

FEDERAL DEPOSIT INSURANCE CORPORATION

Washington, D.C., 20429
FORM 10-Q

(Mark one)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number: FDIC Certificate No. 90211

HINGHAM INSTITUTION FOR SAVINGS

(Exact name of registrant as specified in its charter)

Massachusetts
(State or other jurisdiction of
incorporation or organization)

04-1442480
(I.R.S. Employer
Identification No.)

55 Main Street, Hingham, Massachusetts
(Address of principal offices)

02043
(Zip Code)

(781) 749-2200

(Registrant's telephone number, including area code)
Securities Registered pursuant to Section 12(b) of the Act:

Common Stock, \$1.00 par value per share
(Title of Class)

NASDAQ Stock Market, LLC
(Name of exchange on which registered)

Securities registered under Section 12(g) of the Act: None

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

Indicate by check mark whether the registrant 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 [X] No [ ]

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

Large accelerated filer [ ]
Non-accelerated filer [ ]

Accelerated filer [X]
Smaller reporting company [ ]

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

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

The number of shares outstanding of each of the Bank's classes of Common Stock, as of the latest practicable date is:

Class: Common Stock \$1.00 par value per share
Outstanding as of November 6, 2018: 2,132,750 shares

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**PART I – FINANCIAL INFORMATION****Item 1 – Financial Statements****HINGHAM INSTITUTION FOR SAVINGS AND SUBSIDIARIES****Consolidated Balance Sheets**

	<b>December 31, 2017</b>	<b>September 30, 2018</b>
(Unaudited)		
	<b>(In Thousands)</b>	
<b>ASSETS</b>		
Cash and due from banks	\$ 10,852	\$ 10,043
Federal Reserve and other short-term investments	344,377	286,449
Cash and cash equivalents	355,229	296,492
Securities available for sale, at fair value	34,304	15
Equity securities, at fair value	—	39,704
Federal Home Loan Bank stock, at cost	27,102	21,682
Loans, net of allowance for loan losses of \$12,537,000 at December 31, 2017 and \$13,588,000 at September 30, 2018	1,833,987	1,976,422
Bank-owned life insurance	12,221	12,414
Premises and equipment, net	14,068	14,458
Accrued interest receivable	4,398	5,066
Deferred income tax asset, net	1,301	1,128
Other assets	1,989	2,981
Total assets	<u>\$ 2,284,599</u>	<u>\$ 2,370,362</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Interest-bearing	\$ 1,320,487	\$ 1,494,193
Demand	185,375	220,943
Total deposits	1,505,862	1,715,136
Federal Home Loan Bank advances	579,164	431,242
Mortgage payable	812	766
Mortgagors' escrow accounts	6,424	6,901
Accrued interest payable	575	1,687
Other liabilities	5,604	4,883
Total liabilities	<u>2,098,441</u>	<u>2,160,615</u>
Stockholders' equity:		
Preferred stock, \$1.00 par value, 2,500,000 shares authorized; none issued	—	—
Common stock, \$1.00 par value, 5,000,000 shares authorized; 2,132,750 shares issued and outstanding at December 31, 2017 and September 30, 2018	2,133	2,133
Additional paid-in capital	11,750	11,843
Undivided profits	165,596	195,771
Accumulated other comprehensive income	6,679	—
Total stockholders' equity	<u>186,158</u>	<u>209,747</u>
Total liabilities and stockholders' equity	<u>\$ 2,284,599</u>	<u>\$ 2,370,362</u>

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

Item 1 – Financial Statements (continued)

HINGHAM INSTITUTION FOR SAVINGS AND SUBSIDIARIES

Consolidated Statements of Net Income

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2018	2017	2018
(Unaudited)				
(In Thousands, except per share amounts)				
Interest and dividend income:				
Loans	\$ 19,211	\$ 22,523	\$ 55,663	\$ 64,306
Equity securities	396	503	1,116	1,487
Federal Reserve and other short-term investments	1,079	1,317	2,515	3,814
Total interest and dividend income	20,686	24,343	59,294	69,607
Interest expense:				
Deposits	2,854	5,291	8,084	13,202
Federal Home Loan Bank advances	1,742	2,294	3,979	6,653
Mortgage payable	12	12	38	36
Total interest expense	4,608	7,597	12,101	19,891
Net interest income	16,078	16,746	47,193	49,716
Provision for loan losses	558	350	1,098	1,050
Net interest income, after provision for loan losses	15,520	16,396	46,095	48,666
Other income:				
Customer service fees on deposits	216	216	662	638
Increase in cash surrender value of bank-owned life insurance	67	65	196	193
Gain on equity securities, net	—	544	77	1,290
Miscellaneous	44	42	136	129
Total other income	327	867	1,071	2,250
Operating expenses:				
Salaries and employee benefits	3,008	3,146	9,245	9,534
Occupancy and equipment	422	421	1,305	1,313
Data processing	321	353	929	1,042
Deposit insurance	279	258	795	757
Marketing	85	136	325	428
Foreclosure	11	(33)	14	(41)
Other general and administrative	692	698	2,121	2,088
Total operating expenses	4,818	4,979	14,734	15,121
Income before income taxes	11,029	12,284	32,432	35,795
Income tax provision	4,545	3,436	13,366	10,060
Net income	\$ 6,484	\$ 8,848	\$ 19,066	\$ 25,735
Weighted average common shares outstanding:				
Basic	2,133	2,133	2,133	2,133
Diluted	2,180	2,188	2,180	2,187
Earnings per share:				
Basic	\$ 3.04	\$ 4.15	\$ 8.94	\$ 12.07
Diluted	\$ 2.97	\$ 4.05	\$ 8.75	\$ 11.77

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

Item 1 – Financial Statements (continued)

**HINGHAM INSTITUTION FOR SAVINGS AND SUBSIDIARIES**  
**Consolidated Statements of Comprehensive Income**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
(Unaudited)	<b>(In Thousands)</b>			
Net income	\$ <u>6,484</u>	\$ <u><b>8,848</b></u>	\$ <u>19,066</u>	\$ <u><b>25,735</b></u>
Other comprehensive income:				
Net unrealized holding gain on securities available for sale	1,644	—	2,554	—
Reclassification adjustment for gain on sales of securities available for sale recognized in income (1)	<u>—</u>	<u>—</u>	<u>(77)</u>	<u>—</u>
Net unrealized gain	1,644	—	2,477	—
Tax effect	<u>(589)</u>	<u>—</u>	<u>(888)</u>	<u>—</u>
	<u>1,055</u>	<u>—</u>	<u>1,589</u>	<u>—</u>
Comprehensive income	\$ <u>7,539</u>	\$ <u><b>8,848</b></u>	\$ <u>20,655</u>	\$ <u><b>25,735</b></u>

(1) Amount is included in gain on equity securities, net in the consolidated statements of net income. Provision for income taxes associated with the reclassification adjustment amounted to \$28,000 for the nine months ended September 30, 2017.

