

SB FINANCIAL GROUP, INC.
Form 10-K
March 03, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(Mark
One)

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

For the fiscal year ended December 31, 2013

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 0-13507

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

Ohio (State or other jurisdiction of incorporation or organization)	34-1395608 (I.R.S. Employer Identification No.)
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401 Clinton Street, Defiance, Ohio (Address of principal executive offices)	43512 (Zip Code)
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Registrant's telephone number, including area code: (419) 783-8950

Securities registered pursuant to Section 12(b) of the Act:

Title of each class Common Shares, Without Par Value	Name of each exchange on which registered The NASDAQ Stock Market, LLC
---------------------------------------------------------	---------------------------------------------------------------------------

Securities registered pursuant to Section 12(g) of the Act:
Not Applicable

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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.

Large Accelerate Filer Accelerated Filer 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

The aggregate market value of the common shares of the registrant held by non-affiliates computed by reference to the price at which the common shares were last sold as of the last business day of the registrant's most recently completed second fiscal quarter was \$37.1 million.

The number of common shares of the registrant outstanding at February 26, 2014 was 4,872,729.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement for its Annual Meeting of Shareholders to be held on April 23, 2014 are incorporated by reference into Part III of this Annual Report on Form 10-K.

SB FINANCIAL GROUP, INC.

2013 ANNUAL REPORT ON FORM 10-K

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PART I

Item 1. Business.

Certain statements contained in this Annual Report on Form 10-K which are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. See “Cautionary Statement Regarding Forward-Looking Information” under Item 1A. Risk Factors on page 11 of this Annual Report on Form 10-K.

General

SB Financial Group, Inc., an Ohio corporation (the “Company”), is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to regulation by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”). The Company was organized in 1983. The executive offices of the Company are located at 401 Clinton Street, Defiance, Ohio 43512. The name of the Company was changed to SB Financial Group, Inc. from Rurban Financial Corp. effective April 18, 2013.

Through its direct and indirect subsidiaries, the Company is engaged in a variety of activities, including commercial banking, item processing, and wealth management services, as explained in more detail below.

State Bank

The State Bank and Trust Company (“State Bank”) is an Ohio state-chartered bank and wholly owned subsidiary of the Company, which offers a full range of commercial banking services, including checking accounts, savings accounts, money market accounts and time certificates of deposit; automatic teller machines; commercial, consumer, agricultural and residential mortgage loans; personal and corporate trust services; commercial leasing; bank credit card services; safe deposit box rentals; Internet and telephone banking; and other personalized banking services. The trust and financial services division of State Bank offers various trust and financial services, including asset management services for individuals and corporate employee benefit plans, as well as brokerage services through Cetera Financial Group. State Bank presently operates seventeen banking centers, all located within the Ohio counties of Allen, Defiance, Fulton, Lucas, Paulding, Wood and Williams, and one banking center located in Allen County, Indiana. State Bank also presently operates three Loan Production Offices, two in Franklin County, Ohio and one in Steuben County, Indiana. At December 31, 2013, State Bank had 192 full-time equivalent employees.

RFCBC

RFCBC, Inc. (“RFCBC”) is an Ohio corporation and wholly owned subsidiary of the Company that was incorporated in August 2004. RFCBC operates as a loan subsidiary in servicing and working out problem loans. At December 31, 2013, RFCBC had no employees.

RDSI

Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”) has been in operation since 1964 and became an Ohio corporation in June 1976. RDSI has one operating location in Defiance, Ohio. In September 2006, RDSI acquired Diverse Computer Marketers, Inc. (“DCM”) which was merged into RDSI effective December 31, 2007 and now operates as a division of RDSI doing business as “DCM”. DCM has one operating location in Lansing, Michigan providing item processing and related services to community banks located primarily in the Midwest. At December 31, 2013, RDSI had 8 full-time equivalent employees.

RMC

Rurban Mortgage Company (“RMC”) is an Ohio corporation and wholly owned subsidiary of State Bank. RMC is a mortgage company; however, it is presently inactive. At December 31, 2013, RMC had no employees.

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RII

Rurban Investments, Inc. (“RII”) is a Delaware corporation and wholly owned subsidiary of State Bank. RII is an investment company that engages in the purchases and sale of investment securities. At December 31, 2013, RII had no employees.

SBI

SBT Insurance, LLC (“SBI”) is an Ohio corporation and wholly owned subsidiary of State Bank. SBI is an insurance company that engages in the sale of insurance products to retail and commercial customers of State Bank. At December 31, 2013, SBI had no employees.

