FIRST DEFIANCE FINANCIAL CORP
Form 10-Q
November 07, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the Quarterly Period Ended September 30, 2016

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 0-26850

First Defiance Financial Corp.
(Exact name of registrant as specified in its charter)

Ohio	34-1803915
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

601 Clinton Street, Defiance, Ohio	43512
(Address of principal executive office)	(Zip Code)

Registrant's telephone number, including area code: (419) 782-5015

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer x
Non-accelerated filer ¨ Smaller reporting company ¨

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date. Common Stock, $.01 Par Value – 8,981,025 shares outstanding at October 31, 2016.

FIRST DEFIANCE FINANCIAL CORP.

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PART I-FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	September 30, 2016	December 31, 2015
Assets		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	$47,797	$ 38,769
Federal funds sold	57,000	41,000
	104,797	79,769
Securities:		
Available-for-sale, carried at fair value	234,223	236,435
Held-to-maturity, carried at amortized cost (fair value $193 and $245 at September 30, 2016 and December 31, 2015, respectively)	191	243
	234,414	236,678
Loans held for sale	9,839	5,523
Loans receivable, net of allowance of $25,923 at September 30, 2016 and $25,382 at December 31, 2015, respectively	1,899,771	1,776,835
Accrued interest receivable	7,452	6,171
Federal Home Loan Bank stock	13,800	13,801
Bank owned life insurance	52,594	51,908
Premises and equipment	36,983	38,166
Real estate and other assets held for sale	704	1,321
Goodwill	61,798	61,798
Core deposit and other intangibles	1,452	1,871

Mortgage servicing rights	9,308	9,248
Other assets	17,128	14,587
Total assets	$2,450,040	$ 2,297,676

(continued)

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	September 30, 2016	December 31, 2015
Liabilities and stockholders’ equity		
Liabilities:		
Deposits	$ 1,927,686	$ 1,836,137
Advances from the Federal Home Loan Bank	114,184	59,902
Subordinated debentures	36,083	36,083
Securities sold under repurchase agreements	50,493	57,188
Advance payments by borrowers	2,073	2,674
Deferred taxes	1,775	877
Other liabilities	25,608	24,618
Total liabilities	2,157,902	2,017,479
Stockholders’ equity:		
Preferred stock, $.01 par value per share: 37,000 shares authorized; no shares issued	-	-
Preferred stock, $.01 par value per share: 4,963,000 shares authorized; no shares issued	-	-
Common stock, $.01 par value per share: 25,000,000 shares authorized; 12,720,347 and 12,721,959 shares issued and 8,980,366 and 9,102,831 shares outstanding, respectively	127	127
Additional paid-in capital	126,200	125,734
Accumulated other comprehensive income, net of tax of $2,675 and $1,950, respectively	4,967	3,622
Retained earnings	235,203	219,737
Treasury stock, at cost, 3,739,981 and 3,619,128 shares respectively	(74,359)	(69,023)
Total stockholders’ equity	292,138	280,197
Total liabilities and stockholders’ equity	$ 2,450,040	$ 2,297,676

See accompanying notes

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Income

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest Income				
Loans	$ 20,264	$ 18,419	$ 59,242	$ 54,445
Investment securities:				
Taxable	767	880	2,391	2,712
Non-taxable	731	796	2,280	2,377
Interest-bearing deposits	104	33	287	113
FHLB stock dividends	137	138	413	413
Total interest income	22,003	20,266	64,613	60,060
Interest Expense				
Deposits	1,635	1,363	4,613	3,947
FHLB advances and other	322	178	940	461
Subordinated debentures	191	154	548	451
Notes payable	35	38	108	113
Total interest expense	2,183	1,733	6,209	4,972
Net interest income	19,820	18,533	58,404	55,088
Provision for loan losses	15	(27)	432	93
Net interest income after provision for loan losses	19,805	18,560	57,972	54,995
Non-interest Income				
Service fees and other charges	2,765	2,799	8,208	8,018
Insurance commissions	2,473	2,310	8,113	7,793
Mortgage banking income	2,039	1,680	5,342	5,248
Gain on sale of non-mortgage loans	148	543	604	776
Gain on sale or call of securities	151	-	509	-
Trust income	420	370	1,256	1,095
Income from Bank Owned Life Insurance	225	238	686	658
Other non-interest income	305	42	1,019	485
Total non-interest income	8,526	7,982	25,737	24,073
Non-interest Expense				
Compensation and benefits	10,295	9,791	30,250	27,896
Occupancy	1,822	1,788	5,435	5,361
FDIC insurance premium	352	329	1,008	999

Financial institutions tax	446	447	1,339	1,340
Data processing	1,622	1,531	4,723	4,652
Acquisition related charges	252	-	252	-
Amortization of intangibles	115	157	419	536
Other non-interest expense	3,388	2,805	9,487	9,758
Total non-interest expense	18,292	16,848	52,913	50,542
Income before income taxes	10,039	9,694	30,796	28,526
Federal income taxes	2,994	2,998	9,318	8,666
Net Income	$ 7,045	$ 6,696	$ 21,478	$ 19,860
Earnings per common share (Note 6)				
Basic	$ 0.78	$ 0.72	$ 2.39	$ 2.15
Diluted	$ 0.78	$ 0.72	$ 2.37	$ 2.11
Dividends declared per share (Note 5)	$ 0.22	$ 0.20	$ 0.66	$ 0.575
Average common shares outstanding (Note 6)				
Basic	8,976	9,238	8,980	9,247
Diluted	9,050	9,322	9,050	9,430

See accompanying notes

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Comprehensive Income

(UNAUDITED)

(Amounts in Thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net Income	$ 7,045	$ 6,696	$ 21,478	$ 19,860
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale	69	2,024	2,579	(313)
Reclassification adjustment for security (gains) losses included in net income(1)	(151)	-	(509)	-
Income tax benefit (expense)	29	(709)	(725)	108
Other comprehensive income (loss)	(53)	1,315	1,345	(205)
Comprehensive income	$ 6,992	$ 8,011	$ 22,823	$ 19,655

(1) Amounts are included in gain on sale or call of securities on the Consolidated Condensed Statements of Income. Income tax expense associated with the reclassification adjustments, included in federal income taxes, for the three months ended September 30, 2016 and 2015 was $53 and $0, respectively. Income tax expense associated with the reclassification adjustments, included in federal income taxes, for the nine months ended September 30, 2016 and 2015 was $178 and $0, respectively.

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Statement of Changes in Stockholders' Equity

(UNAUDITED)

(Amounts in Thousands, except share data)

	Preferred Stock	Common Stock Shares	Common Stock	Common Stock Warrant	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance at January 1, 2016	$ -	9,102,831	$ 127	$ -	$ 125,734	$ 3,622	$ 219,737	$ (69,023)	$ 280,197
Net income							21,478		21,478
Other comprehensive income						1,345			1,345
Stock option expense					226				226
Shares issued under stock option plan, net of 1,612 repurchased and/or retired		33,808			(18)		(26)	711	667
Restricted share activity under stock incentive plans		10,405			236		(72)	225	389
Shares issued from direct stock sales		1,068			22			21	43
Shares repurchased		(167,746)						(6,293)	(6,293)
Common stock dividends declared							(5,914)		(5,914)
Balance at September 30, 2016	$ -	8,980,366	$ 127	$ -	$ 126,200	$ 4,967	$ 235,203	$ (74,359)	$ 292,138
Balance at January 1, 2015	$ -	9,234,534	$ 127	$ 878	$ 136,266	$ 4,114	$ 200,600	$ (62,480)	$ 279,505
Net income							19,860		19,860
Other comprehensive loss						(205)			(205)

Stock option expense					103				103
Warrant repurchase				(878)	(11,101)				(11,979)
Shares issued under stock option plan, net of 12,844 repurchased and retired		67,960			227		(313)	1,429	1,343
Restricted share activity under stock incentive plans		15,006			(121)		185	270	334
Excess tax benefit under stock option plan					216				216
Shares issued direct stock sales		1,487			25			27	52
Shares repurchased		(147,039)						(5,348)	(5,348)
Common stock dividends declared							(5,325)		(5,325)
Balance at September 30, 2015	$ -	9,171,948	$ 127	$ -	$ 125,615	$ 3,909	$ 215,007	$ (66,102)	$ 278,556

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FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Cash Flows

(UNAUDITED)

(Amounts in Thousands)

	Nine Months Ended September 30,	
	2016	2015
Operating Activities		
Net income	$21,478	$19,860
Items not requiring (providing) cash		
Provision for loan losses	432	93
Depreciation	2,514	2,439
Amortization of mortgage servicing rights, net of impairment recoveries	1,399	1,073
Amortization of core deposit and other intangible assets	419	536
Net amortization of premiums and discounts on loans and deposits	254	333
Amortization of premiums and discounts on securities	627	551
Loss on write-downs of property, plant and equipment	-	428
Change in deferred taxes	174	(90)
Proceeds from the sale of loans held for sale	197,167	167,687
Originations of loans held for sale	(198,839)	(167,380)
Gain from sale of loans	(4,707)	(4,504)
Gain from sale or call of securities	(509)	-
(Gain)/Loss on sale or write-down of real estate and other assets held for sale	(269)	281
Stock option expense	226	103
Restricted stock expense	389	334
Income from bank owned life insurance	(686)	(658)
Excess tax benefits from share-based compensation	(184)	-
Changes in:		
Accrued interest receivable	(1,281)	(1,105)
Other assets	(3,475)	170
Other liabilities	1,174	194
Net cash provided by operating activities	16,303	20,345
Investing Activities		
Proceeds from maturities of held-to-maturity securities	52	62
Proceeds from maturities, calls and pay-downs of available-for-sale securities	**25,765**	22,215
Proceeds from sale of real estate and other assets held for sale	1,368	2,103
Proceeds from the sale of available-for-sale securities	14,871	-

Proceeds from sale of non-mortgage loans	13,967	16,178
Purchases of available-for-sale securities	(35,538)	(20,684)
Proceeds from Federal Home Loan Bank stock redemption	1	-
Purchase of bank-owned life insurance	-	(4,000)
Net cash paid in Insurance acquisition	-	(297)
Purchases of premises and equipment, net	(1,289)	(1,631)
Net increase in loans receivable	(137,511)	(103,009)
Net cash used in investing activities	(118,314)	(89,063)
Financing Activities		
Net increase in deposits and advance payments by borrowers	90,949	31,795
Repayment of Federal Home Loan Bank advances	(718)	(7,743)
Increase in Federal Home Loan Bank advances	55,000	27,000
Decrease in securities sold under repurchase agreements	(6,695)	(921)
Repayment of warrants	-	(11,979)
Proceeds from exercise of stock options	667	1,559
Proceeds from direct stock sales	43	52
Cash dividends paid on common stock	(5,914)	(5,325)
Net cash paid for repurchase of common stock	(6,293)	(5,348)
Net cash provided by financing activities	127,039	29,090
Increase (decrease) in cash and cash equivalents	25,028	(39,628)
Cash and cash equivalents at beginning of period	79,769	112,936
Cash and cash equivalents at end of period	$104,797	$73,308
Supplemental cash flow information:		
Interest paid	$6,151	$4,939
Income taxes paid	$9,900	$7,300
Transfers from loans to real estate and other assets held for sale	$526	$872
Transfers from property and equipment to real estate and other assets held for sale	$-	$267
Securities purchased but not yet settled	$935	$-

See accompanying notes.

FIRST DEFIANCE FINANCIAL CORP.

Notes to Consolidated Condensed Financial Statements (UNAUDITED)

September 30, 2016 and 2015

1. Basis of Presentation

First Defiance Financial Corp. (“First Defiance” or the “Company”) is a unitary thrift holding company that conducts business through its three wholly owned subsidiaries, First Federal Bank of the Midwest (“First Federal”), First Insurance Group of the Midwest, Inc. (“First Insurance”), and First Defiance Risk Management Inc. (“First Defiance Risk Management”). All significant intercompany transactions and balances are eliminated in consolidation.

First Federal is primarily engaged in attracting deposits from the general public through its offices and using those and other available sources of funds to originate loans primarily in the counties in which its offices are located. First Federal’s traditional banking activities include originating and servicing residential, non-residential real estate, commercial, home improvement and home equity and consumer loans and providing a broad range of depository, trust and wealth management services. In addition, First Federal invests in U.S. Treasury and federal government agency obligations, obligations of the State of Ohio and its political subdivisions, mortgage-backed securities that are issued by federal agencies, including real estate mortgage investment conduits (“REMICs”) and collateralized mortgage obligations (“CMOs”), and corporate bonds. First Insurance is an insurance agency that conducts business through offices located in the Defiance, Maumee, Oregon, Bryan, Lima and Bowling Green, Ohio areas. First Insurance offers property and casualty insurance, life insurance and group health insurance. First Defiance Risk Management is a wholly-owned insurance company subsidiary of the Company that insures the Company and its subsidiaries against certain risks unique to the operations of the Company and for which insurance may not be currently available or economically feasible in today’s insurance marketplace. First Defiance Risk Management pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves.

The consolidated condensed statement of financial condition at December 31, 2015 has been derived from the audited financial statements at that date, which were included in First Defiance’s Annual Report on Form 10-K for the year ended December 31, 2015.

The accompanying consolidated condensed financial statements as of September 30, 2016 and for the three and nine month periods ended September 30, 2016 and 2015 have been prepared by First Defiance without audit and do not include information or footnotes necessary for the complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States. These consolidated condensed financial statements should be read in conjunction with the financial statements and notes thereto included in First Defiance's 2015 Annual Report on Form 10-K for the year ended December 31, 2015. However, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for the fair presentation of the financial statements have been made. The results for the three and nine month periods ended September 30, 2016 are not necessarily indicative of the results that may be expected for the entire year.

2. Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

Earnings Per Common Share

Basic earnings per common share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for the calculation. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, warrants, restricted stock awards and stock grants.

Newly Issued Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09: *Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. The amendments in ASU 2016-09 simplify several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for public companies for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company elected to adopt ASU 2016-09 in the second quarter of 2016. As a result of adoption, net income for the first quarter of 2016 was revised to reflect a $99,000 reduction to tax expense, which increased net income by $99,000 and a credit to tax expense was recorded in the second quarter of 2016. Also as a result of adoption, the Company is accounting for forfeitures as they occur and the amounts previously recorded in equity are prospectively being recorded as income tax benefits. The excess income tax benefits are reflected in the operating activities in the Consolidated Condensed Statements of Cash Flows.

In February 2016, FASB issued ASU 2016-02 (Topic 842): *Leases*. The main objective of ASU 2016-02 is to provide users with useful, transparent, and complete information about leasing transactions. ASU 2016-02 requires the rights and obligations associated with leasing arrangements be reflected on the balance sheet in order to increase transparency and comparability among organizations. Under the updated guidance, lessees will be required to recognize a right-to-use asset and a liability to make a lease payment and disclose key information about leasing arrangements. ASU 2016-02 is effective for public companies for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the impact of ASU 2016-02 on its Consolidated Financial Statements and disclosures.

In January 2016, FASB issued ASU 2016-01: *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The main objective of ASU 2016-01 is to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Some of the amendments in ASU 2016-01 include the following: 1) Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; 2) Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and 4) Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the effects of ASU 2016-01 on its Consolidated Financial Statements and disclosures.

In June 2016, the FASB issued ASU 2016-13: *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU requires an organization to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. Additionally, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 is effective for public companies for annual periods beginning after December 13, 2019, including interim periods within those fiscal years. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company has not yet determined the impact the adoption of ASU 2016-13 will have on the Consolidated Financial Statements and disclosures.

3. Fair Value

FASB ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

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FASB ASC Topic 820 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on the best information available. In that regard, FASB ASC Topic 820 established a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1*: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

- *Level 2*: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by a correlation or other means.

- *Level 3*: Unobservable inputs for determining fair value of assets and liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Available for sale securities - Securities classified as available for sale are generally reported at fair value utilizing Level 2 inputs where the Company obtains fair value measurements from an independent pricing service that uses matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities’ relationship to other benchmark quoted securities (Level 2 inputs). The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows and the bonds’ terms and conditions, among other things. Securities in Level 1 include federal agency preferred stock securities. Securities in Level 2 include U.S. Government agencies, mortgage-backed securities, corporate bonds and municipal securities.

Impaired loans - Fair values for impaired collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisers and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value on the cost to replace the current property. Value of market comparison approach evaluates the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investors required return. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Comparable sales adjustments are based on known sales prices of similar type and similar use properties and duration of time that the property has been on the market to sell. Such adjustments made in the appraisal process are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Real Estate held for sale - Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are then reviewed monthly by members of the asset review committee for valuation changes and are accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which may utilize a single valuation approach or a combination of approaches including cost, comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments may be significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Company’s asset quality or collections department reviews the assumptions and approaches utilized in the appraisal. Appraisal values are discounted from 0% to 20% to account for other factors that may impact the value of collateral. In determining the value of impaired collateral dependent loans and other real estate owned, significant unobservable inputs may be used, which include: physical condition of comparable properties sold, net operating income generated by the property and investor rates of return.