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

Item 1 – Financial Statements (continued)

**HINGHAM INSTITUTION FOR SAVINGS AND SUBSIDIARIES**  
**Consolidated Statements of Changes in Stockholders' Equity**  
**For the Nine Months Ended**  
**September 30, 2017 and 2018**

(Unaudited)	<b>Common Stock</b>	<b>Additional Paid-In Capital</b>	<b>Undivided Profits</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Total Stockholders' Equity</b>
	(In Thousands)				
Balance at December 31, 2016	\$ 2,133	\$ 11,575	\$ 144,580	\$ 2,736	\$ 161,024
Comprehensive income	—	—	19,066	1,589	20,655
Share-based compensation expense	—	131	—	—	131
Cash dividends declared – common (\$0.98 per share)	—	—	(2,092)	—	(2,092)
Balance at September 30, 2017	<u>\$ 2,133</u>	<u>\$ 11,706</u>	<u>\$ 161,554</u>	<u>\$ 4,325</u>	<u>\$ 179,718</u>
<b>Balance at December 31, 2017</b>	<b>\$ 2,133</b>	<b>\$ 11,750</b>	<b>\$ 165,596</b>	<b>\$ 6,679</b>	<b>\$ 186,158</b>
<b>Cumulative effect of change in accounting principle (Note 5)</b>	<b>—</b>	<b>—</b>	<b>6,679</b>	<b>(6,679)</b>	<b>—</b>
<b>Comprehensive income</b>	<b>—</b>	<b>—</b>	<b>25,735</b>	<b>—</b>	<b>25,735</b>
<b>Share-based compensation expense</b>	<b>—</b>	<b>93</b>	<b>—</b>	<b>—</b>	<b>93</b>
<b>Cash dividends declared – common (\$1.05 per share)</b>	<b>—</b>	<b>—</b>	<b>(2,239)</b>	<b>—</b>	<b>(2,239)</b>
<b>Balance at September 30, 2018</b>	<b><u>\$ 2,133</u></b>	<b><u>\$ 11,843</u></b>	<b><u>\$ 195,771</u></b>	<b><u>\$ —</u></b>	<b><u>\$ 209,747</u></b>

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

Item 1 – Financial Statements (continued)

**HINGHAM INSTITUTION FOR SAVINGS AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
(Unaudited)	<b>2017</b>	<b>2018</b>
	<b>(In Thousands)</b>	
Cash flows from operating activities:		
Net income	\$ 19,066	\$ 25,735
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,098	1,050
Amortization of deferred loan origination costs, net	440	465
Share-based compensation expense	131	93
Deferred income tax provision	—	173
Depreciation and amortization of premises and equipment	488	476
Increase in cash surrender value of bank-owned life insurance	(196)	(193)
Gain on sale of foreclosed assets	(23)	—
Gain on equity securities, net	(77)	(1,290)
Changes in operating assets and liabilities:		
Accrued interest receivable and other assets	(1,585)	(1,660)
Accrued interest payable and other liabilities	176	1,073
Net cash provided by operating activities	19,518	25,922
Cash flows from investing activities:		
Activity in available-for-sale securities:		
Maturities, payments and calls	10	2
Proceeds from sales	945	—
Purchases	(3,534)	—
Activity in equity securities:		
Proceeds from sales	—	1,437
Purchases	—	(5,564)
Purchase of Federal Home Loan Bank stock	(2,391)	(911)
Proceeds from redemption of Federal Home Loan Bank stock	—	6,331
Proceeds from sale of foreclosed assets	586	—
Loans originated, net of payments received	(166,284)	(143,950)
Additions to premises and equipment	(75)	(866)
Net cash used in investing activities	(170,743)	(143,521)

(continued)

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

**Item 1 – Financial Statements (continued)**

**Consolidated Statements of Cash Flows (concluded)**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2017</b>	<b>2018</b>
(Unaudited)	<b>(In Thousands)</b>	
Cash flows from financing activities:		
Increase in deposits	82,430	209,274
Increase in mortgagors' escrow accounts	643	477
Cash dividends paid on common stock	(2,729)	(2,921)
Net increase (decrease) in Federal Home Loan Bank advances with maturities of three months or less	380,192	(53,000)
Proceeds from Federal Home Loan Bank advances with maturities of more than three months	95,000	200
Repayment of Federal Home Loan Bank advances with maturities of more than three months	(376,115)	(95,122)
Repayment of mortgage payable	<u>(42)</u>	<u>(46)</u>
Net cash provided by financing activities	<u>179,379</u>	<u>58,862</u>
Net change in cash and cash equivalents	28,154	(58,737)
Cash and cash equivalents at beginning of period	<u>322,932</u>	<u>355,229</u>
Cash and cash equivalents at end of period	<u>\$ 351,086</u>	<u>\$ 296,492</u>
Supplementary information:		
Interest paid on deposit accounts	\$ 8,006	\$ 12,073
Interest paid on Federal Home Loan Bank advances and mortgage payable	4,038	6,706
Income taxes paid	13,517	11,080
Non-cash activities:		
Real estate acquired through foreclosure	\$ 563	\$ —

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



**HINGHAM INSTITUTION FOR SAVINGS AND SUBSIDIARIES**  
**Notes to Unaudited Consolidated Financial Statements**  
**September 30, 2017 and 2018**

**NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The consolidated interim financial statements of Hingham Institution for Savings (the “Bank”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial statements and with the instructions to U.S. Securities and Exchange Commission Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements.

Financial information as of September 30, 2018, and for the three and nine months ended September 30, 2017 and 2018, is unaudited and, in the opinion of management, reflects all adjustments necessary for a fair presentation of such information. Such adjustments were of a normal recurring nature. Interim results are not necessarily indicative of results to be expected for the entire year. The unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements of the Bank for the year ended December 31, 2017 filed on Form 10-K.

**Earnings per common share**

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of shares outstanding during the period. Diluted earnings per share reflect additional shares that would have been outstanding if dilutive potential shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential shares that may be issued by the Bank relate solely to outstanding stock options and are determined using the treasury stock method. The amount of excess tax benefit that would be credited to additional paid-in capital assuming exercise of the options is not considered in the proceeds when applying the treasury stock method.