RST I

Rurban Statutory Trust I (“RST I”) is a trust that was organized in August 2000. In September 2000, RST I closed a pooled private offering of 10,000 Capital Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures with terms similar to the Capital Securities. The sole assets of RST I are the junior subordinated debentures and the back-up obligations, which in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST I under the Capital Securities.

RST II

Rurban Statutory Trust II (“RST II”) is a trust that was organized in August 2005. In September 2005, RST II closed a pooled private offering of 10,000 Capital Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures with terms similar to the Capital Securities. The sole assets of RST II are the junior subordinated debentures and the back-up obligations, which in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST II under the Capital Securities.

Competition

The Company experiences significant competition in attracting depositors and borrowers. Competition in lending activities comes principally from other commercial banks in the lending areas of State Bank, and to a lesser extent, from savings associations, insurance companies, governmental agencies, credit unions, securities brokerage firms and pension funds. The primary factors in competing for loans are interest rates charged and overall banking services.

State Bank’s competition for deposits comes from other commercial banks, savings associations, money market funds and credit unions as well as from insurance companies and securities brokerage firms. The primary factors in competing for deposits are interest rates paid on deposits, account liquidity and convenience of office location. State Bank operates in the highly competitive trust services field and its competition consists primarily of other bank trust departments.

RDSI operates in the highly competitive check and statement processing service business, which consists primarily of data processing providers and commercial printers. The primary factors in competition are price and printing capability.

Supervision and Regulation

The following is a description of the significant statutes and regulations applicable to the Company and its subsidiaries. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to the Company or its subsidiaries could have a material effect on our business.

Regulation of Bank Holding Companies and Their Subsidiaries in General

The Company is a bank holding company and, as such, is subject to regulation under the Bank Holding Company Act of 1956, as amended (the "Bank Holding Company Act"). The Bank Holding Company Act requires the prior approval of the Federal Reserve Board (FRB) before a bank holding company may acquire direct or indirect ownership or control of more than 5% of the voting shares of any bank (unless the bank is already majority owned by the bank holding company), acquire all or substantially all of the assets of another bank or bank holding company, or merge or consolidate with any other bank holding company. Subject to certain exceptions, the Bank Holding Company Act also prohibits a bank holding company from acquiring 5% of the voting shares of any company that is not a bank and from engaging in any business other than banking or managing or controlling banks. The primary exception to this prohibition allows a bank holding company to own shares in any company the activities of which the FRB had determined, as of November 19, 1999, to be so closely related to banking as to be a proper incident thereto.

The Company is subject to the reporting requirements of, and examination and regulation by, the FRB. The FRB has extensive enforcement authority over bank holding companies, including, without limitation, the ability to assess civil money penalties, issue cease and desist or removal orders, and require that a bank holding company divest subsidiaries, including its subsidiary banks. In general, the FRB may initiate enforcement actions for violations of laws and regulations and for unsafe or unsound practices. A bank holding company and its subsidiaries are prohibited from engaging in certain tying arrangements in connection with extensions of credit and/or the provision of other property or services to a customer by the bank holding company or its subsidiaries.

Various requirements and restrictions under the laws of the United States and the State of Ohio affect the operations of State Bank, including requirements to maintain reserves against deposits, restrictions on the nature and amount of loans which may be made and the interest that may be charged thereon, restrictions relating to investments and other activities, limitations on credit exposure to correspondent banks, limitations on activities based on capital and surplus, limitations on payment of dividends, and limitations on branching. Various consumer laws and regulations also affect the operations of State Bank.

The Federal Home Loan Banks (“FHLBs”) provide credit to their members in the form of advances. As a member of the FHLB of Cincinnati, State Bank must maintain certain minimum investments in the capital stock of the FHLB of Cincinnati. State Bank was in compliance with these requirements at December 31, 2013.

Dividends

There can be no assurance as to the amount of dividends which may be declared in future periods with respect to the common shares of the Company, since such dividends are subject to the discretion of the Company’s Board of Directors, cash needs, general business conditions, dividends from the Company’s subsidiaries and applicable governmental regulations and policies.

The ability of the Company to obtain funds for the payment of dividends and for other cash requirements is largely dependent on the amount of dividends that may be declared by its subsidiaries. State Bank may not pay dividends to the Company if, after paying such dividends, it would fail to meet the required minimum levels under the risk-based capital guidelines and the minimum leverage ratio requirements. State Bank must obtain the approval of the FRB and the Ohio Division of Financial Institutions (ODFI) if a dividend in any year would cause the total dividends for that year to exceed the sum of the current year’s net profits and the retained net profits for the preceding two years, less required transfers to surplus. At December 31, 2013, State Bank had \$7.8 million of excess earnings over the preceding three years.