Mortgage servicing rights – On a quarterly basis, mortgage servicing rights are evaluated for impairment based upon the fair value of the rights as compared to the carrying amount. If the carrying amount of an individual tranche exceeds fair value, impairment is recorded on that tranche so that the servicing asset is carried at fair value. Fair value is determined at a tranche level based on a model that calculates the present value of estimated future net servicing income. The valuation model utilizes assumptions that market participants would use in estimating future net servicing income and are validated against available market data (Level 2).

Mortgage banking derivative - The fair value of mortgage banking derivatives are evaluated monthly based on derivative valuation models using quoted prices for similar assets adjusted for specific attributes of the commitments and other observable market data at the valuation date (Level 2).

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The following table summarizes the financial assets measured at fair value on a recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured on a Recurring Basis

September 30, 2016	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Available for sale securities:				
Obligations of U.S. government corporations and agencies	$ -	$ 2,001	$ -	$ 2,001
Mortgage-backed - residential	-	66,591	-	66,591
REMICs	-	1,409	-	1,409
Collateralized mortgage obligations	-	66,998	-	66,998
Preferred stock	1	-	-	1
Corporate bonds	-	10,958	-	10,958
Obligations of state and political subdivisions	-	86,265	-	86,265
Mortgage banking derivative - asset	-	921	-	921
Mortgage banking derivative - liability	-	126	-	126

December 31, 2015	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	$ -	$ 2,994	$ -	$ 2,994
Mortgage-backed – residential	-	64,654	-	64,654
REMICs	-	1,620	-	1,620
Collateralized mortgage obligations-residential	-	71,799	-	71,799
Preferred stock	1	-	-	1
Corporate bonds	-	4,977	-	4,977
Obligations of state and political subdivisions	-	90,390		90,390
Mortgage banking derivative - asset	-	558	-	558

The following table summarizes the financial assets measured at fair value on a non-recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

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Assets and Liabilities Measured on a Non-Recurring Basis

September 30, 2016	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Impaired loans				
1-4 Family Residential Real Estate	$-	$ -	$ 8	$ 8
Multi Family Residential	-	-	-	-
Commercial Real Estate	-	-	863	863
Commercial loans	-	-	111	111
Home Equity and Improvement	-	-	-	-
Total Impaired loans	-	-	982	982
Mortgage servicing rights	-	3,023	-	3,023
Real estate held for sale				
CRE	-	-	377	377

December 31, 2015	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Impaired loans				
1-4 Family Residential Real Estate	$-	$ -	$ 398	$ 398
Multi Family Residential	-	-	91	91
Commercial Real Estate	-	-	4,575	4,575
Commercial			-	-
Home Equity and Improvement	-	-	82	82
Total impaired loans	-	-	5,146	5,146
Mortgage servicing rights	-	872	-	872
Real estate held for sale				
Commercial Real Estate	-	-	280	280

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of September 30, 2016, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value	Valuation Technique (Dollars in Thousands)	Unobservable Inputs	Range of Inputs	Weighted Average
Impaired Loans-Applies to all loan classes	$ 982	Appraisals which utilize sales comparison, net income and cost approach	Discounts for collection issues and changes in market conditions	10-30%	11%
Real estate held for sale – Applies to all classes	$ 377	Appraisals which utilize sales comparison, net income and cost approach	Discounts for changes in market conditions	0-20%	7%

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of December 31, 2015, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value	Valuation Technique (Dollars in Thousands)	Unobservable Inputs	Range of Inputs	Weighted Average
Impaired Loans-Applies to all loan classes	$5,146	Appraisals which utilize sales comparison, net income and cost approach	Discounts for collection issues and changes in market conditions	10-30%	11%
Real estate held for sale – Applies to all classes	$280	Appraisals which utilize sales comparison, net income and cost approach	Discounts for changes in market conditions	30%	30%

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of $982,000, with a $19,000 valuation allowance and a fair value of $5.1 million, with an $8,000 valuation allowance at September 30, 2016 and December 31, 2015, respectively. A provision recovery of $6,000 and a provision recovery of $204,000 for the three months and nine months ended September 30, 2016 and a provision expense of $59,000 and a provision recovery of $659,000 for the three and nine months ended September 30, 2015 was included in earnings.

Mortgage servicing rights which are carried at the lower of cost or fair value had a fair value of $3.0 million with a valuation allowance of $763,000 and a fair value of $872,000 with a valuation allowance of $645,000 at September

30, 2016 and December 31, 2015, respectively. A recovery of $7,000 and a charge of $118,000 for the three and nine months ended September 30, 2016 and a recovery of $24,000 and $191,000 for the three and nine months ended September 30, 2015, respectively, were included in earnings.

Real estate held for sale is determined using Level 3 inputs which include appraisals and are adjusted for estimated costs to sell. The change in fair value of real estate held for sale and fixed assets transferred to real estate held for sale was $22,000 and $74,000 for the three and nine months ended September 30, 2016, which was recorded directly as an adjustment to current earnings through non-interest expense. The change in fair value of real estate held for sale was $19,000 and $724,000 for the three and nine months ended September 30, 2015.

In accordance with FASB ASC Topic 825, the Fair Value Measurements tables are a comparative condensed consolidated statement of financial condition based on carrying amount and estimated fair values of financial instruments as of September 30, 2016 and December 31, 2015. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of First Defiance.

Much of the information used to arrive at “fair value” is highly subjective and judgmental in nature and therefore the results may not be precise. Subjective factors include, among other things, estimated cash flows, risk characteristics and interest rates, all of which are subject to change. With the exception of investment securities, the Company’s financial instruments are not readily marketable and market prices do not exist. Since negotiated prices for the instruments, which are not readily marketable, depend greatly on the motivation of the buyer and seller, the amounts that will actually be realized or paid per settlement or maturity of these instruments could be significantly different.

The carrying amount of cash and cash equivalents, term notes payable and advance payments by borrowers for taxes and insurance, as a result of their short-term nature, is considered to be equal to fair value and are classified as Level 1.

It was not practicable to determine the fair value of Federal Home Loan Bank (“FHLB”) stock due to restrictions placed on its transferability.

The fair value of loans that reprice within 90 days is equal to their carrying amount. For other loans, the estimated fair value is calculated based on discounted cash flow analysis, using interest rates currently being offered for loans with similar terms, resulting in a Level 3 classification. Impaired loans are valued at the lower of cost of fair value as previously described. The allowance for loan losses is considered to be a reasonable adjustment for credit risk. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price. The fair value of loans held for sale is estimated based on binding contracts and quotes from third party investors resulting in a Level 2 classification.

The fair value of accrued interest receivable is equal to the carrying amounts resulting in a Level 2 or Level 3 classification which is consistent with its underlying value.

The fair value of non-interest bearing deposits are considered equal to the amount payable on demand at the reporting date (i.e. carrying value) and are classified as Level 1. The fair value of savings, NOW and certain money market accounts are equal to their carrying amounts and are a Level 2 classification. Fair values of fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

The fair values of securities sold under repurchase agreements are equal to their carrying amounts resulting in a Level 2 classification. The carrying value of subordinated debentures and deposits with fixed maturities is estimated based on discounted cash flow analyses based on interest rates currently being offered on instruments with similar characteristics and maturities resulting in a Level 3 classification.

FHLB advances with maturities greater than 90 days are valued based on discounted cash flow analysis, using interest rates currently being quoted for similar characteristics and maturities resulting in a Level 2 classification. The cost or value of any call or put options is based on the estimated cost to settle the option at September 30, 2016.

		Fair Value Measurements at September 30, 2016			
		(In Thousands)			
	Carrying Value	Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	$104,797	$104,797	$104,797	$-	$-
Investment securities	234,414	234,416	1	234,415	-
Federal Home Loan Bank Stock	13,800	**N/A**	**N/A**	**N/A**	**N/A**
Loans, net, including loans held for sale	1,909,610	1,920,543	-	10,515	1,910,028
Accrued interest receivable	7,452	7,452	-	1,291	6,161
Financial Liabilities:					
Deposits	$1,927,686	$1,933,607	$443,321	$1,490,286	$-
Advances from Federal Home Loan Bank	114,184	114,572	-	114,572	-
Securities sold under repurchase agreements	50,493	50,493	-	50,493	-
Subordinated debentures	36,083	34,780	-	-	34,780

		Fair Value Measurements at December 31, 2015			
		(In Thousands)			
	Carrying Value	Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	$79,769	$79,769	$79,769	$-	$-
Investment securities	236,678	236,680	1	236,679	-
Federal Home Loan Bank Stock	13,801	N/A	N/A	N/A	N/A
Loans, net, including loans held for sale	1,782,358	1,784,998	-	5,899	1,779,099
Accrued interest receivable	6,171	6,171	7	846	5,318
Financial Liabilities:					
Deposits	$1,836,137	$1,840,464	$420,691	$1,419,773	$-
Advances from Federal Home Loan Bank	59,902	59,653	-	59,653	-
Securities sold under repurchase agreements	57,188	57,188	-	57,188	-
Subordinated debentures	36,083	35,307	-	-	35,305

4. Incentive Compensation Plans

First Defiance has established equity based compensation plans for its directors and employees. On March 15, 2010, the Board adopted, and the shareholders approved at the 2010 Annual Shareholders Meeting, the First Defiance Financial Corp. 2010 Equity Incentive Plan (the “2010 Equity Plan”). The 2010 Equity Plan replaced all pre-existing plans. All awards currently outstanding under prior plans will remain in effect in accordance with their respective terms. Any new awards will be made under the 2010 Equity Plan. The 2010 Equity Plan allows for issuance of up to 350,000 common shares through the award of options, stock grants, restricted stock units (“RSU”), stock appreciation rights or other stock-based awards.

As of September 30, 2016, 57,300 options are outstanding at option prices based on the market value of the underlying shares on the date the options were granted. Options granted under all plans vest 20% per year. All options expire ten years from the date of grant. Vested options of retirees expire on the earlier of the scheduled expiration date or three months after the retirement date.

In each of the years 2014-2016, the Company approved a Short-Term (“STIP”) Equity Incentive Plan and a Long-Term (“LTIP”) Equity Incentive Plan for selected members of management.

Under the 2014 and 2015 STIPs, the participants could earn up to 30% to 45% of their salary for potential payout based on the achievement of certain corporate performance targets during the calendar year. The 2016 STIP allows participants to earn up to 10% to 45% of their salary for potential payout based on the achievement of certain corporate performance targets during the calendar year. The final amount of benefits under the STIPs is determined as of December 31 of the same year and paid out in cash in the first quarter of the following year. The participants are required to be employed on the day of payout in order to receive such payment.

Under each LTIP, the participants may earn up to 20% to 45% of their salary for potential payout in the form of equity awards based on the achievement of certain corporate performance targets over a three-year period. The Company granted 30,538; 24,757; and 24,526 RSU’s to the participants in the 2014, 2015 and 2016 LTIPs, respectively, effective January 1 in the year the award was made, which represents the maximum target award. The amount of benefit under each LTIP will be determined individually at the end of the 36 month performance period ending December 31. The benefits earned under each LTIP will be paid out in equity in the first quarter following the end of the performance period. The participants are required to be employed on the day of payout in order to receive such payment.

A total of 7,011 RSU’s were issued to the participants of the 2013 LTIP in the first quarter of 2016 for the three year performance period ended December 31, 2015.

In the nine months ended September 30, 2016, the Company granted 3,894 restricted shares. 1,872 shares were issued to directors and 1,000 shares were issued to employees that have a one-year vesting period. 1,022 shares were issued to an employee with a four year vesting period.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of stock options granted during the nine months ended September 30, 2016 was determined at the date of grant using the Black-Scholes stock option-pricing model and the following assumptions:

	Nine Months Ended	
	September 30, 2016	September 30, 2015
Expected average risk-free rate	2.24%	2.04%
Expected average life	**10.00 years**	**10.00 years**
Expected volatility	41.00%	42.00%
Expected dividend yield	2.33%	2.10%

The weighted-average fair value of options granted was $13.95 for the nine months ended September 30, 2016 and $13.13 for the nine months ended September 30, 2015.

Following is activity under the plans during the nine months ended September 30, 2016:

Stock options	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in 000's)
Options outstanding, January 1, 2016	86,220	$ 20.27		
Forfeited or cancelled	-	-		
Exercised	(35,420)	20.59		
Granted	6,500	37.78		
Options outstanding, September 30, 2016	57,300	$ 22.05	3.88	$ 1,294
Vested or expected to vest at September 30, 2016	57,300	$ 22.05	3.88	$ 1,294
Exercisable at September 30, 2016	39,500	$ 17.30	1.87	$ 1,080

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows (In Thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Proceeds of options exercised	$ 175	$ 154	$ 667	$ 1,559

Related tax benefit recognized	46	21	158	151
Intrinsic value of options exercised	196	121	684	941

As of September 30, 2016, there was $185,000 of total unrecognized compensation costs related to unvested stock options granted under the Company’s equity plans. The cost is expected to be recognized over a weighted-average period of 3.43 years.

At September 30, 2016, 75,468 RSU’s and 12,161 stock grants were outstanding. Compensation expense is recognized over the performance period based on the achievements of targets as established with the plan documents. A total expense of $970,000 was recorded during the nine months ended September 30, 2016 compared to an expense of $730,000 for the same period in 2015. There was approximately $541,000 included within other liabilities at September 30, 2016 related to the STIP.

	Restricted Stock Units		Stock Grants	
Unvested Shares	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Unvested at January 1, 2016	74,545	$ 25.86	10,927	$ 30.98
Granted	24,526	39.30	10,905	23.39
Vested	(7,011)	19.19	(9,171)	22.50
Forfeited	(16,592)	19.19	(500)	32.00
Unvested at September 30, 2016	75,468	$ 32.31	12,161	$ 32.77

The maximum amount of compensation expense that may be recorded for the 2016 STIP and the 2014, 2015 and 2016 LTIPs at September 30, 2016 is approximately $3.6 million. However, the estimated expense expected to be recorded as of September 30, 2016; based on the performance measures in the plans, is $2.3 million of which $917,000 is unrecognized at September 30, 2016 and will be recognized over the remaining performance periods.

5. Dividends on Common Stock

First Defiance declared and paid a $0.22 per common stock dividend in the first, second and third quarters of 2016. First Defiance declared and paid a $0.175 common stock dividend in the first quarter and a $0.20 per common stock dividend in the second and third quarters of 2015.

6. Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per common share:

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Numerator for basic and diluted earnings per common share – Net income	$7,045	$6,696	$21,478	$19,860
Denominator:				
Denominator for basic earnings per common share – weighted average common shares, including participating securities	8,976	9,238	8,980	9,247
Effect of warrants	-	-	-	99
Effect of employee stock options and restricted share activity	74	84	70	84
Denominator for diluted earnings per common share share	9,050	9,322	9,050	9,430
Basic earnings per common share	$0.78	$0.72	$2.39	$2.15
Diluted earnings per common share	$0.78	$0.72	$2.37	$2.11

There were 7,300 and 12,550 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three and nine months ended September 30, 2016, respectively. There were 6,250 and 16,750 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three and nine months ended September 30, 2015, respectively.

7. Investment Securities

The following is a summary of available-for-sale and held-to-maturity securities:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At September 30, 2016	(In Thousands)			
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	$2,000	$ 1	$ -	$2,001
Mortgage-backed securities – residential	64,600	1,996	(5)	66,591
REMICs	1,382	27	-	1,409
Collateralized mortgage obligations	65,640	1,393	(35)	66,998

Preferred stock	-	1	-	1
Corporate bonds	10,910	53	(5)	10,958
Obligations of state and political subdivisions	81,403	4,869	(7)	86,265
Totals	$225,935	$ 8,340	$ (52)	$ 234,223

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	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In Thousands)			
Held-to-Maturity Securities*:				
FHLMC certificates	$12	$ -	$ -	$ 12
FNMA certificates	61	2	-	63
GNMA certificates	25	-	-	25
Obligations of state and political subdivisions	93	-	-	93
Totals	$191	$ 2	$ -	$ 193

At December 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	$3,000	$ 1	$ (7)	$2,994
Mortgage-backed securities - residential	63,815	898	(59)	64,654
REMICs	1,592	28	-	1,620
Collateralized mortgage obligations	71,176	976	(353)	71,799
Preferred stock	-	1	-	1
Corporate bonds	4,955	39	(17)	4,977
Obligations of state and political subdivisions	85,680	4,712	(2)	90,390
Total Available-for-Sale	$230,218	$ 6,655	$ (438)	$236,435

	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In Thousands)			
Held-to-Maturity Securities*:				
FHLMC certificates	$14	$ —	$ —	$14
FNMA certificates	74	2	(1)	75
GNMA certificates	31	1	—	32
Obligations of states and political subdivisions	124	—	—	124
Total Held-to-Maturity	$243	$ 3	$ (1)	$245

* FHLMC, FNMA, and GNMA certificates are residential mortgage-backed securities.

The amortized cost and fair value of the investment securities portfolio at September 30, 2016 are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. For purposes of the maturity table, mortgage-backed securities ("MBS"), collateralized mortgage obligations ("CMO") and REMICs, which are not due at a single maturity date, have not been allocated over the maturity groupings. These securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	$752	$756	$ -	$ -
Due after one year through five years	19,083	19,426	93	93
Due after five years through ten years	32,492	34,459	-	-
Due after ten years	41,986	44,584	-	-
MBS/CMO/REMICS	131,622	134,998	98	100
	$225,935	$234,223	$ 191	$ 193

Investment securities with a carrying amount of $149.8 million at September 30, 2016 were pledged as collateral on public deposits, securities sold under repurchase agreements and Federal Reserve discount window.

