EVANS BANCORP INC
Form 10-Q
May 02, 2016

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For quarterly period ended March 31, 2016

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

For the transition period from to ______

Commission file number 001-35021

EVANS BANCORP, INC. .

(Exact name of registrant as specified in its charter)

New York	16-1332767
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization) Identification No.)

One Grimsby Drive, Hamburg, NY 14075

(Address of principal executive offices) (Zip Code)

(716) 926-2000 .

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed

since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 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 the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if smaller reporting company) 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Common Stock, $.50 par value 4,284,566 shares as of May 2, 2016

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EVANS BANCORP, INC. AND SUBSIDIARIES

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
MARCH 31, 2016 AND DECEMBER 31, 2015
(in thousands, except share and per share amounts)

	March 31, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$ 11,287	$ 11,813
Interest-bearing deposits at banks	22,105	10,808
Securities:		
Available for sale, at fair value (amortized cost: $112,874 at March 31, 2016; $96,374 at December 31, 2015)	114,687	97,141
Held to maturity, at amortized cost (fair value: $1,595 at March 31, 2016; $1,584 at December 31, 2015)	1,607	1,617
Federal Home Loan Bank common stock, at cost	1,296	1,296
Federal Reserve Bank common stock, at cost	1,492	1,487
Loans, net of allowance for loan losses of $13,119 at March 31, 2016 and $12,883 at December 31, 2015	783,654	761,101
Properties and equipment, net of accumulated depreciation of $16,072 at March 31, 2016 and $15,799 at December 31, 2015	11,078	11,051
Goodwill	8,101	8,101
Bank-owned life insurance	21,114	20,978
Other assets	13,494	13,714
TOTAL ASSETS	$ 989,915	$ 939,107
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Demand	$ 174,276	$ 183,098
NOW	95,622	83,674
Regular savings	463,672	439,993
Time	115,479	96,217
Total deposits	849,049	802,982
Securities sold under agreement to repurchase	12,894	10,821
Other borrowings	10,000	10,000
Other liabilities	14,482	12,718
Junior subordinated debentures	11,330	11,330
Total liabilities	897,755	847,851
CONTINGENT LIABILITIES AND COMMITMENTS		

STOCKHOLDERS' EQUITY:		
Common stock, \$.50 par value, 10,000,000 shares authorized; 4,279,296 and 4,260,203 shares issued at March 31, 2016 and December 31, 2015, respectively, and 4,279,210 and 4,257,179 outstanding at March 31, 2016 and December 31, 2015, respectively	2,142	2,132
Capital surplus	43,435	43,318
Treasury stock, at cost, 86 and 3,024 shares at March 31, 2016 and December 31, 2015, respectively	-	-
Retained earnings	47,704	47,616
Accumulated other comprehensive loss, net of tax	(1,121)	(1,810)
Total stockholders' equity	92,160	91,256
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 989,915	\$ 939,107

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
THREE MONTHS ENDED MARCH 31, 2016 AND 2015
(in thousands, except share and per share amounts)

	Three Months Ended March 31, 2016	2015
INTEREST INCOME		
Loans	$ 8,730	$ 7,813
Interest bearing deposits at banks	11	1
Securities:		
Taxable	377	405
Non-taxable	238	237
Total interest income	9,356	8,456
INTEREST EXPENSE		
Deposits	959	781
Other borrowings	50	15
Junior subordinated debentures	87	79
Total interest expense	1,096	875
NET INTEREST INCOME	8,260	7,581
PROVISION FOR LOAN LOSSES	208	201
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	8,052	7,380
NON-INTEREST INCOME		
Bank charges	443	409
Insurance service and fees	1,748	1,829
Gain on loans sold	15	22
Bank-owned life insurance	136	137
Interchange fee income	318	294
Other	334	375
Total non-interest income	2,994	3,066
NON-INTEREST EXPENSE		
Salaries and employee benefits	5,514	4,794
Occupancy	699	695
Repairs and maintenance	176	173
Advertising and public relations	285	211
Professional services	580	511
Technology and communications	422	259
Litigation expense	(100)	-
FDIC insurance	159	147
Other	793	722
Total non-interest expense	8,528	7,512
INCOME BEFORE INCOME TAXES	2,518	2,934

