. The fair value of these SSARs was \$13.73 per share, based on a risk-free interest rate of 2.771%, a dividend yield of 1.762% and a volatility of 23.906% using an expected term of ten years.

A summary of the status of the Company's SSARs as of and changes during the period indicated are presented in the following table:

	Awards	Weighted-average grant date fair value	Weighted-average remaining contractual term (years)
Outstanding December 31, 2017	53,360	\$ 4.20	8.5

Granted	38,941	13.73	10.0
Exercised	-	-	
Forfeited	-	-	
Outstanding September 30, 2018	92,301	\$ 8.22	8.4

Of the SSARs outstanding at September 30, 2018, 27,453 vested and were exercisable. SSARs vest over a three year period – 33% per year.

Share-based compensation expense is included as a component of salaries and employee benefits in the consolidated statements of income. The following tables illustrate stock-based compensation expense recognized on non-vested equity awards during the three and nine months ended September 30, 2018 and 2017 and the unrecognized stock-based compensation expense as of September 30, 2018:

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Stock-based compensation expense:				
Director stock incentive plan	\$ 61	\$ 28	\$ 174	\$ 89
Omnibus stock incentive plan	132	49	368	144
Employee stock purchase plan	-	-	143	23
Total stock-based compensation expense	\$ 193	\$ 77	\$ 685	\$ 256

In addition, during the three and nine months ended September 30, 2018, the Company reversed accruals of (\$35 thousand) and (\$95 thousand) in stock-based compensation expense for restricted stock and SSARs awarded under the Omnibus Plan. The Company accrued \$54 thousand and \$163 thousand in stock-based compensation expense during the three and nine months ended September 30, 2017.

Table Of Contents

(dollars in thousands)	As of September 30, 2018
Unrecognized stock-based compensation expense:	
Director plan	\$ 360
Omnibus plan	944
Total unrecognized stock-based compensation expense	\$ 1,304

The unrecognized stock-based compensation expense as of September 30, 2018 will be recognized ratably over the periods ended January 2021 and January 2021 for the Director Plan and the Omnibus Plan, respectively.

Transactions under the Company's stock option plan for the nine months ended September 30, 2018 are presented in the following table:

	Options	Weighted-average exercise price	Weighted-average remaining contractual term (years)
Outstanding and exercisable, December 31, 2017	750	\$ 18.50	0.2
Granted	-	-	
Exercised	(750)	18.50	
Forfeited	-	-	
Outstanding and exercisable, September 30, 2018	-	\$ -	-

During the first quarter of 2018, there were 750 stock options exercised at a price of \$18.50 per share. The intrinsic value of these stock options was \$2,585. The tax deduction realized from the exercise of these options was \$22,875 resulting in a tax benefit of \$4,804. During the first quarter of 2017, there were 779 stock options exercised at a price of \$19.27 per share. The intrinsic value of these stock options was \$2,891 and the tax deduction realized from the exercise of these options was \$5,761 resulting in a tax benefit of \$1,959. The Company has not issued stock options since 2008.

In addition to the 2012 stock incentive plans, the Company established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 165,000 shares of its un-issued capital stock for issuance under the plan. The ESPP was designed to promote broad-based employee ownership of the Company's stock and to motivate employees to improve job performance and enhance the financial results of the Company. Under the ESPP, participation is voluntary whereby employees use automatic payroll withholdings to purchase the Company's capital stock at a discounted price based on the fair market value of the capital stock as measured on either the commencement or termination dates, as

defined. As of September 30, 2018, 76,484 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and is required to comply with the provisions of current accounting guidance. The Company recognizes compensation expense on its ESPP on the date the shares are purchased and it is included as a component of salaries and employee benefits in the consolidated statements of income.

8. Fair value measurements

The accounting guidelines establish a framework for measuring and disclosing information about fair value measurements. The guidelines of fair value reporting instituted a valuation hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 - inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 - inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument;

Level 3 - inputs are unobservable and are based on the Company's own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions.

A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The Company uses fair value to measure certain assets and, if necessary, liabilities on a recurring basis when fair value is the primary measure for accounting. Thus, the Company uses fair value for AFS securities. Fair value is used on a non-recurring basis to measure certain assets when adjusting carrying values to market values, such as impaired loans, other real estate owned (ORE) and other repossessed assets.

Table Of Contents

The following table represents the carrying amount and estimated fair value of the Company's financial instruments as of the periods indicated:

September 30, 2018

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 16,944	\$ 16,944	\$ 16,944	\$ -	\$ -
Available-for-sale debt securities	171,451	171,451	-	171,451	-
FHLB stock	4,717	4,717	-	4,717	-
Loans and leases, net	690,944	673,293	-	-	673,293
Loans held-for-sale	3,998	4,068	-	4,068	-
Accrued interest receivable	3,300	3,300	-	3,300	-
Financial liabilities:					
Deposits with no stated maturities	665,472	665,472	-	665,472	-
Time deposits	113,589	111,813	-	111,813	-
Short-term borrowings	40,269	40,269	-	40,269	-
FHLB advances	31,704	31,478	-	31,478	-
Accrued interest payable	409	409	-	409	-

December 31, 2017

(dollars in thousands)	Carrying amount	Estimated fair value	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Financial assets:					
Cash and cash equivalents	\$ 15,825	\$ 15,825	\$ 15,825	\$ -	\$ -
Available-for-sale securities	157,385	157,385	828	156,557	-

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

FHLB stock	2,832	2,832	-	2,832	-
Loans and leases, net	628,767	625,052	-	-	625,052
Loans held-for-sale	2,181	2,221	-	2,221	-
Accrued interest receivable	2,786	2,786	-	2,786	-
Financial liabilities:					
Deposits with no stated maturities	623,080	623,080	-	623,080	-
Time deposits	107,066	105,758	-	105,758	-
Short-term borrowings	18,502	18,502	-	18,502	-
FHLB advances	21,204	21,066	-	21,066	-
Accrued interest payable	346	346	-	346	-

The carrying value of short-term financial instruments, as listed below, approximates their fair value. These instruments generally have limited credit exposure, no stated or short-term maturities, carry interest rates that approximate market and generally are recorded at amounts that are payable on demand :

- Cash and cash equivalents;
- Non-interest bearing deposit accounts;
- Savings, interest-bearing checking and money market accounts and
- Short-term borrowings.

Securities: Fair values on investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions.

Loans and leases: The fair value of accruing loans is estimated by calculating the net present value of the future expected cash flows discounted using the exit price notion. The discount rate is based upon current offering rates, with an additional discount for expected

Table Of Contents

potential charge-offs. Additionally, an environmental general credit risk adjustment is subtracted from the net present value to arrive at the total estimated fair value of the accruing loan portfolio.

The carrying value that fair value is compared to is net of the allowance for loan losses and since there is significant judgment included in evaluating credit quality, loans are classified within Level 3 of the fair value hierarchy. The net carrying value of loans acquired through the Wayne Bank branch acquisition approximates the fair value of the loans.

Non-accrual loans: Loans which the Company has measured as non-accruing are generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. These loans are classified within Level 3 of the fair value hierarchy. The fair value consists of loan balances less the valuation allowance.

Loans held-for-sale: The fair value of loans held-for-sale is estimated using rates currently offered for similar loans and is typically obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank of Pittsburgh (FHLB).

Certificates of deposit: The fair value of certificates of deposit is based on discounted cash flows using rates which approximate market rates for deposits of similar maturities. The fair value of certificates of deposit acquired through the Wayne Bank branch acquisition represents the estimated fair value of these deposits.

FHLB advances: Fair value is estimated using the rates currently offered for similar borrowings.

The following tables illustrate the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels as of the periods indicated:

	Total carrying value September 30, 2018	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Available-for-sale securities:				
Agency - GSE	\$ 5,833	\$ -	\$ 5,833	\$ -
Obligations of states and political subdivisions	45,086	-	45,086	-
MBS - GSE residential	120,532	-	120,532	-
Total available-for-sale debt securities	\$ 171,451	\$ -	\$ 171,451	\$ -

	Total carrying value December 31, 2017	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Available-for-sale securities:				
Agency - GSE	\$ 9,099	\$ -	\$ 9,099	\$ -
Obligations of states and political subdivisions	44,306	-	44,306	-
MBS - GSE residential	103,152	-	103,152	-
Equity securities - financial services	828	828	-	-
Total available-for-sale securities	\$ 157,385	\$ 828	\$ 156,557	\$ -

Equity securities are measured at fair value using quoted market prices for identical assets and are classified within Level 1 of the valuation hierarchy. Debt securities in the AFS portfolio are measured at fair value using market quotations provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Assets classified as Level 2 use valuation techniques that are common to bond valuations. That is, in active markets whereby bonds of similar characteristics frequently trade, quotes for similar assets are obtained. For the periods ending September 30, 2018 and December 31, 2017, there were no transfers to or from Level 1 and Level 2 fair value measurements for financial assets measured on a recurring basis.

There were no changes in Level 3 financial instruments measured at fair value on a recurring basis as of and for the periods ending September 30, 2018 and December 31, 2017, respectively.

Table Of Contents

The following table illustrates the financial instruments newly measured at fair value on a non-recurring basis segregated by hierarchy fair value levels as of the periods indicated:

	Total carrying value at September 30, 2018	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Impaired loans	\$ 2,637	\$ -	\$ -	\$ 2,637
Other real estate owned	512	-	-	512
Total	\$ 3,149	\$ -	\$ -	\$ 3,149

	Total carrying value at December 31, 2017	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
(dollars in thousands)				
Impaired loans	\$ 2,952	\$ -	\$ -	\$ 2,952
Other real estate owned	814	-	-	814
Total	\$ 3,766	\$ -	\$ -	\$ 3,766

From time-to-time, the Company may be required to record at fair value financial instruments on a non-recurring basis, such as impaired loans, ORE and other repossessed assets. These non-recurring fair value adjustments involve the application of lower-of-cost-or-market accounting on write downs of individual assets.

The following describes valuation methodologies used for financial instruments measured at fair value on a non-recurring basis. Impaired loans that are collateral dependent are written down to fair value through the

establishment of specific reserves, a component of the allowance for loan losses, and as such are carried at the lower of net recorded investment or the estimated fair value. Estimates of fair value of the collateral are determined based on a variety of information, including available valuations from certified appraisers for similar assets, present value of discounted cash flows and inputs that are estimated based on commonly used and generally accepted industry liquidation advance rates and estimates and assumptions developed by management.

Valuation techniques for impaired loans are typically determined through independent appraisals of the underlying collateral or may be determined through present value of discounted cash flows. Both techniques include various Level 3 inputs which are not identifiable. The valuation technique may be adjusted by management for estimated liquidation expenses and qualitative factors such as economic conditions. If real estate is not the primary source of repayment, present value of discounted cash flows and estimates using generally accepted industry liquidation advance rates and other factors may be utilized to determine fair value.

At September 30, 2018 and December 31, 2017, the range of liquidation expenses and other valuation adjustments applied to impaired loans ranged from -18.75% to -51.73% and from -15.95% to -51.55% respectively. The weighted-average of liquidation expenses and other valuation adjustments applied to impaired loans amounted to -30.46% as of September 30, 2018 and -23.03% as of December 31, 2017, respectively. Due to the multitude of assumptions, many of which are subjective in nature, and the varying inputs and techniques used to determine fair value, the Company recognizes that valuations could differ across a wide spectrum of techniques employed. Accordingly, fair value estimates for impaired loans are classified as Level 3.

For ORE, fair value is generally determined through independent appraisals of the underlying properties which generally include various Level 3 inputs which are not identifiable. Appraisals form the basis for determining the net realizable value from these properties. Net realizable value is the result of the appraised value less certain costs or discounts associated with liquidation which occurs in the normal course of business. Management's assumptions may include consideration of the location and occupancy of the property, along with current economic conditions. Subsequently, as these properties are actively marketed, the estimated fair values may be periodically adjusted through incremental subsequent write-downs. These write-downs usually reflect decreases in estimated values resulting from sales price observations as well as changing economic and market conditions. At September 30, 2018 and December 31, 2017, the discounts applied to the appraised values of ORE ranged from -18.47% to -68.96% and from -17.95% to -99.00%, respectively. As of September 30, 2018 and December 31, 2017, the weighted-average of discount to the appraisal values of ORE amounted to -40.88% and -30.40% respectively.

9. Acquisition

On March 17, 2017, the Company completed the acquisition of the West Scranton branch of Wayne Bank, the wholly owned banking subsidiary of Norwood Financial Corp., pursuant to the terms of the Branch Purchase and Deposit Assumption Agreement dated September 29, 2016. The Company purchased all of the deposit liabilities associated with the branch, certain loans, and the branch real estate, and immediately closed the branch and consolidated the acquired deposits and loans into its nearby West Scranton branch

Table Of Contents

office. The Company expects this transaction to expand its customer base in West Scranton.

The transaction has been accounted for using the acquisition method of accounting. The acquired assets and assumed liabilities were recorded at book value which also represented estimated fair value at the date of acquisition. Management made significant estimates and exercised significant judgement in estimating fair value, but the fair value adjustments were deemed immaterial to the financial statements.

The Company recognized \$41 thousand of acquisition-related costs during 2017. These costs were expensed as incurred and are presented in non-interest expenses on the consolidated statements of income. Costs incurred in 2017 consist principally of legal fees and other professional fees.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition:

(dollars in thousands)	March 17, 2017
Cash and cash equivalents	\$ 11,817
Loans	1,574
Bank premises and equipment	264
Goodwill	209
Accrued interest receivable and other assets	4
Total assets acquired	\$ 13,868
Deposits	\$ 13,809
Accrued interest payable and other liabilities	59
Total liabilities assumed	\$ 13,868

The Company acquired \$1.6 million in residential and consumer loans. None of the loans that were acquired had evidence of credit quality deterioration.

The Company recorded goodwill associated with the acquisition of the West Scranton branch of Wayne bank totaling \$0.2 million. Goodwill is not amortized, but is periodically evaluated for impairment. The Company did not recognize any impairment during 2017. For income tax purposes, goodwill will be deducted over a 15 year period.