Payment of dividends by State Bank may be restricted at any time at the discretion of the regulatory authorities, if they deem such dividends to constitute an unsafe and/or unsound banking practice. Moreover, the FRB expects the Company to serve as a source of strength to its subsidiary banks, which may require it to retain capital for further investment in the subsidiary, rather than for dividends to shareholders of the Company.

Affiliate Transactions

The Company and the Bank are legal entities separate and distinct. Various legal limitations restrict the Bank from lending or otherwise supplying funds to the Company (or any other affiliate), generally limiting such transactions with the affiliate to 10% of the Bank’s capital and surplus and limiting all such transactions with all affiliates to 20% of the Bank’s capital and surplus. Such transactions, including extensions of credit, sales of securities or assets and provision of services, also must be on terms and conditions consistent with safe and sound banking practices, including credit standards, that are substantially the same or at least as favorable to the Bank as those prevailing at the time for transactions with unaffiliated companies.

Federally insured banks are subject, with certain exceptions, to certain additional restrictions (including collateralization) on extensions of credit to their parent holding companies or other affiliates, on investments in the stock or other securities of affiliates and on the taking of such stock or securities as collateral from any borrower. In addition, such banks are prohibited from engaging in certain tying arrangements in connection with any extension of credit or the providing of any property or service.

Regulatory Capital

The FRB has adopted risk-based capital guidelines for bank holding companies and for state member banks, such as State Bank. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk weighted assets by assigning assets and off-balance-sheet items to broad risk categories. The minimum ratio of total capital to risk weighted assets (including certain off-balance-sheet items, such as standby letters of credit) is 8%. Of that 8%, at least 4% must be comprised of common shareholders' equity (including retained earnings but excluding treasury stock), non-cumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, less goodwill and certain other intangible assets ("Tier 1 capital"). The remainder of total risk-based capital ("Tier 2 capital") may consist, among other things, of certain amounts of mandatory convertible debt securities, subordinated debt, preferred stock not qualifying as Tier 1 capital, allowance for loan and lease losses and net unrealized gains, after applicable taxes, on available-for-sale equity securities with readily determinable fair values, all subject to limitations established by the guidelines. 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 four risk weights (0%, 20%, 50%, and 100%) 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.

In July 2013, the FRB and the federal banking agencies published final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and State Bank. These rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. "Basel III" refers to various documents released by the Basel Committee on Banking Supervision.

Effective in 2015, State Bank and the Company will be subject to new capital regulations (with some provisions transitioned into full effectiveness over two to four years). The new requirements create a new required ratio for common equity Tier 1 ("CET1") capital, increases the leverage and Tier 1 capital ratios, changes the risk-weights of certain assets for purposes of the risk-based capital ratios, creates an additional capital conservation buffer over the required capital ratios and changes what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Company to pay dividends, repurchase shares or pay discretionary bonuses.

When these new requirements become effective, certain of the minimum capital requirements for State Bank will change. The minimum leverage ratio of 4% of adjusted total assets and total capital ratio of 8% of risk-weighted assets will remain the same; however, the Tier 1 capital ratio will increase from 4.0% to 6.5% of risk-weighted assets. In addition, the Company will have to meet the new minimum CET1 capital ratio of 4.5% of risk-weighted assets. CET1 consists generally of common stock, retained earnings and accumulated other comprehensive income (AOCI), subject to certain adjustments.

Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock will be deducted from capital, subject to a two-year transition period. In addition, Tier 1 capital will include AOCI, which includes all unrealized gains and losses on available for sale debt and equity securities, subject to a two-year transition period. Because of its asset size, State Bank has the one-time option of

deciding in the first quarter of 2015 whether to permanently opt-out of the inclusion of AOCI in its capital calculations. State Bank is considering whether to take advantage of this opt-out to reduce the impact of market volatility on its regulatory capital levels.

The new requirements also include changes in the risk-weights of certain assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in nonaccrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less; a 250% risk weight (up from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital; and increased risk-weights (0% to 600%) for equity exposures.

In addition to the minimum CET1, Tier 1 and total capital ratios, State Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above each of the required minimum capital levels in order to avoid limitations on paying dividends, engaging in share repurchases and paying certain discretionary bonuses. This new capital conservation buffer requirement is phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented in January 2019.

The FRB's prompt corrective action standards will change when these new capital ratios become effective. Under the new standards, in order to be considered well-capitalized, State Bank will be required to have at least a CET1 ratio of 6.5% (new), a Tier 1 ratio of 8% (increased from 6%), a total capital ratio of 10% (unchanged) and a leverage ratio of 5% (unchanged) and not be subject to specified requirements to meet and maintain a specific capital ratio for a capital measure.