INCOME TAX PROVISION	804	1,029
NET INCOME	$ 1,714	$ 1,905
Net income per common share-basic	$ 0.40	$ 0.45
Net income per common share-diluted	$ 0.40	$ 0.44
Cash dividends per common share	$ 0.38	$ 0.36
Weighted average number of common shares outstanding	4,263,109	4,213,509
Weighted average number of diluted shares outstanding	4,328,034	4,291,676

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UNAUDITED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME
THREE MONTHS ENDED MARCH 31, 2016 AND 2015
(in thousands, except share and per share amounts)

	Three Months Ended March 31,			
	2016		2015	
NET INCOME		$ 1,714		$ 1,905
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:				
Unrealized gain on available-for-sale securities:				
Unrealized gain on available-for-sale securities	649		331	
Less: Reclassification of gain on sale of securities	-		-	
		649		331
Defined benefit pension plans:				
Amortization of prior service cost	5		5	
Amortization of actuarial assumptions	35		24	
Total		40		29
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX		689		360
COMPREHENSIVE INCOME		$ 2,403		$ 2,265

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2016 AND 2015
(in thousands, except share and per share amounts)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance, December 31, 2014	$ 2,123	$ 43,102	$ 42,822	$ (1,508)	$ (751)	$ 85,788
Net Income			1,905			1,905
Other comprehensive income				360		360
Cash dividends ($0.36 per common share)			(1,517)			(1,517)
Stock options and restricted stock expense		117				117
Excess tax benefit from stock-based compensation		14				14
Repurchased 1,397 shares in Treasury stock					(34)	(34)
Reissued 20,942 restricted shares		(503)			503	-
Reissued 4,872 shares through stock option exercise		(48)			116	68
Balance, March 31, 2015	$ 2,123	$ 42,682	$ 43,210	$ (1,148)	$ (166)	$ 86,701
Balance, December 31, 2015	$ 2,132	$ 43,318	$ 47,616	$ (1,810)	$ -	$ 91,256
Net Income			1,714			1,714
Other comprehensive income				689		689
Cash dividends ($0.38 per common share)			(1,626)			(1,626)
Stock options and restricted stock expense		118				118
Excess tax benefit from stock-based compensation		9				9
Issued 19,093 restricted shares	10	(10)				-
Reissued 2,938 restricted shares, net of forfeitures						-
Balance, March 31, 2016	$ 2,142	$ 43,435	$ 47,704	$ (1,121)	$ -	$ 92,160

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UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2016 AND 2015
(in thousands)

	Three Months Ended March 31,	
	2016	2015
OPERATING ACTIVITIES:		
Interest received	$ 9,090	$ 8,256
Fees received	2,839	2,779
Interest paid	(1,068)	(896)
Cash paid to employees and vendors	(8,353)	(7,804)
Income taxes paid	(9)	(1)
Proceeds from sale of loans held for resale	880	2,658
Originations of loans held for resale	(335)	(4,995)
Net cash provided by (used in) operating activities	3,044	(3)
INVESTING ACTIVITIES:		
Available for sales securities:		
Purchases	(20,471)	(4,244)
Proceeds from maturities, calls, and payments	3,883	2,451
Held to maturity securities:		
Proceeds from maturities, calls, and payments	11	11
Additions to properties and equipment	(300)	(111)
Purchase of tax credit investment	(359)	(667)
Net increase in loans	(23,176)	(3,595)
Net cash used in investing activities	(40,412)	(6,155)
FINANCING ACTIVITIES:		
Proceeds from (repayments of) borrowings, net	2,072	(16,803)
Net increase in deposits	46,067	72,723
Repurchase of treasury stock	-	(34)
Reissuance of treasury stock	-	68
Net cash provided by financing activities	48,139	55,954
Net increase in cash and cash equivalents	10,771	49,796
CASH AND CASH EQUIVALENTS:		

Beginning of period	22,621	10,898
End of period	$ 33,392	$ 60,694

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THREE MONTHS ENDED MARCH 31, 2016 AND 2015
(in thousands)