As of September 30, 2016, the Company's investment portfolio consisted of 358 securities, 13 of which were in an unrealized loss position.

The following tables summarize First Defiance's securities that were in an unrealized loss position at September 30, 2016 and December 31, 2015:

	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Loses
	(In Thousands)					
At September 30, 2016						
Available-for-sale securities:						
Obligations of U.S. government corporations and agencies	$2,048	$ (5)	$ -	$ -	$2,048	$ (5)
Collateralized mortgage obligations	4,092	(15)	1,312	(20)	5,404	(35)
Obligations of state and political subdivisions	804	(7)	-	-	804	(7)
Corporate bonds	2,010	(2)	997	(3)	3,007	(5)
Held to maturity securities:						
FHLMC/FNMA certificates	13	-	8	-	21	-
Total temporarily impaired securities	$8,967	$ (29)	$ 2,317	$ (23)	$11,284	$ (52)

	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Loses
	(In Thousands)					
At December 31, 2015						
Available-for-sale securities:						
Obligations of U.S. government corporations and agencies	$993	$ (7)	$ -	$ -	$993	$ (7)
Collateralized mortgage obligations	12,374	(150)	8,158	(203)	20,532	(353)
Corporate bonds	983	(17)	-	-	983	(17)
Obligations of state and political subdivisions	-	-	433	(2)	433	(2)
Mortgage-backed securities-residential	12,525	(59)	-	-	12,525	(59)
Held to maturity securities:						
FNMA certificates	13	(1)	-	-	13	(1)
Total temporarily impaired securities	$26,888	$ (234)	$ 8,591	$ (205)	$35,479	$ (439)

Realized gains from the sales and calls of investment securities totaled $151,000 ($98,000 after tax) in the third quarter of 2016, while there were no realized gains in the third quarter of 2015. There were realized gains from the sales and calls of investment securities totaling $509,000 ($331,000 after tax) for the first nine months of 2016 compared to no realized gains for the first nine months of 2015.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment portfolio is evaluated for OTTI by segregating the portfolio into two general segments. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC Topic 320. Certain collateralized debt obligations (“CDOs”) are evaluated for OTTI under FASB ASC Topic 325, Investment – Other.

When OTTI occurs under either model, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected compared to the book value of the security and is recognized in earnings. The amount of OTTI related to other factors shall be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

With the exception of corporate bonds, the above securities all have fixed interest rates, and all securities have defined maturities. Their fair value is sensitive to movements in market interest rates. First Defiance has the ability and intent to hold these investments for a time necessary to recover the amortized cost without impacting its liquidity position and it is more than likely that the Company will not be required to sell the investments before anticipated recovery.

During the first nine months of 2016 and 2015, management determined there was no OTTI.

The proceeds from the sales and calls of securities and the associated gains and losses are listed below:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2016	2015	2016	2015
	(In Thousands)			
Proceeds	$6,356	$ -	$ 14,871	$ -
Gross realized gains	151	-	509	-
Gross realized losses	-	-	-	-

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8. Loans

Loans receivable consist of the following:

	September 30, 2016	December 31, 2015
	(In Thousands)	
Real Estate:		
Secured by 1-4 family residential	$209,097	$ 205,330
Secured by multi-family residential	199,829	167,558
Secured by commercial real estate	843,991	780,870
Construction	177,075	163,877
	1,429,992	1,317,635
Other Loans:		
Commercial	456,099	419,349
Home equity and improvement	118,165	116,962
Consumer finance	17,251	16,281
	591,515	552,592
Total loans	2,021,507	1,870,227
Deduct:		
Undisbursed loan funds	(94,552)	(66,902)
Net deferred loan origination fees and costs	(1,261)	(1,108)
Allowance for loan loss	(25,923)	(25,382)
Totals	$1,899,771	$ 1,776,835

Loan segments have been identified by evaluating the portfolio based on collateral and credit risk characteristics.

The following table discloses allowance for loan loss activity for the quarter ended September 30, 2016 and 2015 by portfolio segment (In Thousands):

Quarter Ended September 30, 2016	1-4 Family Residential Real Estate	Multi-Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer Finance	Total
Beginning Allowance	$ 2,839	$ 2,365	$ 10,904	$ 633	$ 6,740	$ 2,278	$ 189	$25,948
Charge-Offs	(111)	0	(79)	0	(26)	(74)	(24)	(314)

Recoveries	3	0	62	0	159	40	10	274
Provisions	(299)	(185)	(280)	(221)	1,006	(47)	41	15
Ending Allowance	$ 2,432	$ 2,180	$ 10,607	$ 412	$ 7,879	$ 2,197	$ 216	$25,923

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Quarter Ended September 30, 2015	1-4 Family Residential Real Estate	Multi-Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer Finance	Total
Beginning Allowance	$ 2,877	$ 2,269	$ 12,096	$ 308	$ 5,567	$ 2,107	$ 160	$ 25,384
Charge-Offs	(185)	0	(64)	0	(43)	(110)	(5)	(407)
Recoveries	105	0	25	0	42	76	11	259
Provisions	(18)	(25)	96	(69)	(155)	152	(8)	(27)
Ending Allowance	$ 2,779	$ 2,244	$ 12,153	$ 239	$ 5,411	$ 2,225	$ 158	$ 25,209

The following table discloses allowance for loan loss activity for the year-to-date periods ended September 30, 2016 and September 30, 2015 by portfolio segment and impairment method (In Thousands):

Year-to-date Period Ended September 30, 2016	1-4 Family Residential Real Estate	Multi-Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer	Total
Beginning Allowance	$ 3,212	$ 2,151	$ 11,772	$ 517	$ 5,255	$ 2,304	$ 171	$ 25,382
Charge-Offs	(203)	0	(92)	0	(381)	(170)	(41)	(887)
Recoveries	123	0	468	0	234	113	58	996
Provisions	(700)	29	(1,541)	(105)	2,771	(50)	28	432
Ending Allowance	$ 2,432	$ 2,180	$ 10,607	$ 412	$ 7,879	$ 2,197	$ 216	$ 25,923

Year-to-date Period Ended September 30, 2015	1-4 Family Residential Real Estate	Multi-Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer	Total
Beginning Allowance	$ 2,494	$ 2,453	$ 11,268	$ 221	$ 6,509	$ 1,704	$ 117	$ 24,766
Charge-Offs	(275)	(114)	(250)	0	(68)	(340)	(21)	(1,068)
Recoveries	178	0	789	0	255	156	40	1,418
Provisions	382	(95)	346	18	(1,285)	705	22	93
Ending Allowance	$ 2,779	$ 2,244	$ 12,153	$ 239	$ 5,411	$ 2,225	$ 158	$ 25,209

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2016 (In Thousands):

	1-4 Family Residential Real Estate	Multi Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity & Improvement	Consumer Finance	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	$ 101	$ 1	$ 89	$ -	$ 24	$ 39	$ -	$ 254
Collectively evaluated for impairment	2,331	2,179	10,518	412	7,855	2,158	216	25,669
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	$ 2,432	$ 2,180	$ 10,607	$ 412	$ 7,879	$ 2,197	$ 216	$ 25,923
Loans:								
Loans individually evaluated for impairment	$ 6,767	$ 3,580	$ 16,885	$ -	$ 4,416	$ 1,424	$ 66	$ 33,138
Loans collectively evaluated for impairment	202,600	196,409	829,692	82,254	453,130	117,290	17,186	1,898,561

Loans acquired with deteriorated credit quality	-	-	144	-	12	-	-	156
Total ending loans balance	$ 209,367	$ 199,989	$ 846,721	$ 82,254	$ 457,558	$ 118,714	$ 17,252	$ 1,931,855

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The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2015 (In Thousands):

	1-4 Family Residential Real Estate	Multi Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity & Improvement	Consumer Finance	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	$ 201	$ -	$ 139	$ -	$ 63	$ 34	$ -	$ 437
Collectively evaluated for impairment	3,011	2,151	11,633	517	5,192	2,270	171	24,945
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	$ 3,212	$ 2,151	$ 11,772	$ 517	$ 5,255	$ 2,304	$ 171	$ 25,382
Loans:								
Loans individually evaluated for impairment	$ 7,574	$ 3,313	$ 23,493	$ -	$ 6,107	$ 1,491	$ 71	$ 42,049
Loans collectively evaluated for impairment	198,106	164,382	759,281	96,845	414,527	115,977	16,199	1,765,317

Loans acquired with deteriorated credit quality	-	-	153	-	16	-	-	169
Total ending loans balance	$ 205,680	$ 167,695	$ 782,927	$ 96,845	$ 420,650	$ 117,468	$ 16,270	$ 1,807,535

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The following table presents the average balance, interest income recognized and cash basis income recognized on impaired loans by class of loans (In Thousands):

	Three Months Ended September 30, 2016			Nine Months Ended September 30, 2016		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	$ 3,876	$ 34	$ 33	$ 3,892	$ 109	$ 106
Residential Non Owner Occupied	2,935	29	29	3,234	95	94
Total Residential Real Estate	6,811	63	62	7,126	204	200
Construction	-	-	-	-	-	-
Multi-Family	3,607	14	14	4,087	68	68
CRE Owner Occupied	7,171	30	30	7,810	134	115
CRE Non Owner Occupied	6,341	73	73	5,220	178	175
Agriculture Land	1,851	16	2	2,427	66	16
Other CRE	1,570	13	13	1,556	31	31
Total Commercial Real Estate	16,933	132	118	17,013	409	337
Commercial Working Capital	2,259	26	11	1,769	56	33
Commercial Other	2,198	8	7	2,742	36	34
Total Commercial	4,457	34	18	4,511	92	67
Home Equity and Home Improvement	1,446	12	12	1,631	40	40
Consumer Finance	65	1	1	69	3	3
Total Impaired Loans	$ 33,319	$ 256	$ 225	$ 34,437	$ 816	$ 715

The following table presents the average balance, interest income recognized and cash basis income recognized on impaired loans by class of loans (In Thousands):

	Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	$ 5,750	$ 67	$ 66	$ 5,854	$ 203	$ 201
Residential Non Owner Occupied	3,762	38	38	4,045	117	117
Total Residential Real Estate	9,512	105	104	9,899	320	318
Construction	-	-	-	50	2	2
Multi-Family	3,168	12	11	2,680	25	25
CRE Owner Occupied	6,475	39	39	6,566	117	117
CRE Non Owner Occupied	2,696	29	29	7,445	273	273
Agriculture Land	2,236	21	2	1,741	53	30
Other CRE	1,509	5	5	2,023	31	30
Total Commercial Real Estate	12,916	94	75	17,775	474	450
Commercial Working Capital	1,030	11	11	1,478	38	36
Commercial Other	2,989	7	6	3,483	33	41
Total Commercial	4,019	18	17	4,961	71	77
Home Equity and Home Improvement	2,160	19	19	2,257	60	60
Consumer Finance	58	1	2	55	2	3
Total Impaired Loans	$ 31,833	$ 249	$ 228	$ 37,677	$ 954	$ 935

The following table presents loans individually evaluated for impairment by class of loans (In Thousands):

	September 30, 2016			December 31, 2015		
	Unpaid Principal Balance*	Recorded Investment	Allowance for Loan Losses Allocated	**Unpaid Principal Balance***	Recorded Investment	Allowance for Loan Losses Allocated
With no allowance recorded:						
Residential Owner Occupied	$1,591	$ 1,569	$ -	$1,383	$ 1,360	$ -
Residential Non Owner Occupied	2,486	2,478	-	2,147	2,141	-
Total 1-4 Family Residential Real Estate	4,077	4,047	-	3,530	3,501	-
Multi-Family Residential Real Estate	3,675	3,525	-	3,463	3,313	-
CRE Owner Occupied	5,646	5,331	-	4,869	4,520	-
CRE Non Owner Occupied	6,373	5,940	-	7,932	7,685	-
Agriculture Land	1,841	1,884	-	3,546	3,596	-
Other CRE	1,256	1,152	-	4,076	4,046	-
Total Commercial Real Estate	15,116	14,307	-	20,423	19,847	-
Construction	-	-	-	-	-	-
Commercial Working Capital	2,176	2,162	-	1,644	1,648	-
Commercial Other	2,005	1,917	-	3,573	3,607	-
Total Commercial	4,181	4,079	-	5,217	5,255	-
Home Equity and Home Improvement	716	670	-	817	772	-
Consumer Finance	59	59	-	60	59	-
Total loans with no allowance recorded	$27,824	$ 26,687	$ -	$33,510	$ 32,747	$ -
With an allowance recorded:						
Residential Owner Occupied	$2,340	$ 2,313	$ 93	$2,918	$ 2,837	$ 188
Residential Non Owner Occupied	415	407	8	1,231	1,236	13
Total 1-4 Family Residential Real Estate	2,755	2,720	101	4,149	4,073	201
Multi-Family Residential Real Estate	54	55	1	-	-	-
CRE Owner Occupied	2,261	1,791	79	3,250	2,767	132
CRE Non Owner Occupied	340	341	4	385	308	2
Agriculture Land	46	47	1	68	69	2
Other CRE	822	399	5	926	502	3
Total Commercial Real Estate	3,469	2,578	89	4,629	3,646	139
Construction	-	-	-	-	-	-
Commercial Working Capital	107	107	2	594	596	62
Commercial Other	367	230	22	252	256	1
Total Commercial	474	337	24	846	852	63
Home Equity and Home Improvement	788	754	39	724	719	34
Consumer Finance	8	7	-	12	12	-
Total loans with an allowance recorded	$7,548	$ 6,451	$ 254	$10,360	$ 9,302	$ 437

* Presented gross of charge offs

The following table presents the current balance of the aggregate amounts of non-performing assets, comprised of non-performing loans and real estate owned on the dates indicated:

	September 30, 2016	December 31, 2015
	(In Thousands)	
Non-accrual loans	$18,198	$ 16,261
Loans over 90 days past due and still accruing	-	-
Total non-performing loans	18,198	16,261
Real estate and other assets held for sale	704	1,321
Total non-performing assets	$18,902	$ 17,582
Troubled debt restructuring, still accruing	$9,113	$ 11,178

The following table presents the aging of the recorded investment in past due and non accrual loans as of September 30, 2016 by class of loans (In Thousands):

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non Accrual
Residential Owner Occupied	$141,829	$ 30	$ 573	$ 847	$ 1,450	$ 1,834
Residential Non Owner Occupied	65,410	481	78	119	678	1,081
Total 1-4 Family Residential Real Estate	207,239	511	651	966	2,128	2,915
Multi-Family Residential Real Estate	199,989	-	-	-	-	2,713
CRE Owner Occupied	348,245	134	1,128	1,678	2,940	4,972
CRE Non Owner Occupied	331,569	158	488	272	918	1,753
Agriculture Land	107,249	53	-	-	53	857
Other Commercial Real Estate	55,498	-	-	249	249	1,004
Total Commercial Real Estate	842,561	345	1,616	2,199	4,160	8,586
Construction	82,254	-	-	-	-	-
Commercial Working Capital	202,496	-	790	39	829	1,207
Commercial Other	252,800	188	17	1,228	1,433	2,059
Total Commercial	455,296	188	807	1,267	2,262	3,266

Home Equity/Home Improvement	117,737	657	162	158	977	719
Consumer Finance	17,057	131	64	-	195	13
Total Loans	$1,922,133	$ 1,832	$ 3,300	$ 4,590	$ 9,722	$ 18,212

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The following table presents the aging of the recorded investment in past due and non accrual loans as of December 31, 2015 by class of loans (In Thousands):

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non Accrual
Residential Owner Occupied	$138,974	$ 159	$ 673	$ 391	$ 1,223	$ 1,428
Residential Non Owner Occupied	64,577	324	356	226	906	1,179
Total 1-4 Family Residential Real Estate	203,551	483	1,029	617	2,129	2,607
Multi-Family Residential Real Estate	165,671	-	-	2,024	2,024	2,417
CRE Owner Occupied	322,940	772	1,218	1,266	3,256	4,141
CRE Non Owner Occupied	304,166	-	106	538	644	1,229
Agriculture Land	98,055	57	-	-	57	695
Other Commercial Real Estate	53,494	-	-	315	315	1,364
Total Commercial Real Estate	778,655	829	1,324	2,119	4,272	7,429
Construction	96,845	-	-	-	-	-
Commercial Working Capital	168,938	16	-	154	170	251
Commercial Other	249,070	203	46	2,223	2,472	2,833
Total Commercial	418,008	219	46	2,377	2,642	3,084
Home Equity and Home Improvement	116,599	733	92	44	869	689
Consumer Finance	16,216	27	3	24	54	36
Total Loans	$1,795,545	$ 2,291	$ 2,494	$ 7,205	$ 11,990	$ 16,262

Troubled Debt Restructurings

As of September 30, 2016 and December 31, 2015, the Company had a recorded investment in troubled debt restructurings (“TDRs”) of $14.7 million and $17.6 million, respectively. The Company allocated $254,000 and $335,000 of specific reserves to those loans at September 30, 2016 and December 31, 2015, and has committed to lend additional amounts totaling up to $10,000 and $48,000 at September 30, 2016 and December 31, 2015, respectively.