State Bank conducted a proforma analysis of the application of these new capital requirements as of September 30, 2013. Based on that analysis, State Bank determined that it meets all these new requirements, including the full 2.5% capital conservation buffer, and would remain well capitalized if these new requirements had been in effect on that date.

In addition, as noted above, beginning in 2016, if State Bank does not have the required capital conservation buffer, its ability to pay dividends to the Company would be limited.

Federal Deposit Insurance Corporation ("FDIC")

The FDIC is an independent federal agency which insures the deposits of federally-insured banks and savings associations up to certain prescribed limits and safeguards the safety and soundness of financial institutions. State Bank's deposits are subject to the deposit insurance assessments of the FDIC. Under the FDIC's deposit insurance assessment system, the assessment rate for any insured institution may vary according to regulatory capital levels of the institution and other factors such as supervisory evaluations.

The FDIC is authorized to prohibit any insured institution from engaging in any activity that poses a serious threat to the insurance fund and may initiate enforcement actions against a bank, after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may also terminate the deposit insurance of any institution that has engaged in or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, order or condition imposed by the FDIC.

SEC and NASDAQ Regulation

The Company is subject to the jurisdiction of the Securities and Exchange Commission (the "SEC") and certain state securities authorities relating to the offering and sale of its securities. The Company is subject to the registration, reporting and other regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the rules adopted by the SEC under those acts. The Company's common shares are listed on The NASDAQ Global Market under the symbol "SBFG", and the Company is subject to the rules and regulations of The NASDAQ Stock Market, Inc. ("NASDAQ") applicable to listed companies.

Sarbanes-Oxley Act of 2002 and Related Rules Affecting Corporate Governance

As mandated by the Sarbanes-Oxley Act of 2002 (“SOX”), the SEC has adopted rules and regulations governing, among other matters, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. The SEC has also approved corporate governance rules promulgated by NASDAQ. The Board of Directors of the Company has taken a series of actions to comply with the NASDAQ and SEC rules and to further strengthen its corporate governance practices. The Company has adopted and implemented a Code of Conduct and Ethics and a copy of that policy can be found on the Company’s website at www.yourSBFinancial.com by first clicking “Corporate Governance” and then “Code of Conduct”. The Company has also adopted charters of the Audit Committee, the Compensation Committee and the Governance and Nominating Committee, which charters are available on the Company’s website at www.yourSBFinancial.com by first clicking “Corporate Governance” and then “Supplementary Info”.

USA Patriot Act

The Uniting and Strengthening of America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “Patriot Act”) gives the United States Government greater powers over financial institutions to combat money laundering and terrorist access to the financial system in our country. The Patriot Act requires regulated financial institutions to establish programs for obtaining identifying information from customers seeking to open new accounts and establish enhanced due diligence policies, procedures and controls designed to detect and report suspicious activity.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Act was enacted into law on July 21, 2010. The Dodd-Frank Act is significantly changing the regulation of financial institutions and the financial services industry. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the new law and the effects they will have on the Company will not be known for months and even years.

Among the provisions already implemented pursuant to the Dodd-Frank Act, the following provisions have or may have an effect on the business of the Company and its subsidiaries:

- the CFPB has been formed with broad powers to adopt and enforce consumer protection regulations;
- the federal law prohibiting the payment of interest on commercial demand deposit accounts was eliminated effective July 21, 2011;
- the standard maximum amount of deposit insurance per customer was permanently increased to \$250,000;
- the assessment base for determining deposit insurance premiums has been expanded from domestic deposits to average assets minus average tangible equity;
- public companies in all industries are or will be required to provide shareholders the opportunity to cast a non-binding advisory vote on executive compensation;
- new capital regulations for bank holding companies have been adopted, which will impose stricter requirements, and any new trust preferred securities issued after May 19, 2010 will no longer constitute Tier I capital; and
-

new corporate governance requirements applicable generally to all public companies in all industries require new compensation practices and disclosure requirements, including requiring companies to “claw back” incentive compensation under certain circumstances, to consider the independence of compensation advisors and to make additional disclosures in proxy statements with respect to compensation matters.

Many provisions of the Dodd-Frank Act have not yet been implemented and will require interpretation and rule making by federal regulators. As a result, the ultimate effect of the Dodd-Frank Act on the Company cannot yet be determined. However, it is likely that the implementation of these provisions will increase compliance costs and fees paid to regulators, along with possibly restricting the operations of the Company and its subsidiaries.