	Three Months Ended March 31, 2016	2015
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net income	$ 1,714	$ 1,905
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	359	356
Deferred tax expense	36	42
Provision for loan losses	208	201
Gain on loans sold	(15)	(22)
Stock options and restricted stock expense	118	117
Proceeds from sale of loans held for resale	880	2,658
Originations of loans held for resale	(335)	(4,995)
Changes in assets and liabilities affecting cash flow:		
Other assets	561	327
Other liabilities	(482)	(592)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	$ 3,044	$ (3)

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PART 1 – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTH PERIODS ENDED MARCH 31, 2016 AND 2015

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies followed by Evans Bancorp, Inc. (the “Company”), a financial holding company, and its two direct, wholly-owned subsidiaries: (i) Evans Bank, National Association (the “Bank”), and the Bank’s subsidiaries, Evans National Leasing, Inc. (“ENL”), Evans National Holding Corp. (“ENHC”) and Suchak Data Systems, LLC (“SDS”); and (ii) Evans National Financial Services, LLC (“ENFS”), and ENFS’s subsidiary, The Evans Agency, LLC (“TEA”), and TEA’s subsidiaries, Frontier Claims Services, Inc. (“FCS”) and ENB Associates Inc. (“ENBA”), in the preparation of the accompanying interim unaudited consolidated financial statements conform with U.S. generally accepted accounting principles (“GAAP”) and with general practice within the industries in which it operates. Except as the context otherwise requires, the Company and its direct and indirect subsidiaries are collectively referred to in this report as the “Company.”

The results of operations for the three and three month periods ended March 31, 2016 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015.

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2. SECURITIES

The amortized cost of securities and their approximate fair value at March 31, 2016 and December 31, 2015 were as follows:

	March 31, 2016 (in thousands)			
	Amortized	Unrealized		Fair
	Cost	Gains	Losses	Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 24,835	$ 387	$ (15)	$ 25,207
States and political subdivisions	36,659	1,046	(23)	37,682
Total debt securities	$ 61,494	$ 1,433	$ (38)	$ 62,889
Mortgage-backed securities:				
FNMA	$ 18,427	$ 276	$ (26)	$ 18,677
FHLMC	4,393	96	(32)	4,457
GNMA	11,044	120	(30)	11,134
CMO	17,516	116	(102)	17,530
Total mortgage-backed securities	$ 51,380	$ 608	$ (190)	$ 51,798
Total securities designated as available for sale	$ 112,874	$ 2,041	$ (228)	$ 114,687
Held to Maturity:				
Debt securities				
States and political subdivisions	$ 1,607	$ 12	$ (24)	$ 1,595
Total securities designated as held to maturity	$ 1,607	$ 12	$ (24)	$ 1,595

	December 31, 2015 (in thousands)			
	Amortized	Unrealized		Fair

	Cost	Gains	Losses	Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 21,914	$ 166	$ (234)	$ 21,846
States and political subdivisions	36,838	874	(29)	37,683
Total debt securities	$ 58,752	$ 1,040	$ (263)	$ 59,529
Mortgage-backed securities:				
FNMA	$ 12,312	$ 168	$ (25)	$ 12,455
FHLMC	4,629	61	(56)	4,634
GNMA	7,047	82	(61)	7,068
CMO	13,634	24	(203)	13,455
Total mortgage-backed securities	$ 37,622	$ 335	$ (345)	$ 37,612
Total securities designated as available for sale	$ 96,374	$ 1,375	$ (608)	$ 97,141
Held to Maturity:				
Debt securities				
States and political subdivisions	$ 1,617	$ 6	$ (39)	$ 1,584
Total securities designated as held to maturity	$ 1,617	$ 6	$ (39)	$ 1,584

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Available for sale securities with a total fair value of $98.4 million and $86.0 million at March 31, 2016 and December 31, 2015, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

The Company uses the Federal Home Loan Bank of New York ("FHLBNY") as its primary source of overnight funds and also has several long-term advances with FHLBNY. The Company had $10.0 million in borrowed funds at FHLBNY at each of March 31, 2016 and December 31, 2015. The Company has placed sufficient collateral in the form of residential and commercial real estate loans at FHLBNY that meet FHLB collateral requirements. As a member of the Federal Home Loan Bank ("FHLB") System, the Bank is required to hold stock in FHLBNY. The Bank held $1.3 million in FHLBNY stock at each of March 31, 2016 and December 31, 2015 at cost. The Company regularly evaluates investments in FHLBNY for impairment, considering liquidity, operating performance, capital position, stock repurchase and dividend history. As of March 31, 2016, the Bank's investment in FHLBNY stock was not impaired.