Earnings per common share have been computed based on the following:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2017</b>	<b>2018</b>	<b>2017</b>	<b>2018</b>
	<b>(In Thousands)</b>			
Average number of shares outstanding used to calculate basic earnings per share	2,133	<b>2,133</b>	2,133	<b>2,133</b>
Effect of dilutive options	47	<b>55</b>	47	<b>54</b>
Average number of shares outstanding used to calculate diluted earnings per share	2,180	<b>2,188</b>	2,180	<b>2,187</b>

There were no antidilutive options for the three and nine months ended September 30, 2017 or 2018.

**Fair value hierarchy**

The Bank groups its assets measured at fair value in three levels, based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value, as follows:

**Level 1** – Valuation is based on quoted prices in active markets for identical assets. Level 1 assets generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets.

**Level 2** – Valuation is based on observable inputs other than Level 1 prices, such as quoted prices for similar assets; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets.

**Level 3** – Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets. Level 3 assets include those whose value is determined using unobservable inputs to pricing models, discounted cash flow methodologies, or similar techniques, as well as assets for which the determination of fair value requires significant management judgment or estimation.

## Notes to Unaudited Consolidated Financial Statements (continued)

### Loans

The Bank's loan portfolio includes residential real estate, commercial real estate, construction, home equity, commercial and consumer segments. A substantial majority of the loan portfolio is secured by real estate in the eastern Massachusetts area. The remainder of the real estate loan portfolio is located in the Washington D.C. metropolitan area ("WMA"). The ability of the Bank's debtors to honor their contracts is dependent upon the real estate, construction, and general economic conditions in these markets.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and net deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time a loan is 90 days past due (the loan is in default) unless the credit is well-secured and in process of collection. Personal loans are typically charged off no later than becoming 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on non-accrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on non-accrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### Allowance for loan losses

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

The allowance for loan losses is evaluated on a regular basis by management. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance consists of general and allocated loss components, as further discussed below.

#### General component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by loan segment. Management uses a rolling average of historical losses based on a time frame (currently two years) appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; national and local economic trends and conditions; industry conditions and effects of changes in credit concentrations. There were no changes in the Bank's policies or methodology pertaining to the general component of the allowance for loan losses during the nine months ended September 30, 2018.

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

*Residential real estate* – The Bank generally does not originate loans with a loan-to-value ratio greater than 80 percent (without private mortgage insurance). All loans in this segment are collateralized by residential real estate that is owner-occupied at the time of origination and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment. The Bank only originates these loans in Massachusetts.

*Commercial real estate* – Loans in this segment are primarily secured by income-producing properties throughout Massachusetts. Beginning in late 2016, the Bank began originating loans on income producing commercial real estate in the greater Washington D.C. metropolitan area. Underwriting and portfolio management policies are the same for both markets. Generally, loan amounts do not exceed 75% of the appraised value of the collateral. The underlying cash flows generated by the properties are adversely impacted by a downturn in the economy as evidenced by increased vacancy rates which, in turn, will have an effect on the credit quality in this segment. Management obtains income and expense statements annually and regularly monitors the cash flows of these loans.

*Construction* – Loans in this segment include both owner-occupied and speculative real estate development loans for which payment is derived from sale of the property. Credit risk is affected by cost overruns, time to sell at an adequate price, the overall health of the economy and market conditions. The Bank only originates these loans in Massachusetts.

## Notes to Unaudited Consolidated Financial Statements (continued)

*Home equity* – Loans in this segment include equity lines of credit and second mortgage loans, and are generally collateralized by second liens on residential real estate. Repayment is dependent on the credit quality of the individual borrower. The Bank generally does not originate loans with combined loan-to-value ratios greater than 70% when taking into account both the balance of the home equity loans and the first mortgage loan. Similar to residential real estate, the overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment. The Bank only originates these loans in Massachusetts.

*Commercial* – Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer spending, will have an effect on the credit quality in this segment. These loans are not a focus of the Bank's origination program and are originated only in Massachusetts.

*Consumer* – Loans in this segment are generally unsecured and repayment is dependent on the credit quality of the individual borrower. These loans are not a focus of the Bank's origination program and are originated only in Massachusetts.

### Allocated component

The allocated component relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for residential real estate, commercial real estate, construction, home equity and commercial loans. A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impaired loans are generally maintained on a non-accrual basis. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows (or collateral value) of the impaired loan is lower than the carrying amount of that loan. Large groups of smaller balance homogeneous loans, such as consumer loans, are collectively evaluated for impairment.

The Bank periodically may agree to modify the contractual terms of loans. When a loan is modified and a concession is made to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR"). All TDRs are initially classified as impaired.

## NOTE 2: COMMITMENTS

At December 31, 2017 and September 30, 2018, outstanding loan commitments were as follows:

	<b>December 31, 2017</b>	<b>September 30, 2018</b>
	<b>(In Thousands)</b>	
Unused lines of credit	\$ 116,396	\$ 128,675
Commitments to originate loans	50,013	38,270
Unadvanced funds on construction loans	98,367	96,471
Standby letters of credit	32	25
Total	<u>\$ 264,808</u>	<u>\$ 263,441</u>

## Notes to Unaudited Consolidated Financial Statements (continued)

At September 30, 2018, the Bank had the following contractual obligations outstanding:

	Payments Due by Year				
	Total	Less Than One Year	One to Three Years	Three to Five Years	More than Five Years
	(In thousands)				
Certificates of deposit	\$ 871,661	\$ 732,957	\$ 120,966	\$ 17,738	\$ —
Federal Home Loan Bank advances	431,242	431,242	—	—	—
Mortgage payable (1)	766	63	138	156	409
Data processing agreements (2)	3,963	900	1,611	1,452	—
Lease agreements (3)	1,227	326	549	225	127

- (1) Under the mortgage agreement the balance of the note may be paid off at any date after January 2020 without penalty.
- (2) Estimated payments subject to change based on transaction volume.
- (3) Leases contain provisions to pay certain operating expenses, the cost of which is not included above. Lease commitments are based on the initial contract term, or longer when, in the opinion of management, it is more likely than not that the lease will be renewed.

### NOTE 3: DIVIDEND DECLARATION

On September 26, 2018, the Board of Directors declared a cash dividend of \$0.36 per share to all stockholders of record as of October 9, 2018, payable October 17, 2018.

### NOTE 4: FAIR VALUES OF ASSETS AND LIABILITIES

#### Determination of Fair Value

The Bank uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Fair value is 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. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Bank's assets and liabilities. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the asset or liability.

#### Assets Measured at Fair Value on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below. There are no liabilities measured at fair value on a recurring basis.