The Volcker Rule

In December 2013, five federal agencies adopted a final regulation implementing the Volcker Rule provision of the Dodd-Frank Act (the “Volcker Rule”). The Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The trading activity includes a purchase or sale as principal of a security, derivative, commodity future or option on any such instrument in order to benefit from short-term price movements or to realize short-term profits. The Volcker Rule exempts specified U.S. Government, agency and/or municipal obligations, and it excepts trading conducted in certain capacities, including as a broker or other agent, through a deferred compensation or pension plan, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities.

The Volcker Rule also prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund, with a number of exceptions. The Company does not engage in any of the trading activities or have any ownership interest in or relationship with any of the types of funds regulated by the Volcker Rule.

Executive and Incentive Compensation

In June 2010, the Federal Reserve Board, the OCC and the FDIC issued joint interagency guidance on incentive compensation policies (the “Joint Guidance”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. This principles-based guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (a) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (b) be compatible with effective internal controls and risk management and (c) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Pursuant to the Joint Guidance, the Federal Reserve Board will review as part of a regular, risk-focused examination process, the incentive compensation arrangements of financial institutions such as the Company. Such reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination and deficiencies will be incorporated into the institution’s supervisory ratings, which can affect the institution’s ability to make acquisitions and take other actions. Enforcement actions may be taken against an institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization’s safety and soundness and prompt and effective measures are not being taken to correct the deficiencies.

On February 7, 2011, federal banking regulatory agencies jointly issued proposed rules on incentive-based compensation arrangements under applicable provisions of the Dodd-Frank Act (the “Proposed Rules”). The Proposed Rules generally apply to financial institutions with \$1.0 billion or more in assets that maintain incentive-based compensation arrangements for certain covered employees. The Proposed Rules (i) prohibit covered financial institutions from maintaining incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risk by providing the covered person with “excessive” compensation; (ii) prohibit covered financial institutions from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to a material financial loss, (iii) require covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with the Proposed Rules and (iv) require covered financial institutions to provide enhanced disclosure to regulators regarding their incentive-based compensation arrangements for covered person within 90 days following the end of the fiscal year.

Pursuant to rules adopted by the stock exchanges and approved by the SEC in January 2013 under the Dodd-Frank Act, public companies are required to implement “clawback” procedures for incentive compensation payments and to disclose the details of the procedures which allow recovery of incentive compensation that was paid on the basis of erroneous financial information necessitating a restatement due to material noncompliance with financial reporting requirements. This clawback policy is intended to apply to compensation paid within a three-year look-back window of the restatement and would cover all executives who received incentive awards. Public company compensation committee members are also required to meet heightened independence requirements and to consider the independence of compensation consultants, legal counsel and other advisors to the compensation committee. The compensation committees must have the authority to hire advisors and to have the company fund reasonable compensation of such advisors.

Effect of Environmental Regulation

Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has not had a material effect upon the capital expenditures, earnings or competitive position of the Company and its subsidiaries. The Company believes that the nature of the operations of its subsidiaries has little, if any, environmental impact. The Company, therefore, anticipates no material capital expenditures for environmental control facilities for its current fiscal year or for the foreseeable future. The Company’s subsidiaries may be required to make capital expenditures for environmental control facilities related to properties which they may acquire through foreclosure proceedings in the future; however, the amount of such capital expenditures, if any, is not currently determinable.

I. DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL

The following are the condensed average balance sheets for the years ending December 31 and the interest earned or paid on such amounts and the average interest rate thereon:

(\$ in thousands)	2013			2012			2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Assets:									
Taxable securities	\$ 78,520	\$ 1,244	1.58 %	\$ 90,182	\$ 1,515	1.68 %	\$ 97,528	\$ 2,010	2.06 %
Non-taxable securities (1)	17,267	1,065	6.17 %	15,160	919	6.06 %	21,892	1,483	6.77 %
Federal funds sold	-	-	N/A	-	-	N/A	219	1	0.25 %
Loans, net (2)(3)	469,603	22,936	4.88 %	455,516	24,047	5.28 %	438,383	24,558	5.60 %
Total earning assets	565,390	25,245	4.47 %	560,858	26,481	4.72 %	558,022	28,052	5.03 %
Cash and due from banks	20,827			20,728			26,477		
Allowance for loan losses	(6,962)			(6,591)			(6,534)		
Premises and equipment	14,635			15,360			16,797		
Other assets	46,030			47,680			48,766		
Total assets	\$ 639,920			\$ 638,035			\$ 643,528		
Liabilities									
Savings and interest-bearing demand deposits	\$ 262,954	\$ 136	0.05 %	\$ 245,528	\$ 210	0.09 %	\$ 234,497	\$ 368	0.16 %
Time deposits	180,154	2,095	1.16 %	206,135	2,759	1.34 %	217,546	3,614	1.66 %
Repurchase agreements	12,011	11	0.09 %	15,180	142	0.94 %	31,307	912	2.91 %
Advances from FHLB	18,551	339	1.83 %	15,547	333	2.14 %	15,674	402	2.57 %
Trust preferred securities	20,620	1,407	6.82 %	20,620	1,882	9.13 %	20,620	1,406	6.82 %
Notes payable & other borrowed funds	1,074	47	4.38 %	2,058	64	3.11 %	3,085	96	3.12 %
Total interest-bearing liabilities	495,364	4,035	0.81 %	505,068	5,390	1.07 %	522,728	6,798	1.30 %
Demand deposits	78,540			70,749			64,239		
Other liabilities	11,316			11,918			9,526		