The Bank, as a member of the Federal Reserve Bank ("FRB") system, is currently required to purchase and hold shares of capital stock in the FRB in an amount equal to 6% of its capital and surplus. The Bank's investment in FRB capital stock totaled $1.5 million at each of March 31, 2016 and December 31, 2015, at cost. Based on the current capital adequacy and liquidity position of the FRB, management believes there is no impairment in the Company's investment at March 31, 2016 and the cost of the investment approximates fair value.

The scheduled maturities of debt and mortgage-backed securities at March 31, 2016 and December 31, 2015 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	March 31, 2016		December 31, 2015	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
	(in thousands)		(in thousands)	
Debt securities available for sale:				
Due in one year or less	$ 4,377	$ 4,428	$ 4,082	$ 4,142

Due after one year through five years	29,114	29,716	29,113	29,448
Due after five years through ten years	21,802	22,341	19,356	19,615
Due after ten years	6,201	6,404	6,201	6,324
	61,494	62,889	58,752	59,529
Mortgage-backed securities available for sale	51,380	51,798	37,622	37,612
Total available for sale securities	$ 112,874	$ 114,687	$ 96,374	$ 97,141
Debt securities held to maturity:				
Due in one year or less	$ 315	$ 314	$ 309	$ 308
Due after one year through five years	358	352	374	365
Due after five years through ten years	828	827	828	815
Due after ten years	106	102	106	96
	1,607	1,595	1,617	1,584
Total held to maturity securities	$ 1,607	$ 1,595	$ 1,617	$ 1,584

Information regarding unrealized losses within the Company's available for sale securities at March 31, 2016 and December 31, 2015 is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities. All unrealized losses are considered temporary and related to market interest rate fluctuations.

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	March 31, 2016					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ -	$ -	$ 1,985	$ (15)	$ 1,985	$ (15)
States and political subdivisions	1,196	(1)	1,115	(22)	2,311	(23)
Total debt securities	$ 1,196	$ (1)	$ 3,100	$ (37)	$ 4,296	$ (38)
Mortgage-backed securities:						
FNMA	$ 6,581	$ (26)	$ -	$ -	$ 6,581	$ (26)
FHLMC	-	-	1,216	(32)	1,216	(32)
GNMA	4,427	(22)	1,614	(8)	6,041	(30)
CMO'S	5,984	(81)	3,637	(21)	9,621	(102)
Total mortgage-backed securities	$ 16,992	$ (129)	$ 6,467	$ (61)	$ 23,459	$ (190)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 630	$ (7)	$ 426	$ (17)	$ 1,056	$ (24)
Total temporarily impaired securities	$ 18,818	$ (137)	$ 9,993	$ (115)	$ 28,811	$ (252)

December 31, 2015

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 4,531	$ (89)	$ 5,855	$ (145)	$ 10,386	$ (234)
States and political subdivisions	3,133	(6)	1,117	(23)	4,250	(29)
Total debt securities	$ 7,664	$ (95)	$ 6,972	$ (168)	$ 14,636	$ (263)
Mortgage-backed securities:						
FNMA	$ 3,856	$ (25)	$ -	$ -	$ 3,856	$ (25)
FHLMC	-	-	1,234	(56)	1,234	(56)
GNMA	3,480	(55)	471	(6)	3,951	(61)
CMO'S	6,677	(89)	3,661	(114)	10,338	(203)
Total mortgage-backed securities	$ 14,013	$ (169)	$ 5,366	$ (176)	$ 19,379	$ (345)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 626	$ (11)	$ 495	$ (28)	$ 1,121	$ (39)
Total temporarily impaired securities	$ 22,303	$ (275)	$ 12,833	$ (372)	$ 35,136	$ (647)