	Level 1	Level 2	Level 3	Total Fair Value
	(In Thousands)			
<b>December 31, 2017</b>				
Securities available for sale:				
Debt securities	\$ —	\$ 17	\$ —	\$ 17
Equity securities	31,306	2,981	—	34,287
Total securities available for sale	\$ 31,306	\$ 2,998	\$ —	\$ 34,304
<b>September 30, 2018</b>				
Securities available for sale - debt securities	\$ —	\$ 15	\$ —	\$ 15
Equity securities	36,687	3,017	—	39,704
Total	\$ 36,687	\$ 3,032	\$ —	\$ 39,719

As of September 30, 2018, the Bank adopted ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. The adoption did not have a material impact on the Bank's disclosures.

## Notes to Unaudited Consolidated Financial Statements (continued)

### Assets Measured at Fair Value on a Non-recurring Basis

The Bank may also be required, from time to time, to measure certain other assets on a non-recurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets.

There are no assets or liabilities measured at fair value on a non-recurring basis at December 31, 2017 and September 30, 2018.

### Summary of Fair Values of Financial Instruments

Effective January 1, 2018, the Bank adopted Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”) 2016-01, *Financial Instruments – Overall, (Subtopic 825-10)*. The amendments in this Update, among other provisions, requires public business entities to use the exit price notion when measuring the fair value of financial instruments. In addition, the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost on the balance sheet was eliminated.

The estimated fair values, and related carrying amounts, of the Bank’s financial instruments are as follows. Certain financial instruments and all nonfinancial instruments are exempt from disclosure requirements. Accordingly, the aggregate fair value amounts presented herein do not represent the underlying fair value of the Bank.

	Carrying Amount	Fair Value		
		Level 1	Level 2	Level 3
(In Thousands)				
<b>December 31, 2017</b>				
Financial assets:				
Cash and cash equivalents	\$ 355,229	\$ 355,229	\$ —	\$ —
Securities available for sale	34,304	31,306	2,998	—
Federal Home Loan Bank stock	27,102	—	—	27,102
Loans, net	1,833,987	—	—	1,842,923
Accrued interest receivable	4,398	—	—	4,398
Financial liabilities:				
Deposits	\$ 1,505,862	\$ —	\$ —	\$ 1,507,159
Federal Home Loan Bank advances	579,164	—	578,991	—
Mortgage payable	812	—	—	872
Mortgagors’ escrow accounts	6,424	—	—	6,424
Accrued interest payable	575	—	—	575
<b>September 30, 2018</b>				
Financial assets:				
Cash and cash equivalents	\$ 296,492	\$ 296,492	\$ —	\$ —
Debt securities available for sale	15	—	15	—
Equity securities	39,704	36,687	3,017	—
Federal Home Loan Bank stock	21,682	—	—	21,682
Loans, net	1,976,422	—	—	1,976,517
Accrued interest receivable	5,066	—	—	5,066
Financial liabilities:				
Deposits	\$ 1,715,136	\$ —	\$ —	\$ 1,721,059
Federal Home Loan Bank advances	431,242	—	431,247	—
Mortgage payable	766	—	—	797
Mortgagors’ escrow accounts	6,901	—	—	6,901
Accrued interest payable	1,687	—	—	1,687

## Notes to Unaudited Consolidated Financial Statements (continued)

### NOTE 5: SECURITIES

#### Securities available for sale

The amortized cost and estimated fair value of securities available for sale, with gross unrealized gains and losses, follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
<u>December 31, 2017</u>				
Debt securities available for sale:				
Residential mortgage-backed securities	\$ 17	\$ —	\$ —	\$ 17
Equity securities:				
Community Reinvestment Act Qualified Investment Fund	7,500	—	(159)	7,341
Other equity securities	18,220	8,732	(6)	26,946
Total equity securities	25,720	8,732	(165)	34,287
Total securities	\$ 25,737	\$ 8,732	\$ (165)	\$ 34,304
<u>September 30, 2018</u>				
Residential mortgage-backed securities	\$ 15	\$ —	\$ —	\$ 15

At December 31, 2017 and September 30, 2018, all debt securities were pledged to secure Federal Home Loan Bank advances. For the nine months ended September 30, 2017, proceeds from sales of securities available for sale amounted to \$945,000, resulting in gross realized gains of \$77,000 and no gross realized losses. There were no sales of securities available for sale during the nine months ended September 30, 2018. At December 31, 2017, all other equity securities were in the banking, insurance, ratings or payments sectors.

There were no securities available for sale with gross unrealized losses at September 30, 2018. Information pertaining to securities with gross unrealized losses at December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	Less Than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
	(In Thousands)			
<u>December 31, 2017</u>				
Equity securities	\$ 6	\$ 242	\$ 159	\$ 7,341

#### Equity securities

At September 30, 2018, equity securities include a \$7.6 million investment in the Community Reinvestment Act Qualified Investment Fund and a \$32.1 million investment in equity securities in the banking, insurance, rating agencies, technology and payments sectors. At year-end 2017, the entire securities portfolio was classified as available for sale and was carried at fair value with unrealized gains or losses reported in accumulated other comprehensive income/loss, a separate component of stockholders' equity. The net unrealized gain on the portfolio amounted to \$6.7 million, net of tax effects, at December 31, 2017. Effective January 1, 2018, the Bank adopted FASB ASU 2016-01, *Financial Instruments – Overall, (Subtopic 825-10)*. Consequently, beginning January 1, 2018, equity securities (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are measured at fair value with changes in fair value recognized in net income. As a result, net unrealized gains and losses are reflected in the Consolidated Statements of Net Income, regardless of whether such gains and losses are realized. The cumulative effect of adopting this standard was to increase undivided profits and decrease accumulated other comprehensive income by \$6.7 million.

For the three and nine months ended September 30, 2018, proceeds from sales of equity securities amounted to \$1.2 million and \$1.4 million, respectively. Unrealized gains recognized during the three and nine months ended September 30, 2018, on equity securities still held at September 30, 2018, totaled \$435,000 and \$1.2 million, respectively.

Notes to Unaudited Consolidated Financial Statements (continued)

NOTE 6: LOANS

A summary of the balances of loans are as follows:

	December 31, 2017	September 30, 2018
	(In Thousands)	
Real estate loans:		
Residential	\$ 689,273	\$ 709,443
Commercial	998,567	1,129,773
Construction	122,715	114,705
Home equity	32,536	32,635
Total real estate loans	<u>1,843,091</u>	<u>1,986,556</u>
Other loans:		
Commercial	221	148
Consumer	480	398
Total other loans	<u>701</u>	<u>546</u>
 Total loans	 1,843,792	 1,987,102
Allowance for loan losses	(12,537)	(13,588)
Net deferred loan origination costs	2,732	2,908
Loans, net	<u>\$ 1,833,987</u>	<u>\$ 1,976,422</u>

A blanket lien on “qualified collateral,” defined principally as 67-79% of the carrying value of first mortgage loans on certain owner-occupied residential property, 77% of the carrying value of first mortgage loans on certain non-owner-occupied residential property, 71% of the carrying value of first mortgage loans on certain multi-family residential property and 57% of the carrying value of loans on certain commercial property, is used to secure borrowings from the Federal Home Loan Bank of Boston. In addition, qualified collateral includes 93% of the fair value of all debt securities. Additionally, a blanket lien on home equity and second mortgage loans is used to secure borrowing from the Federal Reserve Bank of Boston through its discount window.