The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Each TDR is uniquely designed to meet the specific needs of the borrower. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral or an additional guarantor is often requested when granting a concession. Commercial mortgage loans modified in a TDR often involve temporary interest-only payments, re-amortization of remaining debt in order to lower payments, and sometimes reducing the interest rate lower than the current market rate. Residential mortgage loans modified in a TDR are comprised of loans where monthly payments are lowered, either through interest rate reductions or principal only payments for a period of time, to accommodate the borrowers' financial needs, interest is capitalized into principal, or the term and amortization are extended. Home equity modifications are made infrequently and usually involve providing an interest rate that is lower than the borrower would be able to obtain due to credit issues. All retail loans where the borrower is in bankruptcy are classified as TDRs regardless of whether or not a concession is made.

Of the loans modified in a TDR, $5.5 million are on non-accrual status and partial charge-offs have in some cases been taken against the outstanding balance. Loans modified as a TDR may have the financial effect of increasing the allowance associated with the loan. If the loan is determined to be collateral dependent, the estimated fair value of the collateral, less any selling costs is used to determine if there is a need for a specific allowance or charge-off. If the loan is determined to be cash flow dependent, the allowance is measured based on the present value of expected future cash flows discounted at the loan's pre-modification effective interest rate.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three and nine month periods ending September 30, 2016 and September 30, 2015:

	Loans Modified as a TDR for the Three Months Ended September 30, 2016 ($ in thousands)		Loans Modified as a TDR for the Nine Months Ended September 30, 2016 ($ in thousands)	
Troubled Debt Restructurings	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	5	$ 86	10	$ 208
1-4 Family Non Owner Occupied	1	8	3	128
Multi Family	0	-	1	54
CRE Owner Occupied	0	-	0	-
CRE Non Owner Occupied	2	215	4	870
Agriculture Land	1	46	1	46
Other CRE	0	-	0	-
Commercial Working Capital	0	-	1	226
Commercial Other	0	-	1	590
Home Equity and Improvement	4	52	8	340
Consumer Finance	1	13	2	16

Total	14	$ 420	31	$ 2,478

The loans described above increased the ALLL by $31,000 in the three month period ending September 30, 2016 and decreased the ALLL by $9,000 in the nine month period ending September 30, 2016.

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Troubled Debt Restructurings	Loans Modified as a TDR for the Three Months Ended September 30, 2015 ($ in thousands)		Loans Modified as a TDR for the Nine Months Ended September 30, 2015 ($ in thousands)	
	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	0	$ -	3	$ 226
1-4 Family Non Owner Occupied	0	-	4	63
CRE Owner Occupied	1	72	2	632
CRE Non Owner Occupied	0	-	2	252
Agriculture Land	0	-	3	1,552
Other CRE	0	-	0	-
Commercial Working Capital	2	114	4	119
Commercial Other	1	19	2	73
Home Equity and Improvement	4	114	11	217
Consumer Finance	2	2	6	37
Total	10	$ 321	37	$ 3,171

The loans described above decreased the ALLL by $3,000 in the three month period ending September 30, 2015 and $23,000 in the nine month period ending September 30, 2015.

Of the 2016 modifications, 10 were made TDRs due to the fact that the borrower has been in bankruptcy, 1 was made a TDR due to an interest only period, 6 were made TDRs due to extending the maturity, 4 were made TDRs due to advancing funds to a watchlist credit, 1 was to term out a line of credit and 9 were made to refinance current debt for payment relief.

The following table presents loans by class modified as TDRs for which there was a payment default within twelve months following the modification during the three and nine month periods ended September 30, 2016 and September 30, 2015:

Troubled Debt Restructurings That Subsequently Defaulted	Three Months Ended September 30, 2016 ($ in thousands)		Nine Months Ended September 30, 2016 ($ in thousands)	
	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	1	$ 190	1	$ 190

1-4 Family Non Owner Occupied	0		-	0		-
CRE Owner Occupied	0		-	0		-
CRE Non Owner Occupied	0		-	1		11
Agriculture Land	0		-	0		-
Other CRE	0		-	0		-
Commercial Working Capital or Other	0		-	0		-
Commercial Other	0		-	0		-
Home Equity and Improvement	0		-	0		-
Consumer Finance	0		-	0		-
Total	1	$	190	2	$	201

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The TDRs that subsequently defaulted described above had no effect on the allowance for loan losses for the three and nine month periods ended September 30, 2016.

	Three Months Ended September 30, 2015 ($ in thousands)		Nine Months Ended September 30, 2015 ($ in thousands)	
Troubled Debt Restructurings That Subsequently Defaulted	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	0	$ -	0	$ -
1-4 Family Non Owner Occupied	0	-	1	105
CRE Owner Occupied	0	-	0	-
CRE Non Owner Occupied	0	-	0	-
Agriculture Land	0	-	0	-
Other CRE	0	-	0	-
Commercial Working Capital or Other	1	120	1	120
Commercial Other	5	1,829	5	1,829
Home Equity and Improvement	0	-	1	22
Consumer Finance	0	-	0	-
Total	6	$ 1,949	8	$ 2,076

The TDRs that subsequently defaulted described above had no effect on the allowance for loan losses for the three and nine month periods ended September 30, 2015.

The terms of certain other loans were modified during the period ending September 30, 2016 that did not meet the definition of a TDR. The modification of these loans involved a modification of the terms of a loan to borrowers who were not experiencing financial difficulties. A total of 81 loans were modified under this definition during the three month period ended September 30, 2016 and a total of 284 loans were modified under this definition during the nine month period ended September 30, 2016.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed on the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification.

Credit Quality Indicators

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are analyzed individually by classifying the loans as to credit risk. This analysis includes all non-homogeneous loans, such as commercial and commercial real estate loans and certain homogenous mortgage, home equity and consumer loans. This analysis is performed on a quarterly basis. First Defiance uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Not Graded. Loans classified as not graded are generally smaller balance residential real estate, home equity and consumer installment loans which are originated primarily by using an automated underwriting system. These loans are monitored based on their delinquency status and are evaluated individually only if they are seriously delinquent.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of September 30, 2016, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows (In Thousands):

Class	Pass	Special Mention	Substandard	Doubtful	Not Graded	Total
1-4 Family Owner Occupied	$5,585	$286	$ 1,637	$ -	$135,771	$143,279
1-4 Family Non Owner Occupied	57,485	926	3,581	-	4,096	66,088
Total 1-4 Family Real Estate	63,070	1,212	5,218	-	139,867	209,367
Multi-Family Residential Real Estate	195,606	310	3,958	-	115	199,989
CRE Owner Occupied	319,942	23,239	7,564	-	440	351,185
CRE Non Owner Occupied	325,109	1,016	6,355	-	6	332,486
Agriculture Land	102,228	2,869	2,206	-	-	107,303
Other CRE	52,585	-	2,420	-	742	55,747
Total Commercial Real Estate	799,864	27,124	18,545	-	1,188	846,721
Construction	63,927	-	-	-	18,327	82,254
Commercial Working Capital	189,208	11,509	2,608	-	-	203,325
Commercial Other	244,846	6,579	2,808	-	-	254,233

Total Commercial	434,054	18,088	5,416	-	-	457,558
Home Equity and Home Improvement	-	-	691	-	118,023	118,714
Consumer Finance	-	-	13	-	17,239	17,252
Total Loans	$1,556,521	$46,734	$ 33,841	$ -	$294,759	$1,931,855

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As of December 31, 2015, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows (In Thousands):

Class	Pass	Special Mention	Substandard	Doubtful	Not Graded	Total
Residential Owner Occupied	$5,828	$123	$ 2,427	$ -	$131,820	$140,198
Residential Non Owner Occupied	55,169	1,420	4,439	-	4,454	65,482
Total 1-4 Family Real Estate	60,997	1,543	6,866	-	136,274	205,680
Multi-Family Residential Real Estate	163,405	498	3,675	-	117	167,695
CRE Owner Occupied	297,856	17,896	9,730	-	714	326,196
CRE Non Owner Occupied	293,057	2,143	9,595	-	15	304,810
Agriculture Land	92,262	1,947	3,903	-	-	98,112
Other CRE	47,109	469	5,739	-	492	53,809
Total Commercial Real Estate	730,284	22,455	28,967	-	1,221	782,927
Construction	76,152	2,159	-	-	18,534	96,845
Commercial Working Capital	163,071	2,497	3,540	-	-	169,108
Commercial Other	243,308	2,706	5,528	-	-	251,542
Total Commercial	406,379	5,203	9,068	-	-	420,650
Home Equity and Home Improvement	-	-	689	-	116,779	117,468
Consumer Finance	-	-	15	-	16,255	16,270
Total Loans	$1,437,217	$31,858	$ 49,280	$ -	$289,180	$1,807,535

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled $142,000 as of September 30, 2016.

9. Mortgage Banking

Net revenues from the sales and servicing of mortgage loans consisted of the following:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
	(In Thousands)			
Gain from sale of mortgage loans	$1,683	$1,197	$4,103	$3,728
Mortgage loans servicing revenue (expense):				
Mortgage loans servicing revenue	885	866	2,638	2,593
Amortization of mortgage servicing rights	(536)	(407)	(1,281)	(1,264)
Mortgage servicing rights valuation adjustments	7	24	(118)	191
	356	483	1,239	1,520
Net revenue from sale and servicing of mortgage loans	$2,039	$1,680	$5,342	$5,248

The unpaid principal balance of residential mortgage loans serviced for third parties was $1.37 billion at September 30, 2016 and $1.34 billion at December 31, 2015.

Activity for capitalized mortgage servicing rights and the related valuation allowance follows for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
	(In Thousands)			
Mortgage servicing assets:				
Balance at beginning of period	$9,906	$9,872	$9,893	$9,923
Loans sold, servicing retained	701	449	1,459	1,255
Amortization	(536)	(407)	(1,281)	(1,264)
Carrying value before valuation allowance at end of period	10,071	9,914	10,071	9,914
Valuation allowance:				
Balance at beginning of period	(770)	(744)	(645)	(911)

Impairment recovery (charges)	7	24	(118)	191
Balance at end of period	(763)	(720)	(763)	(720)
Net carrying value of MSRs at end of period	$9,308	$9,194	$9,308	$9,194
Fair value of MSRs at end of period	$9,493	$9,629	$9,493	$9,629

Amortization of mortgage servicing rights is computed based on payments and payoffs of the related mortgage loans serviced. Estimates of future amortization expense are not easily estimable**.**

The Company established an accrual for secondary market buy-back losses that resulted in a reversal of $131,000 for the first nine months of 2016. In the first nine months of 2015, the Company reversed $84,000. The reversals are mainly due to no actual losses being recorded in the first nine months of 2016 and 2015. There is approximately $83,000 and $226,000 accrued and included within other liabilities at September 30, 2016 and 2015, respectively, for potential secondary market buy-back losses.

10. Deposits

A summary of deposit balances is as follows:

	September 30, 2016	December 31, 2015
	(In Thousands)	
Non-interest-bearing checking accounts	$443,321	$ 420,691
Interest-bearing checking and money market accounts	810,393	767,201
Savings deposits	241,016	219,655
Retail certificates of deposit less than $250,000	399,749	403,902
Retail certificates of deposit greater than $250,000	33,207	24,688
	$1,927,686	$ 1,836,137

11. Borrowings

First Defiance's FHLB advances and junior subordinated debentures owed to unconsolidated subsidiary trusts are comprised of the following:

	September 30, 2016	December 31, 2015
	(In Thousands)	
FHLB Advances:		
Single maturity fixed rate advances	$72,000	$ 47,000
Putable advances	5,000	5,000
Amortizable mortgage advances	7,184	7,902
Overnight advances	30,000	-
Total	$114,184	$ 59,902

Junior subordinated debentures owed to unconsolidated subsidiary trusts	$36,083	$ 36,083

The putable advance can be put back to the Company at the option of the FHLB on a quarterly basis. A $5.0 million putable advance with a weighted average rate of 2.35% was not yet callable by the FHLB at September 30, 2016. The call date for this advance is December 12, 2016 and the maturity date is March 12, 2018. Putable advances are callable at the option of the FHLB on a quarterly basis.

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In March 2007, the Company sponsored an affiliated trust, First Defiance Statutory Trust II (Trust Affiliate II) that issued $15 million of Guaranteed Capital Trust Securities (Trust Preferred Securities). In connection with this transaction, the Company issued $15.5 million of Junior Subordinated Deferrable Interest Debentures (Subordinated Debentures) to Trust Affiliate II. The Company formed Trust Affiliate II for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Subordinated Debentures held by Trust Affiliate II are the sole assets of that trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate II are payable quarterly at a variable rate equal to the three-month LIBOR rate plus 1.5%. The Coupon rate payable on the Trust Preferred Securities issued by Trust Affiliate II was 2.35% as of September 30, 2016 and 2.01% as of December 31, 2015.

The Trust Preferred Securities issued by Trust Affiliate II are subject to mandatory redemption, in whole or part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures mature on June 15, 2037, but can be redeemed at the Company’s option at any time now.

The Company also sponsored an affiliated trust, First Defiance Statutory Trust I (Trust Affiliate I), that issued $20 million of Trust Preferred Securities in 2005. In connection with this transaction, the Company issued $20.6 million of Subordinated Debentures to Trust Affiliate I. Trust Affiliate I was formed for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Junior Debentures held by Trust Affiliate I are the sole assets of the trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate I are payable quarterly at a variable rate equal to the three-month LIBOR rate plus 1.38%. The Coupon rate payable on the Trust Preferred Securities issued by Trust Affiliate I was 2.23% and 1.89% on September 30, 2016 and December 31, 2015 respectively.

The Trust Preferred Securities issued by Trust Affiliate I are subject to mandatory redemption, in whole or in part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures mature on December 15, 2035, but can be redeemed at the Company’s option at any time now.

The subordinated debentures may be included in Tier 1 capital (with certain limitations applicable) under current regulatory guidelines and interpretations.

Interest on both issues of Trust Preferred Securities may be deferred for a period of up to five years at the option of the issuer.

Repurchase Agreements. We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor levels on a continuous basis. We may be required to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agent.

The remaining contractual maturity of the securities sold under agreements to repurchase in the consolidated balance sheets as of September 30, 2016 and December 31, 2015 is presented in the following tables.

	Overnight and Continuous (In Thousands)	Up to 30 Days	30-90 Days	Greater than 90 Days	Total
At September 30, 2016					
Repurchase agreements:					
Mortgage-backed securities – residential	$26,433	$ -	$ -	$ -	$26,433
Collateralized mortgage obligations	24,060	-	-	-	24,060
Total borrowings	$50,493	$ -	$ -	$ -	$50,493
Gross amount of recognized liabilities for repurchase agreements					$50,493

	Overnight and Continuous (In Thousands)	Up to 30 Days	30-90 Days	Greater than 90 Days	Total
At December 31, 2015					
Repurchase agreements:					
Mortgage-backed securities – residential	$23,998	$ -	$ -	$ -	$23,998
Collateralized mortgage obligations	33,190	-	-	-	33,190
Total borrowings	$57,188	$ -	$ -	$ -	$57,188
Gross amount of recognized liabilities for repurchase agreements					$57,188

12. Commitments, Guarantees and Contingent Liabilities

Loan commitments are made to accommodate the financial needs of First Federal's customers; however, there are no long-term, fixed-rate loan commitments that result in market risk. Standby letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. They primarily are issued to facilitate customers' trade transactions.

Both arrangements have credit risk, essentially the same as that involved in extending loans to customers, and are subject to the Company's normal credit policies. Collateral (e.g., securities, receivables, inventory and equipment) is obtained based on Management's credit assessment of the customer.

The Company's maximum obligation to extend credit for loan commitments (unfunded loans and unused lines of credit) and standby letters of credit outstanding as of the periods stated below were as follows (In Thousands):

	September 30, 2016		December 31, 2015	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	$51,486	$ 120,932	$80,862	$ 76,253
Unused lines of credit	15,689	420,335	31,991	323,171
Standby letters of credit	-	9,891	-	19,632
Total	$67,175	$ 551,158	$112,853	$ 419,056

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Commitments to make loans are generally made for periods of 60 days or less. In addition to the above commitments, First Defiance had commitments to sell $38.1 million and $19.9 million of loans to Freddie Mac, Fannie Mae, Federal Home Loan Bank of Cincinnati or BB&T Mortgage at September 30, 2016 and December 31, 2015, respectively.

13. Income Taxes

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax in the state of Indiana. The Company is no longer subject to examination by taxing authorities for years before 2011. The Company currently operates primarily in the states of Ohio and Michigan, which tax financial institutions based on their equity rather than their income. As a result of adopting ASU 2016-09, a $54,000 credit to tax expense was recorded in the third quarter of 2016 and a $184,000 credit to tax expense was recorded for the first nine months of 2016.