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Management has assessed the securities available for sale in an unrealized loss position at March 31, 2016 and December 31, 2015 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities' amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company had not recorded any other-than-temporary impairment ("OTTI") charges as of March 31, 2016 and did not record any OTTI charges during 2015. Nevertheless, it remains possible that there could be deterioration in the asset quality of the securities portfolio in the future. The credit worthiness of the Company's portfolio is largely reliant on the ability of U.S. government sponsored agencies such as FHLB, Federal National Mortgage Association ("FNMA"), Government National Mortgage Association ("GNMA"), and Federal Home Loan Mortgage Corporation ("FHLMC"), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The relatively stable past performance is not a guarantee for similar performance of the Company's securities portfolio going forward.

3. FAIR VALUE MEASUREMENTS

The Company follows the provisions of ASC Topic 820, "Fair Value Measurements." Those provisions relate to financial assets and liabilities carried at fair value and fair value disclosures related to financial assets and liabilities. ASC Topic 820 defines fair value and specifies a hierarchy of valuation techniques based on the nature of the inputs used to develop the fair value measures. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

There are three levels of inputs to fair value measurements:

- Level 1, meaning the use of quoted prices for identical instruments in active markets;
- Level 2, meaning the use of quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable; and
- Level 3, meaning the use of unobservable inputs.

Observable market data should be used when available.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

The following table presents, for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis March 31, 2016 and December 31, 2015:

(in thousands)	Level 1	Level 2	Level 3	Fair Value
March 31, 2016				
Securities available-for-sale:				
U.S. government agencies	$ -	$ 25,207	$ -	$ 25,207
States and political subdivisions	-	37,682	-	37,682
Mortgage-backed securities	-	51,798	-	51,798
Mortgage servicing rights	-	-	496	496
December 31, 2015				
Securities available-for-sale:				
U.S. government agencies	$ -	$ 21,846	$ -	$ 21,846
States and political subdivisions	-	37,683	-	37,683
Mortgage-backed securities	-	37,612	-	37,612
Mortgage servicing rights	-	-	557	557

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Securities available for sale

Fair values for securities are determined using independent pricing services and market-participating brokers. The Company's independent pricing service utilizes evaluated pricing models that vary by asset class and incorporate available trade, bid and other market information for structured securities, cash flow and, when available, loan performance data. Because many fixed income securities do not trade on a daily basis, the evaluated pricing applications apply information as applicable through processes, such as benchmarking of like securities, sector groupings, and matrix pricing, to prepare evaluations. In addition, model processes, such as the Option Adjusted Spread model, are used to assess interest rate impact and develop prepayment scenarios. The models and the process take into account market convention. For each asset class, a team of evaluators gathers information from market sources and integrates relevant credit information, perceived market movements and sector news into the evaluated pricing applications and models. The company's service provider may occasionally determine that it does not have sufficient verifiable information to value a particular security. In these cases the Company will utilize valuations from another pricing service.

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis, the Company reviews changes in the market value of its security portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis, the Company has its entire security portfolio priced by a second pricing service to determine consistency with another market evaluator. If, during the Company's review or when comparing with another servicer, a material difference between pricing evaluations were to exist, the Company would submit an inquiry to the service provider regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than the initial evaluation it can submit a challenge for a change to that security's valuation. There were no material differences in valuations noted in the first quarter of 2016 or during fiscal year 2015.

Securities available for sale are classified as Level 2 in the fair value hierarchy as the valuation provided by the third-party provider uses observable market data.