The following is a summary of past due and non-accrual loans at December 31, 2017 and September 30, 2018:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Loans on Non-accrual
	(In Thousands)				
<u>December 31, 2017</u>					
Residential real estate	\$ 7,148	\$ 1,212	\$ 334	\$ 8,694	\$ 1,301
Commercial real estate	4,972	—	—	4,972	155
Home equity	198	—	249	447	249
Commercial	1	—	—	1	—
Total loans	<u>\$ 12,319</u>	<u>\$ 1,212</u>	<u>\$ 583</u>	<u>\$ 14,114</u>	<u>\$ 1,705</u>
<u>September 30, 2018</u>					
Commercial real estate	<u>\$ 153</u>	<u>\$ 364</u>	<u>\$ —</u>	<u>\$ 517</u>	<u>\$ 484</u>

At December 31, 2017 and September 30, 2018, there were no loans past due 90 days or more and still accruing interest.

**Notes to Unaudited Consolidated Financial Statements (continued)**

An analysis of the activity in the allowance for loan losses, by segment, for the periods ended September 30, 2017 and 2018 follows:

	<b>Residential Real Estate</b>	<b>Commercial Real Estate</b>	<b>Construction</b>	<b>Home Equity</b>	<b>Commercial</b>	<b>Consumer</b>	<b>Total</b>
	(In Thousands)						
<b><u>Nine months ended September 30, 2017</u></b>							
Balance December 31, 2016	\$ 2,634	\$ 6,690	\$ 1,556	\$ 141	\$ 2	\$ 7	\$ 11,030
Provision (credit) for loan losses	(63)	1,376	(190)	(24)	—	(1)	1,098
Loans charged off	—	—	—	—	—	(1)	(1)
Recoveries of loans previously charged off	—	—	—	—	—	1	1
Balance September 30, 2017	<u>\$ 2,571</u>	<u>\$ 8,066</u>	<u>\$ 1,366</u>	<u>\$ 117</u>	<u>\$ 2</u>	<u>\$ 6</u>	<u>\$ 12,128</u>
<b><u>Three months ended September 30, 2017</u></b>							
Balance June 30, 2017	\$ 2,647	\$ 7,317	\$ 1,461	\$ 139	\$ 1	\$ 6	\$ 11,571
Provision (credit) for loan losses	(76)	749	(95)	(22)	1	1	558
Loans charged off	—	—	—	—	—	(1)	(1)
Recoveries of loans previously charged off	—	—	—	—	—	—	—
Balance September 30, 2017	<u>\$ 2,571</u>	<u>\$ 8,066</u>	<u>\$ 1,366</u>	<u>\$ 117</u>	<u>\$ 2</u>	<u>\$ 6</u>	<u>\$ 12,128</u>
<b><u>Nine months ended September 30, 2018</u></b>							
Balance December 31, 2017	\$ 2,607	\$ 8,508	\$ 1,301	\$ 113	\$ 2	\$ 6	\$ 12,537
Provision (credit) for loan losses	63	1,121	(131)	(2)	1	(2)	1,050
Loans charged off	—	—	—	—	(1)	(1)	(2)
Recoveries of loans previously charged off	2	—	—	—	—	1	3
Balance September 30, 2018	<u>\$ 2,672</u>	<u>\$ 9,629</u>	<u>\$ 1,170</u>	<u>\$ 111</u>	<u>\$ 2</u>	<u>\$ 4</u>	<u>\$ 13,588</u>
<b><u>Three months ended September 30, 2018</u></b>							
Balance June 30, 2018	\$ 2,666	\$ 9,297	\$ 1,167	\$ 100	\$ 2	\$ 5	\$ 13,237
Provision (credit) for loan losses	5	332	3	11	—	(1)	350
Loans charged off	—	—	—	—	—	—	—
Recoveries of loans previously charged off	1	—	—	—	—	—	1
Balance September 30, 2018	<u>\$ 2,672</u>	<u>\$ 9,629</u>	<u>\$ 1,170</u>	<u>\$ 111</u>	<u>\$ 2</u>	<u>\$ 4</u>	<u>\$ 13,588</u>



## Notes to Unaudited Consolidated Financial Statements (continued)

An analysis of the allowance for loan losses, by segment, as of December 31, 2017 and September 30, 2018 follows:

	<b>Residential Real Estate</b>	<b>Commercial Real Estate</b>	<b>Construction</b>	<b>Home Equity</b>	<b>Commercial</b>	<b>Consumer</b>	<b>Total</b>
<b>(In Thousands)</b>							
<b>December 31, 2017</b>							
Allowance for impaired loans	\$ 133	\$ 5	\$ —	\$ —	\$ —	\$ —	\$ 138
Allowance for non-impaired loans	2,474	8,503	1,301	113	2	6	12,399
	<u>\$ 2,607</u>	<u>\$ 8,508</u>	<u>\$ 1,301</u>	<u>\$ 113</u>	<u>\$ 2</u>	<u>\$ 6</u>	<u>\$ 12,537</u>
Impaired loans	\$ 2,723	\$ 480	\$ —	\$ 249	\$ —	\$ —	\$ 3,452
Non-impaired loans	686,550	998,087	122,715	32,287	221	480	1,840,340
	<u>\$ 689,273</u>	<u>\$ 998,567</u>	<u>\$ 122,715</u>	<u>\$ 32,536</u>	<u>\$ 221</u>	<u>\$ 480</u>	<u>\$ 1,843,792</u>
<b>September 30, 2018</b>							
Allowance for impaired loans	\$ 122	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 122
Allowance for non-impaired loans	2,550	9,629	1,170	111	2	4	13,466
	<u>\$ 2,672</u>	<u>\$ 9,629</u>	<u>\$ 1,170</u>	<u>\$ 111</u>	<u>\$ 2</u>	<u>\$ 4</u>	<u>\$ 13,588</u>
Impaired loans	\$ 1,403	\$ 484	\$ —	\$ —	\$ —	\$ —	\$ 1,887
Non-impaired loans	708,040	1,129,289	114,705	32,635	148	398	1,985,215
	<u>\$ 709,443</u>	<u>\$ 1,129,773</u>	<u>\$ 114,705</u>	<u>\$ 32,635</u>	<u>\$ 148</u>	<u>\$ 398</u>	<u>\$ 1,987,102</u>