14. Derivative Financial Instruments

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from its commitments to fund the loans. These mortgage banking derivatives are not designated in hedge relationships. First Federal had approximately $19.9 million and $14.9 million of interest rate lock commitments at September 30, 2016 and December 31, 2015, respectively. There were $38.1 million and $19.9 million of forward commitments for the future delivery of residential mortgage loans at September 30, 2016 and December 31, 2015, respectively.

The fair value of these mortgage banking derivatives are reflected by a derivative asset. The table below provides data about the carrying values of these derivative instruments:

	September 30, 2016			December 31, 2015		
	Assets	(Liabilities)		Assets	(Liabilities)	
	Carrying Value	Carrying Value	Derivative Net Carrying Value	Carrying Value	Carrying Value	Derivative Net Carrying Value
	(In Thousands)					
Derivatives not designated as hedging instruments						
Mortgage Banking Derivatives	$921	$ (126)	$ 795	$ 558	$ -	$ 558

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The table below provides data about the amount of gains and losses recognized in income on derivative instruments not designated as hedging instruments:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(In Thousands)			
Derivatives not designated as hedging instruments				
Mortgage Banking Derivatives – Gain (Loss)	$(193)	$(94)	$237	$311

The above amounts are included in mortgage banking income with gain on sale of mortgage loans.

Note 15 - Other Comprehensive Income (Loss)

The before and after tax amounts allocated to each component of other comprehensive income (loss) are presented in the table below. Reclassification adjustments related to securities available for sale are included in gains on sale or call of securities in the accompanying consolidated condensed statements of income.

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
	(In Thousands)		
Three months ended September 30, 2016:			
Securities available for sale and transferred securities:			
Change in net unrealized gain (loss) during the period	$69	$ (24)	$ 45
Reclassification adjustment for net gains included in net income	(151)	53	(98)
Total other comprehensive income (loss)	$(82)	$ 29	$ (53)
Nine months ended September 30, 2016:			
Securities available for sale and transferred securities:			
Change in net unrealized gain (loss) during the period	$2,579	$ (903)	$ 1,676
Reclassification adjustment for net gains included in net income	(509)	178	(331)
Total other comprehensive income (loss)	$2,070	$ (725)	$ 1,345

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
	(In Thousands)		
Three months ended September 30, 2015:			
Securities available for sale and transferred securities:			
Change in net unrealized gain (loss) during the period	$2,024	$ 709	$ 1,315
Reclassification adjustment for net gains included in net income	-	-	-
Total other comprehensive income (loss)	$2,024	$ 709	$ 1,315
Nine months ended September 30, 2015:			
Securities available for sale and transferred securities:			
Change in net unrealized gain (loss) during the period	$(313)	$ (108)	$ (205)
Reclassification adjustment for net gains included in net income	-	-	-
Total other comprehensive income (loss)	$(313)	$ (108)	$ (205)

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Activity in accumulated other comprehensive income (loss), net of tax, was as follows:

	Securities Available For Sale	Post-retirement Benefit	Accumulated Other Comprehensive Income
	(In Thousands)		
Balance January 1, 2016	$4,042	$ (420)	$ 3,622
Other comprehensive income (loss) before reclassifications	1,676	-	1,676
Amounts reclassified from accumulated other comprehensive income	(331)	-	(331)
Net other comprehensive income during period	1,345	-	1,345
Balance September 30, 2016	$5,387	$ (420)	$ 4,967
Balance January 1, 2015	$4,697	$ (583)	$ 4,114
Other comprehensive income (loss) before reclassifications	(205)	-	(205)
Amounts reclassified from accumulated other comprehensive income	-	-	-
Net other comprehensive income during period	(205)	-	(205)
Balance September 30, 2015	$4,492	$ (583)	$ 3,909

Note 16 – Affordable Housing Projects Tax Credit Partnership

The Company makes certain equity investments in various limited partnerships that sponsor affordable housing projects utilizing the Low Income Housing Tax Credit (“LIHTC”) pursuant to Section 42 of the Internal Revenue Code. The purpose of these investments is to achieve a satisfactory return on capital, to facilitate the sale of affordable housing product offerings, and to assist in achieving goals associated with the Community Reinvestment Act. The primary activities of the limited partnerships include the identification, development, and operation of multi-family housing that is leased to qualifying residential tenants. Generally, these types of investments are funded through a combination of debt and equity.

The Company is a limited partner in each LIHTC Partnership. A separate unrelated third party is the general partner. Each limited partnership is managed by the general partner, who exercises full control over the affairs of the limited partnership. The general partner has all the rights, powers and authority granted or permitted to be granted to a general partner of a limited partnership. Duties entrusted to the general partner of each limited partnership include, but are not limited to: investment in operating companies, company expenditures, investment of excess funds, borrowing funds, employment of agents, disposition of fund property, prepayment and refinancing of liabilities, votes and consents, contract authority, disbursement of funds, accounting methods, tax elections, bank accounts, insurance, litigation, cash reserve, and use of working capital reserve funds. Except for limited rights granted to consent to certain transactions, the limited partner(s) may not participate in the operation, management, or control of the limited partnership's business, transact any business in the limited partnership's name or have any power to sign documents for or otherwise bind the limited partnership. In addition, the general partner may only be removed by the limited partner(s) in the event the general partner fails to comply with the terms of the agreement or is negligent in performing its duties.

The general partner of each limited partnership has both the power to direct the activities which most significantly affect the performance of each partnership and the obligation to absorb losses or the right to receive benefits that could be significant to the entities. Therefore, the Company has determined that it is not the primary beneficiary of any LIHTC partnership. All of the LIHTC's investments are accounted for under the proportional amortization method, as there were no investments held prior to January of 2014. As of September 30, 2016 and December 31, 2015 the Company had $6.9 million and $4.3 million in qualified investments recorded in other assets and $4.6 million and $2.4 million in unfunded commitments recorded in other liabilities, respectively.

Unfunded Commitments

As of September 30, 2016, the expected payments for unfunded affordable housing commitments were as follows (In Thousands):

	Amount
2016	$ 1,089
2017	1,143
2018	1,137
2019	308
2020	179
Thereafter	778
Total Unfunded Commitments	$ 4,634

The following table presents tax credits and other tax benefits recognized and amortization expense related to affordable housing for the three and nine months ended September 30, 2016 and 2015 (In Thousands):

	Three Months Ended September 30,	
	2016	2015
Proportional Amortization Method		
Tax credits and other tax benefits recognized	$ 170	$ 118
Amortization expense in federal income taxes	130	89

	Nine Months Ended September 30,	
	2016	2015
Proportional Amortization Method		
Tax credits and other tax benefits recognized	$ 484	$ 354

Amortization expense in federal income taxes	368	268

There were no impairment losses of LIHTC investments for the three and nine months ended September 30, 2016 and 2015.

Note 17 – Acquisition

On August 23, 2016, First Defiance announced the execution of a definitive agreement (the “Agreement”) to acquire Commercial Bancshares, Inc. (“Commercial Bancshares”) and its wholly-owned subsidiary, Commercial Savings Bank (“CSB”). Each Commercial Bancshares shareholder will receive 1.1808 shares of First Defiance common stock (“First Defiance Shares”) or $51.00 in cash, subject to total consideration being paid 80% in First Defiance Shares and 20% in cash as provided in the Agreement. Based on the twenty-day average closing price of First Defiance Shares of $43.19 ending August 22, 2016, the transaction is valued at approximately $63 million in the aggregate, including cash payment of approximately $1.5 million to cancel outstanding options. On June 30, 2016, Commercial Bancshares had $342 million in assets, $298 million in loans and $301 million in deposits at its seven banking offices. The transaction is expected to be completed in the first quarter of 2017, pending regulatory approvals, the approval of shareholders of Commercial Bancshares and the completion of other customary closing conditions.

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

Forward-Looking Information

Certain statements contained in this quarterly report are not historical facts, including but not limited to statements that can be identified by the use of forward-looking terminology such as “may”, “will”, “expect”, “anticipate”, or “continue” or the negative thereof or other variations thereon or comparable terminology are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934 (“Exchange Act”), as amended. Actual results could differ materially from those indicated in such statements due to risks, uncertainties and changes with respect to a variety of market and other factors. The Company assumes no obligation to update any forward-looking statements.

General

First Defiance is a unitary thrift holding company that conducts business through its wholly owned subsidiaries, First Federal, First Insurance and First Defiance Risk Management.

First Federal is a federally chartered stock savings bank that provides financial services to communities based in northwest Ohio, northeast Indiana, and southeastern Michigan where it operates 34 full service banking centers in twelve northwest Ohio counties, one northeast Indiana county, and one southeastern Michigan county. First Federal operates one loan production office in one central Ohio county.

First Federal provides a broad range of financial services including checking accounts, savings accounts, certificates of deposit, real estate mortgage loans, commercial loans, consumer loans, home equity loans and trust and wealth management services through its extensive branch network.

First Insurance sells a variety of property and casualty, group health and life and individual health and life insurance products. First Insurance is an insurance agency that does business in the Defiance, Bryan, Bowling Green, Lima, Maumee and Oregon, Ohio areas.

First Defiance Risk Management is a wholly owned insurance company subsidiary of the Company that insures the Company and its subsidiaries against certain risks unique to the operations of the Company and for which insurance may not be currently available or economically feasible in today's insurance marketplace. First Defiance Risk Management pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves.

On August 23, 2016, First Defiance announced the execution of a definitive agreement (the "Agreement") to acquire Commercial Bancshares and its wholly-owned subsidiary, CSB. Each Commercial Bancshares shareholder will receive 1.1808 shares of First Defiance Shares or $51.00 in cash, subject to total consideration being paid 80% in First Defiance Shares and 20% in cash as provided in the Agreement. Based on the twenty-day average closing price of First Defiance Shares of $43.19 ending August 22, 2016, the transaction is valued at approximately $63 million in the aggregate, including cash payment of approximately $1.5 million to cancel outstanding options. On June 30, 2016, Commercial Bancshares had $342 million in assets, $298 million in loans and $301 million in deposits at its seven banking offices. The transaction is expected to be completed in the first quarter of 2017, pending regulatory approvals, the approval of shareholders of Commercial Bancshares and the completion of other customary closing conditions.

Impact of Legislation - Over the last several years, Congress and the U.S. Department of the Treasury have enacted legislation and taken actions to address the disruptions in the financial system, declines in the housing market, and the overall regulation of financial institutions and the financial system. In this regard, the 2010 Dodd-Frank Act, includes provisions affecting large and small financial institutions alike, including several provisions that profoundly affect the regulation of community banks, thrifts, and bank and thrift holding companies, such as First Defiance. The Dodd-Frank Act relaxed rules regarding interstate branching, allows financial institutions to pay interest on business checking accounts, changed the scope of federal deposit insurance coverage, imposed new capital requirements on bank and thrift holding companies, and imposed limits on debit card interchange fees charged by issuer banks (commonly known as the Durbin Amendment).

The Dodd-Frank Act also established the CFPB as an independent bureau within the Federal Reserve, which has broad authority to regulate consumer financial products and services and entities offering such products and services, including banks.

The CFPB has indicated that mortgage lending is an area of supervisory focus and that it will concentrate its examination and rulemaking efforts on the variety of mortgage-related topics required under the Dodd-Frank Act, including steering consumers to less-favorable products, discrimination, abusive or unfair lending practices, predatory lending, origination disclosures, minimum mortgage underwriting standards, mortgage loan originator compensation, and servicing practices. The CFPB has published numerous final regulations impacting the mortgage industry, including rules related to ability-to-pay, mortgage servicing, and mortgage loan originator compensation and more regulations are anticipated. First Defiance cannot predict the content of the final CFPB and other federal agency regulations or the impact they might have on First Defiance’s financial results. The CFPB’s authority over mortgage lending, and its authority to change regulations adopted in the past by other regulators, or to rescind or ignore past regulatory guidance, could increase First Defiance’s compliance costs and litigation exposure.

Regulatory Capital Requirements – The federal banking regulators have adopted risk-based capital guidelines for financial institutions and their holding companies, designed to absorb losses. The guidelines provide a systematic analytical framework, which makes regulatory capital requirements sensitive to differences in risk profiles among banking organizations, takes off-balance sheet exposures expressly into account in evaluating capital adequacy and minimizes disincentives to holding liquid, low-risk assets. Capital levels as measured by these standards are also used to categorize financial institutions for purposes of certain prompt corrective action regulatory provisions.

In July 2013, the United States banking regulators issued final (or, in the case of the FDIC, interim final) new capital rules applicable to smaller banking organizations, which also implement certain provisions of the Dodd-Frank Act (the “Basel III Capital Rules”). Community banking organizations, including First Defiance and First Federal, began transitioning to the new rules on January 1, 2015. The new minimum capital requirements became effective on January 1, 2015, whereas a new capital conservation buffer and deductions from common equity capital phase in from January 1, 2016, through January 1, 2019, and most deductions from common equity tier 1 capital will phase in from January 1, 2015, through January 1, 2019.

The new rules include (a) a new common equity tier 1 (“CET1”) capital ratio of at least 4.5%, (b) a Tier 1 capital ratio of at least 6.0%, rather than the former 4.0%, (c) a minimum total capital ratio that remains at 8.0%, and (d) a minimum leverage ratio of 4%.

Common equity for the CET1 capital ratio includes common stock (plus related surplus) and retained earnings, plus limited amounts of minority interests in the form of common stock, less the majority of certain regulatory deductions.

Tier 1 capital includes common equity as defined for the CET1 capital ratio, plus certain non-cumulative preferred stock and related surplus, cumulative preferred stock and related surplus and trust preferred securities that have been grandfathered (but which are not permitted going forward), and limited amounts of minority interests in the form of additional Tier 1 capital instruments, less certain deductions.

Tier 2 capital, which can be included in the total capital ratio, includes certain capital instruments (such as subordinated debt) and limited amounts of the allowance for loan and lease losses, subject to new eligibility criteria, less applicable deductions.

The deductions from CET1 capital include goodwill and other intangibles, certain deferred tax assets, mortgage-servicing assets above certain levels, gains on sale in connection with a securitization, investments in a banking organization’s own capital instruments and investments in the capital of unconsolidated financial institutions (above certain levels). The deductions phase in from 2015 through 2019.

Under the guidelines, capital is compared to the relative risk related to the balance sheet. To derive the risk included in the balance sheet, one of several risk weights is applied to different balance sheet and off-balance sheet assets, primarily based on the relative credit risk of the counterparty. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The new rules also place restrictions on the payment of capital distributions, including dividends, and certain discretionary bonus payments to executive officers if the company does not hold a capital conservation buffer of greater than 2.5% composed of CET1 capital above its minimum risk-based capital requirements, or if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% at the beginning of the quarter. The capital conservation buffer phases in starting on January 1, 2016, at .625%. The implementation of Basel III did not have a material impact on First Defiance's or First Federal's capital ratios.

Business Strategy - First Defiance's primary objective is to be a high-performing community banking organization, well regarded in its market areas. First Defiance accomplishes this through emphasis on local decision making and empowering its employees with tools and knowledge to serve its customers' needs. First Defiance believes in a "Customer First" philosophy that is strengthened by its Trusted Advisor initiative. First Defiance also has a tagline of "Better Together" as an indication of its commitment to local, responsive, personalized service. First Defiance believes this strategy results in greater customer loyalty and profitability through core relationships. First Defiance is focused on diversification of revenue sources and increased market penetration in areas where the growth potential exists for a balance between acquisition and organic growth. The primary elements of First Defiance's business strategy are commercial banking, consumer banking, including the origination and sale of single-family residential loans, enhancement of fee income, wealth management and insurance sales, each united by a strong customer service culture throughout the organization.

Commercial and Commercial Real Estate Lending - Commercial and commercial real estate lending have been an ongoing focus and a major component of First Federal's success. First Federal provides primarily commercial real estate and commercial business loans with an emphasis on owner- occupied commercial real estate and commercial business lending, including a focus on the deposit balances that accompany these relationships. First Federal's client base tends to be small to middle market customers with annual gross revenues generally between $1 million and $50 million. First Federal's focus is also on securing multiple guarantors in addition to collateral where possible. These customers require First Federal to have a high degree of knowledge and understanding of their business in order to provide them with solutions to their financial needs. First Federal's "Customer First" philosophy and culture complements this need of its clients. First Federal believes this personal service model differentiates First Federal from its competitors, particularly the larger regional institutions. First Federal offers a wide variety of products to support commercial clients including remote deposit capture and other cash management services. First Federal also believes that the small business customer is a strong market for First Federal. First Federal participates in many of the Small Business Administration lending programs and implemented a program in 2014 targeting the small business customer. Maintaining a diversified portfolio with an emphasis on monitoring industry concentrations and reacting to changes in the credit characteristics of industries is an ongoing focus.

Consumer Banking - First Federal offers customers a full range of deposit and investment products including demand, checking, money market, certificates of deposits, Certificate of Deposit Account Registry Service ("CDARS") and savings accounts. First Federal offers a full range of investment products through the wealth management department and a wide variety of consumer loan products, including residential mortgage loans, home equity loans, and installment loans. First Federal also offers online banking services, which include mobile banking and online bill pay.