Mortgage servicing rights

Mortgage servicing rights ("MSRs") do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider determines the fair value by discounting projected net servicing cash flows of the remaining servicing portfolio. The valuation model used by the provider considers market loan prepayment predictions and other economic factors which management considers to be significant unobservable inputs. The fair value of MSRs is mostly affected by changes in mortgage interest rates since rate changes cause the loan prepayment acceleration factors to increase or decrease. Management has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of MSRs to enable management to maintain an appropriate system of internal control. Mortgage servicing rights are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for mortgage servicing rights during the three month periods ended March 31, 2016 and 2015, respectively:

	Three months ended March 31,	
(in thousands)	2016	2015
Mortgage servicing rights - January 1	$ 557	$ 518
Gains (losses) included in earnings	(69)	(45)
Additions from loan sales	8	24
Mortgage servicing rights - March 31	$ 496	$ 497

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Quantitative information about the significant unobservable inputs used in the fair value measurement of MSRs at the respective dates is as follows:

	March 31, 2016	December 31, 2015
Servicing fees	0.25 %	0.25 %
Discount rate	9.52 %	9.52 %
Prepayment rate (CPR)	9.93 %	8.55 %

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at March 31, 2016 and December 31, 2015:

(in thousands)	Level 1	Level 2	Level 3	Fair Value
March 31, 2016				
Impaired loans	$ -	-	17,849	$ 17,849
December 31, 2015				

Impaired loans	$ -	-	17,758	$ 17,758

Impaired loans

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Each loan's collateral has a unique appraisal and management's discount of the value is based on factors unique to each impaired loan. The significant unobservable input in determining the fair value is management's subjective discount on appraisals of the collateral securing the loan, which ranges from 10%-50%. Collateral may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management's expertise and knowledge of the client and the client's business.

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The Company has an appraisal policy in which appraisals are obtained upon a commercial loan being downgraded on the Company internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired commercial loans are either graded a 6 or 7 on the internal loan rating scale. For consumer loans, the Company obtains appraisals when a loan becomes 90 days past due or is determined to be impaired, whichever occurs first. Subsequent to the downgrade or reaching 90 days past due, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of $19.5 million, with a allowance for loan loss of $1.7 million, at each of March 31, 2016 and December 31, 2015.

FAIR VALUE OF FINANCIAL INSTRUMENTS

At March 31, 2016 and December 31, 2015, the estimated fair values of the Company's financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis, were as follows:

	March 31, 2016		December 31, 2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Level 1:				
Cash and cash equivalents	$ 33,392	$ 33,392	$ 22,621	$ 22,621
Level 2:				
Available for sale securities	114,687	114,687	97,141	97,141
FHLB and FRB stock	2,788	2,788	2,783	2,783
Level 3:				
Held to maturity securities	1,607	1,595	1,617	1,584
Loans, net	783,654	795,249	761,101	772,472
Mortgage servicing rights	496	496	557	557
Financial liabilities:				
Level 1:				

Demand deposits	$ 174,276	$ 174,276	$ 183,098	$ 183,098
NOW deposits	95,622	95,622	83,674	83,674
Regular savings deposits	463,672	463,672	439,993	439,993
Level 2:				
Securities sold under agreement to repurchase	12,894	12,894	10,821	10,821
Other borrowed funds	10,000	10,080	10,000	9,874
Junior subordinated debentures	11,330	11,330	11,330	11,330
Level 3:				
Time deposits	115,479	116,402	96,217	96,975

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The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practical to estimate that value.

Cash and Cash Equivalents. For these short-term instruments, the carrying amount is a reasonable estimate of fair value. “Cash and Cash Equivalents” includes interest-bearing deposits at other banks.

FHLB and FRB stock. The carrying value of FHLB and FRB stock, which are non-marketable equity investments, approximate fair value.

Securities held to maturity. The Company holds certain municipal bonds as held-to-maturity. These bonds are generally small in dollar amount and are issued only by certain local municipalities within the Company’s market area. The original terms are negotiated directly and on an individual basis consistent with our loan and credit guidelines. These bonds are not traded on the open market and management intends to hold the bonds to maturity. The fair value of held-to-maturity securities is estimated by discounting the future cash flows using the current rates at which similar agreements would be made with municipalities with similar credit ratings and for the same remaining maturities.

Loans and Leases, net. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities, net of the appropriate portion of the allowance for loan losses. For variable rate loans, the carrying amount is a reasonable estimate of fair value. This fair value calculation is not necessarily indicative of the exit price, as defined in ASC 820.