The following is a summary of impaired loans at December 31, 2017 and September 30, 2018:

	<b>December 31, 2017</b>			<b>September 30, 2018</b>		
	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>
<b>(In Thousands)</b>						
Impaired loans without a valuation allowance:						
Residential real estate	\$ 1,668	\$ 1,721		\$ 364	\$ 416	
Commercial real estate	155	155		484	484	
Home equity	249	249		—	—	
Total	<u>2,072</u>	<u>2,125</u>		<u>848</u>	<u>900</u>	
Impaired loans with a valuation allowance:						
Residential real estate	1,055	1,055	\$ 133	1,039	1,039	\$ 122
Commercial real estate	325	325	5	—	—	—
Total	<u>1,380</u>	<u>1,380</u>	<u>138</u>	<u>1,039</u>	<u>1,039</u>	<u>122</u>
Total impaired loans	<u>\$ 3,452</u>	<u>\$ 3,505</u>	<u>\$ 138</u>	<u>\$ 1,887</u>	<u>\$ 1,939</u>	<u>\$ 122</u>

## Notes to Unaudited Consolidated Financial Statements (continued)

The following is information pertaining to impaired loans for the periods ended September 30, 2017 and 2018:

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
	(In thousands)					
Impaired loans:						
Residential real estate	\$ 2,456	\$ 15	\$ 16	\$ 2,293	\$ 50	\$ 28
Commercial real estate	1,640	9	25	1,895	27	171
Home equity	14	—	—	274	—	13
Total impaired loans	<u>\$ 4,110</u>	<u>\$ 24</u>	<u>\$ 41</u>	<u>\$ 4,462</u>	<u>\$ 77</u>	<u>\$ 212</u>

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
	(In thousands)					
Impaired loans:						
Residential real estate	\$ 1,727	\$ 15	\$ 1	\$ 2,304	\$ 50	\$ 37
Commercial real estate	413	2	15	685	10	173
Home equity	94	—	1	214	—	11
Total impaired loans	<u>\$ 2,234</u>	<u>\$ 17</u>	<u>\$ 17</u>	<u>\$ 3,203</u>	<u>\$ 60</u>	<u>\$ 221</u>

No additional funds are committed to be advanced in connection with impaired loans.

In the course of resolving non-performing loans, the Bank may choose to restructure the contractual terms of certain loans, with terms modified to fit the ability of the borrower to repay in line with its current financial status. A loan is considered a troubled debt restructure if, for reasons related to the debtor's financial difficulties, a concession is granted to the debtor that would not otherwise be considered. For the nine months ended September 30, 2017 and 2018, troubled debt restructurings were not considered material.

### Credit Quality Information

The Bank uses a seven-grade internal rating system for residential real estate, commercial real estate, construction and commercial loans as follows:

*Loans rated 1-3B:* Loans in this category are considered "pass" rated with low to average risk.

*Loans rated 4:* Loans in this category are considered "special mention." These loans are currently protected, but exhibit conditions that have the potential for weakness. The borrower may be affected by unfavorable economic, market or other external conditions that may affect their ability to repay the debt. These may also include credits where there is deterioration of the collateral or have deficiencies which may affect our ability to collect on the collateral. This rating is consistent with the "Other Assets Especially Mentioned" category used by the FDIC.

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

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

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

## Notes to Unaudited Consolidated Financial Statements (continued)

Commercial loans are assigned an initial grade at the origination of the loan. After origination, the Bank has a quality control program performed by an independent third party. On a quarterly basis, all commercial, construction and residential loan relationships with individual loans of \$500,000 or more are assigned a risk rating. An in-depth review is performed on all relationships totaling \$850,000 or greater along with loans on the Bank's Watch List. Watch List loans are those loans that are more than two payments past due at the end of the quarter, loans for which the borrowing entity or sponsor has filed bankruptcy, loans rated four or higher in a previous review, impaired loans, troubled debt restructurings and loans past contractual maturity. Results of the independent loan review are reported to the Bank's Audit Committee on a quarterly basis and become the mechanism for monitoring the overall credit quality of the portfolio.

The following table presents the Bank's loans by risk rating as of December 31, 2017 and September 30, 2018:

Rating	Residential	Commercial	Construction	Commercial
	Real Estate	Real Estate		
(In Thousands)				
<b>December 31, 2017</b>				
1- 3B	\$ 685,563	\$ 993,988	\$ 122,715	\$ 221
4	3,343	4,579	—	—
5	367	—	—	—
	<u>\$ 689,273</u>	<u>\$ 998,567</u>	<u>\$ 122,715</u>	<u>\$ 221</u>
<b>September 30, 2018</b>				
1- 3B	\$ 707,700	\$ 1,127,747	\$ 114,705	\$ 148
4	1,379	1,695	—	—
5	364	331	—	—
	<u>\$ 709,443</u>	<u>\$ 1,129,773</u>	<u>\$ 114,705</u>	<u>\$ 148</u>

For home equity and consumer loans, management uses delinquency reports as the key credit quality indicator.

### NOTE 7: RECENT ACCOUNTING PRONOUNCEMENTS

#### Accounting Standards Issued But Yet Not Adopted

The following identifies ASUs applicable to the Bank that have been issued but are not yet effective:

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. This Update is intended to improve financial reporting about leasing transactions and the key provision impacting the Bank is the requirement for a lessee to record a right-to-use asset and a liability representing the obligation to make lease payments for long-term operating leases. In July 2018, the FASB issued ASU 2018-11, *Leases (Topic 842) Targeted Improvements*, which reduces the transition requirements for ASU 2016-02, allowing companies to elect not to restate comparative periods in transition and to recognize the effects of ASU 2016-02 as a cumulative-effect adjustment to retained earnings as of the adoption date. These Updates will be effective for fiscal years beginning after December 15, 2018, including interim periods. It is expected that assets and liabilities will increase based on the present value of remaining lease payments for leases in place at the adoption date; however, based on the current level of long-term leases in place, this is not expected to be material to the Bank's results of operations or financial position.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326)*. This Update requires entities to measure expected credit losses based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. Credit losses on available-for-sale debt securities should be measured in a manner similar to current GAAP. However, the amendments in this Update require that credit losses be presented as an allowance rather than as a write down. The Update will be effective for fiscal years beginning after December 15, 2019, including interim periods. Management is evaluating the provisions of the Update and will closely monitor developments and additional guidance to determine the potential impact on the Bank's consolidated financial statements. The Bank is currently testing an updated model to comply with ASU 2016-13.