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Total liabilities	585,220	587,735	596,493
Shareholders' equity	54,700	50,300	47,035
Total liabilities and shareholders' equity	\$ 639,920	\$ 638,035	\$ 643,528
Net interest income (tax equivalent basis)	\$ 21,210	\$ 21,091	\$ 21,254
Net interest income as a percent of average interest-earning assets	3.75 %	3.76 %	3.81 %

- (1) Security interest is computed on a tax equivalent basis using a 34% statutory tax rate. The tax equivalent adjustment was \$0.4 million, \$0.3 million and \$0.50 million in 2013, 2012 and 2011, respectively.
- (2) Nonaccruing loans and loans held for sale are included in the average balances.
- (3) Loan interest is computed on a tax equivalent basis using a 34% statutory tax rate. The tax equivalent adjustment was \$0.04 million, \$0.05 million and \$0.04 million in 2013, 2012 and 2011, respectively.

I. DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL

(Continued)

The following tables set forth the effect of volume and rate changes on interest income and expense for the periods indicated. For purposes of these tables, changes in interest due to volume and rate were determined as follows:

- Volume Variance - change in volume multiplied by the previous year's rate.
- Rate Variance - change in rate multiplied by the previous year's volume.
- Rate/Volume Variance - change in volume multiplied by the change in rate. This variance was allocated to volume variance and rate variance in proportion to the relationship of the absolute dollar amount of the change in each.
- Interest on non-taxable securities has been adjusted to a fully tax equivalent basis using a statutory tax rate of 34% in 2013 and 2012.

(\$ in thousands)	Total Variance 2013/2012	Variance Attributable To	
		Volume	Rate
Interest income			
Taxable securities	\$ (271)	\$ 124	\$ (395)
Non-taxable securities	146	128	18
Federal funds sold	-	-	-
Loans, net of unearned income and deferred fees	(1,111)	744	(1,855)
	(1,236)	996	(2,232)
Interest expense			
Savings and interest-bearing demand deposits	(135)	16	(151)
Time deposits	(603)	(348)	(255)
Repurchase agreements	(131)	(30)	(101)
Advances from FHLB	6	64	(58)
Trust preferred securities	(408)	-	(408)
Other borrowed funds	(84)	(63)	(21)
	(1,355)	(361)	(994)
Net interest income	\$ 119	\$ 1,357	\$ (1,238)

II. INVESTMENT PORTFOLIO

A. The fair value of securities available for sale as of December 31 in each of the following years are summarized as follows:

(\$ in thousands)	2013	2012	2011
U.S. Treasury and government agencies	\$ 11,300	\$ 14,511	\$ 25,424
Mortgage-backed securities	57,223	63,764	67,699
State and political subdivisions	18,155	18,249	16,792
Money Market Mutual Fund	3,092	2,155	2,040
Marketable equity securities	23	23	23
Total	\$ 89,793	\$ 98,702	\$ 111,978

B. The maturity distribution and weighted average interest rates of securities available for sale at December 31, 2013 are set forth in the table below. The weighted average interest rates are based on coupon rates for securities purchased at par value and on effective interest rates considering amortization or accretion if the securities were purchased at a premium or discount:

(\$ in thousands)	Maturing			
	Within One Year	After One Year but within Five Years	After Five Years but within Ten Years	After Ten Years
U.S. Treasury and government agencies	\$ -	\$ 102	\$ 7,183	\$ 4,015
Mortgage-backed securities	-	3,758	15,953	37,512
State and political subdivisions	-	1,358	3,859	12,938
Total Securities with maturity	\$ -	\$ 5,218	\$ 26,995	\$ 54,465
Weighted average yield by maturity (1)	0.00 %	2.87 %	2.24 %	2.99 %
Money Market Mutual Fund with no maturity	\$ 3,092	-	-	-
Marketable equity securities with no maturity	23	-	-	-
Total Securities with no stated maturity	\$ 3,115	\$ -	\$ -	\$ -
Weighted average yield no maturity (1)	< 0.01%	-	-	-

(1) Yields are presented on a tax-equivalent basis. Money market funds represent the payments received on mortgage-backed securities or funds received from the maturity or calls of U.S Treasury, government agency and municipal securities. These funds are then reinvested back into these securities.