10. Employee Benefits

Bank-Owned Life Insurance (BOLI)

The Company has purchased single premium BOLI policies on certain officers. The policies are recorded at their cash surrender values. Increases in cash surrender values are included in non-interest income in the consolidated statements of income. In March 2017, the Company purchased an additional \$8.0 million of BOLI. The policies' cash surrender value totaled \$20.5 million and \$19.9 million, respectively, as of September 30, 2018 and 2017 and is reflected as an asset on the consolidated balance sheets. As of September 30, 2018 and 2017, the Company has recorded income of \$448 thousand and \$422 thousand, respectively.

Officer Life Insurance

In 2017, the Bank entered into separate split dollar life insurance arrangements (Split Dollar Agreements) with eleven officers. This plan provides each officer a specified death benefit should the officer die while in the Bank's employ. The Bank paid the insurance premiums in March 2017 and the arrangements were effective in March 2017. The Bank owns the policies and all cash values thereunder. Upon death of the covered employee, the agreed-upon amount of death proceeds from the policies will be paid directly to the insured's beneficiary. As of September 30, 2018, the policies had total death benefits of \$20.5 million of which \$4.1 million would have been paid to the officer's beneficiaries and the remaining \$16.4 million would have been paid to the Bank. In addition, three executive officers have the opportunity to retain a split dollar benefit equal to two times their highest base salary after separation from service if the vesting requirements are met. As of September 30, 2018, the Company accrued expenses of \$55 thousand for the split dollar benefit.

Supplemental Executive Retirement plan (SERP)

On March 29, 2017, the Bank entered into separate supplemental executive retirement agreements (individually the "SERP Agreement") with five officers, pursuant to which the Bank will credit an amount to a SERP account established on each participant's behalf while they are actively employed by the Bank for each calendar month from March 1, 2017 until retirement. As of September 30, 2018, the Company accrued expenses of \$743 thousand in connection with the SERP.

Table Of Contents

Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is management's discussion and analysis of the significant changes in the consolidated financial condition of the Company as of September 30, 2018 compared to December 31, 2017 and a comparison of the results of operations for the three and nine months ended September 30, 2018 and 2017. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company's 2017 Annual Report filed on Form 10-K.

Forward-looking statements

Certain of the matters discussed in this Quarterly Report on Form 10-Q may constitute forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. The words "expect," "anticipate," "intend," "plan," "believe," "estimate," and similar expressions are intended to identify such forward-looking statements.

The Company's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation:

- § the effects of economic conditions on current customers, specifically the effect of the economy on loan customers' ability to repay loans;
- § the costs and effects of litigation and of unexpected or adverse outcomes in such litigation;
- § the impact of new or changes in existing laws and regulations, including the Tax Cuts and Jobs Act and Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the regulations promulgated there under;
- § impacts of the capital and liquidity requirements of the Basel III standards and other regulatory pronouncements, regulations and rules;
- § governmental monetary and fiscal policies, as well as legislative and regulatory changes;
 - § effects of short- and long-term federal budget and tax negotiations and their effect on economic and business conditions;
- § the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters;
- § the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks;
- § the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating locally, regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the internet;
- § technological changes;
- § the interruption or breach in security of our information systems and other technological risks and attacks resulting in failures or disruptions in customer account management, general ledger processing and loan or deposit updates and potential impacts resulting therefrom including additional costs, reputational damage, regulatory penalties, and financial losses;
- § acquisitions and integration of acquired businesses;
- § the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities;
- § volatilities in the securities markets;

- § acts of war or terrorism;
- § disruption of credit and equity markets; and
- § the risk that our analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

The Company cautions readers not to place undue reliance on forward-looking statements, which reflect analyses only as of the date of this document. The Company has no obligation to update any forward-looking statements to reflect events or circumstances after the date of this document.

Readers should review the risk factors described in other documents that we file or furnish, from time to time, with the Securities and Exchange Commission, including Annual Reports to Shareholders, Annual Reports filed on Form 10-K and other current reports filed or furnished on Form 8-K.

Executive Summary

The Company is a Pennsylvania corporation and a bank holding company, whose wholly-owned state chartered commercial bank is The Fidelity Deposit and Discount Bank. The Company is headquartered in Dunmore, Pennsylvania. We consider Lackawanna and Luzerne Counties our primary marketplace.

As a leading Northeastern Pennsylvania community bank, our goals are to enhance shareholder value while continuing to build a full-service community bank. We focus on growing our core business of retail and business lending and deposit gathering while

Table Of Contents

maintaining strong asset quality and controlling operating expenses. We continue to implement strategies to diversify earning assets (see “Funds Deployed” section of this management’s discussion and analysis) and to increase low cost core deposits (see “Funds Provided” section of this management’s discussion and analysis). These strategies include a greater level of commercial lending and the ancillary business products and services supporting our commercial customers’ needs as well as residential lending strategies and an array of consumer products. We focus on developing a full banking relationship with existing, as well as new, small- and middle-sized business prospects. In addition, we explore opportunities to selectively expand our franchise footprint, consisting presently of our 10-branch network. Currently, the Company is constructing a new branch in Back Mountain, PA in order to expand our presence in Luzerne County, which is expected to open in the fourth quarter of 2018. We incurred \$1.2 million in investment costs related to the construction of this new branch during the first nine months of 2018 and expect another \$0.3 million during the last quarter of 2018. In addition, the Company has received regulatory approval and will begin constructing a branch location in Mountain Top, PA. We currently expect that this branch will open during the first half of 2019.

We are impacted by both national and regional economic factors, with commercial, commercial real estate and residential mortgage loans concentrated in Northeastern Pennsylvania, primarily in Lackawanna and Luzerne counties. Although the U.S. economy has shown signs of improvement, the general operating environment and our local market area continue to remain challenging due to the lagging unemployment rate and strong local competition. For the near-term, we expect to continue to operate in a rising interest rate environment. A rising rate environment positions the Company to improve its net interest income performance. The Federal Open Market Committee (FOMC) adjusted the short-term federal funds rate up 75 basis points so far during 2018. Expectations are for short-term rates to rise another 25 basis points this year, potentially further pressuring deposit rate pricing. The U.S. Treasury yield curve is expected to continue to flatten for the remainder of 2018, but inversion is unlikely. According to the U.S. Bureau of Labor Statistics, the national unemployment rate for September 2018 was 3.7%, down four percentage points from December 2017. Growth in all loan sectors at prudent pricing should mitigate the projected increase in interest expense from higher deposit and borrowing rates and help maintain an acceptable interest rate margin during 2018 and beyond. The unemployment rate in Scranton - Wilkes-Barre Metropolitan Statistical Area (local) decreased during the first nine months of 2018, but continued to lag behind the unemployment rates of the state and nation. The local unemployment rate at September 30, 2018 was 4.5%, a decrease of 0.5 percentage points from 5.0% at December 31, 2017 and a decrease from 4.9% at September 30, 2017. The local unemployment rate decreased during the first nine months of 2018 due to an increase in jobs as more people entered the labor force. Seasonal fluctuations in unemployment are expected. The median home values in the region have gone up 9.9% over the past year, and according to Zillow, an online database advertising firm providing access to its real estate search engines to various media outlets, values are expected to rise 0.5% within the next year. In light of these expectations, we will continue to monitor the economic climate in our region and scrutinize growth prospects with credit quality as a principal consideration.

Our efforts and focus continue on building relationships concentrating on loans, deposits, wealth management, business services and retail opportunities with clients and prospects with the goal to exceed expectations by providing a valued service.

In addition to the challenging economic environment in which we compete, the regulation and oversight of our business has changed significantly in recent years. As described more fully in Part I, Item 1A, “Risk Factors,” and in the “Supervisory and Regulation” section of management’s discussion and analysis of financial condition and results of operations in our 2017 Annual Report filed on Form 10-K, certain aspects of the Dodd-Frank Wall Street Reform Act (Dodd-Frank Act) continue to have a significant impact on us. In addition, final rules to implement Basel III regulatory capital reform, approved by the federal bank regulatory agencies in 2013, subject many banks including the Company, to capital requirements which will be phased in. The initial provisions effective for us began on January 1, 2015. The rules also revise the minimum risk-based and leverage capital ratio requirements applicable to the

Company and revise the calculation of risk-weighted assets to enhance their risk sensitivity. We will continue to prepare for the impacts of the continuing implementation of the Dodd-Frank Act and the Basel III capital standards, and related rulemaking will have on our business, financial condition and results of operations.

Non-GAAP Financial Measures

The following are non-GAAP financial measures which management believes provide useful insight to the reader of the consolidated financial statements but should be supplemental to GAAP used to prepare the Company's financial statements and should not be read in isolation or relied upon as a substitute for GAAP measures. In addition, the Company's non-GAAP measures may not be comparable to non-GAAP measures of other companies. The Company's tax rate used to calculate the fully-taxable equivalent (FTE) adjustment was 21% at September 30, 2018 compared to 34% at September 30, 2017.

The following table reconciles the non-GAAP financial measures of FTE net interest income:

(dollars in thousands)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Interest income (GAAP)	\$ 9,028	\$ 7,928	\$ 25,706	\$ 23,148
Adjustment to FTE	182	325	522	959
Interest income adjusted to FTE (Non-GAAP)	9,210	8,253	26,228	24,107
Interest expense	1,317	882	3,213	2,357
Net interest income adjusted to FTE (Non-GAAP)	\$ 7,893	\$ 7,371	\$ 23,015	\$ 21,750

Table Of Contents

The efficiency ratio is non-interest expenses as a percentage of FTE net interest income plus non-interest income. The following table reconciles the non-GAAP financial measures of the efficiency ratio to GAAP:

(dollars in thousands)	Three months ended		Nine months ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Efficiency Ratio (non-GAAP)				
Non-interest expenses (GAAP)	\$ 6,172	\$ 6,035	\$ 18,542	\$ 17,883
Net interest income (GAAP)	7,711	7,046	22,493	20,791
Plus: taxable equivalent adjustment	182	325	522	959
Non-interest income (GAAP)	2,283	2,248	6,937	6,484
Net interest income (FTE) plus non-interest income (non-GAAP)	\$ 10,176	\$ 9,619	\$ 29,952	\$ 28,234
Efficiency ratio (non-GAAP)	60.65%	62.74%	61.91%	63.34%

General

The Company's earnings depend primarily on net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields earned on interest-earning assets, which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is determined by the Company's interest rate spread (the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in the marketplace.

The Company's earnings are also affected by the level of its non-interest income and expenses and by the provisions for loan losses and income taxes. Non-interest income mainly consists of: service charges on the Company's loan and deposit products; interchange fees; trust and asset management service fees; increases in the cash surrender value of the bank owned life insurance and from net gains or losses from sales of loans and securities. Non-interest expense consists of: compensation and related employee benefit costs; occupancy; equipment; data processing; advertising and marketing; FDIC insurance premiums; professional fees; loan collection; net other real estate owned (ORE) expenses; supplies and other operating overhead.

Comparison of the results of operations

Three and nine months ended September 30, 2018 and 2017

Overview

For the third quarter of 2018, the Company generated net income of \$2.9 million, or \$0.75 per diluted share, compared to \$2.2 million, or \$0.60 per diluted share, for the third quarter of 2017. The \$0.7 million, or 29%, increase in net income stemmed from \$0.7 million more net interest income and \$0.1 million less provision for income taxes which more than offset a \$0.1 million rise in non-interest expenses. In the year-to-date comparison, net income grew \$1.8 million, or 28%, to \$8.2 million, or \$2.15 per diluted share, for the first nine months of 2018 from \$6.4 million, or \$1.72 per diluted share, for the first nine months of 2017. Higher net interest income of \$1.7 million and \$0.5 million more non-interest income combined with a \$0.5 million lower provision for income taxes were partially offset by \$0.7 million higher non-interest expenses and \$0.2 million additional provision for loan losses.

Return on average assets (ROA) was 1.22% and 1.03% for the third quarters of 2018 and 2017, respectively, and 1.21% and 1.02% for the nine months ended September 30, 2018 and 2017, respectively. During the same time periods, return on average shareholders' equity (ROE) was 12.65% and 10.36%, respectively, and 12.34% and 10.24%, respectively. The increases in ROA and ROE were the result of the higher pace of net income growth during 2018 despite asset and equity growth.

Net interest income and interest sensitive assets / liabilities

For the third quarter of 2018, net interest income increased \$0.7 million, or 9%, to \$7.7 million from \$7.0 million for the third quarter of 2017 due to interest income increasing faster than interest expense. The \$1.1 million growth in interest income was produced by the addition of \$72.5 million in average interest-earning assets combined with a higher yield earned on those assets. The loan portfolio contributed \$0.9 million to this interest income growth due to \$54.6 million more average loans earning a higher yield. A larger average balance of higher yielding mortgage-backed securities produced \$0.2 million more interest income from investments. On the liability side, \$12.4 million in additional average interest-bearing deposits with a 16 basis point increase in

Table Of Contents

rates paid on these deposits resulted in \$0.2 million more interest expense for the third quarter of 2018 compared to the 2017 like period. Over the same time periods, the Company utilized \$27.7 million more in average overnight borrowings on which they paid a 93 basis point higher rate resulting in \$0.2 million in additional interest expense.

Net interest income increased \$1.7 million, or 8%, from \$20.8 million for the nine months ended September 30, 2017 to \$22.5 million for the nine months ended September 30, 2018, due to higher interest income which more than offset the additional interest expense. Total average interest-earning assets increased \$59.2 million along with an increase in the yields earned thereon resulting in \$2.6 million of growth in interest income. In the loan portfolio, the Company experienced average balance growth of \$36.8 million combined with higher yields in the commercial and residential portfolios, which had the effect of producing \$1.9 million more interest income. Although all loan portfolios showed more interest income, the consumer loan portfolio increased due to average balance growth while the commercial and residential loan portfolios experienced increases mostly due to higher yields. In the investment portfolio, an increase in the average balances of mortgage-backed securities was the biggest driver of interest income growth of \$0.6 million. On the liability side, total interest-bearing liabilities grew \$28.7 million on average with a 16 basis point increase in rates paid on these interest-bearing liabilities. Growth in average interest-bearing deposits of \$32.6 million with a 14 basis point higher rate paid thereon caused \$0.7 million higher interest expense. Although the balance of average borrowings declined during the first nine months of 2018, interest expense on borrowings increased \$0.1 million due to higher rates paid on overnight borrowings.