Fee Income Development - Generation of fee income and the diversification of revenue sources are accomplished through the mortgage banking operation, First Insurance and the wealth management department as First Defiance seeks to reduce reliance on retail transaction fee income.

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Deposit Growth - First Federal’s focus has been to grow core deposits with an emphasis on total relationship banking with both our retail and commercial customers. First Federal has initiated a pricing strategy that considers the whole relationship of the customer. First Federal will continue to focus on increasing its market share in the communities it serves by providing quality products with extraordinary customer service, business development strategies and branch expansion. First Federal will look to grow its footprint in areas believed to further complement its overall market share and complement its strategy of being a high-performing community bank.

Asset Quality - Maintaining a strong credit culture is of the utmost importance to First Federal. First Federal has maintained a strong credit approval and review process that has allowed the Company to maintain a credit quality standard that balances the return with the risks of industry concentrations and loan types. First Federal is primarily a collateral lender with an emphasis on cash flow performance, while obtaining additional support from personal guarantees and secondary sources of repayment. First Federal has directed its attention to loan types and markets that it knows well and in which it has historically been successful. First Federal strives to have loan relationships that are well diversified in both size and industry, and monitors the overall trends in the portfolio to maintain its industry and loan type concentration targets. First Federal maintains a problem loan remediation process that focuses on detection and resolution. First Federal maintains a strong process of internal control that subjects the loan portfolio to periodic internal reviews as well as independent third-party loan review.

Expansion Opportunities - First Defiance believes it is well positioned to take advantage of acquisitions or other business opportunities in its market areas. First Defiance believes it has a track record of successfully accomplishing both acquisitions and de novo branching in its market area. This track record puts the Company in a solid position to enter or expand its business. First Defiance will continue to be disciplined as well as opportunistic in its approach to future acquisitions and de novo branching with a focus on its primary geographic market area, which it knows well, and has been competing in for a long period of time, as well as surrounding market areas.

Investments - First Defiance invests in U.S. Treasury and federal government agency obligations, obligations of municipal and other political subdivisions, mortgage-backed securities which are issued by federal agencies, corporate bonds, and collateralized mortgage obligations ("CMOs") and real estate mortgage investment conduits ("REMICs"). Management determines the appropriate classification of all such securities at the time of purchase in accordance with FASB ASC Topic 320.

Securities are classified as held-to-maturity when First Defiance has the positive intent and ability to hold the security to maturity. Held-to-maturity securities are stated at amortized cost and had a recorded value of $191,000 at September 30, 2016. Securities not classified as held-to-maturity are classified as available-for-sale, which are stated at fair value and had a recorded value of $234.2 million at September 30, 2016. The available-for-sale portfolio consists of obligations of U.S. Government corporations and agencies ($2.0 million), certain municipal obligations ($86.3 million), CMOs/REMICs ($68.4 million), corporate bonds ($11.0 million), mortgage backed securities ($66.6 million).

In accordance with ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income.

Lending - In order to properly assess the collateral dependent loans included in its loan portfolio, the Company has established policies regarding the monitoring of the collateral underlying such loans. The Company requires an appraisal that is less than one year old for all new collateral dependent real estate loans, and all renewed collateral dependent real estate loans where significant new money is extended. The appraisal process is handled by the Credit Department, which selects the appraiser and orders the appraisal. First Defiance's loan policy prohibits the account officer from talking or communicating with the appraiser to insure that the appraiser is not influenced by the account officer in any way in making their determination of value.

First Federal generally does not require updated appraisals for performing loans unless significant new money is requested by the borrower.

When a collateral dependent loan is downgraded to classified status, First Federal reviews the most current appraisal on file and, if necessary, based on First Federal's assessment of the appraisal, such as age, market, etc., First Federal will discount this amount to a more appropriate current value based on inputs from lenders and realtors. This amount may then be discounted further by First Federal's estimation of the carrying and selling costs. In most instances, if the appraisal is more than twelve to fifteen months old, we may require a new appraisal. Finally, First Federal assesses whether there is any collateral short fall, taking into consideration guarantor support and liquidity, and determines if a charge off is necessary.

When a collateral dependent loan moves to non-performing status, First Federal generally gets a new third party appraisal and charges the loan down appropriately based upon the new appraisal and an estimate of costs to liquidate the collateral. All properties that are moved into the Other Real Estate Owned ("OREO") category are supported by current appraisals, and the OREO is carried at the lower of cost or fair value, which is determined based on appraised value less First Federal's estimate of the liquidation costs.

First Federal does not adjust any appraisals upward without written documentation of this valuation change from the appraiser. When setting reserves and charge offs on classified loans, appraisal values may be discounted downward based upon First Federal's experience with liquidating similar properties.

All loans over 90 days past due and/or on non-accrual are classified as non-performing loans. Non-performing status automatically occurs in the month in which the 90 day delinquency occurs.

As stated above, once a collateral dependent loan is identified as non-performing, First Federal generally gets an appraisal.

Appraisals are received within approximately 60 days after they are requested. The First Federal Loan Loss Reserve Committee reviews the amount of each new appraisal and makes any necessary charge off decisions at its meeting prior to the end of each quarter.

Any partially charged-off collateral dependent loans are considered non-performing, and as such, would need to show an extended period of time with satisfactory payment performance as well as cash flow coverage capability supported by current financial statements before First Federal will consider an upgrade to performing status. First Federal may consider moving the loan to accruing status after approximately six months of satisfactory payment performance.

For loans where First Federal determines that an updated appraisal is not necessary, other means are used to verify the value of the real estate, such as recent sales of similar properties on which First Federal had loans as well as calls to appraisers, brokers, realtors and investors. First Federal monitors and tracks its loan to value quarterly to determine accuracy and any necessary charge offs. Based on these results, changes may occur in the processes used.

Loan modifications constitute a TDR if First Federal for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. For loans that are considered TDRs, First Federal either computes the present value of expected future cash flows discounted at the original loan's effective interest rate or it may measure impairment based on the fair value of the collateral. For those loans measured for impairment utilizing the present value of future cash flows method, any discount is carried as a reserve in the allowance for loan and lease losses. For those loans measured for impairment utilizing the fair value of the collateral, any shortfall is charged off.

Earnings - The profitability of First Defiance is primarily dependent on its net interest income and non-interest income. Net interest income is the difference between interest income on interest-earning assets, principally loans and securities, and interest expense on interest-bearing deposits, FHLB advances, and other borrowings. The Company's non-interest income is mainly derived from service fees and other charges, mortgage banking income, and insurance commissions. First Defiance's earnings also depend on the provision for loan losses and non-interest expenses, such as employee compensation and benefits, occupancy and equipment expense, deposit insurance premiums, and miscellaneous other expenses, as well as federal income tax expense.

<u>Changes in Financial Condition</u>

At September 30, 2016, First Defiance's total assets, deposits and stockholders' equity amounted to \$2.45 billion, \$1.93 billion and \$292.1 million, respectively, compared to \$2.30 billion, \$1.84 billion and \$280.2 million, respectively, at December 31, 2015.

Net loans receivable (excluding loans held for sale) increased \$122.9 million to \$1.90 billion. The variance in loans receivable between September 30, 2016 and December 31, 2015 include increases in commercial real estate loans (up \$95.4 million), commercial loans (up \$36.8 million), home equity and improvement loans (up \$1.2 million), and residential real estate loans (up $3.8 million). These increases were slightly offset by a decrease in construction loans (down $14.5 million).

The investment securities portfolio decreased $2.3 million to $234.4 million at September 30, 2016 from $236.7 million at December 31, 2015. The decrease is the result of $25.8 million of securities maturing or being called and $14.9 million of securities being sold during the first nine months of 2016. This was partially offset by purchases of $35.5 million of securities. There was an unrealized gain in the investment portfolio of $8.3 million at September 30, 2016 compared to an unrealized gain of $6.2 million at December 31, 2015.

Deposits increased $91.5 million to $1.93 billion at September 30, 2016 from $1.84 billion at December 31, 2015. Non-interest bearing demand deposits increased $22.6 million to $443.3 million, interest-bearing demand deposits and money market accounts increased $43.2 million to $810.4 million, savings deposits increased $21.4 million to $241.0 million retail time deposits increased $4.3 million to $432.9 million.

Stockholders’ equity increased to $292.1 million at September 30, 2016 from $280.2 million at December 31, 2016. The increase in stockholders’ equity was the result of recording net income of $21.5 million, an increase in other comprehensive income of $1.3 million and a $667,000 increase due to the exercise of stock options. These were partially offset by $5.9 million of common stock dividends being paid in the first nine months of 2016 and $6.3 million in repurchased common stock.

Average Balances, Net Interest Income and Yields Earned and Rates Paid

The following table presents for the periods indicated the total dollar amount of interest from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in thousands of dollars and rates, and the net interest margin. The table reports interest income from tax-exempt loans and investment on a tax-equivalent basis. All average balances are based upon daily balances (dollars in thousands).

	Three Months Ended September 30,							
	2016				2015			
	Average Balance	Interest(1)	Yield/ Rate(2)		Average Balance	Interest(1)	Yield/ Rate(2)	
Interest-earning assets:								
Loans receivable	$1,879,760	$ 20,316	4.30	%	$1,696,370	$ 18,472	4.32	%
Securities	231,864	1,892	3.37	(3)	236,485	2,105	3.63	(3)
Interest bearing deposits	68,746	104	0.60		53,627	33	0.24	
FHLB stock	13,800	137	3.95		13,802	138	3.97	
Total interest-earning assets	2,194,170	22,449	4.09		2,000,284	20,748	4.13	
Non-interest-earning assets	231,365				222,559			
Total assets	$2,425,535				$2,222,843			
Interest-bearing liabilities:								
Deposits	$1,487,465	$ 1,635	0.44	%	$1,397,965	$ 1,363	0.39	%
FHLB advances and other	84,598	322	1.51		41,047	178	1.72	
Subordinated debentures	36,140	191	2.10		36,128	154	1.69	
Securities sold under repurchase agreements	52,948	35	0.26		54,598	38	0.28	
Total interest-bearing liabilities	1,661,151	2,183	0.52		1,529,738	1,733	0.45	
Non-interest bearing deposits	441,903	-			388,849	-		
Total including non-interest bearing demand deposits	2,103,054	2,183	0.41		1,918,587	1,733	0.36	
Other non-interest-bearing liabilities	33,872				27,021			
Total liabilities	2,136,926				1,945,608			
Stockholders' equity	288,609				277,235			
Total liabilities and stock- holders' equity	$2,425,535				$2,222,843			
Net interest income; interest rate spread		$ 20,266	3.57	%		$ 19,015	3.68	%
Net interest margin (4)			3.69	%			3.78	%
Average interest-earning assets to average interest-bearing liabilities			132	%			131	%

(1) Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. In order to compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a

pre-tax equivalent amount based on the marginal corporate federal income tax rate of 35%.

(2) Annualized

(3) Securities yield=annualized interest income divided by the average balance of securities, excluding average unrealized gains/losses.

(4) Net interest margin is net interest income divided by average interest-earning assets.

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	Nine Months Ended September 30,							
	2016				2015			
	Average Balance	Interest(1)	Yield/ Rate(2)		Average Balance	Interest(1)	Yield/ Rate(2)	
Interest-earning assets:								
Loans receivable	$1,834,981	$59,395	4.32	%	$1,672,393	$54,590	4.36	%
Securities	230,058	5,899	3.55	(3)	241,016	6,369	3.64	(3)
Interest bearing deposits	69,599	287	0.55		56,315	113	0.27	
FHLB stock	13,800	413	4.00		13,802	413	4.00	
Total interest-earning assets	2,148,438	65,994	4.12		1,983,526	61,485	4.16	
Non-interest-earning assets	228,496				221,609			
Total assets	$2,376,934				$2,205,135			
Interest-bearing liabilities:								
Deposits	$1,457,010	$4,613	0.42	%	$1,396,731	$3,947	0.38	%
FHLB advances	82,598	940	1.52		34,038	461	1.81	
Subordinated debentures	36,140	548	2.03		36,129	451	1.67	
Securities sold under repurchase agreements	54,615	108	0.27		53,740	113	0.28	
Total interest-bearing liabilities	1,630,363	6,209	0.51		1,520,638	4,972	0.44	
Non-interest bearing deposits	432,274	-			379,305	-		
Total including non-interest bearing demand deposits	2,062,637	6,209	0.40		1,899,943	4,972	0.35	
Other non-interest-bearing liabilities	30,886				28,062			
Total liabilities	2,093,523				1,928,005			
Stockholders' equity	283,411				277,130			
Total liabilities and stock- holders' equity	$2,376,934				$2,205,135			
Net interest income; interest rate spread		$59,785	3.61	%		$56,513	3.72	%
Net interest margin (4)			3.73	%			3.82	%
Average interest-earning assets to average interest-bearing liabilities			132	%			130	%

(1) Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. In order to compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a pre-tax equivalent amount based on the marginal corporate federal income tax rate of 35%.

(2) Annualized.

(3) Securities yield=annualized interest income divided by the average balance of securities, excluding average unrealized gains/losses.

(4) Net interest margin is net interest income divided by average interest-earning assets.

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Results of Operations

Three Months Ended September 30, 2016 and 2015

On a consolidated basis, First Defiance's net income for the quarter ended September 30, 2016 was $7.0 million compared to net income of $6.7 million for the comparable period in 2015. On a per share basis, basic and diluted earnings per common share for the quarter ended September 30, 2016 were both $0.78, compared to basic and diluted earnings per common share of $0.72 for the same period in 2015.

Net Interest Income

First Defiance's net interest income is determined by its interest rate spread (i.e. the difference between the yields 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.

Net interest income was $19.8 million for the quarter ended September 30, 2016, up from $18.5 million for the same period in 2015. The tax-equivalent net interest margin was 3.69% for the quarter ended September 30, 2016, a decrease from 3.78% for the same period in 2015. The decrease in margin between the 2016 and 2015 third quarters was due to a decrease in interest-earning asset yields, which decreased to 4.09% for the quarter ended September 30, 2016, down 4 basis points from 4.13% for the same period in 2015. The cost of interest-bearing liabilities between the two periods increased 7 basis points to 0.52% in the third quarter of 2016 from 0.45% in the same period in 2015. Total average loans grew $183.4 million since September 30, 2015 while interest bearing liabilities, including non-interest bearing demand deposits, increased $184.5 million for that same period. The change in interest bearing liability mix combined with lower earning asset yields resulted in a lower net interest margin for the third quarter of 2016. Management is encouraged by the continued growth in loan and deposit balances and looks for additional opportunities to maintain or minimize any negative impact to its margin in this sustained low rate environment.

Total interest income increased $1.7 million to $22.0 million for the quarter ended September 30, 2016 from $20.3 million for the same period in 2015. The yield on total interest earning assets decreased to 4.09% for the quarter ended September 30, 2016 from 4.13% for the same period in 2015. The loan portfolio yield decreased slightly to 4.30% for the quarter ended September 30, 2016 from 4.32% for the same period in 2015 while investment portfolio yields declined to 3.37% for the quarter ended September 30, 2016 from 3.63% for the same period in 2015. The decline in the investment yield was mainly attributed to an increase in amortization expense as the prepayments speeds increased in the third quarter as rates declined as well as new purchases being recorded below the current portfolio yield. Income from loans increased to $20.3 million for the quarter ended September 30, 2016 compared to $18.4 million for the same period in 2015 due to $183.4 million of average loan growth year over year. Interest income from investments decreased to $1.5 million for the quarter ended September 30, 2016 from $1.7 million for the same period in 2015 due to the aforementioned drop in yield above.

Total interest expense increased $450,000 in the third quarter of 2016 compared to the same period in 2015, to $2.2 million from $1.7 million. There was a 7 basis point increase in the average cost of interest-bearing liabilities in the third quarter of 2016 due to a slight increase in the rates on interest bearing deposits. Interest expense related to interest-bearing deposits increased to $1.6 million in the third quarter of 2016 from $1.4 million in the same period in 2015. Interest expense recognized by the Company related to subordinated debentures was $191,000 in the third quarter of 2016 compared to $154,000 for the same period in 2015. Expenses on FHLB advances and securities sold under repurchase agreements were $322,000 and $35,000 respectively in the third quarter of 2016 compared to $178,000 and $38,000 respectively for the same period in 2015.

Allowance for Loan Losses

The allowance for loan losses represents management's assessment of the estimated probable incurred credit losses in the loan portfolio at each balance sheet date. Management analyzes the adequacy of the allowance for loan losses regularly through reviews of the loan portfolio. Consideration is given to economic conditions, changes in interest rates and the effect of such changes on collateral values and borrower's ability to pay, changes in the composition of the loan portfolio and trends in past due and non-performing loan balances. The allowance for loan losses is a material estimate that is susceptible to significant fluctuation and is established through a provision for loan losses based on management's evaluation of the inherent risk in the loan portfolio. In addition to extensive in-house loan monitoring procedures, the Company utilizes an outside party to conduct an independent loan review of commercial loan and commercial real estate loan relationships. The goal is to have approximately 55% to 60% of the portfolio reviewed annually. This includes all relationships over $5.0 million with new exposure greater than $2.0 million and a sample of those relationships greater than $5.0 million; loan relationships between $1.0 million and $5.0 million with new exposure greater than $750,000 and a sample of those relationships between $1.0 million and $5.0 million; and a sample of relationships less than $1.0 million. Management utilizes the results of this outside loan review to assess the effectiveness of its internal loan grading system as well as to assist in the assessment of the overall adequacy of the allowance for loan losses associated with these types of loans.