C. Excluding those holdings of the investment portfolio in U.S. Treasury securities and other agencies of the U.S. Government, there were no other securities of any one issuer which exceeded 10% of the shareholders' equity of

the Company at December 31, 2013.

III. LOAN PORTFOLIO

A. Types of Loans - Total loans on the balance sheet are comprised of the following classifications at December 31 for the years indicated:

Types of Loans

(\$ in thousands)	2013	2012	2011	2010	2009
Commercial business and agricultural	\$ 124,578	\$ 124,043	\$ 116,473	\$ 113,251	\$ 126,128
Commercial real estate	205,301	201,392	187,829	177,890	179,909
Residential real estate mortgage	99,620	87,859	87,656	84,775	92,972
Consumer loans to individuals and other	47,804	50,371	50,897	51,904	53,876
Total	477,303	463,665	442,855	427,820	452,885
Residential Loans held for sale	3,366	6,147	5,238	9,055	16,858
Total Loans	\$469,536	\$469,536	\$447,792	\$436,599	\$469,743

Concentrations of Credit Risk: The Company grants commercial, real estate and installment loans to customers mainly in Northwest Ohio. Commercial loans include loans collateralized by commercial real estate, business assets and, in the case of agricultural loans, crops and farm equipment and the loans are expected to be repaid from cash flow from operations of businesses. As of December 31, 2013, commercial business and agricultural loans made up approximately 26.1 percent of the loan portfolio while commercial real estate loans accounted for approximately 43.0 percent of the loan portfolio. As of December 31, 2013, residential first mortgage loans made up approximately 20.9 percent of the loan portfolio and are secured by first mortgages on residential real estate. As of December 31, 2013, consumer loans to individuals made up approximately 10.0 percent of the loan portfolio and are primarily secured by consumer assets.

B. Maturities and Sensitivities of Loans to Changes in Interest Rates - The following table shows the amounts of commercial and agricultural loans outstanding as of December 31, 2013 which, based on remaining scheduled repayments of principal, are due in the periods indicated. Also, the amounts have been classified according to sensitivity to changes in interest rates for commercial and agricultural loans due after one year. (Variable-rate loans are those loans with floating or adjustable interest rates.)

(\$ in thousands)	Maturing	Commercial Business & Agricultural	Commercial Real Estate	Total
Within one year		\$ 17,079	\$ 22,734	\$ 39,813
After one year but within five years		38,756	63,624	102,380
After five years		68,743	118,943	187,686
Total commercial business, commercial real estate and agricultural loans		\$ 124,578	\$ 205,301	\$ 329,879

III. LOAN PORTFOLIO (Continued)

(\$ in thousands)	Interest Sensitivity		Total
	Fixed Rate	Variable Rate	
Commercial Business and Agricultural			
Due after one year but within five years	\$20,514	\$18,242	\$38,756
Due after five years	14,214	54,528	68,742
Total	\$34,728	\$72,770	\$107,498
Commercial Real Estate			
Due after one year but within five years	25,647	37,977	63,624
Due after five years	36,327	82,616	118,943
Total	\$61,974	\$120,593	\$182,567
Commercial Business, Commercial Real Estate and Agricultural			
Due after one year but within five years	46,161	56,219	102,380
Due after five years	50,542	137,144	187,686
Total	\$96,703	\$193,363	\$290,066

C. Risk Elements

1. Non-accrual, Past Due, Restructured and Impaired Loans – The following schedule summarizes non-accrual, past due, and restructured loans at December 31 for the years indicated:

Risk Elements

(\$ in thousands)	2013	2012	2011	2010	2009
(a) Loans accounted for on a non-accrual basis	\$4,844	\$5,305	\$6,900	\$12,283	\$18,543
(b) Accruing loans which are contractually past due 90 days or more as to interest or principal payments	-	-	-	-	-
(c) Loans not included in (a) which are "Troubled Debt Restructurings" as defined by Accounting Standards Codification 310-40	1,739	1,258	1,334	1,107	1,364
Total non-performing loans and TDRs	\$6,583	\$6,563	\$8,234	\$13,390	\$19,907