The FTE net interest rate spread decreased by 15 and 11 basis points, respectively, for the three and nine months ended September 30, 2018 compared to the same 2017 periods. Over the same periods, the FTE net interest margin decreased by 7 and 6 basis points, respectively. The Company's lower tax rate in 2018 caused FTE interest income from nontaxable interest-earning assets to decline. The negative impact of this lower FTE adjustment had the effect of reducing net interest rate spread and margin by eight basis points for the quarter and seven basis points year-to-date. The rates paid on interest-bearing liabilities rose faster than the yields earned on interest-earning assets causing a further decline in net interest rate spread. The overall cost of funds, which includes the impact of non-interest bearing deposits, increased 17 and 11 basis points for the three and nine months ended September 30, 2018 compared to the same period in 2017. The primary reason for the increase was higher average interest-bearing liabilities and the rates paid thereon.

For the last quarter of 2018, the Company expects to operate in an increasing interest rate environment. A rate environment with rising interest rates positions the Company to improve its interest income performance from new and maturing earning assets. Until there is a sustained period of yield curve steepening, with rates rising more sharply at the long end, the interest rate margin may experience compression. However for the remainder of 2018, the Company anticipates net interest income to improve as growth in interest-earning assets would help mitigate an adverse impact of rate movements on cost of funds. The FOMC has been gradually increasing the short-term federal funds rate since the end of 2015, and it has started to effect the rates paid on funding sources. On the asset side, the prime interest rate, the benchmark rate that banks use as a base rate for adjustable rate loans, rose 75 basis points so far in 2018. The focus for the remainder of 2018 is to manage net interest income after years of a sustained low interest rate environment through a rising rate environment by maintaining a reasonable spread. Interest expense is projected to continue to grow through the end of 2018 from growth in deposits and borrowings and an increase in rates paid on both. Continued growth in the loan portfolios complemented with investment security growth is currently expected to boost interest income, and when coupled with a proactive relationship approach to deposit cost setting strategies should help contain the interest rate margin at acceptable levels.

The Company's cost of interest-bearing liabilities was 83 and 70 basis points for the three and nine months ended September 30, 2018, respectively, and 59 and 54 basis points for the three and nine months ended September 30, 2017, respectively. During both periods, an increase in average interest-bearing liabilities and their rates primarily caused the higher cost of interest-bearing liabilities. During 2017 and 2018, rates paid on interest-bearing deposits

started to increase from historic low levels. Interest rates along the treasury yield curve have been volatile with shorter-term rates rising faster than long-term rates producing a flatter yield curve during 2018. Competition among banks has already begun to pressure banks to increase deposit rates. If rates continue to rise, the effect could pressure net interest income even further if short-term rates continue to rise more rapidly than longer-term interest rates, thereby compressing the interest rate spread. To help mitigate the impact of the imminent change to the economic landscape, the Company has successfully developed and will continue to strengthen its association with existing customers, develop new business relationships, generate new loan volumes, and retain and generate higher levels of average non-interest bearing deposit balances. Strategically deploying no- and low-cost deposits into interest earning-assets is an effective margin-preserving strategy that the Company expects to continue to pursue and expand to help stabilize net interest margin.

The Company's Asset Liability Management (ALM) team meets regularly to discuss among other things, interest rate risk and when deemed necessary adjusts interest rates. ALM also discusses revenue enhancing strategies to help combat the potential for a decline in net interest income. The Company's marketing department, together with ALM, lenders and deposit gatherers, continue to develop prudent strategies that will grow the loan portfolio and accumulate low-cost deposits to improve net interest income performance.

The table that follows sets forth a comparison of average balances of assets and liabilities and their related net tax equivalent yields and rates for the years indicated. Within the table, interest income was FTE adjusted, using the corporate federal tax rate of 21% at September 30, 2018 and 34% at September 30, 2017 to recognize the income from tax-exempt interest-earning assets as if the interest was taxable. See "Non-GAAP Financial Measures" within this management's discussion and analysis for the FTE adjustments. This treatment allows a uniform comparison among yields on interest-earning assets. Loans include loans held-for-

Table Of Contents

sale (HFS) and non-accrual loans but exclude the allowance for loan losses. Net deferred loan cost amortization of \$182 thousand and \$113 thousand during the third quarters of 2018 and 2017, respectively, and \$485 thousand and \$354 thousand for the nine months ended September 30, 2018 and 2017, respectively, are included in interest income from loans. Average balances are based on amortized cost and do not reflect net unrealized gains or losses. Net interest margin is calculated by dividing net interest income-FTE by total average interest-earning assets. Cost of funds includes the effect of average non-interest bearing deposits as a funding source:

(dollars in thousands)	Three months ended September 30, 2018			September 30, 2017		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets						
Interest-bearing deposits	\$ 2,142	\$ 10	1.77 %	\$ 3,646	\$ 12	1.30 %
Restricted regulatory securities	4,374	44	4.03	3,255	40	4.89
Investments:						
Agency - GSE	5,920	40	2.69	17,481	63	1.43
MBS - GSE residential	116,126	759	2.59	88,928	547	2.44
State and municipal (nontaxable)	44,801	510	4.51	41,880	578	5.48
Other	-	-	-	294	8	9.96
Total investments	166,847	1,309	3.11	148,583	1,196	3.19
Loans and leases:						
C&I and CRE (taxable)	303,581	3,755	4.91	298,598	3,515	4.67
C&I and CRE (nontaxable)	33,196	323	3.86	32,318	333	4.09
Consumer	146,669	1,463	3.96	108,513	1,123	4.10
Residential real estate	212,572	2,306	4.30	202,003	2,034	4.00
Total loans and leases	696,018	7,847	4.47	641,432	7,005	4.33
Total interest-earning assets	869,381	9,210	4.20 %	796,916	8,253	4.11 %
Non-interest earning assets	60,554			59,987		
Total assets	\$ 929,935			\$ 856,903		
Liabilities and shareholders' equity						
Interest-bearing liabilities						
Deposits:						
Interest-bearing checking	\$ 198,166	\$ 287	0.57 %	\$ 189,037	\$ 208	0.44 %
Savings and clubs	131,637	60	0.18	126,768	42	0.13
MMDA	112,264	265	0.94	119,705	216	0.72
Certificates of deposit	112,585	369	1.30	106,761	276	1.03
Total interest-bearing deposits	554,652	981	0.70	542,271	742	0.54
Repurchase agreements	9,662	3	0.14	7,269	3	0.18
Overnight borrowings	45,479	260	2.26	17,817	60	1.33
FHLB advances	18,725	73	1.54	23,704	77	1.28

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Total interest-bearing liabilities	628,518	1,317	0.83 %	591,061	882	0.59 %
Non-interest bearing deposits	203,530			173,627		
Non-interest bearing liabilities	8,077			6,942		
Total liabilities	840,125			771,630		
Shareholders' equity	89,810			85,273		
Total liabilities and shareholders' equity	\$ 929,935			\$ 856,903		
Net interest income - FTE		\$ 7,893			\$ 7,371	
Net interest spread			3.37 %			3.52 %
Net interest margin			3.60 %			3.67 %
Cost of funds			0.63 %			0.46 %

Table Of Contents

(dollars in thousands)	Nine months ended September 30, 2018			September 30, 2017		
	Average balance	Interest	Yield / rate	Average balance	Interest	Yield / rate
Assets						
Interest-earning assets						
Interest-bearing deposits	\$ 7,540	\$ 94	1.66 %	\$ 2,604	\$ 22	1.15 %
Restricted regulatory securities	3,228	122	5.06	3,304	96	3.90
Investments:						
Agency - GSE	6,205	110	2.37	17,982	191	1.42
MBS - GSE residential	115,219	2,267	2.63	88,742	1,696	2.56
State and municipal (nontaxable)	44,231	1,499	4.53	41,397	1,700	5.49
Other	252	13	6.85	294	23	10.06
Total investments	165,907	3,889	3.13	148,415	3,610	3.25
Loans and leases:						
C&I and CRE (taxable)	294,645	10,679	4.85	295,520	10,234	4.63
C&I and CRE (nontaxable)	31,464	872	3.71	31,393	981	4.18
Consumer	131,029	3,893	3.97	101,323	3,175	4.19
Residential real estate	207,957	6,679	4.29	200,047	5,989	4.00
Total loans and leases	665,095	22,123	4.45	628,283	20,379	4.34
Total interest-earning assets	841,770	26,228	4.17 %	782,606	24,107	4.12 %
Non-interest earning assets	60,440			56,515		
Total assets	\$ 902,210			\$ 839,121		
Liabilities and shareholders' equity						
Interest-bearing liabilities						
Deposits:						
Interest-bearing checking	\$ 206,905	\$ 822	0.53 %	\$ 185,093	\$ 548	0.40 %
Savings and clubs	134,404	181	0.18	125,787	122	0.13
MMDA	110,871	684	0.83	117,596	578	0.66
Certificates of deposit	109,736	984	1.20	100,829	723	0.96
Total interest-bearing deposits	561,916	2,671	0.64	529,305	1,971	0.50
Repurchase agreements	10,792	13	0.16	10,068	15	0.20
Overnight borrowings	19,443	324	2.22	23,892	197	1.10
FHLB advances	18,876	205	1.45	19,096	174	1.21
Total interest-bearing liabilities	611,027	3,213	0.70 %	582,361	2,357	0.54 %
Non-interest bearing deposits	195,392			167,313		
Non-interest bearing liabilities	7,384			6,021		
Total liabilities	813,803			755,695		
Shareholders' equity	88,407			83,426		
Total liabilities and shareholders' equity	\$ 902,210			\$ 839,121		
Net interest income - FTE		\$ 23,015			\$ 21,750	
Net interest spread			3.47 %			3.58 %

Net interest margin	3.66 %	3.72 %
Cost of funds	0.53 %	0.42 %

Table Of Contents

Changes in net interest income are a function of both changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities. The following table presents the extent to which changes in interest rates and changes in volumes of interest-earning assets and interest-bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (1) the changes attributable to changes in volume (changes in volume multiplied by the prior period rate), (2) the changes attributable to changes in interest rates (changes in rates multiplied by prior period volume) and (3) the net change. The combined effect of changes in both volume and rate has been allocated proportionately to the change due to volume and the change due to rate. Tax-exempt income was not converted to a tax-equivalent basis on the rate/volume analysis:

(dollars in thousands)	Nine months ended September 30,					
	2018 compared to 2017			2017 compared to 2016		
	Increase (decrease) due to					
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Interest-bearing deposits	\$ 58	\$ 14	\$ 72	\$ (72)	\$ 35	\$ (37)
Restricted regulatory securities	(2)	28	26	60	(5)	55
Investments:						
Agency - GSE	(166)	85	(81)	(3)	21	18
MBS - GSE residential	522	49	571	336	297	633
State and municipal	74	7	81	157	(30)	127
Other	(3)	(3)	(6)	-	-	-
Total investments	427	138	565	490	288	778
Loans and leases:						
Residential real estate	241	449	690	265	104	369
C&I and CRE	(27)	514	487	801	367	1,168
Consumer	890	(172)	718	1,042	(684)	358
Total loans and leases	1,104	791	1,895	2,108	(213)	1,895
Total interest income	1,587	971	2,558	2,586	105	2,691
Interest expense:						
Deposits:						
Interest-bearing checking	72	202	274	71	136	207
Savings and clubs	9	50	59	9	-	9
Money market	(34)	140	106	(70)	27	(43)
Certificates of deposit	68	193	261	8	63	71
Total deposits	115	585	700	18	226	244
Repurchase agreements	1	(3)	(2)	(1)	-	(1)
Overnight borrowings	(42)	169	127	191	(8)	183
FHLB advances	(2)	33	31	174	-	174
Total interest expense	72	784	856	382	218	600
Net interest income	\$ 1,515	\$ 187	\$ 1,702	\$ 2,204	\$ (113)	\$ 2,091

Provision for loan losses

The provision for loan losses represents the necessary amount to charge against current earnings, the purpose of which is to increase the allowance for loan losses (the allowance) to a level that represents management's best estimate of known and inherent losses in the Company's loan portfolio. Loans determined to be uncollectible are charged off against the allowance. The required amount of the provision for loan losses, based upon the adequate level of the allowance, is subject to the ongoing analysis of the loan portfolio. The Company's Special Assets Committee meets periodically to review problem loans. The committee is comprised of management, including credit administration officers, loan officers, loan workout officers and collection personnel. The committee reports quarterly to the Credit Administration Committee of the board of directors.

Management continuously reviews the risks inherent in the loan portfolio. Specific factors used to evaluate the adequacy of the loan loss provision during the formal process include:

- specific loans that could have loss potential;
- levels of and trends in delinquencies and non-accrual loans;
- levels of and trends in charge-offs and recoveries;
- trends in volume and terms of loans;

Table Of Contents

- changes in risk selection and underwriting standards;
- changes in lending policies and legal and regulatory requirements;
- experience, ability and depth of lending management;
- national and local economic trends and conditions; and
- changes in credit concentrations.

The provision for loan losses remained stable at \$0.4 million for both the third quarter of 2018 and 2017. For the nine months ended September 30, 2018 and 2017, the Company recorded a provision for loan losses of \$1.1 million and \$0.9 million, respectively, a \$0.2 million increase. The provision for loan losses derives from the reserve required from the allowance for loan losses calculation. In the year-to-date comparison, the increase was primarily due to loan growth from auto and residential loans as well as certain macroeconomic factors associated with them. These macroeconomic factors included risks inherent with higher auto loan portfolio concentrations and decreasing market values in certain urban markets within the residential portfolio.