## Notes to Unaudited Consolidated Financial Statements (concluded)

### Recently Adopted Accounting Principles Previously Disclosed

In addition to ASU 2016-01 and ASU 2018-13, which were discussed previously in Notes 4 and 5, the Bank adopted the following ASUs effective January 1, 2018:

- ASU 2014-09, Revenue from Contracts with Customers (Topic 606)
- ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments
- ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash
- ASU 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting

The adoption of these accounting standards did not have a material impact on the Bank's consolidated financial statements.

### NOTE 8: SUBSEQUENT EVENTS

The Bank has evaluated subsequent events through November 6, 2018, which is the date the financial statements were available to be issued. The fair value of the Bank's equity securities portfolio has declined since the interim balance sheet date of September 30, 2018. Based on the market prices as of the close of November 5, 2018, the fair value of the Bank's equity securities has declined by \$2.9 million on a pre-tax basis. This decline is primarily concentrated in the financial services sector, where the Bank has long-standing concentrated holdings in banks, diversified insurers, payment networks, and ratings agencies. The Bank only makes equity investments where there is the prospect for long-term investment.

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

### Cautionary Note Regarding Forward-Looking Statements

The following discussion of the financial condition and results of operations of the Bank should be read in conjunction with the Consolidated Financial Statements and Notes thereto included elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2017. Matters discussed in this Quarterly Report on Form 10-Q and in our public disclosures, whether written or oral, relating to future events or our future performance, including any discussion, expressed or implied, of our anticipated growth, operating results, future earnings per share, plans and objectives, contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are often identified by the words “believe,” “plan,” “estimate,” “project,” “target,” “continue,” “intend,” “expect,” “future,” “anticipate,” and similar expressions that are not statements of historical fact. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict, including changes in political and economic climate, interest rate fluctuations and competitive product and pricing pressures within the Bank’s market, bond market fluctuations, personal and corporate customers’ bankruptcies and inflation. Our actual results and timing of certain events could differ materially from those anticipated in these forward-looking statements as a result of certain factors including, but not limited to, those set forth under “Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q and in our other public filings with the FDIC. It is routine for internal projections and expectations to change as the year or each quarter in the year progresses and, therefore, it should be clearly understood that all forward-looking statements and the internal projections and beliefs upon which we base our expectations included in this Quarterly Report on Form 10-Q are made only as of the date of this Quarterly Report on Form 10-Q and may change. While we may elect to update forward-looking statements at some point in the future, we do not undertake any obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

### Note on Core Return on Average Equity and Core Return on Average Assets

Effective January 1, 2018, the Bank adopted FASB ASU 2016-01, *Financial Instruments – Overall, (Subtopic 825-10)*. Consequently, beginning January 1, 2018, equity securities (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are measured at fair value with changes in fair value recognized in the Consolidated Statements of Net Income, regardless of whether such gains and losses are realized, and included in the other income category. This change affects the Bank’s portfolio of marketable equity securities, which includes common equity securities and a mutual fund which invests in securities which qualify for Community Reinvestment Act securities test. This portfolio primarily includes common equity investments, which the Bank views as long-term partnership interests in operating companies. Consequently the Bank does not view the quarterly fluctuation in market value as indicative of the change in the intrinsic value of these portfolio holdings. The performance of these holdings should be evaluated on the basis of their contribution to growth in book value per share over time, not via quarterly adjustments to net income. Consistent with this view, beginning the first quarter of 2018, “Management's Discussion and Analysis of Financial Condition and Results of Operations” incorporates core net income, core return on average equity and core return on average assets, non-GAAP measurements which exclude the after-tax effect of gain (loss) on equity securities, both realized and unrealized.

## INTRODUCTION

Net income for the quarter ended September 30, 2018 was \$8,848,000 or \$4.15 per share basic and \$4.05 per share diluted as compared to \$6,484,000 or \$3.04 per share basic and \$2.97 per share diluted in earnings for the third quarter of 2017. The Bank’s annualized return on average equity for the third quarter of 2018 was 17.06%, and the annualized return on average assets was 1.52% as compared to 14.60% and 1.21% for the same period in 2017. Excluding the after-tax gains on equity securities, both realized and unrealized, core net income for the third quarter of 2018 was \$8,424,000 or \$3.95 per share basic and \$3.85 per share diluted, representing an annualized core return on average equity of 16.24% and an annualized core return on average assets of 1.45%. This compares to core net income of \$6,484,000 or \$3.04 per share basic and \$2.97 per share diluted, representing an annualized core return on average equity of 14.60% and an annualized core return on average assets of 1.21% for the same period in 2017.

Net income for the nine months ended September 30, 2018 was \$25,735,000 or \$12.07 per share basic and \$11.77 per share diluted as compared to \$19,066,000 or \$8.94 per share basic and \$8.75 per share diluted for the same period last year. The Bank’s annualized return on average equity for the first nine months of 2018 was 17.17%, and the annualized return on average assets was 1.49% as compared to 14.81% and 1.22% for the same period in 2017. Excluding the after-tax gains on equity securities, both realized and unrealized, core net income for the nine months ended September 30, 2018 was \$24,729,000 or \$11.60 per share basic and \$11.31 per share diluted, representing an annualized core return on average equity of 16.50% and an annualized core return on average assets of 1.43%. This compares to core net income of \$19,017,000 or \$8.92 per share basic and \$8.72 per share diluted, representing an annualized core return on average equity of 14.77% and an annualized core return on average assets of 1.22% for the same period in 2017.

Balance sheet growth was satisfactory in the first nine months of 2018, as deposits increased by \$209.3 million from December 31, 2017 and \$266.6 million from September 30, 2017, representing 19% annualized growth year-to-date and 18% growth from September 30, 2017. This growth reflected modest growth in retail and business deposits, as well as the use of more attractively priced wholesale deposits in lieu of comparable Federal Home Loan Bank (“FHLB”) advances. Net loans increased by \$142.4 million from December 31, 2017 and \$206.6 million from September 30, 2017, representing 10% annualized growth year-to-date and 12% growth from September 30, 2017. Total assets increased by \$85.8 million from December 31, 2017 and \$155.4 million from

September 30, 2017, representing 5% annualized growth year-to-date and 7% growth from September 30, 2017. Stockholders' equity increased to \$209.7 million as of September 30, 2018, representing 17% annualized growth year-to-date and a 17% increase from September 30, 2017. Book value per share increased to \$98.35 per share at September 30, 2018 from \$87.29 per share at December 31, 2017 and \$84.27 per share at September 30, 2017.