The allowance for loan loss is made up of two basic components. The first component of the allowance for loan loss is the specific reserve in which the Company sets aside reserves based on the analysis of individual impaired credits. In establishing specific reserves, the Company analyzes all substandard, doubtful and loss graded loans quarterly and makes judgments about the risk of loss based on the cash flow of the borrower, the value of any collateral and the financial strength of any guarantors. If the loan is impaired and cash flow dependent, then a specific reserve is established for the discount on the net present value of expected future cash flows. If the loan is impaired and collateral dependent, then any shortfall is usually charged off. The Company also considers the impacts of any Small Business Association or Farm Service Agency guarantees. The specific reserves were $254,000 at September 30, 2016 compared to $437,000 at December 31, 2015.

The second component is a general reserve, which is used to record loan loss reserves for groups of homogenous loans in which the Company estimates the losses incurred in the portfolio based on quantitative and qualitative factors. For purposes of the general reserve analysis, the loan portfolio is stratified into nine different loan pools based on loan type to allocate historic loss experience. The loss experience factor is then applied to the non-impaired loan portfolio. Beginning June 30, 2015, the Company refined the methodology to its allowance for loan loss calculation pertaining to the general reserve component for non-impaired loans. There was no change to the calculation of the component for reserves on impaired loans. Within the general reserve, the determination of the historical loss component was modified from using a three-year average annual loss rate to a loss migration measurement. The loss migration measurement implemented June 30, 2015, utilizes an average of four (4) four-year loss migration periods for each loan portfolio segment with differentiation between loan risk grades. This approach provides for a more precise reflection of probable incurred losses by risk grade within each loan portfolio segment over an average loan life cycle. Management believes that capturing the risk grade changes and cumulative losses over the life cycle of a loan more accurately depicts management's estimate of historical losses as well as being more reflective of the ongoing risks in the loan portfolio. Prior to June 30, 2015, the approach to this component quantified the historical loss by calculating a rolling twelve quarter average annual loss rate for each portfolio segment, without differentiation between loan risk grades. This modification resulted in a change in the general reserves between the loan portfolio segments but did not have a material impact on the overall allowance for loan losses.

The quantitative general allowance decreased $900,000 to $8.9 million at September 30, 2016 from $9.8 million at December 31, 2015 primarily due to the roll off of a high charge-off quarter in the migration analysis resulting in a lower migration loss percentage for a majority of loan segments.

In addition to the quantitative analysis, a qualitative analysis is performed each quarter to provide additional general reserves on the non-impaired loan portfolio for various factors. The overall qualitative factors are based on nine sub-factors. The nine sub-factors have been aggregated into three qualitative factors: economic, environment and risk.

<u>ECONOMIC</u>

1) Changes in international, national and local economic business conditions and developments, including the condition of various market segments.
2) Changes in the value of underlying collateral for collateral dependent loans.

<u>ENVIRONMENT</u>

3) Changes in the nature and volume in the loan portfolio.
4) The existence and effect of any concentrations of credit and changes in the level of such concentrations.
5) Changes in lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices.
6) Changes in the quality and breadth of the loan review process.
7) Changes in the experience, ability and depth of lending management and staff.

RISK

8) Changes in the trends of the volume and severity of delinquent and classified loans, and changes in the volume of non-accrual loans, trouble debt restructuring, and other loan modifications.
9) Changes in the political and regulatory environment.

The qualitative analysis at September 30, 2016 indicated a general reserve of $16.8 million compared with $15.2 million at December 31, 2015. Management reviewed the overall economic, environmental and risk factors and determined that it was appropriate to increase, primarily, the economic factors, due to uncertain global economic conditions and related market volatility which present higher than normal risks to the U.S. economy.

First Defiance's general reserve percentages for main loan segments not otherwise classified ranged from 0.50% for pass rated construction loans to 1.81% for home equity and improvement loans at September 30, 2016.

As a result of the quantitative and qualitative analyses, along with the change in specific reserves, the Company recorded a provision for loan losses of $15,000 in the third quarter of 2016 compared to a credit provision of $27,000 for the same period in 2015. The allowance for loan losses was $25.9 million and $25.4 million and represented 1.35% and 1.41% of loans, net of undisbursed loan funds and deferred fees and costs, as of September 30, 2016 and December 31, 2015, respectively. Charge offs of $314,000 were partially offset by recoveries of $274,000 and a provision of $15,000, resulted in a slight decrease to the overall allowance for loan loss of $25,000 for the third quarter of 2016. In management's opinion, the overall allowance for loan losses of $25.9 million as of September 30, 2016 is adequate.

Management also assesses the value of real estate owned as of the end of each accounting period and recognizes write-downs to the value of that real estate in the income statement if conditions dictate. For the quarter ended September 30, 2016, First Defiance had write-downs that totaled $22,000 for real estate held for sale. Management believes that the values recorded at September 30, 2016 for real estate owned and repossessed assets represent the realizable value of such assets.

Total classified loans decreased to $33.7 million at September 30, 2016, compared to $49.1 million at December 31, 2015.

First Defiance's ratio of allowance for loan losses to non-performing loans was 142.5% at September 30, 2016 compared with 156.1% at December 31, 2015. Management monitors collateral values of all loans included on the watch list that are collateral dependent and believes that the allowances for those loans at September 30, 2016 are appropriate. Of the $18.2 million in non-accrual loans at September 30, 2016, $13.5 million or 74.0% are less than 90 days past due.

At September 30, 2016, First Defiance had total non-performing assets of $18.9 million, compared to $17.6 million at December 31, 2015. Non-performing assets include loans that are on non-accrual, real estate owned and other assets held for sale. Non-performing assets at September 30, 2016 and December 31, 2015 by category were as follows:

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Table 1 – Nonperforming Asset

	September 30, 2016	December 31, 2015
	(In Thousands)	
Non-performing loans:		
One to four family residential real estate	$2,920	$ 2,610
Non-residential and multi-family residential real estate	11,302	9,848
Commercial	3,245	3,078
Construction	-	-
Home equity and improvement	718	689
Consumer Finance	13	36
Total non-performing loans	18,198	16,261
Real estate owned	704	1,321
Other repossessed assets	-	-
Total repossessed assets	$704	1,321
Total Nonperforming assets	$18,902	$ 17,582
Restructured loans, accruing	$9,113	$ 11,178
Total nonperforming assets as a percentage of total assets	0.77 %	0.77 %
Total nonperforming loans as a percentage of total loans*	0.95 %	0.91 %
Total nonperforming assets as a percentage of total loans plus REO*	0.98 %	0.97 %
Allowance for loan losses as a percent of total nonperforming assets	137.14 %	144.36 %

* Total loans are net of undisbursed loan funds and deferred fees and costs.

Non-performing loans in the commercial loan category represented 0.71% of the total loans in those categories at September 30, 2016 compared to 0.73% for the same category at December 31, 2015. Non-performing loans in the commercial real estate loan category represented 1.08% of the total loans in those categories at September 30, 2016 compared to 1.04% for the same category at December 31, 2015. Management believes that the current allowance for loan losses is appropriate and that the provision for loan losses is consistent with both charge-off experience and the risk inherent in the overall credits in the portfolio.

First Federal's Asset Review Committee meets monthly to review the status of work-out strategies for all criticized relationships, which include all non-accrual loans. Based on such factors as anticipated collateral values in liquidation scenarios, cash flow projections, assessment of net worth of guarantors and all other factors which may mitigate risk of loss, the Asset Review Committee makes recommendations regarding proposed charge-offs which are approved by the Senior Loan Committee or the Loan Loss Reserve Committee.

Table 2 – Net Charge-offs and Non-accruals by Loan Type

	For the Nine Months Ended September 30, 2016		As of September 30, 2016	
	Net Charge-offs (Recoveries) (In Thousands)	% of Total Net Charge-offs	Nonaccrual Loans (In Thousands)	% of Total Non-Accrual Loans
Residential	$ 80	(73.39)%	$ 2,920	16.05 %
Construction	-	0.00 %	-	0.00 %
Commercial real estate	(376)	344.94 %	11,302	62.10 %
Commercial	147	(134.86)%	3,245	17.83 %
Consumer finance	(17)	15.60 %	13	0.07 %
Home equity and improvement	57	(52.29)%	718	3.95 %
Total	$ (109)	100.00 %	$ 18,198	100.00 %

	For the Nine Months Ended September 30, 2015		As of September 30, 2015	
	Net Charge-offs (Recoveries) (In Thousands)	% of Total Net Charge-offs	Nonaccrual Loans (In Thousands)	% of Total Non-Accrual Loans
Residential	$ 97	(27.71)%	$ 2,745	16.52 %
Construction	-	0.00 %	-	0.00 %
Commercial real estate	(425)	121.43 %	10,090	60.75 %
Commercial	(187)	53.43 %	3,117	18.76 %
Consumer finance	(19)	5.43 %	29	0.17 %
Home equity and improvement	184	(52.57)%	631	3.80 %
Total	$ (350)	100.00 %	$ 16,612	100.00 %

Table 3 – Allowance for Loan Loss Activity

	For the Quarter Ended				
	3rd 2016	2nd 2016	1st 2016	4th 2015	3rd 2015
	(In Thousands)				
Allowance at beginning of period	$25,948	$25,668	$25,382	$25,209	$25,384

Provision for credit losses	15	53	364	43	(27)
Charge-offs:					
Residential	111	37	55	8	185
Commercial real estate	79	-	13	103	64
Commercial	26	18	336	-	43
Consumer finance	24	18	-	32	5
Home equity and improvement	74	66	30	10	110
Total charge-offs	314	139	434	153	407
Recoveries	274	366	356	282	259
Net charge-offs (recoveries)	40	(227)	78	(129)	148
Ending allowance	$ 25,923	$ 25,948	$ 25,668	$ 25,382	$ 25,209

The following table sets forth information concerning the allocation of First Federal's allowance for loan losses by loan categories at the dates indicated.

Table 4 – Allowance for Loan Loss Allocation by Loan Category

	September 30, 2016		June 30, 2016		March 31, 2016		December 31, 2015		September 30, 2015	
	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category
	(Dollars In Thousands)									
Residential	$2,432	10.34 %	$2,839	10.71 %	$3,109	11.05 %	$3,212	10.98 %	$2,779	11.48 %
Construction	412	8.76 %	633	8.35 %	489	7.71 %	517	8.76 %	239	7.22 %
Commercial real estate	12,787	51.64 %	13,269	51.84 %	13,894	52.37 %	13,923	50.71 %	14,397	51.55 %
Commercial	7,879	22.56 %	6,740	22.19 %	5,820	21.85 %	5,255	22.42 %	5,411	22.51 %
Consumer	216	0.85 %	189	0.86 %	124	0.83 %	171	0.87 %	158	0.88 %
Home equity and improvement	2,197	5.85 %	2,278	6.05 %	2,232	6.19 %	2,304	6.26 %	2,225	6.36 %
	$25,923	100.00%	$25,948	100.00%	$25,668	100.00%	$25,382	100.00%	$25,209	100.00%

Key Asset Quality Ratio Trends

Table 5 – Key Asset Quality Ratio Trends

	3rd Qtr 2016	2nd Qtr 2016	1st Qtr 2016	4th Qtr 2015	3rd Qtr 2015
Allowance for loan losses / loans*	1.35 %	1.39 %	1.41 %	1.41 %	1.45 %
Allowance for loan losses / non-performing assets	137.14 %	148.26 %	136.40 %	144.36 %	116.99 %
Allowance for loan losses / non-performing loans	142.45 %	158.00 %	144.96 %	156.09 %	151.75 %
Non-performing assets / loans plus REO*	0.98 %	0.94 %	1.03 %	0.97 %	1.24 %
Non-performing assets / total assets	0.77 %	0.73 %	0.80 %	0.77 %	0.97 %
Net charge-offs / average loans (annualized)	0.01 %	-0.05 %	0.02 %	-0.03 %	0.03 %

* Total loans are net of undisbursed funds and deferred fees and costs.

Non-Interest Income.

Total non-interest income for the third quarter of 2016 was $8.5 million compared with $8.0 million in the third quarter of 2015.

Service Fees. Service fees and other charges decreased by $34,000 to $2.77 million in the third quarter of 2016 compared to $2.80 in the same period in 2015.

First Federal's overdraft privilege program generally provides for the automatic payment of modest overdraft limits on all accounts deemed to be in good standing when the account is accessed using paper-based check processing, a teller withdrawal, a point-of-sale terminal, an ACH transaction, an online banking or voice-response transfer, or an ATM. To be in good standing, an account must be brought to a positive balance within a 30-day period and have not excessively used the overdraft privilege program. Overdraft limits are established for all customers without discrimination using a risk assessment approach for each account classification. The approach includes a systematic review and evaluation of the normal deposit flows made to each account classification to establish reasonable and prudent negative balance limits that would be routinely repaid by normal, expected and reoccurring deposits. The risk assessment by portfolio approach assumes a minimal degree of undetermined credit risk associated with unidentified individual accounts that are overdrawn for 30 or more days. Consumer accounts overdrawn for more than 60 days are automatically charged off. Fees are charged as a one-time fee per occurrence, up to five charges per day, and the fee charged for an item that is paid is equal to the fee charged for a non-sufficient fund item that is returned.

Overdrawn balances, net of allowance for losses, are reflected as loans on First Defiance’s balance sheet. The fees charged for this service are established based both on the return of processing costs plus a profit, and on the level of fees charged by competitors in the Company’s market area for similar services. These fees are considered to be compensation for providing a service to the customer and therefore deemed to be noninterest income rather than interest income. Fee income recorded for the quarters ending September 30, 2016 and 2015 related to the overdraft privilege product, net of adjustments to the allowance for uncollectible overdrafts, were $659,000 and $752,000, respectively. Accounts charged off are included in noninterest expense. The allowance for uncollectible overdrafts was $16,000 at September 30, 2016, $18,000 at December 31, 2015 and $27,000 at September 30, 2015.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans increased $359,000 to $2.0 million for the third quarter of 2016 compared to $1.7 million for the same period in 2015. Mortgage banking activity was elevated from the third quarter a year ago, with our markets experiencing higher purchase and refinance loan volumes. Gains realized from the sale of mortgage loans increased in the third quarter of 2016 to $1.7 million from $1.2 million in the same period in 2015. Mortgage loan servicing revenue was $885,000 in the third quarter of 2016, up slightly from $866,000 in the third quarter of 2015. The amortization of mortgage servicing rights expense increased $129,000 to $536,000 in the third quarter of 2016 compared to $407,000 for the same period in 2015. The Company recorded a positive valuation adjustment of $7,000 on mortgage servicing rights in the third quarter of 2016 compared to a positive valuation adjustment of $24,000 for the same period in 2015.

Gain on Sale on Non-Mortgage Loans. Gains on the sale of non-mortgages, which include SBA and FSA loans, totaled $148,000 in the third quarter of 2016 compared to $543,000 in the third quarter of 2015 mainly due to a decrease in volume of these types of loans.

Gain on Sale of Securities. The third quarter 2016 had $151,000 in gains on the sale of securities, compared to no gain or losses in the third quarter of 2015.

Trust Income. Trust income was $420,000 in the third quarter of 2016, up 13.5% from $370,000 for the same period in 2015.

Other Non-Interest Income. Other income increased $263,000 in the third quarter of 2016 compared to the same period of 2015, which is mainly the result of a $62,000 increase in the value of the assets of the Company’s deferred compensation plan versus a decrease of $166,000 in the third quarter of 2015.

Non-Interest Expense.

Non-interest expense increased to $18.3 million for the third quarter of 2016, an increase of $1.5 million compared to $16.8 million in the third quarter of 2015.

Compensation and Benefits. Compensation and benefits increased to $10.3 million for the quarter ended September 30, 2016 from $9.8 million for the same period in 2015. The increase is mainly attributable to merit increases, staff additions to support growth strategies and higher incentive compensation.

Acquisition Related Charges. There was $252,000 of costs related to the pending merger with Commercial Bancshares included in expenses in the third quarter of 2016.

Other Non-Interest Expense. Other non-interest expense of $3.4 million in the third quarter of 2016, increased from $2.8 million in the third quarter of 2015 primarily due to an increase in the value of the liabilities of the deferred compensation plan which totaled $296,000 in the third quarter 2016 versus a credit of $182,000 in the same quarter of 2015.

The efficiency ratio, considering tax equivalent interest income and excluding securities gains and losses, for the third quarter of 2016 was 63.87% compared to 62.41% for the same period in 2015.

Income Taxes.

First Defiance computes federal income tax expense in accordance with ASC Topic 740, Subtopic 942, which resulted in an effective tax rate of 29.82% for the quarter ended September 30, 2016 compared to 30.93% for the same period in 2015. The tax rate is lower than the statutory 35% tax rate for the Company mainly because of investments in tax-exempt securities and bank-owned life insurance ("BOLI"). The earnings on tax-exempt securities and BOLI are not subject to federal income tax. As a result of adopting ASU 2016-09, a $54,000 credit to tax expense was recorded in the third quarter of 2016.