For a discussion on the allowance for loan losses, see “Allowance for loan losses,” located in the comparison of financial condition section of management’s discussion and analysis contained herein.

Other income

For the third quarter of 2018, non-interest income amounted to \$2.3 million, unchanged from the third quarter of 2017. Interchange fees grew almost \$0.1 million due to a higher volume of debit card transactions and fees from trust activities increased almost \$0.1 million due to more assets under management. These increases were offset by \$0.1 million less service charges on loans and \$0.1 million lower gains on loan sales.

Non-interest income totaled \$6.9 million for the nine months ended September 30, 2018, an increase of \$0.5 million, or 7%, from the \$6.4 million recorded for the same 2017 period. Trust fees were \$0.3 million higher due to the larger level of assets under management. There were also increases in debit card interchange fees of \$0.2 million, financial service fees of \$0.1 million and \$0.1 million in additional gains on the sale of securities. These increases were partially offset by \$0.2 million less gains on loan sales and \$0.2 million lower service charges on loans.

Other operating expenses

For the quarter ended September 30, 2018, total other operating expenses were \$6.2 million, an increase of \$0.1 million, or 2%, compared to \$6.1 million for the same 2017 quarter. Salary and employee benefits rose \$0.2 million, or 7%, to \$3.4 million for the third quarter of 2018 from \$3.2 million for the third quarter of 2017. The increase was primarily due to higher salaries from merit increases and new positions added. Data processing and communications expense increased \$0.1 million during the third quarter of 2018 compared to the third quarter of 2017 because a higher level of accounts and transactions led to additional data center service costs. Partially offsetting these increases was a \$0.1 million decrease in loan collection costs.

For the nine months ended September 30, 2018, non-interest expenses increased \$0.7 million, or 4%, compared to the nine months ended September 30, 2017, from \$17.8 million to \$18.5 million. Salaries and employee benefit expenses contributed the most to the increase growing \$0.7 million, or 7%. The basis of this increase included \$0.4 million higher salaries from staff additions and merit increases, \$0.2 million in additional stock-based compensation expense and \$0.1 million more in expenses from a post-retirement benefit plan entered into at the end of the first quarter of

2017. Data processing and communications expense also increased \$0.2 million. Partially offsetting these increases was a \$0.1 million decrease in professional expense, \$0.1 million lower collection expenses and \$0.1 million less ORE expense.

The ratios of non-interest expense less non-interest income to average assets, known as the expense ratio, for the nine months ended September 30, 2018 and 2017 were 1.72% and 1.82%, respectively. The expense ratio decreased because of higher average assets during the nine months ended September 30, 2018 compared to the same 2017 period. The efficiency ratio decreased from 63.34% at September 30, 2017 to 61.91% at September 30, 2018 due to higher total revenue. For more information on the calculation of the efficiency ratio, see “Non-GAAP Financial Measures” located within this management’s discussion and analysis.

Provision for income taxes

On December 22, 2017, the Tax Cuts and Jobs Act (the “Tax Act”) was signed into law and as a result the Company’s federal corporate tax rate was reduced from 34% to 21% effective January 1, 2018. The provision for income taxes decreased \$0.5 million, or 23%, from \$2.1 million for the nine months ended September 30, 2017 to \$1.6 million for the nine months ended September 30, 2018 despite higher income before taxes due to the lower corporate tax rate. The Company's effective tax rate was 16.4% at September 30, 2018 compared to 24.5% at September 30, 2017.

Table Of Contents

Comparison of financial condition at

September 30, 2018 and December 31, 2017

Overview

Consolidated assets increased \$86.3 million, or 10%, to \$949.9 million as of September 30, 2018 from \$863.6 million at December 31, 2017. The increase in assets occurred principally in the loan and investment portfolios. The asset growth was funded mostly by growth in deposits of \$48.9 million and borrowings of \$32.3 million.

Funds Deployed:

Investment securities

At the time of purchase, management classifies investment securities into one of three categories: trading, available-for-sale (AFS) or held-to-maturity (HTM). To date, management has not purchased any securities for trading purposes. All of the securities the Company purchases are classified as AFS even though there is no immediate intent to sell them. The AFS designation affords management the flexibility to sell securities and position the balance sheet in response to capital levels, liquidity needs or changes in market conditions. Debt securities AFS are carried at fair value on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within shareholders' equity as a component of accumulated other comprehensive income (AOCI). Beginning on January 1, 2018, equity securities were carried at fair value on the consolidated balance sheets with unrealized gains and losses, net of deferred income taxes, reported separately within the consolidated statements of income as a component of non-interest income. The Company sold all of its remaining equity securities during the second quarter of 2018. Securities designated as HTM are carried at amortized cost and represent debt securities that the Company has the ability and intent to hold until maturity.

As of September 30 2018, the carrying value of investment securities amounted to \$171.5 million, or 18% of total assets, compared to \$157.4 million, or 18% of total assets, at December 31, 2017. On September 30, 2018, 70% of the carrying value of the investment portfolio was comprised of U.S. Government Sponsored Enterprise residential mortgage-backed securities (MBS – GSE residential or mortgage-backed securities) that amortize and provide monthly cash flow that the Company can use for reinvestment, loan demand, unexpected deposit outflow, facility expansion or operations.

Investment securities were comprised of AFS securities as of September 30, 2018 and December 31, 2017. The AFS securities were recorded with a net unrealized loss of \$3.2 million and a net unrealized gain of \$2.3 million as of September 30, 2018 and December 31, 2017. On January 1, 2018, \$0.5 million of net unrealized gains on equity securities were reclassified from AOCI to retained earnings. Of the remaining net decline in the unrealized gain position of \$5.0 million, \$3.4 million was net unrealized losses on mortgages-backed securities, \$1.5 was net unrealized losses on municipal securities and \$0.1 million was net unrealized losses on agency securities. The direction and magnitude of the change in value of the Company's investment portfolio is attributable to the direction and magnitude of the change in interest rates along the treasury yield curve. Generally, the values of debt securities move in the opposite direction of the changes in interest rates. As interest rates along the treasury yield curve decline, especially at the intermediate and long end, the values of debt securities tend to rise. Whether or not the value of the Company's investment portfolio will continue to exceed its amortized cost will be largely dependent on the direction and magnitude of interest rate movements and the duration of the debt securities within the Company's investment portfolio. When interest rates rise, the market values of the Company's debt securities portfolio could be subject to market value declines.

As of September 30, 2018, the Company had \$137.4 million in public deposits, or 18% of total deposits. Pennsylvania state law requires the Company to maintain pledged securities on these public deposits. As of September 30, 2018, the balance of pledged securities required for deposit and repurchase agreement accounts was \$110.6 million, or 64% of total securities.

Quarterly, management performs a review of the investment portfolio to determine the causes of declines in the fair value of each security. The Company uses inputs provided by independent third parties to determine the fair value of its investment securities portfolio. Inputs provided by the third parties are reviewed and corroborated by management. Evaluations of the causes of the unrealized losses are performed to determine whether impairment exists and whether the impairment is temporary or other-than-temporary. Considerations such as the Company's intent and ability to hold the securities to maturity, recoverability of the invested amounts over the intended holding period, the length of time and the severity in pricing decline below cost, the interest rate environment, the receipt of amounts contractually due and whether or not there is an active market for the securities, for example, are applied, along with an analysis of the financial condition of the issuer for management to make a realistic judgment of the probability that the Company will be unable to collect all amounts (principal and interest) due in determining whether a security is other-than-temporarily impaired. If a decline in value is deemed to be other-than-temporary, the amortized cost of the security is reduced by the credit impairment amount and a corresponding charge to current earnings is recognized. During the nine months ended September 30, 2018, the Company did not incur other-than-temporary impairment charges from its investment securities portfolio.

During the first nine months of 2018, the carrying value of total investments increased \$14.1 million, or 9%. The Company attempts to maintain a well-diversified and proportionate investment portfolio that is structured to complement the strategic direction of the Company. Its growth typically supplements the lending activities but also considers the current and forecasted economic conditions, the Company's liquidity needs and interest rate risk profile. The Company expects to grow the portfolio and increase its relative size with a preference toward mortgage-backed securities. If rates rise, the strategy is expected to provide a good source of cash flow to

Table Of Contents

reinvest into higher yielding interest-sensitive assets. During the third quarter of 2018, the Company purchased approximately \$15 million of securities, primarily MBS-GSE residential, funded by FHLB advances with maturity dates laddered out from 3 to 5 years matching a spread expected to produce a suitable after-tax return.

A comparison of investment securities at September 30, 2018 and December 31, 2017 is as follows:

(dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
MBS - GSE residential	\$ 120,532	70.3 %	\$ 103,152	65.5 %
State & municipal subdivisions	45,086	26.3	44,306	28.2
Agency - GSE	5,833	3.4	9,099	5.8
Equity securities - financial services	-	-	828	0.5
Total	\$ 171,451	100.0 %	\$ 157,385	100.0 %

As of September 30, 2018, there were no investments from any one issuer with an aggregate book value that exceeded 10% of the Company's shareholders' equity.

The distribution of debt securities by stated maturity and tax-equivalent yield at September 30, 2018 are as follows:

(dollars in thousands)	One year or less		More than one year to five years		More than five years to ten years		More than ten years		Total	
	\$	%	\$	%	\$	%	\$	%	\$	%
MBS - GSE residential	\$ -	- %	\$ 55	5.50 %	\$ 1,199	4.44 %	\$ 119,278	3.36 %	\$ 120,532	3.37 %
State & municipal subdivisions	-	-	927	6.04	4,677	4.92	39,482	4.80	45,086	4.84
Agency - GSE	-	-	2,914	2.60	2,919	2.80	-	-	5,833	2.70
Total debt securities	\$ -	- %	\$ 3,896	3.40 %	\$ 8,795	4.14 %	\$ 158,760	3.71 %	\$ 171,451	3.72 %

In the above table, the book yields on state & municipal subdivisions were adjusted to a tax-equivalent basis using the corporate federal tax rate of 21%. In addition, average yields on securities AFS are based on amortized cost and do not reflect unrealized gains or losses.

Federal Home Loan Bank Stock

Investment in Federal Home Loan Bank (FHLB) stock is required for membership in the organization and is carried at cost since there is no market value available. The amount the Company is required to invest is dependent upon the relative size of outstanding borrowings the Company has with the FHLB of Pittsburgh. Excess stock is repurchased from the Company at par if the amount of borrowings decline to a predetermined level. In addition, the Company earns a return or dividend based on the amount invested. The dividends received from the FHLB totaled \$44 thousand and \$122 thousand for the three and nine months ended September 30, 2018 and \$40 thousand and \$96 thousand for the same 2017 periods, respectively. The balance in FHLB stock was \$4.7 million and \$2.8 million as of September 30, 2018 and December 31, 2017, respectively.

Loans held-for-sale (HFS)

Upon origination, most residential mortgages and certain Small Business Administration (SBA) guaranteed loans may be classified as held-for-sale (HFS). In the event of market rate increases, fixed-rate loans and loans not immediately scheduled to re-price would no longer produce yields consistent with the current market. In declining interest rate environments, the Company would be exposed to prepayment risk as rates on fixed-rate loans decrease, and customers look to refinance loans. Consideration is given to the Company's current liquidity position and projected future liquidity needs. To better manage prepayment and interest rate risk, loans that meet these conditions may be classified as HFS. Occasionally, residential mortgage and/or other nonmortgage loans may be transferred from the loan portfolio to HFS. The carrying value of loans HFS is based on the lower of cost or estimated fair value. If the fair values of these loans decline below their original cost, the difference is written down and charged to current earnings. Subsequent appreciation in the portfolio is credited to current earnings but only to the extent of previous write-downs.

As of September 30, 2018 and December 31, 2017, loans HFS consisted of residential mortgages with carrying amounts of \$4.0 million and \$2.2 million, respectively, which approximated their fair values. During the nine months ended September 30, 2018, residential mortgage loans with principal balances of \$24.9 million were sold into the secondary market and the Company recognized net gains of \$0.5 million, compared to \$30.9 million and \$0.6 million, respectively, during the nine months ended September 30, 2017. During the nine months ended September 30, 2018, the Company also sold one SBA guaranteed loan with a principal balance of \$0.4 million and recognized a net gain on the sale of \$47 thousand, compared to \$2.4 million and \$100 thousand, respectively, during the nine months ended September 30, 2017.

The Company retains mortgage servicing rights (MSRs) on loans sold into the secondary market. MSRs are retained so that the Company can foster personal relationships. At September 30, 2018 and December 31, 2017, the servicing portfolio balance of sold

Table Of Contents

residential mortgage loans was \$304.9 million and \$299.3 million, respectively. At September 30, 2018 and December 31, 2017, the servicing portfolio balance of sold SBA loans was \$5.6 million and \$5.6 million, respectively.

Loans and leases

As of September 30, 2018, the Company had gross loans and leases totaling \$701.9 million compared to \$638.6 million at December 31, 2017. The growth of \$63.3 million, or 10%, was largely attributed to the consumer portfolio, more specifically the auto and lease portfolio. The composition of the loan portfolio with the exception of the auto and lease and non-owner occupied real estate categories remains consistent. The expectation for the remainder of 2018 is the auto and lease portfolio will remain at current levels. The relationship managers continue to focus on relationship banking by communicating with our existing clients and developing new relationships.

Commercial and industrial and commercial real estate

As of September 30, 2018, the commercial portfolio recognized net growth of \$17.9 million, or 6%, compared to December 31, 2017. The growth was largely attributed to growth in the commercial and industrial portfolio of \$8.2 million, or 7%, and commercial real estate owner occupied category of \$11.8 million, or 11%. The commercial non-owner occupied real estate category recognized a reduction of \$3.3 million, or 4%. Our expectations for the fourth quarter will yield similar results.