(\$ in thousands)	2013	2012
Cash basis interest income recognized on impaired loans outstanding	\$228	\$190
Interest income actually recorded on impaired loans and included in net income for the period	232	170

Unrecorded interest income on non-accrual loans	95	362
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III. LOAN PORTFOLIO (Continued)

Management believes the allowance for loan losses at December 31, 2013 was adequate to absorb any losses on non-performing loans, as the allowance balance is maintained by management at a level considered adequate to cover losses that are probable based on past loss experience, general economic conditions, information about specific borrower situations, including their financial position and collateral values, and other factors and estimates which are subject to change over time.

1. Discussion of the Non-accrual Policy

The accrual of interest income is discontinued when the collection of a loan or interest, in whole or in part, is doubtful. When interest accruals are discontinued, interest income accrued in the current period is reversed. Loans which are past due 90 days or more as to interest or principal payments are considered for non-accrual status.

2. Potential Problem Loans

As of December 31, 2013, in addition to the \$4.8 million of non-performing loans reported under Item III.C.1. above (which amount includes all loans classified by management as doubtful or loss), there were approximately \$5.2 million in other outstanding loans where known information about possible credit problems of the borrowers caused management to have concerns as to the ability of such borrowers to comply with the present loan repayment terms (loans classified as substandard by management) and which may result in disclosure of such loans pursuant to Item III.C.1. at some future date. In regard to loans classified as substandard, management believes that such potential problem loans have been adequately evaluated in the allowance of loan losses.

3.	Foreign Outstandings
	None

4. Loan Concentrations

At December 31, 2013, loans outstanding related to agricultural operations or collateralized by agricultural real estate and equipment aggregated approximately \$39.2 million, or 8.2% of total loans.

D. Other Interest-Bearing Assets

There were no other interest-bearing assets as of December 31, 2013 which would be required to be disclosed under Item III.C.1 or Item III.C.2. if such assets were loans.

IV. SUMMARY OF LOAN LOSS EXPERIENCE

A. The following schedule presents an analysis of the allowance for loan losses, average loan data and related ratios at December 31 for the years indicated:

Summary of Loan Loss Experience

(\$ in thousands)	2013	2012	2011	2010	2009
Loans					
Loans outstanding at end of period	\$477,303	\$463,389	\$442,855	\$427,820	\$452,885
Average loans outstanding during period	\$469,603	\$455,516	\$438,883	\$445,700	\$453,787
Allowance for loan losses					
Balance at beginning of period	\$6,811	\$6,529	\$6,715	\$7,030	\$5,020
Loans charged-off:					
Commercial business and agricultural loans					
	-	(400)	(642)	(4,739)	(1,248)
Commercial real estate	(111)	(287)	(2,057)	(4,748)	(918)
Residential real estate mortgage	(264)	(129)	(248)	(1,210)	(1,218)
Consumer loans and other	(444)	(512)	(460)	(637)	(491)
	(819)	(1,328)	(3,407)	(11,334)	(3,875)
Recoveries of loans previously charged-off					
Commercial business and agricultural loans					
	22	48	468	193	50
Commercial real estate	17	50	32	171	14
Residential real estate mortgage	21	86	700	53	54
Consumer loans and other	12	76	27	14	29
	72	260	1,227	431	147
Net loans charged-off	(747)	(1,068)	(2,180)	(10,903)	(3,728)
Provision for loan losses	900	1,350	1,994	10,588	5,738
Balance at end of period	\$6,964	\$6,811	\$6,529	\$6,715	\$7,030
Ratio of net charge-offs during the period to average loans outstanding during the period					
	0.16	% 0.24	% 0.49	% 2.45	% 0.84

The allowance for loan losses balance and the provision for loan losses are determined by management based upon periodic reviews of the loan portfolio. In addition, management considers the level of charge-offs on loans, as well as the fluctuations of charge-offs and recoveries on loans, in the factors which caused these changes. Estimating the risk of loss and the amount of loss is necessarily subjective. Accordingly, the allowance is maintained by management at a level considered adequate to cover losses that are currently anticipated based on past loss experience, economic conditions, information about specific borrower situations, including their financial position and collateral values, and other factors and estimates which are subject to change over time.

IV. SUMMARY OF LOAN LOSS EXPERIENCE (Continued)

B. The following schedule provides a breakdown of the allowance for loan losses allocated by type of loan and related ratios at December 31 for the years indicated:

Allocation of the Allowance for Loan Losses

	Percentage of Loans In Each Category to	Allowance								
	Total									