Nine Months Ended September 30, 2016 and 2015

On a consolidated basis, First Defiance's net income for the nine months ended September 30, 2016 was $21.5 million compared to income of $19.9 million for the same period in 2015. On a per share basis, basic and diluted earnings per common share for the nine months ended September 30, 2016 were $2.39 and $2.37, respectively, compared to basic and diluted earnings per common share of $2.15 and $2.11, respectively, for the same period in 2015.

Net Interest Income

Net interest income was $58.4 million for the nine months ended September 30, 2016 compared to $55.1 million for the same period in 2015. For the nine month period ended September 30, 2016, total interest income increased $4.6 million to $64.6 million compared to $60.1 million for the same period in 2015.

Interest expense increased by $1.2 million to $6.2 million for the nine months ended September 30, 2016 compared to $5.0 million for the same period in 2015. The increase is attributable to average interest-bearing liabilities increasing $109.7 million from September 30, 2015 to September 30, 2016.

Net interest margin for the first nine months of 2016 was 3.73%, down 9 basis points from the 3.82% margin reported in the nine month period ended September 30, 2015.

Provision for Loan Losses

The provision for loan losses was $432,000 for the nine months ended September 30, 2016, compared to $93,000 during the nine months ended September 30, 2015. Charge-offs for the first nine months of 2016 totaled $887,000 and recoveries of previously charged off loans totaled $996,000 for net recoveries of $109,000. By comparison, $1.1 million of charge-offs were recorded in the same period of 2015 and $1.4 million of recoveries were realized for net recoveries of $349,000.

Non-Interest Income

Total non-interest income increased to $25.7 million for the nine months ended September 30, 2016 from $24.1 million recognized for the same period in 2015.

Service Fees. Service fees and other charges were $8.2 million for the first nine months of 2016, up from $8.0 million for the same period in 2015.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans was $5.3 million for the nine months ended September 30, 2016 compared to $5.2 million for the same period in 2015. Gains realized from the sale of mortgage loans increased $375,000 to $4.1 million for the first nine months of 2016 from $3.7 million for the same period in 2015. Mortgage loan servicing revenue remained flat at $2.6 million in the first nine months of 2016 and 2015. The gains realized from the sale of mortgage loans were partially offset by a decrease in the valuation of mortgage servicing rights. The Company recorded a negative valuation adjustment of $118,000 in the nine months ended September 30, 2016 compared to a positive adjustment of $191,000 in the same period of 2015.

Gain on Sale on Non-Mortgage Loans. Gain on the sale of non-mortgages, which includes SBA and FSA loans, totaled $604,000 in the first nine months of 2016 compared to $776,000 in the same period of 2015, a decrease of $172,000.

Gain on Sale of Securities. First Defiance recorded a gain on the sale or call of securities of $509,000 in the first nine months of 2016 compared with no securities gains or losses during the same period of 2015.

Other Non-Interest Income. Other income increased $534,000 for the first nine months of 2016 compared to the same period of 2015, which is mainly the result of a $48,000 increase in the value of the liabilities of the Company’s deferred compensation plan versus a decrease of $237,000 in the first nine months of 2015.

Non-Interest Expense

Non-interest expense was $52.9 million for the first nine months of 2016, up from $50.5 million for the same period in 2015.

Compensation and Benefits. Compensation and benefits increased to $30.3 million for the nine months ended September 30, 2016 compared to $27.9 million for the same period in 2015. The increase is mainly attributable to merit increases, staff additions to support growth strategies and higher medical insurance costs.

Acquisition Related Charges. There was $252,000 of costs related to the pending merger with Commercial Bancshares included in expenses in the first nine months of 2016.

Other Non-Interest Expenses. Other non-interest expenses decreased $271,000 to $9.5 million for the first nine months of 2016 from $9.8 million for the same period in 2015. The decrease is due to lower OREO write-downs of $650,000 and management consulting of $381,000 partially offset by higher deferred compensation plan costs of $484,000

The efficiency ratio for the first nine months of 2016 was 62.24% compared to 62.72% for the same period in 2015.

Income Taxes.

First Defiance computes federal income tax expense in accordance with ASC Topic 740, Subtopic 942, which resulted in an effective tax rate of 30.26% for the first nine months of 2016 compared to 30.38% for the same period in 2015. The tax rate is lower than the statutory 35% tax rate for the Company mainly because of investments in tax-exempt securities and bank-owned life insurance (“BOLI”). The earnings on tax-exempt securities and BOLI are not subject to federal income tax. As a result of adopting ASU 2016-09, a $184,000 credit to tax expense was recorded for the first nine months of 2016.

Liquidity

As a regulated financial institution, First Federal is required to maintain appropriate levels of "liquid" assets to meet short-term funding requirements.

First Defiance had $16.3 million of cash provided by operating activities during the first nine months of 2016.

At September 30, 2016, First Federal had $172.4 million in outstanding loan commitments and loans in process to be funded generally within the next six months and an additional $445.9 million committed under existing consumer and commercial lines of credit and standby letters of credit. Also at that date, First Federal had commitments to sell $38.1 million of mortgage loans. First Defiance believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If First Defiance requires funds beyond its internal funding capabilities, advances from the FHLB of Cincinnati and other financial institutions are available.

Liquidity risk arises from the possibility that the Company may not be able to meet its financial obligations and operating cash needs or may become overly reliant upon external funding sources. In order to manage this risk, the Company’s Board of Directors has established a Liquidity Policy that identifies primary sources of liquidity, establishes procedures for monitoring and measuring liquidity and quantifies minimum liquidity requirements. This policy designates First Federal’s Asset/Liability Committee (“ALCO”) as the body responsible for meeting these objectives. The ALCO reviews liquidity on a monthly basis and approves significant changes in strategies that affect balance sheet or cash flow positions. Liquidity is centrally managed on a daily basis by the Company’s Chief Financial Officer and Controller.

Capital Resources

Capital is managed at First Federal and on a consolidated basis. Capital levels are maintained based on regulatory capital requirements and the economic capital required to support credit, market, liquidity and operational risks inherent in our business, as well as flexibility needed for future growth and new business opportunities.

In July 2013, the federal banking agencies approved the final rules implementing the Basel Committee on Banking Supervision’s capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements increased for both quantity and quality of capital held by the Company and the Bank. The rules include a new minimum common equity Tier 1 capital to risk-weighted assets ratio (“CET1”) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), which effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance sheet exposures.

The Company met each of the well capitalized ratio guidelines at September 30, 2016. The following table indicates the capital ratios for First Defiance and First Federal at September 30, 2016 and December 31, 2015. (In Thousands):

September 30, 2016

	Actual		**Minimum Required for Adequately Capitalized**		**Minimum Required for Well Capitalized**	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
CET1 Capital (to Risk-Weighted Assets) (1)						
Consolidated	$229,022	10.34%	$ 99,628	4.5 %	N/A	N/A
First Federal	$244,589	11.08%	$ 99,298	4.5 %	$ 143,431	6.5 %
Tier 1 Capital (1)						
Consolidated	$264,022	11.20%	$ 94,287	4.0 %	N/A	N/A
First Federal	$244,589	10.39%	$ 94,146	4.0 %	$ 117,683	5.0 %
Tier 1 Capital (to Risk Weighted Assets) (1)						
Consolidated	$264,022	11.93%	$ 132,838	6.0 %	N/A	N/A
First Federal	$244,589	10.39%	$ 132,398	6.0 %	$ 176,530	8.0 %
Total Capital (to Risk Weighted Assets) (1)						
Consolidated	$289,945	13.10%	$ 177,117	8.0 %	N/A	N/A
First Federal	$270,512	12.26%	$ 176,530	8.0 %	$ 220,663	10.0 %

(1) Core capital is computed as a percentage of adjusted total assets of $2.36 billion consolidated and $2.35 billion for the Bank. Risk-based capital is computed as a percentage of total risk-weighted assets of $2.21 billion for consolidated and the Bank.

December 31, 2015

	Actual		**Minimum Required for Adequately Capitalized**		**Minimum Required for Well Capitalized**	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
CET1 Capital (to Risk-Weighted Assets) (1)						
Consolidated	$218,297	10.71%	$ 91,710	4.5 %	N/A	N/A
First Federal	$236,625	11.61%	$ 91,678	4.5 %	$ 132,424	6.5 %
Tier 1 Capital (1)						
Consolidated	$253,297	11.46%	$ 88,424	4.0 %	N/A	N/A
First Federal	$236,625	10.72%	$ 88,267	4.0 %	$ 110,334	5.0 %
Tier 1 Capital (to Risk Weighted Assets) (1)						
Consolidated	$253,297	12.43%	$ 122,280	6.0 %	N/A	N/A

First Federal	$236,625	11.61%	$ 122,237	6.0 %	$ 162,983	8.0 %
Total Capital (to Risk Weighted Assets) (1)						
Consolidated	$278,679	13.67%	$ 163,040	8.0 %	N/A	N/A
First Federal	$262,007	12.86%	$ 162,983	8.0 %	$ 203,729	10.0 %

Core capital is computed as a percentage of adjusted total assets of $2.21 billion for consolidated and the Bank.

(1) Risk-based capital is computed as a percentage of total risk-weighted assets of $2.04 billion for consolidated and the Bank.

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Critical Accounting Policies

First Defiance has established various accounting policies which govern the application of accounting principles generally accepted in the United States in the preparation of its financial statements. The significant accounting policies of First Defiance are described in the footnotes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. Certain accounting policies involve significant judgments and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. Those policies which are identified and discussed in detail in the Company's 2015 Annual Report on Form 10-K include the Allowance for Loan Losses, Goodwill, and the Valuation of Mortgage Servicing Rights. There have been no material changes in assumptions or judgments relative to those critical policies during the first nine months of 2016.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As discussed in detail in the Annual Report on Form 10-K for the year ended December 31, 2015, First Defiance's ability to maximize net income is dependent on management's ability to plan and control net interest income through management of the pricing and mix of assets and liabilities. Because a large portion of assets and liabilities of First Defiance are monetary in nature, changes in interest rates and monetary or fiscal policy affect its financial condition and can have significant impact on the net income of the Company. First Defiance does not use off-balance sheet derivatives to enhance its risk management, nor does it engage in trading activities beyond the sale of mortgage loans.

First Defiance monitors its exposure to interest rate risk on a monthly basis through simulation analysis that measures the impact changes in interest rates can have on net interest income. The simulation technique analyzes the effect of a presumed 100 basis point shift in interest rates (which is consistent with management's estimate of the range of potential interest rate fluctuations) and takes into account prepayment speeds on amortizing financial instruments, loan and deposit volumes and rates, non-maturity deposit assumptions and capital requirements.

The table below presents, for the twelve months subsequent to September 30, 2016 and December 31, 2015, an estimate of the change in net interest income that would result from a gradual (ramp) and immediate (shock) change in interest rates, moving in a parallel fashion over the entire yield curve, relative to the measured base case scenario. Based on our net interest income simulation as of September 30, 2016, net interest income sensitivity to changes in interest rates for the twelve months subsequent to September 30, 2016 was slightly more asset sensitive for the ramp and shock compared to the sensitivity profile for the twelve months subsequent to December 31, 2015. This is due in part to our strategy to grow longer term loans and fund that growth out of existing liquidity.

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Net Interest Income Sensitivity Profile

(dollars in thousands)	Impact on Future Annual Net Interest Income September 30, 2016		December 31, 2015	
Gradual Change in Interest Rates				
+200	$ 1,299	1.59 %	$ 563	0.71 %
+100	626	0.77 %	215	0.27 %
-100	(1,706)	-2.09 %	(1,332)	-1.68 %
Immediate Change in Interest Rates				
+200	$ 3,171	3.89 %	$ 1,660	2.09 %
+100	1.563	1.92 %	719	0.91 %
-100	(3,213)	-3.94 %	(2,605)	-3.28 %

To analyze the impact of changes in interest rates in a more realistic manner, non-parallel interest rate scenarios are also simulated. These non-parallel interest rate scenarios indicate that net interest income may decrease from the base case scenario should the yield curve flatten or become inverted for a period of time. Conversely, if the yield curve should steepen, net interest income may increase.

The results of all the simulation scenarios are within the board mandated guidelines as of September 30, 2016.

In addition to the simulation analysis, First Defiance also uses an economic value of equity (“EVE”) analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis generally calculates the net present value of First Federal’s assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. However, the likelihood of a decrease in rates beyond 100 basis points as of September 30, 2016 was considered to be remote given the current interest rate environment and, therefore, was not included in this analysis. The results of this analysis are reflected in the following tables for the nine months ended September 30, 2016 and the year-ended December 31, 2015.

September 30, 2016

Economic Value of Equity

Change in Rates	$ Amount	$ Change	% Change
	(Dollars in Thousands)		
+400 bp	513,532	85,225	19.90 %
+ 300 bp	497,338	69,032	16.12 %
+ 200 bp	478,862	50,555	11.80 %
+ 100 bp	456,498	28,191	6.58 %
0 bp	428,307	-	-
- 100 bp	389,679	(38,627)	(9.02)%

December 31, 2015

Economic Value of Equity			
Change in Rates	$ Amount	$ Change	% Change
	(Dollars in Thousands)		
+400 bp	509,640	56,545	12.48 %
+ 300 bp	499,038	45,946	10.14 %
+ 200 bp	486,652	33,558	7.41 %
+ 100 bp	471,332	18,237	4.03 %
0 bp	453,095	-	-
- 100 bp	426,010	(27,085)	(5.98)%

Item 4. Controls and Procedures

Disclosure controls are procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Exchange Act, such as this report, is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls are also designed to ensure that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable, not absolute, assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the 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) as of September 30, 2016. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective.

No changes occurred in the Company’s internal controls over financial reporting during the quarter ended September 30, 2016 that materially affected, or are reasonably likely to materially affect, the internal controls over financial reporting.

FIRST DEFIANCE FINANCIAL CORP.

PART II-OTHER INFORMATION

Item 1. Legal Proceedings

Neither First Defiance nor any of its subsidiaries is engaged in any legal proceedings of a material nature.

Item 1A. Risk Factors

There are no material changes from the risk factors set forth under Part I, Item 1A. “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

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

(a) The Company had no unregistered sales of equity securities during the quarter ended September 30, 2016.
(b) Not applicable.
(c) The following table provides information regarding First Defiance’s purchases of its common stock during the three-month period ended September 30, 2016:

Period	Total Number of Shares Purchased	Average Price Paid Per Share		Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
Beginning Balance, July 1, 2016					377,500
July 1 – July 31, 2016	-	$	-	-	377,500
August1 – August 31, 2016	-		-	-	377,500
September 1 – September 30, 2016	-		-	-	377,500
Total	-	$	-	-	377,500

(1) On January 29, 2016, the Company announced that its Board of Directors authorized another program for the repurchase of up to 5% of the outstanding common shares or 450,000 shares. There is no expiration date for the new repurchase program. No shares were repurchased during the quarter ended September 30, 2016.

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

(a) Not applicable.

(b) There have been no material changes to the procedures by which shareholders may recommend nominees to the First Defiance Board of Directors.

Item 6. Exhibits

Exhibit 2.1	Agreement and Plan of Merger, dated as of August 23, 2016 by and between First Defiance and Commercial Bancshares, Inc. (1)
Exhibit 3.1	Articles of Incorporation of First Defiance (2)
Exhibit 3.2	Code of Regulations of First Defiance (2)
Exhibit 3.3	Certificate of Amendment to Articles of Incorporation of First Defiance (3)
Exhibit 31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 101	The following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 is formatted in eXtensible Business Reporting Language (“XBRL”): (i) Unaudited Consolidated Condensed Balance Sheet at September 30, 2016 and December 31, 2015, (ii) Unaudited Consolidated Condensed Statements of Income for the Three and Nine Months ended September 30, 2016 and 2015 (iii) Unaudited Consolidated Condensed Statements of Comprehensive Income for the Three and Nine Months ended September 30, 2016 and 2015, (iv) Unaudited Consolidated Condensed Statements of Changes in Stockholder’ Equity for the Nine Months ended September 30, 2016 and 2015, (v) Unaudited Consolidated Condensed Statements of Cash Flows for the Nine Months ended September 30, 2016 and 2015 and (vi) Notes to Unaudited Consolidated Condensed Financial Statements.

(1) Incorporated herein by reference to the like numbered exhibit in the Registrant’s Form 8-K filed on August 24, 2016 (Film No. 161848221).

(2) Incorporated herein by reference to the like numbered exhibit in the Registrant’s Form S-1 (File No. 33-93354), filed on June 9, 1995.

(3) Incorporated herein by reference to exhibit 3 in Form 8-K filed December 8, 2008 (Film No. 081236105).

FIRST DEFIANCE FINANCIAL CORP.

SIGNATURES

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

		First Defiance Financial Corp. (Registrant)	
Date:	November 7, 2016	By:	/s/ Donald P. Hileman Donald P. Hileman President and Chief Executive Officer
Date:	November 7, 2016	By:	/s/ Kevin T. Thompson Kevin T. Thompson Executive Vice President and Chief Financial Officer