Consumer

The consumer loan portfolio grew 20%, or \$33.7 million, from \$169.7 million at December 31, 2017 to \$203.4 million at September 30, 2018. The growth was largely supported by a 36%, or \$30.1 million, increase in auto loans and leases. Home equity installment loans also contributed to the segment's growth with increased volume of \$4.2 million, or 15%, over December 31, 2017.

Consumer loan growth is expected to soften over the last quarter of 2018 as new auto and lease volume will likely be similar to the portfolio's runoff. Targeted sales and marketing campaigns continue to support home equity loan volume in the face of 2018 Tax Act changes.

Residential

The residential loan portfolio grew approximately \$11.6 million, or 8%, from \$146.8 million at December 31, 2017 to \$158.4 million at September 30, 2018. Held-for-investment and construction real estate mortgages both demonstrated growth in the first nine months of 2018. Held-for-investment residential loans grew \$8.8 million from \$136.9 million to \$145.7 million and construction loan balances grew \$2.8 million from \$9.9 million to \$12.7 million. Held-for-investment real estate makes up approximately 92% of the total residential portfolio at September 30, 2018.

The composition of the loan portfolio at September 30, 2018 and December 31, 2017 is summarized as follows:

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

(dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Commercial and industrial	\$ 121,788	17.3 %	\$ 113,601	17.8 %
Commercial real estate:				
Non-owner occupied	89,568	12.8	92,851	14.5
Owner occupied	121,144	17.3	109,383	17.1
Construction	7,510	1.1	6,228	1.0
Consumer:				
Home equity installment	31,511	4.5	27,317	4.3
Home equity line of credit	52,936	7.5	53,273	8.3
Auto and leases	113,643	16.2	83,510	13.1
Other	5,292	0.8	5,604	0.9
Residential:				
Real estate	145,711	20.7	136,901	21.5
Construction	12,754	1.8	9,931	1.5
Gross loans	701,857	100.0 %	638,599	100.0 %
Less:				
Allowance for loan losses	(9,944)		(9,193)	
Unearned lease revenue	(969)		(639)	
Net loans	\$ 690,944		\$ 628,767	
Loans held-for-sale	\$ 3,998		\$ 2,181	

Table Of Contents

Allowance for loan losses

Management evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. The provision for loan losses represents the amount necessary to maintain an appropriate allowance. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- identification of specific impaired loans by loan category;
- calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- application of historical loss percentages (trailing twelve-quarter average) to pools to determine the allowance allocation; and
- application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio, regulations, and/or current economic conditions.

A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial loans. Commercial loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed. The credit risk grades may be changed at any time management determines an upgrade or downgrade may be warranted. The credit risk grades for the commercial loan portfolio are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what management believes to be best practices and within common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial loan portfolio from period-to-period are based upon the credit risk grading system and from periodic reviews of the loan portfolio.

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount, if applicable, based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered regarding not only loans considered for specific reserves, but also the collectability of loans that may be past due. The assessment process also includes the review of

all loans on non-accrual status as well as a review of certain loans to which the lenders or the Credit Administration function have assigned a criticized or classified risk rating.

45

Table Of Contents

The following tables set forth the activity in the allowance for loan losses and certain key ratios for the period indicated:

(dollars in thousands)	As of and for the nine months ended September 30, 2018	As of and for the twelve months ended December 31, 2017	As of and for the nine months ended September 30, 2017			
Balance at beginning of period	\$ 9,193	\$ 9,364	\$ 9,364			
Charge-offs:						
Commercial and industrial	(106)	(143)	(76)			
Commercial real estate	(166)	(635)	(416)			
Consumer	(275)	(658)	(505)			
Residential	(117)	(309)	(38)			
Total	(664)	(1,745)	(1,035)			
Recoveries:						
Commercial and industrial	67	10	5			
Commercial real estate	36	47	44			
Consumer	187	67	53			
Residential	-	-	-			
Total	290	124	102			
Net charge-offs	(374)	(1,621)	(933)			
Provision for loan losses	1,125	1,450	925			
Balance at end of period	\$ 9,944	\$ 9,193	\$ 9,356			
Allowance for loan losses to total loans	1.42	%	1.44	%	1.47	%
Net charge-offs to average total loans outstanding	0.07	%	0.26	%	0.20	%
Average total loans	\$ 665,095		\$ 630,960		\$ 628,283	
Loans 30 - 89 days past due and accruing	\$ 4,013		\$ 2,893		\$ 2,444	
Loans 90 days or more past due and accruing	\$ 14		\$ 6		\$ -	
Non-accrual loans	\$ 3,777		\$ 3,441		\$ 3,864	
Allowance for loan losses to non-accrual loans	2.63	x	2.67	x	2.42	x
Allowance for loan losses to non-performing loans	2.62	x	2.67	x	2.42	x

The allowance for loan losses was \$9.9 million at September 30, 2018 and \$9.4 million at September 30, 2017. Relative to the loan portfolio, the allowance decreased from 1.47% of total loans at September 30, 2017 to 1.42% at September 30, 2018, as the actual allowance increased \$0.5 million, or 6%, year-over-year, while total loans increased \$66.4 million, or 10%, over the same time period. The decline in the allowance relative to total loans was considered appropriate by management due to the Company's improving asset quality.

During the three month period ended March 31, 2018, management reduced qualitative factors associated with owner-occupied commercial real estate and residential home equity lines of credit due to lower levels of delinquency

associated with these loans. In the subsequent quarters, qualitative factors were unchanged from the levels at March 31, 2018.

Net charge-offs against the allowance totaled \$0.4 million for the nine month period ended September 30, 2018 compared with \$0.9 million for the nine month period ended September 30, 2017, representing a \$0.5 million decrease. The decline in net charge-offs was attributed to total charge-offs decreasing \$0.3 million for the first three quarters of 2018 compared to the same period in 2017, and total recoveries increasing \$0.2 million over the same time period.

Table Of Contents

The allocation of net charge-offs among major categories of loans are as follows for the periods indicated:

	For the nine months ended September 30, 2018	% of Total Net Charge-offs		For the nine months ended September 30, 2017	% of Total Net Charge-offs	
(dollars in thousands)						
Net charge-offs						
Commerical and industrial	\$ (39)	10 %		\$ (71)	8 %	
Commercial real estate	(130)	35		(372)	40	
Consumer	(88)	24		(452)	48	
Residential	(117)	31		(38)	4	
Total net charge-offs	\$ (374)	100 %		\$ (933)	100 %	

For the nine month period ended September 30, 2018, allowance levels rose by \$0.7 million to \$9.9 million compared to \$9.2 million at December 31, 2017, while total loans increased by \$62.9 million to \$700.9 million compared to \$638.0 million at December 31, 2017. Management believes that the current balance in the allowance for loan losses is sufficient to meet the identified potential credit quality issues that may arise and other issues unidentified but inherent to the portfolio. Potential problem loans are those where there is known information that leads management to believe repayment of principal and/or interest is in jeopardy and the loans are currently neither on non-accrual status nor past due 90 days or more. The allowance decreased from 1.44% of total loans at December 31, 2017 to 1.42% of total loans at September 30, 2018, as loan growth outpaced the growth in the allowance.

For a discussion on the provision for loan losses, see the “Provision for loan losses,” located in the results of operations section of management’s discussion and analysis contained herein.

The allowance for loan losses can generally absorb losses throughout the loan portfolio. However, in some instances an allocation is made for specific loans or groups of loans. Allocation of the allowance for loan losses for different categories of loans is based on the methodology used by the Company, as previously explained. The changes in the allocations from period-to-period are based upon quarter-end reviews of the loan portfolio.

Allocation of the allowance among major categories of loans for the periods indicated, as well as the percentage of loans in each category to total loans, is summarized in the following table. This table should not be interpreted as an indication that charge-offs in future periods will occur in these amounts or proportions, or that the allocation indicates future charge-off trends. When present, the portion of the allowance designated as unallocated is within the Company’s guidelines:

September 30, 2018	December 31, 2017	September 30, 2017
Category	Category	Category
% of	% of	% of

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

(dollars in thousands)	AllowanceLoans			AllowanceLoans			AllowanceLoans		
Category			%			%			%
Commercial real estate	\$ 4,030	31	%	\$ 4,060	33	%	\$ 4,102	33	%
Commercial and industrial	1,334	17		1,374	18		1,399	18	
Consumer	2,674	29		2,063	26		1,969	26	
Residential real estate	1,777	23		1,608	23		1,799	23	
Unallocated	129	-		88	-		87	-	
Total	\$ 9,944	100	%	\$ 9,193	100	%	\$ 9,356	100	%

The allocation of the allowance for the commercial loan portfolio, which is comprised of commercial real estate and commercial & industrial loans, accounted for approximately 54% of the total allowance for loan losses at September 30, 2018, which represents a five percentage point decrease from September 30, 2017 and a five percentage point decrease from December 31, 2017. The relative decrease in the allowance allocated to the commercial loan portfolio was mostly related to improving asset quality, which reduced the historical loss percentages applied to the commercial loan portfolio.

The allocation of the allowance for the consumer category of loans, accounted for approximately 27% of the total allowance for loan losses at September 30, 2018, which represents a six percentage point increase from September 30, 2017 and a five percentage point increase from December 31, 2017. This higher allocation for the consumer category of loans was mostly related to increases in the qualitative factor assigned for this segment due to the rising rate environment and concerns about the urban residential housing market; consumer loan growth, specifically in the Company's auto portfolio; and the addition of a consumer installment TDR loan with a large specific impairment in the first quarter of 2018.

The allocation of the allowance for the residential real estate category of loans, accounted for approximately 18% of the total allowance for loan losses at September 30, 2018, which represents a one percentage point decrease from September 30, 2017 and a

Table Of Contents

one percentage point increase from December 31, 2017. The year-over-year decrease in the allowance allocated to residential real estate was attributed to the charge down to fair market value of a residential real estate loan with a large specific impairment. The year-to-date increase in the allowance allocated to residential real estate was attributed an increase in individually impaired residential real estate loans along with growth in this category of loans.

The unallocated amount represents the portion of the allowance not specifically identified with a loan or groups of loans. The unallocated reserve was approximately 1% of the total allowance for loan losses at September 30, 2018, which is consistent with the unallocated reserve percentage at September 30, 2017 and December 31, 2017. Management provided the amount in order to support growth in the loan portfolio and reinforce the allowance for identified and potential credit risks that still exist from an uncertain local economic climate.

Non-performing assets

The Company defines non-performing assets as accruing loans past due 90 days or more, non-accrual loans, TDRs, other real estate owned (ORE) and repossessed assets. At September 30, 2018, non-performing assets represented 0.65% of total assets compared with 0.76% as of September 30, 2017 and 0.73% as of December 31, 2017. The year-over-year improvement resulted from a combination of \$71.6 million in total asset growth and a \$0.5 million net reduction in total non-performing assets. The year-to-date improvement in the non-performing assets to total assets ratio resulted from growth in total assets (10%, or \$86.2 million) along with a decline in non-performing assets (-1%, or \$0.1 million decrease).

The following table sets forth non-performing assets data as of the period indicated:

(dollars in thousands)	September 30, 2018	December 31, 2017	September 30, 2017
Loans past due 90 days or more and accruing	\$ 14	\$ 6	\$ -
Non-accrual loans *	3,777	3,441	3,864
Total non-performing loans	3,791	3,447	3,864
Troubled debt restructurings	1,841	1,871	1,881
Other real estate owned and repossessed assets	577	973	927
Total non-performing assets	\$ 6,209	\$ 6,291	\$ 6,672
Total loans, including loans held-for-sale	\$ 704,886	\$ 640,141	\$ 636,096
Total assets	\$ 949,854	\$ 863,637	\$ 878,266
Non-accrual loans to total loans	0.54%	0.54%	0.61%
Non-performing loans to total loans	0.54%	0.54%	0.61%
Non-performing assets to total assets	0.65%	0.73%	0.76%

* In the table above, the amount includes non-accrual TDRs of \$1.9 million as of September 30, 2018, \$1.6 million as of December 31, 2017 and \$2.0 million as of September 30, 2017.

In the review of loans for both delinquency and collateral sufficiency, management concluded that there were a number of loans that lacked the ability to repay in accordance with contractual terms. The decision to place loans on

non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Generally, commercial loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by residential real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest, and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. Uncollected interest income accrued on all loans placed on non-accrual is reversed and charged to interest income.

From December 31, 2017 to September 30, 2018, non-performing loans, which consists of accruing loans that were over 90 days past due as well as all non-accrual loans, increased from \$3.4 million to \$3.8 million, a \$0.4 million, or 10%, increase. The rise in non-performing loans was the result of additions of \$2.1 million and miscellaneous expenses added to balances of \$0.1 million for non-accrual loans. These increases were partially offset by payments received of \$0.5 million, charge-offs of \$0.3 million, transfers back to accrual of \$0.3 million and transfers to ORE of \$0.7 million for all non-accrual loans. Also, there was an \$8 thousand increase in accruing loans that were over 90 days past due from December 31, 2017 to September 30, 2018.

From December 31, 2017 to September 30, 2018, the portion of accruing loans that were over 90 days past due increased from one loan totaling \$6 thousand to one loan totaling \$14 thousand. The Company seeks payments from all past due customers through an aggressive customer communication process. A past due loan will be placed on non-accrual at the 90 day point when it is deemed that a customer is non-responsive and uncooperative to collection efforts.

From December 31, 2017 to September 30, 2018, non-accrual loans of all types increased by \$0.3 million, or 10%, from \$3.4 million to \$3.7 million. At December 31, 2017, there were a total of 39 loans to 32 unrelated borrowers with balances that ranged from less than \$1 thousand to \$0.6 million. At September 30, 2018, there were a total of 40 loans to 32 unrelated borrowers with balances that

Table Of Contents

ranged from less than \$1 thousand to \$0.6 million. The increase in non-accrual loans is primarily attributed to two loans to a single borrower, totaling \$0.7 million, being placed on non-accrual status during the third quarter of 2018.