Deposits. The fair value of demand deposits, NOW accounts, muni-vest accounts and regular savings accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated using the rates currently offered for deposits of similar remaining maturities.

Junior Subordinated Debentures. There is no active market for the Company’s debentures and there have been no issuances of similar instruments in recent years. The Company looked at a market bond index to estimate a discount margin to value the debentures. The discount margin was very similar to the spread to LIBOR established at the issuance of the debentures. As a result, the Company determined that the fair value of the adjustable-rate debentures approximates their face amount.

Securities Sold Under Agreement to Repurchase. The fair value of the securities sold under agreement to repurchase approximates its carrying value as the repurchase agreements are one day agreements.

Other Borrowed Funds. The fair value of the short-term portion of other borrowed funds approximates its carrying value. The fair value of the long-term portion of other borrowed funds is estimated using a discounted cash flow analysis based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

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4. LOANS AND THE ALLOWANCE FOR LOAN LOSSES

Loan Portfolio Composition

The following table presents selected information on the composition of the Company's loan portfolio as of the dates indicated:

	March 31, 2016	December 31, 2015
Mortgage loans on real estate:	(in thousands)	
Residential mortgages	$ 105,545	$ 103,941
Commercial and multi-family	406,206	399,819
Construction-Residential	1,149	1,546
Construction-Commercial	68,692	60,892
Home equities	61,593	61,042
Total real estate loans	643,185	627,240
Commercial and industrial loans	150,813	144,330
Consumer loans	1,684	1,596
Other	488	139
Net deferred loan origination costs	603	679
Total gross loans	796,773	773,984
Allowance for loan losses	(13,119)	(12,883)
Loans, net	$ 783,654	$ 761,101

The Bank sells certain fixed rate residential mortgages to FNMA while maintaining the servicing rights for those mortgages. In the three month period ended March 31, 2016, the Bank sold mortgages to FNMA totaling $0.9 million, as compared with $2.6 million in mortgages sold to FNMA in the three month period ended March 31, 2015. At March 31, 2016, the Bank had a loan servicing portfolio principal balance of $75.8 million upon which it earns servicing fees, as compared with $77.3 million at December 31, 2015. The value of the mortgage servicing rights for that portfolio was $0.5 million at March 31, 2016 and $0.6 million at December 31, 2015. At March 31, 2016, there were no residential mortgage loans held-for-sale, compared with $0.5 million in residential mortgages held-for-sale at December 31, 2015. The Company had no commercial loans held-for-sale at March 31, 2016 or December 31, 2015. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

As noted in Note 1, these financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015. Disclosures related to the basis for accounting for loans, the method for recognizing interest income on loans, the policy for placing loans on nonaccrual status and the subsequent recording of payments and resuming accrual of interest, the policy for determining past due status, a description of the Company's accounting policies and methodology used to estimate the allowance for loan losses, the policy for charging-off loans, the accounting policies for impaired loans, and more descriptive information on the Company's credit risk ratings are all contained in the Notes to the Audited Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. Unless otherwise noted in this Form 10-Q, the policies and methodology described in the Annual Report for the year ended December 31, 2015 are consistent with those utilized by the Company in the three-month period ended March 31, 2016.

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Credit Quality Indicators

The Bank monitors the credit risk in its loan portfolio by reviewing certain credit quality indicators ("CQI"). The primary CQI for its commercial mortgage and commercial and industrial ("C&I") portfolios is the individual loan's credit risk rating. The following list provides a description of the credit risk ratings that are used internally by the Bank when assessing the adequacy of its allowance for loan and lease losses:

- 1-3-Pass
- 4-Watch
- 5-O.A.E.M. (Other Assets Especially Mentioned) or Special Mention
- 6-Substandard
- 7-Doubtful
- 8-Loss

The Company's consumer loans, including residential mortgages and home equities, are not individually risk rated or reviewed in the Company's loan review process. Consumers are not required to provide the Company with updated financial information as are commercial customers. Consumer loans also carry smaller balances. Given the lack of updated information after the initial underwriting of the loan and small size of individual loans, the Company uses delinquency status as the primary credit quality indicator for consumer loans. However, once a consumer loan is identified as impaired, it is individually evaluated for impairment.