The composition of non-performing loans as of September 30, 2018 is as follows:

	Gross loan balances	Past due 90 days or more and still accruing	Non- accrual loans	Total non- performing loans	% of gross loans
(dollars in thousands)					
Commercial and industrial	\$ 121,788	\$ -	\$ 169	\$ 169	0.14%
Commercial real estate:					
Non-owner occupied	89,568	-	538	538	0.60%
Owner occupied	121,144	-	911	911	0.75%
Construction	7,510	-	46	46	0.61%
Consumer:					
Home equity installment	31,511	-	462	462	1.47%
Home equity line of credit	52,936	-	43	43	0.08%
Auto loans and leases *	112,674	14	62	76	0.07%
Other	5,292	-	-	-	-
Residential:					
Real estate	145,711	-	1,546	1,546	1.06%
Construction	12,754	-	-	-	-
Loans held-for-sale	3,998	-	-	-	-
Total	\$ 704,886	\$ 14	\$ 3,777	\$ 3,791	0.54%

*Net of unearned lease revenue of \$1.0 million.

Payments received from non-accrual loans are recognized on a cost recovery method. Payments are first applied to the outstanding principal balance, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of interest income. If the non-accrual loans that were outstanding as of September 30, 2018 had been performing in accordance with their original terms, the Company would have recognized interest income with respect to such loans of \$190 thousand.

The following tables set forth the activity in TDRs for the periods indicated:

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

As of and for the nine months ended September 30, 2018

(dollars in thousands)	Accruing Commercial & Industrial		Non-accruing Consumer Commercial HELOC		Residential	Consumer	Total
	real estate	real estate	real estate	real estate	real estate	installment	
Troubled Debt Restructures:							
Beginning balance	\$ 24	\$ 1,847	\$ 395	\$ 542	\$ 636	\$ -	\$ 3,444
Additions	-	-	-	-	365	414	779
Transfers	-	-	(395)	-	-	-	(395)
Pay downs / payoffs	-	(30)	-	(14)	-	(1)	(45)
Charge offs	-	-	-	-	(78)	-	(78)
Ending balance	\$ 24	\$ 1,817	\$ -	\$ 528	\$ 923	\$ 413	\$ 3,705
Number of loans	1	10	-	1	2	1	15

Table Of Contents

As of and for the year ended December 31, 2017

(dollars in thousands)	Accruing Commercial & Industrial		Non-accruing Consumer Commercial HELOC		Residential	Total
	Commercial	Industrial real estate	Consumer	Commercial real estate	real estate	
Troubled Debt Restructures:						
Beginning balance	\$ 25	\$ 1,798	\$ 650	\$ -	\$ 881	\$ 3,354
Additions	-	1,059	-	-	-	1,059
Transfers	-	(969)	-	969	-	-
Pay downs / payoffs	(1)	(41)	-	(227)	(18)	(287)
Charge offs	-	-	(255)	(200)	(227)	(682)
Ending balance	\$ 24	\$ 1,847	\$ 395	\$ 542	\$ 636	\$ 3,444
Number of loans	1	10	1	1	1	14

The Company, on a regular basis, reviews changes to loans to determine if they meet the definition of a TDR. TDRs arise when a borrower experiences financial difficulty and the Company grants a concession that it would not otherwise grant based on current underwriting standards in order to maximize the Company's recovery.

From December 31, 2017 to September 30, 2018, the balance of TDRs increased \$0.3 million from 14 loans to 10 unrelated borrowers totaling \$3.4 million to 15 loans to 10 unrelated borrowers totaling \$3.7 million. The increase was driven by the addition of 2 TDRs to a single borrower totaling \$0.7 million in the first quarter of 2018. This increase was partially offset by the transfer to ORE of a consumer HELOC TDR with balance of \$0.4 million in the first quarter of 2018.

Loans modified in a TDR may or may not be placed on non-accrual status. At December 31, 2017, three TDRs totaling \$1.6 million were on non-accrual. At September 30, 2018, four TDRs totaling \$1.9 million were on non-accrual. During the first quarter of 2018, one non-accrual consumer HELOC TDR was transferred to ORE and during the third quarter of 2018, two TDRs were placed on non-accrual status.

If applicable, a TDR loan classified as non-accrual would require a minimum of six months of payments before consideration for a return to accrual status. The concessions granted consisted of temporary interest-only payments or a reduction in the rate of interest to a below-market rate for a contractual period of time. The Company believes concessions have been made in the best interests of the borrower and the Company. If loans characterized as a TDR perform according to the restructured terms for a satisfactory period of time, the TDR designation may be removed in a new calendar year if the loan yields a market rate of interest.

Foreclosed assets held-for-sale

From December 31, 2017 to September 30, 2018, foreclosed assets held-for-sale (ORE) decreased from \$1.0 million to \$0.6 million, a \$0.4 million, or 41%, decrease. The following table sets forth the activity in the ORE component of foreclosed assets held-for-sale:

	September 30, 2018	December 31, 2017
(dollars in thousands)	Amount#	Amount #
Balance at beginning of period	\$ 973 11	\$ 1,298 13
Additions	725 8	272 5
Pay downs	(2)	(18)
Write downs	(123)	(100)
Sold	(996)(10)	(479) (7)
Balance at end of period	\$ 577 9	\$ 973 11

As of September 30, 2018, ORE consisted of nine properties from nine unrelated borrowers totaling \$0.6 million. Four of these properties (\$0.2 million) were added in 2018; two of these properties (\$48 thousand) were added in 2017; one was added in 2016 (\$0.2 million); one was added in 2015 (\$0.1 million); and one was added in 2014 (\$42 thousand). Of the nine properties, one totaling \$0.1 million had a signed sales agreement, one totaling \$15 thousand was in the process of being sold, while the seven remaining properties totaling \$0.5 million were listed for sale.

As of December 31, 2017 and September 30, 2018, the Company had no other repossessed assets held-for-sale.

Table Of Contents

Cash surrender value of bank owned life insurance

The Company maintains bank owned life insurance (BOLI) for a chosen group of employees at the time of purchase, namely its officers, where the Company is the owner and sole beneficiary of the policies. BOLI is classified as a non-interest earning asset. Increases in the cash surrender value are recorded as components of non-interest income. The BOLI is profitable from the appreciation of the cash surrender values of the pool of insurance and its tax-free advantage to the Company. This profitability is used to offset a portion of current and future employee benefit costs. In March 2017, the Company invested \$8.0 million in additional BOLI as a source of funding for additional life insurance benefits that provides for payments upon death for officers and employee benefit expenses related to the Company's non-qualified SERP implemented for certain executive officers. The BOLI can be liquidated if necessary with associated tax costs. However, the Company intends to hold this pool of insurance, because it provides income that enhances the Company's capital position. Therefore, the Company has not provided for deferred income taxes on the earnings from the increase in cash surrender value.

Premises and equipment

Net of depreciation, premises and equipment decreased \$0.4 million during the first nine months of 2018. The Company recorded \$1.0 million in depreciation expense which was partially offset by \$0.6 million in additions to fixed assets. For the last quarter of 2018, we expect premises and equipment to increase, projected to grow by \$1.6 million, net of depreciation, by the end of the year primarily due to the building of a new Back Mountain branch scheduled for completion during the fourth quarter.

Other assets

During the first nine months of 2018, the \$5.0 million, or 31%, increase in other assets was due mostly to a \$1.3 million investment settlement pending; \$1.3 million more in construction in process; \$1.1 million in higher residual values associated with recording new automobile leases, net of lease disposals; \$0.7 million higher prepaid dealer reserve; \$0.3 million lower net deferred tax liability and \$0.2 million higher prepaid expenses.

Funds Provided:

Deposits

The Company is a community based commercial depository financial institution, member FDIC, which offers a variety of deposit products with varying ranges of interest rates and terms. Generally, deposits are obtained from consumers, businesses and public entities within the communities that surround the Company's 10 branch offices and all deposits are insured by the FDIC up to the full extent permitted by law. Deposit products consist of transaction accounts including: savings; clubs; interest-bearing checking; money market and non-interest bearing checking (DDA). The Company also offers short- and long-term time deposits or certificates of deposit (CDs). CDs are deposits with stated maturities which can range from seven days to ten years. Cash flow from deposits is influenced by economic conditions, changes in the interest rate environment, pricing and competition. To determine interest rates on its deposit products, the Company considers local competition, spreads to earning-asset yields, liquidity position and rates charged for alternative sources of funding such as short-term borrowings and FHLB advances.

The following table represents the components of deposits as of the date indicated:

(dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Interest-bearing checking	\$ 216,418	27.8 %	\$ 202,536	27.7 %
Savings and clubs	129,193	16.6	129,992	17.8
Money market	113,273	14.5	111,921	15.3
Certificates of deposit	113,589	14.6	107,066	14.7
Total interest-bearing	572,473	73.5	551,515	75.5
Non-interest bearing	206,588	26.5	178,631	24.5
Total deposits	\$ 779,061	100.0 %	\$ 730,146	100.0 %

Total deposits increased \$48.9 million, or 7%, from \$730.2 million at December 31, 2017 to \$779.1 million at September 30, 2018. Non-interest bearing checking accounts contributed the most to the growth with an increase of \$28.0 million. During the first nine months of 2018, the Company received \$13.5 million in non-interest bearing deposits from a new business relationship. The remainder of the growth in non-interest bearing checking resulted mostly from growth in business accounts, but personal and public accounts grew as well. The Company focused on obtaining a full-banking relationship with existing customers as well as forming new customer relationships. Interest-bearing checking deposits grew \$13.9 million from growth in business and public accounts. One new public customer contributed \$10.5 million to this interest-bearing deposit growth. Additionally, money market accounts grew \$1.4 million during the first nine months of 2018 and CDs also increased \$6.5 million. These increases were partially offset by a \$0.8 million decrease in savings and clubs. The Company will continue to execute on its relationship development strategy, explore the demographics within its marketplace and develop creative programs for its customers. The Company expects asset growth for the last

Table Of Contents

quarter of 2018 funded primarily by growth in deposits plus utilization of available borrowing capacity. Growth in deposits is expected from the opening of a new branch in Back Mountain and expanding our footprint in Luzerne County. Seasonal public deposit fluctuations are expected to remain volatile and at times may partially offset this deposit growth.

Customers' interest in long-term time deposit products started to pick up in 2018 as interest rates have risen. The Company's portfolio of CDs increased mostly due to CD promotions and customers' desire for higher-yielding deposit alternatives. During the first nine months of 2018, deposit customers began to move some money from savings and money market accounts to CDs. If rates continue to rise, demand for CDs may continue to grow thereby possibly increasing funding costs. The Company will continue to pursue strategies to grow and retain retail and business customers with an emphasis on deepening and broadening existing and creating new relationships.

The Company uses the Certificate of Deposit Account Registry Service (CDARS) reciprocal program to obtain FDIC insurance protection for customers who have large deposits that at times may exceed the FDIC maximum amount of \$250,000 per person. In the CDARS program, deposits with varying terms and interest rates, originated in the Company's own markets, are exchanged for deposits of other financial institutions that are members in the CDARS network. By placing the deposits in other participating institutions, the deposits of our customers are fully insured by the FDIC. In return for deposits placed with network institutions, the Company receives from network institutions deposits that are approximately equal in amount and are comprised of terms similar to those placed for our customers. Deposits the Company receives from other institutions are considered reciprocal deposits by regulatory definitions. As of September 30, 2018, the Company did not have any CDARS. As of December 31, 2017, CDARS represented \$1.1 million, or less than 1%, of total deposits.

The maturity distribution of certificates of deposit at September 30, 2018 is as follows:

	Three months or less	More than three months to six months	More than six months to twelve months	More than twelve months	Total
(dollars in thousands)					
CDs of \$100,000 or more	\$ 5,147	\$ 11,344	\$ 31,992	\$ 16,325	\$ 64,808
CDARS	-	-	-	-	-
Total CDs of \$100,000 or more	5,147	11,344	31,992	16,325	64,808
CDs of less than \$100,000	6,575	7,251	12,924	22,031	48,781
Total CDs	\$ 11,722	\$ 18,595	\$ 44,916	\$ 38,356	\$ 113,589

Certificates of deposit of \$250,000 or more amounted to \$37.3 million and \$30.9 million as of September 30, 2018 and December 31, 2017, respectively.

Approximately 10% of the CDs, with a weighted-average interest rate of 0.83%, are scheduled to mature in 2018 and an additional 63%, with a weighted-average interest rate of 1.42%, are scheduled to mature in 2019. Renewing CDs may re-price to lower or higher market rates depending on the rate on the maturing CD, the pace and direction of interest rate movements, the shape of the yield curve, competition, the rate profile of the maturing accounts and depositor preference for alternative, non-term products. The Company does expect CD growth to continue during the

last quarter of 2018, and will develop CD promotional programs when the Company deems that it is economically feasible to do so or when demand exists. The Company currently expects the cost of deposit funds to rise due to the current increasing interest rate environment. As with all promotions, the Company will consider the needs of the customers and simultaneously be mindful of the liquidity levels and the interest rate sensitivity exposure of the Company.

Borrowings

Borrowings are used as a complement to deposit generation as an alternative funding source whereby the Company will borrow under customer repurchase agreements in the local market, advances from the FHLB of Pittsburgh and other correspondent banks for asset growth and liquidity needs.

Repurchase agreements are non-insured interest-bearing liabilities that have a perfected security interest in qualified investments of the Company as required by the FDIC Depositor Protection Act of 2009. Repurchase agreements are offered through a sweep product. A sweep account is designed to ensure that on a daily basis, an attached DDA is adequately funded and excess funds are transferred, or swept, into an interest-bearing overnight repurchase agreement account. Due to the constant inflow and outflow of funds of the sweep product, their balances tend to be somewhat volatile, similar to a DDA. Customer liquidity is the typical cause for variances in repurchase agreements. In addition, short-term borrowings may include overnight balances which the Company may require to fund daily liquidity needs such as deposit and repurchase agreement cash outflow, loan demand and operations. Short-term borrowings increased \$21.8 million during the first nine months of 2018. The Company will continue to use short-term borrowings to fund asset growth in the near term but expects to replace some of these borrowings with deposits during the last quarter of 2018.

At September 30, 2018, the Company had \$31.7 million in FHLB advances with a weighted average interest rate of 2.15%. During the first quarter of 2018, the Company paid off \$2.5 million of FHLB advances and another \$2.0 million was paid off during the third quarter of 2018. During September 2018, the Company borrowed \$15 million with maturity dates laddered out from 3 to 5 years in order to purchase securities. As of September 30, 2018, the Company had the ability to borrow an additional \$171.7 million from the

Table Of Contents

FHLB.

The following table represents the components of borrowings as of the date indicated:

(dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Overnight borrowings	\$ 31,778	44.2 %	\$ 7,455	18.8 %
Securities sold under repurchase agreements	8,491	11.8	11,047	27.8
FHLB advances	31,704	44.0	21,204	53.4
Total	\$ 71,973	100.0 %	\$ 39,706	100.0 %

The original maturity dates of FHLB advances as of September 30, 2018 are as follows:

(dollars in thousands)	Amount	Weighted average rate
Maturity date 1 year or less	\$ 16,704	1.38 %
After 1 but within 2	-	-
After 2 but within 3	5,000	2.95
After 3 but within 4	5,000	2.99
After 4 years	5,000	3.07
Total	\$ 31,704	2.15 %

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Management of interest rate risk and market risk analysis.

The adequacy and effectiveness of an institution's interest rate risk management process and the level of its exposures are critical factors in the regulatory evaluation of an institution's sensitivity to changes in interest rates and capital adequacy. Management believes the Company's interest rate risk measurement framework is sound and provides an effective means to measure, monitor, analyze, identify and control interest rate risk in the balance sheet.

The Company is subject to the interest rate risks inherent in its lending, investing and financing activities. Fluctuations of interest rates will impact interest income and interest expense along with affecting market

values of all interest-earning assets and interest-bearing liabilities, except for those assets or liabilities with a short term remaining to maturity. Interest rate risk management is an integral part of the asset/liability management process. The Company has instituted certain procedures and policy guidelines to manage the interest rate risk position. Those internal policies enable the Company to react to changes in market rates to protect net interest income from significant fluctuations. The primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on net interest income along with creating an asset/liability structure that maximizes earnings.

Asset/Liability Management. One major objective of the Company when managing the rate sensitivity of its assets and liabilities is to stabilize net interest income. The management of and authority to assume interest rate risk is the responsibility of the Company's Asset/Liability Committee (ALCO), which is comprised of senior management and members of the board of directors. ALCO meets quarterly to monitor the relationship of interest sensitive assets to interest sensitive liabilities. The process to review interest rate risk is a regular part of managing the Company. Consistent policies and practices of measuring and reporting interest rate risk exposure, particularly regarding the treatment of non-contractual assets and liabilities, are in effect. In addition, there is an annual process to review the interest rate risk policy with the board of directors which includes limits on the impact to earnings from shifts in interest rates.

Interest Rate Risk Measurement. Interest rate risk is monitored through the use of three complementary measures: static gap analysis, earnings at risk simulation and economic value at risk simulation. While each of the interest rate risk measurements has limitations, collectively, they represent a reasonably comprehensive view of the magnitude of interest rate risk in the Company and the distribution of risk along the yield curve, the level of risk through time and the amount of exposure to changes in certain interest rate relationships.

Static Gap. The ratio between assets and liabilities re-pricing in specific time intervals is referred to as an interest rate sensitivity gap. Interest rate sensitivity gaps can be managed to take advantage of the slope of the yield curve as well as forecasted changes in the level of interest rate changes.

Table Of Contents

To manage this interest rate sensitivity gap position, an asset/liability model commonly known as cumulative gap analysis is used to monitor the difference in the volume of the Company's interest sensitive assets and liabilities that mature or re-price within given time intervals. A positive gap (asset sensitive) indicates that more assets will re-price during a given period compared to liabilities, while a negative gap (liability sensitive) indicates the opposite effect. The Company employs computerized net interest income simulation modeling to assist in quantifying interest rate risk exposure. This process measures and quantifies the impact on net interest income through varying interest rate changes and balance sheet compositions. The use of this model assists the ALCO to gauge the effects of the interest rate changes on interest-sensitive assets and liabilities in order to determine what impact these rate changes will have upon the net interest spread. At September 30, 2018, the Company maintained a one-year cumulative gap of positive (asset sensitive) \$41.4 million, or 4%, of total assets. The effect of this positive gap position provided a mismatch of assets and liabilities which may expose the Company to interest rate risk during periods of falling interest rates. Conversely, in an increasing interest rate environment, net interest income could be positively impacted because more assets than liabilities will re-price upward during the one-year period.

Certain shortcomings are inherent in the method of analysis discussed above and presented in the next table. Although certain assets and liabilities may have similar maturities or periods of re-pricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets, such as adjustable-rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the table amounts. The ability of many borrowers to service their adjustable-rate debt may decrease in the event of an interest rate increase.

The following table illustrates the Company's interest sensitivity gap position at September 30, 2018:

(dollars in thousands)	Three months or less	More than three months to twelve months	More than one year to three years	More than three years	Total
Cash and cash equivalents	\$ 2,683	\$ -	\$ -	\$ 14,261	\$ 16,944
Investment securities (1)(2)	4,517	23,997	32,336	115,318	176,168
Loans and leases(2)	190,822	123,756	199,357	181,007	694,942
Fixed and other assets	-	20,464	-	41,336	61,800
Total assets	\$ 198,022	\$ 168,217	\$ 231,693	\$ 351,922	\$ 949,854
Total cumulative assets	\$ 198,022	\$ 366,239	\$ 597,932	\$ 949,854	
Non-interest-bearing transaction deposits (3)	\$ -	\$ 20,679	\$ 56,770	\$ 129,139	\$ 206,588
Interest-bearing transaction deposits (3)	171,918	-	143,484	143,482	458,884
Certificates of deposit	11,722	63,511	33,830	4,526	113,589
Repurchase agreements	8,491	-	-	-	8,491
Short-term borrowings	31,778	-	-	-	31,778

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

FHLB advances	-	16,704	5,000	10,000	31,704
Other liabilities	-	-	-	8,768	8,768
Total liabilities	\$ 223,909	\$ 100,894	\$ 239,084	\$ 295,915	\$ 859,802
Total cumulative liabilities	\$ 223,909	\$ 324,803	\$ 563,887	\$ 859,802	
Interest sensitivity gap	\$ (25,887)	\$ 67,323	\$ (7,391)	\$ 56,007	
Cumulative gap	\$ (25,887)	\$ 41,436	\$ 34,045	\$ 90,052	
Cumulative gap to total assets	-2.7%	4.4%	3.6%	9.5%	

(1) Includes FHLB stock and the net unrealized gains/losses on available-for-sale securities.

(2) Investments and loans are included in the earlier of the period in which interest rates were next scheduled to adjust or the period in which they are due. In addition, loans were included in the periods in which they are scheduled to be repaid based on scheduled amortization. For amortizing loans and MBS – GSE residential, annual prepayment rates are assumed reflecting historical experience as well as management’s knowledge and experience of its loan products.

(3) The Company’s demand and savings accounts were generally subject to immediate withdrawal. However, management considers a certain amount of such accounts to be core accounts having significantly longer effective maturities based on the retention experiences of such deposits in changing interest rate environments. The effective maturities presented are the recommended maturity distribution limits for non-maturing deposits based on historical deposit studies.

Earnings at Risk and Economic Value at Risk Simulations. The Company recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet that extend beyond static re-pricing gap analysis. Although it will continue to measure its re-pricing gap position, the Company utilizes additional modeling for identifying and measuring the interest rate risk in the overall

Table Of Contents

balance sheet. The ALCO is responsible for focusing on “earnings at risk” and “economic value at risk”, and how both relate to the risk-based capital position when analyzing the interest rate risk.

Earnings at Risk. An earnings at risk simulation measures the change in net interest income and net income should interest rates rise and fall. The simulation recognizes that not all assets and liabilities re-price one-for-one with market rates (e.g., savings rate). The ALCO looks at “earnings at risk” to determine income changes from a base case scenario under an increase and decrease of 200 basis points in interest rate simulation models.

Economic Value at Risk. An earnings at risk simulation measures the short-term risk in the balance sheet. Economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the Company’s existing assets and liabilities. The ALCO examines this ratio quarterly utilizing an increase and decrease of 200 basis points in interest rate simulation models. The ALCO recognizes that, in some instances, this ratio may contradict the “earnings at risk” ratio.

The following table illustrates the simulated impact of an immediate 200 basis points upward or downward movement in interest rates on net interest income, net income and the change in the economic value (portfolio equity). This analysis assumed that the adjusted interest-earning asset and interest-bearing liability levels at September 30, 2018 remained constant. The impact of the rate movements was developed by simulating the effect of the rate change over a twelve-month period from the September 30, 2018 levels:

	% change	
	Rates +200	Rates -200
Earnings at risk:		
Net interest income	0.6 %	(7.2) %
Net income	1.8	(15.3)
Economic value at risk:		
Economic value of equity	(3.4)	(25.2)
Economic value of equity as a percent of total assets	(0.6)	(4.0)

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may normally change beyond the Company’s policy guideline for a short period of time as long as the risk-based capital ratio (after adjusting for the excess equity exposure) is greater than 10%. At September 30, 2018, the Company’s risk-based capital ratio was 14.87%.

The table below summarizes estimated changes in net interest income over a twelve-month period beginning October 1, 2018, under alternate interest rate scenarios using the income simulation model described above:

Net		
interest	\$	%

(dollars in thousands)	income	variance	variance	
Simulated change in interest rates				
+200 basis points	\$ 33,411	\$ 197	0.6	%
+100 basis points	33,365	151	0.5	
Flat rate	33,214	-	-	
-100 basis points	32,091	(1,123)	(3.4)	
-200 basis points	30,824	(2,390)	(7.2)	

Simulation models require assumptions about certain categories of assets and liabilities. The models schedule existing assets and liabilities by their contractual maturity, estimated likely call date or earliest re-pricing opportunity. MBS – GSE residential securities and amortizing loans are scheduled based on their anticipated cash flow including estimated prepayments. For investment securities, the Company uses a third-party service to provide cash flow estimates in the various rate environments. Savings, money market and interest-bearing checking accounts do not have stated maturities or re-pricing terms and can be withdrawn or re-price at any time. This may impact the margin if more expensive alternative sources of deposits are required to fund loans or deposit runoff. Management projects the re-pricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity. The model reinvests all maturities, repayments and prepayments for each type of asset or liability into the same product for a new like term at current product interest rates. As a result, the mix of interest-earning assets and interest bearing-liabilities is held constant.

Liquidity

Liquidity management ensures that adequate funds will be available to meet customers' needs for borrowings, deposit withdrawals and maturities, facility expansion and normal operating expenses. Sources of liquidity are cash and cash equivalents, asset maturities and pay-downs within one year, loans HFS, investments AFS, growth of core deposits and repurchase agreements, utilization of borrowing capacities from the FHLB, correspondent banks, CDARs, the Discount Window of the Federal Reserve Bank of Philadelphia (FRB) and proceeds from the issuance of capital stock. Though regularly scheduled investment and loan payments are

Table Of Contents

dependable sources of daily liquidity, sales of both loans HFS and investments AFS, deposit activity and investment and loan prepayments are significantly influenced by general economic conditions including the interest rate environment. During low and declining interest rate environments, prepayments from interest-sensitive assets tend to accelerate and provide significant liquidity that can be used to invest in other interest-earning assets but at lower market rates. Conversely, in periods of high or rising interest rates, prepayments from interest-sensitive assets tend to decelerate causing prepayment cash flows from mortgage loans and mortgage-backed securities to decrease. Rising interest rates may also cause deposit inflow but priced at higher market interest rates or could also cause deposit outflow due to higher rates offered by the Company's competition for similar products. The Company closely monitors activity in the capital markets and takes appropriate action to ensure that the liquidity levels are adequate for funding, investing and operating activities.

The Company's contingency funding plan (CFP) sets a framework for handling liquidity issues in the event circumstances arise which the Company deems to be less than normal. The Company established guidelines for identifying, measuring, monitoring and managing the resolution of potentially serious liquidity crises. The CFP outlines required monitoring tools, acceptable alternative funding sources and required actions during various liquidity scenarios. Thus, the Company has implemented a proactive means for the measurement and resolution for handling potentially significant adverse liquidity conditions. At least quarterly, the CFP monitoring tools, current liquidity position and monthly projected liquidity sources and uses are presented and reviewed by the Company's Asset/Liability Committee. As of September 30, 2018, the Company had not experienced any adverse issues that would give rise to its inability to raise liquidity in an emergency situation.

During the nine months ended September 30, 2018, the Company accumulated \$1.1 million of cash. During the period, the Company's operations provided approximately \$10.3 million mostly from \$22.9 million of net cash inflow from the components of net interest income; partially offset by net non-interest expense/income related payments of \$11.1 million, a \$1.1 million increase in the residual value from the Company's automobile leasing activities, \$0.3 million in estimated tax payments and \$0.1 million in originations of loans HFS over proceeds. Cash inflow from interest-earning assets, deposits, borrowings and the sale of securities were used to purchase investment securities and replace maturing and cash runoff of securities, fund the loan portfolio, pay down FHLB advances and make net dividend payments. The Company received a large amount of public deposits over the past two years. The seasonal nature of deposits from municipalities and other public funding sources requires the Company to be prepared for the inherent volatility and the unpredictable timing of cash outflow from this customer base, including maintaining the requirements to pledge investment securities. Accordingly, the use of short-term overnight borrowings could be used to fulfill funding gap needs. The CFP is a tool to help the Company ensure that alternative funding sources are available to meet its liquidity needs.

In September 2018, the Company used \$15 million in FHLB advances to purchase securities. In September 2018, the Company also purchased 2 letters of credit from the FHLB totaling \$29.9 million to pledge to public deposits.