The following tables provide data, at the class level, of credit quality indicators of certain loans for the dates specified:

March 31, 2016
(in thousands)

Corporate Credit Exposure – By Credit Rating	Commercial Real Estate Construction	Commercial and Multi-Family Mortgages	Total Commercial Real Estate	Commercial and Industrial
3	$ 40,299	$ 324,754	$ 365,053	$ 81,975
4	22,985	62,966	85,951	51,685
5	1,224	11,409	12,633	10,320
6	4,184	7,077	11,261	6,719

7	-	-	-	114
Total	$ 68,692	$ 406,206	$ 474,898	$ 150,813

December 31, 2015
(in thousands)

Corporate Credit Exposure – By Credit Rating	Commercial Real Estate Construction	Commercial and Multi-Family Mortgages	Total Commercial Real Estate	Commercial and Industrial
3	$ 42,383	$ 340,837	$ 383,220	$ 80,379
4	13,098	40,019	53,117	47,509
5	1,224	11,772	12,996	8,973
6	4,187	7,191	11,378	7,350
7	-	-	-	119
Total	$ 60,892	$ 399,819	$ 460,711	$ 144,330

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Past Due Loans

The following tables provide an analysis of the age of the recorded investment in loans that are past due as of the dates indicated:

March 31, 2016
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans
Commercial and industrial	$ 607	$ 217	$ 537	$ 1,361	$ 149,452	$ 150,813	$ 175	$ 5,331
Residential real estate:								
Residential	1,014	-	521	1,535	104,010	105,545	-	737
Construction	-	-	-	-	1,149	1,149	-	-
Commercial real estate:								
Commercial	5,533	-	3,291	8,824	397,382	406,206	2,839	3,698
Construction	456	-	3,728	4,184	64,508	68,692	-	4,184
Home equities	94	104	762	960	60,633	61,593	-	963
Consumer	7	-	-	7	1,677	1,684	-	14
Other	-	-	-	-	488	488	-	-
Total Loans	$ 7,711	$ 321	$ 8,839	$ 16,871	$ 779,299	$ 796,170	$ 3,014	$ 14,927

NOTE: Loan balances do not include $603 thousand in net deferred loan origination costs as of March 31, 2016.

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December 31, 2015
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans
Commercial and industrial	$ 160	$ 224	$ 66	$ 450	$ 143,880	$ 144,330	$ 40	$ 5,312
Residential real estate:								
Residential	822	402	569	1,793	102,148	103,941	-	1,400
Construction	-	-	-	-	1,546	1,546	-	-
Commercial real estate:								
Commercial	1,919	963	457	3,339	396,480	399,819	457	3,574
Construction	-	-	-	-	60,892	60,892	-	4,187
Home equities	253	236	267	756	60,286	61,042	-	1,058
Consumer	8	-	-	8	1,588	1,596	-	14
Other	-	-	-	-	139	139	-	-
Total Loans	$ 3,162	$ 1,825	$ 1,359	$ 6,346	$ 766,959	$ 773,305	$ 497	$ 15,545

NOTE: Loan balances do not include $679 thousand in net deferred loan origination costs as of December 31, 2015.

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Allowance for loan losses

The following tables present the activity in the allowance for loan losses according to portfolio segment, for the three month periods ended March 31, 2016 and 2015:

March 31, 2016

(in thousands)	Commercial and Industrial	Commercial Real Estate Mortgages*	Consumer **	Residential Mortgages*	HELOC	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 4,383	$ 7,135	$ 85	$ 909	$ 371	$ -	$ 12,883
Charge-offs	(13)	-	(7)	-	-	-	(20)
Recoveries	7	38	3	-	-	-	48
Provision (Credit)	203	269	12	(213)	(63)	-	208
Ending balance	$ 4,580	$ 7,442	$ 93	$ 696	$ 308	$ -	$ 13,119
Allowance for loan losses:							
Ending balance:							
Individually evaluated for impairment	$ 516	$ 1,134	$ 41	$ 2	$ -	$ -	$ 1,693
Collectively evaluated							