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers and in connection with the overall interest rate management strategy. These instruments involve, to a varying degree, elements of credit, interest rate and liquidity risk. In accordance with GAAP, these instruments are either not recorded in the consolidated financial statements or are recorded in amounts that differ from the notional amounts. Such instruments primarily include lending commitments and lease obligations.

Lending commitments include commitments to originate loans and commitments to fund unused lines of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon,

the total commitment amounts do not necessarily represent future cash requirements.

In addition to lending commitments, the Company has contractual obligations related to operating lease commitments. Operating lease commitments are obligations under various non-cancelable operating leases on buildings and land used for office space and banking purposes. In April 2018, the Company signed an operating lease for a new branch location in Mountain Top, PA. Otherwise, the Company's position with respect to lending commitments and significant contractual lease obligations, both on a short- and long-term basis has not changed materially from December 31, 2017.

During the third quarter of 2016, the Company entered into an agreement to acquire all the deposits, certain loans and fixed assets of a bank branch. The transaction was completed in March 2017. As a result of this transaction, the Company experienced an increase of \$13.9 million in deposits in March 2017.

As of September 30, 2018, the Company maintained \$16.9 million in cash and cash equivalents and \$175.4 million of investments AFS and loans HFS. Also as of September 30, 2018, the Company had approximately \$171.7 million available to borrow from the FHLB, \$21.0 million from correspondent banks, \$90.6 million from the FRB and \$46.2 million from the CDARS program. The combined total of \$521.8 million represented 55% of total assets at September 30, 2018. Management believes this level of liquidity to be strong and adequate to support current operations.

Capital

During the nine months ended September 30, 2018, total shareholders' equity increased \$2.7 million, or 3%, due principally from the \$8.2 million in net income added into retained earnings which was partially offset by the \$3.9 million, after tax decline in the net

Table Of Contents

unrealized gain position in the Company's investment portfolio. The Company's capital position was further enhanced by \$0.1 million from investments in the Company's common stock via the Employee Stock Purchase Plan (ESPP), \$0.3 million from issuance of stock through the Company's DRP and \$0.7 million from stock-based compensation expense from the ESPP and unvested restricted stock and SSARs. These items were partially offset by \$2.7 million of cash dividends declared on the Company's common stock. The Company's dividend payout ratio, defined as the rate at which current earnings are paid to shareholders, was 33.4% for the nine months ended September 30, 2018. The balance of earnings is retained to further strengthen the Company's capital position.

As of September 30, 2018, the Company reported a net unrealized loss position of \$2.5 million, net of tax, from the debt securities AFS portfolio compared to a net unrealized gain of \$1.8 million as of December 31, 2017. The Company experienced \$2.7 million in net unrealized losses on mortgage-backed securities and \$1.2 million in net unrealized losses on municipal securities during the first nine months of 2018. Additionally during the first quarter of 2018, \$0.4 million in unrealized gains on equity securities, net of tax, were reclassified to retained earnings. These equity securities were subsequently sold. Management believes that changes in fair value of the Company's securities are due to changes in interest rates and not in the creditworthiness of the issuers. Generally, when U.S. Treasury rates rise, investment securities' pricing declines and fair values of investment securities also decline. While volatility has existed in the yield curve within the past twelve months, a rising rate environment is inevitable and during the period of rising rates, the Company expects pricing in the bond portfolio to decline. There is no assurance that future realized and unrealized losses will not be recognized from the Company's portfolio of investment securities. To help maintain a healthy capital position, the Company can issue stock to participants in the DRP and ESPP plans. The DRP affords the Company the option to acquire shares in open market purchases and/or issue shares directly from the Company to plan participants. During the first nine months of 2018, the Company purchased shares in the open market to fulfill the needs of the DRP. Both the DRP and the ESPP have been a consistent source of capital from the Company's loyal employees and shareholders and their participation in these plans will continue to help strengthen the Company's balance sheet.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under these guidelines, assets and certain off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets. The guidelines require all banks and bank holding companies to maintain a minimum ratio of total risk-based capital to total risk-weighted assets (Total Risk Adjusted Capital) of 8%, including Tier I common equity to total risk-weighted assets (Tier I Common Equity) of 4.5%, Tier I capital to total risk-weighted assets (Tier I Capital) of 6% and Tier I capital to average total assets (Leverage Ratio) of at least 4%. A capital conservation buffer, comprised of common equity Tier I capital, is also established above the regulatory minimum capital requirements rising up to 2.50% by 2019. As of September 30, 2018 and December 31, 2017, the Company and the Bank exceeded all capital adequacy requirements to which it was subject.

Table Of Contents

The Company continues to closely monitor and evaluate alternatives to enhance its capital ratios as the regulatory and economic environments change. The following table depicts the capital amounts and ratios of the Company, on a combined basis, and the Bank as of September 30, 2018 and December 31, 2017:

(dollars in thousands)	Actual Amount	Ratio	For capital adequacy purposes		For capital adequacy purposes with capital conservation buffer*		To be well capitalized under prompt corrective action provisions	
			Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2018:								
Total capital (to risk-weighted assets)								
Consolidated	\$ 100,888	14.9%	≥ \$ 54,292	8.0%	≥ \$ 67,017	9.9%	N/A	N/A
Bank	\$ 100,006	14.7%	≥ \$ 54,286	8.0%	≥ \$ 67,010	9.9%	≥ \$ 67,858	10.0%
Tier 1 common equity (to risk-weighted assets)								
Consolidated	\$ 92,386	13.6%	≥ \$ 30,539	4.5%	≥ \$ 43,264	6.4%	N/A	N/A
Bank	\$ 91,505	13.5%	≥ \$ 30,536	4.5%	≥ \$ 43,259	6.4%	≥ \$ 44,108	6.5%
Tier I capital (to risk-weighted assets)								
Consolidated	\$ 92,386	13.6%	≥ \$ 40,719	6.0%	≥ \$ 53,444	7.9%	N/A	N/A
Bank	\$ 91,505	13.5%	≥ \$ 40,715	6.0%	≥ \$ 53,438	7.9%	≥ \$ 54,286	8.0%
Tier I capital (to average assets)								
Consolidated	\$ 92,386	9.9%	≥ \$ 37,205	4.0%	≥ \$ 37,205	4.0%	N/A	N/A
Bank	\$ 91,505	9.8%	≥ \$ 37,214	4.0%	≥ \$ 37,214	4.0%	≥ \$ 46,517	5.0%

As of December 31, 2017:

Edgar Filing: FIDELITY D & D BANCORP INC - Form 10-Q

Total capital (to risk-weighted assets)							
Consolidated	\$ 93,204	14.9%	≥ \$ 50,028	8.0%	≥ \$ 57,845	9.3%	N/A N/A
Bank	\$ 93,130	14.9%	≥ \$ 50,122	8.0%	≥ \$ 57,954	9.3%	≥ \$ 62,653 10.0%
Tier 1 common equity (to risk-weighted assets)							
Consolidated	\$ 85,369	13.7%	≥ \$ 28,141	4.5%	≥ \$ 35,957	5.8%	N/A N/A
Bank	\$ 85,280	13.6%	≥ \$ 28,194	4.5%	≥ \$ 36,025	5.8%	≥ \$ 40,724 6.5%
Tier I capital (to risk-weighted assets)							
Consolidated	\$ 85,369	13.7%	≥ \$ 37,521	6.0%	≥ \$ 45,338	7.3%	N/A N/A
Bank	\$ 85,280	13.6%	≥ \$ 37,592	6.0%	≥ \$ 45,423	7.3%	≥ \$ 50,122 8.0%
Tier I capital (to average assets)							
Consolidated	\$ 85,369	9.9%	≥ \$ 34,471	4.0%	≥ \$ 34,471	4.0%	N/A N/A
Bank	\$ 85,280	9.9%	≥ \$ 34,483	4.0%	≥ \$ 34,483	4.0%	≥ \$ 43,103 5.0%

* The minimums under Basel III increase by 0.625% (the capital conservation buffer) annually until 2019.

The Company advises readers to refer to the Supervision and Regulation section of Management's Discussion and Analysis of Financial Condition and Results of Operation, of its 2017 Form 10-K for a discussion on the regulatory environment and recent legislation and rulemaking.

Item 4. Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was carried out by the Company's management, with the participation of its President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports the Company files or furnishes under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the

Table Of Contents

SEC's rules and regulations, and are effective. The Company made no changes in its internal controls over financial reporting or in other factors that materially affected, or are reasonably likely to materially affect, these controls during the last fiscal quarter ended September 30, 2018.

59

Table Of Contents

PART II - Other Information

Item 1. Legal Proceedings

The nature of the Company's business generates some litigation involving matters arising in the ordinary course of business. However, in the opinion of the Company after consultation with legal counsel, no legal proceedings are pending, which, if determined adversely to the Company or the Bank, would have a material adverse effect on the Company's undivided profits or financial condition. No legal proceedings are pending other than ordinary routine litigation incidental to the business of the Company and the Bank. In addition, to management's knowledge, no governmental authorities have initiated or contemplated any material legal actions against the Company or the Bank.

Item 1A. Risk Factors

Management of the Company does not believe there have been any material changes to the risk factors that were disclosed in the 2017 Form 10-K filed with the Securities and Exchange Commission on March 15, 2018.

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

None

Item 3. Default Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

The following exhibits are filed herewith or incorporated by reference as a part of this Form 10-Q:

3(i) Amended and Restated Articles of Incorporation of Registrant. Incorporated by reference to Annex B of the Proxy Statement/Prospectus included in Registrant's Amendment 4 to its Registration Statement No. 333-90273 on Form S-4, filed with the SEC on April 6, 2000.

3(ii) Amended and Restated Bylaws of Registrant. Incorporated by reference to Exhibit 3(ii) to Registrant's Form 8-K filed with the SEC on November 21, 2007.

*10.1 Registrant's 2012 Dividend Reinvestment and Stock Repurchase Plan. Incorporated by reference to Exhibit 4.1 to Registrant's Registration Statement No. 333-183216 on Form S-3 filed with the SEC on August 10, 2012 as amended February 3, 2014.

*10.2 Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

*10.3 Amendment, dated October 2, 2007, to the Registrant's 2000 Independent Directors Stock Option Plan. Incorporated by reference to Exhibit 10.2 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

*10.4 Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 4.4 to Registrant's Registration Statement No. 333-64356 on Form S-8 filed with the SEC on July 2, 2001.

*10.5 Amendment, dated October 2, 2007, to the Registrant's 2000 Stock Incentive Plan. Incorporated by reference to Exhibit 10.1 to Registrant's Form 8-K filed with the SEC on October 4, 2007.

*10.6 Registrant's 2002 Employee Stock Purchase Plan. Incorporated by reference to Appendix A to Definitive proxy Statement filed with the SEC on March 28, 2002.

*10.7 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Daniel J. Santaniello, dated March 23, 2011. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

*10.8 Amended and Restated Executive Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Timothy P. O'Brien, dated March 23, 2011. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on March 29, 2011.

*10.9 2012 Omnibus Stock Incentive Plan. Incorporated by reference to Appendix A to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.

*10.10 2012 Director Stock Incentive Plan. Incorporated by reference to Appendix B to Registrant's Definitive Proxy Statement filed with the SEC on March 30, 2012.

Table Of Contents

*10.11 Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Salvatore R. DeFrancesco, Jr. dated as of March 17, 2016. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on March 18, 2016.

*10.12 Change in Control and Severance Agreement between the Registrant, The Fidelity Deposit and Discount Bank and Michael J. Pacyna dated as of March 29, 2017. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on April 4, 2017.

*10.13 Employment Agreement between Fidelity D & D Bancorp, Inc., The Fidelity Deposit and Discount Bank and Eugene J. Walsh dated as of March 29, 2017. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on April 4, 2017.

*10.14 Form of Supplemental Executive Retirement Plan – Applicable to Daniel J. Santaniello and Salvatore R. DeFrancesco, Jr. Incorporated by reference to Exhibit 99.1 to Registrant's Current Report on Form 8-K filed with the SEC on April 4, 2017.

*10.15 Form of Supplemental Executive Retirement Plan – Applicable to Eugene J. Walsh and Timothy P O'Brien. Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K filed with the SEC on April 4, 2017.

*10.16 Form of Split Dollar Life Insurance Agreement – Applicable to Daniel J. Santaniello, Salvatore R. DeFrancesco, Jr. and Eugene J. Walsh. Incorporated by reference to Exhibit 99.3 to Registrant's Current Report on Form 8-K filed with the SEC on April 4, 2017.

*10.17 Form of Split Dollar Life Insurance Agreement – Applicable to Timothy P O'Brien and Michael Pacyna. Incorporated by reference to Exhibit 99.4 to Registrant's Current Report on Form 8-K filed with the SEC on April 4, 2017.

11 Statement regarding computation of earnings per share. Included herein in Note No. 6, "Earnings per share," contained within the Notes to Consolidated Financial Statements, and incorporated herein by reference.

31.1 Rule 13a-14(a) Certification of Principal Executive Officer, filed herewith.

31.2 Rule 13a-14(a) Certification of Principal Financial Officer, filed herewith.

32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

101 Interactive data files: The following, from Fidelity D&D Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, is formatted in XBRL (eXtensible Business Reporting Language): Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017; Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017; Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017; Consolidated Statements of Changes in Shareholders' Equity for the nine months ended September 30, 2018 and 2017; Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017 and the Notes to the Consolidated Financial Statements. **

* Management contract or compensatory plan or arrangement.

** Pursuant to Rule 406T of Regulation S-T, the interactive data files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

Table Of Contents

Signatures

FIDELITY D & D BANCORP, INC.

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.

Fidelity D & D Bancorp, Inc.

Date: November 8, 2018 /s/Daniel J. Santaniello
Daniel J. Santaniello,

President and Chief Executive Officer

Fidelity D & D Bancorp, Inc.

Date: November 8, 2018 /s/Salvatore R. DeFrancesco, Jr.
Salvatore R. DeFrancesco, Jr.,

Treasurer and Chief Financial Officer