Since September 30, 2017, the Bank declared dividends of \$1.73 per share, which included a \$0.34 special dividend declared in the fourth quarter of 2017.

Key credit and operational metrics remained strong in the third quarter of 2018. At September 30, 2018, non-performing assets totaled 0.02% of total assets, compared with 0.07% at December 31, 2017 and 0.05% at September 30, 2017. Non-performing loans as a percentage of the total loan portfolio totaled 0.02% at September 30, 2018, as compared to 0.09% at December 31, 2017 and 0.06% at September 30, 2017. The efficiency ratio was 29.17% for the third quarter of 2018, as compared to 29.37% in the same period last year. Non-interest expense (annualized) as a percentage of average assets fell to 0.86% for the third quarter of 2018, as compared to 0.90% for the same period last year. The efficiency ratio was 29.84% for the first nine months of 2018, as compared to 30.58% in the same period last year. Non-interest expense (annualized) as a percentage of average assets fell to 0.88% for the first nine months of 2018, as compared to 0.94% for the same period last year. These metrics reflect the Bank's continued focus on credit quality and disciplined expense controls.

The Bank continues to exceed all of the minimum regulatory capital requirements.

## **RESULTS OF OPERATIONS**

### **COMPARISON OF THE THREE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017**

#### **General**

The Bank reported net income of \$8.8 million for the quarter ended September 30, 2018 as compared to \$6.5 million for the quarter ended September 30, 2017. Net income was \$4.15 per share basic and \$4.05 per share diluted for the quarter ended September 30, 2018 as compared with \$3.04 per share basic and \$2.97 per share diluted for the same period in 2017. Earnings for the quarter ended September 30, 2018 were positively impacted by an increase of \$668,000 in net interest income, an increase of \$540,000 in non-interest income, a \$208,000 decrease in the provision for loan losses and a decrease of \$1.1 million in the income tax provision, offset by a \$161,000 increase in operating expenses.

The Bank's annualized return on average equity for the quarter ended September 30, 2018 was 17.06%, and the annualized return on average assets was 1.52%. The Bank's annualized return on average equity for the quarter ended September 30, 2017 was 14.60%, and the annualized return on average assets was 1.21%.

Excluding the after-tax gains on equity securities, both realized and unrealized, core net income for the third quarter of 2018 was \$8.4 million or \$3.95 per share basic and \$3.85 per share diluted, representing an annualized core return on average equity of 16.24% and an annualized core return on average assets of 1.45%. This compares to net income of \$6.5 million or \$3.04 per share basic and \$2.97 per share diluted, representing an annualized core return on average equity of 14.60% and an annualized core return on average assets of 1.21% for the same period in 2017.

#### **Net Interest Income**

Net interest income was \$16.7 million for the third quarter of 2018 and \$16.1 million for the third quarter of 2017. The \$668,000 increase was due to a \$172.4 million, or 8%, increase in average interest-earning assets, partially offset by a 22 basis points decline in the weighted average spread in the three months ended September 30, 2018, compared to the same period in 2017. For the quarter ended September 30, 2018, the weighted average rate spread and net interest margin were 2.67% and 2.93%, respectively, compared to 2.89% and 3.04%, respectively, for the quarter ended September 30, 2017. Average interest-bearing liabilities increased by \$118.7 million, or 7%, and the rate paid on interest-bearing liabilities increased by 56 basis points.

Interest and dividend income increased by \$3.7 million to \$24.3 million for the third quarter of 2018 as compared to \$20.7 million for the third quarter of 2017. The yield on total interest-earning assets was 4.25% for the quarter ended September 30, 2018 as compared to 3.91% for the quarter ended September 30, 2017.

Interest income on loans increased \$3.3 million when comparing the two periods, primarily resulting from an 14% increase in average loan balances combined with a 13 basis points increase in yield. Long-term rates have increased slightly from recent historic lows; while, starting in December 2015, the Federal Reserve began increasing the overnight rate, which has also impacted many short-term rates. This has allowed the Bank to gradually increase the interest rate on new loan originations, particularly construction loan rates. Term funding for stabilized commercial real estate, particularly multifamily properties, remains highly competitive, and the Bank's ability to pass on increases in the cost of funds has been more limited for these loans.

Securities, Federal Home Loan Bank stock and short-term investments, which includes the Bank's cash holdings at the Federal Reserve, accounted for 14% of the total average interest-earning assets for the quarter ended September 30, 2018, as compared to 18% for the same period in 2017. This decrease was driven by the Bank using a portion of its cash balances to reduce outstanding FHLB advances and listing services time deposits during the first nine months of 2018, in order to minimize the carrying cost of its on-balance sheet liquidity. Income for these categories combined increased \$345,000 when comparing the two periods, primarily due to higher yields, partially offset by a \$68.0 million decline in average balances. During the last quarter of 2017 and the first nine months of 2018, the Bank made additional purchases of marketable equity securities, some of which pay cash dividends. Additionally,

the Federal Home Loan Bank has continued to pay an elevated dividend on the Bank's stock investment. At the same time, the interest on excess reserves paid by the Federal Reserve has increased over this period.

The average rate on interest-bearing liabilities increased to 1.58% for the third quarter of 2018 from 1.02% for the comparable quarter of 2017. Total interest expense increased by \$3.0 million when comparing the quarters ended September 30, 2018 and 2017 due to increases in the total average balances combined with higher interest rates on deposits and borrowings.

Interest expense on deposits increased by \$2.4 million when comparing the two periods, due to an increase of \$238.0 million in average interest-bearing deposits combined with a 51 basis points increase in the weighted average rate. Beginning in 2015, the Bank has seen increasing market pressure to raise rates on term deposits and some core deposits, driven largely by strong loan demand in the Bank's market area, changes in the economic environment and increasing short term rates. Given the current economic environment, management believes it is likely that deposit market rates will continue to increase throughout 2018.

Interest expense on borrowed funds for the third quarter of 2018 increased \$552,000 as compared to the same quarter in 2017, primarily due to a 91 basis points increase in the weighted average rate, partially offset by a \$119.3 million decrease in average outstanding balances. During the third quarter of 2018, the Bank increased the use of more attractively priced wholesale deposits in lieu of short-term Federal Home Loan Bank advances. During the second and third quarter of 2017, the FHLB called \$330 million of long term option advances taken during 2016, and in the first nine months of 2018, the FHLB called \$85 million of option advances taken during the first half of 2017, all of which had favorable rates and were replaced by shorter term advances at higher rates.

The following tables detail components of net interest income and yields/rates on average earning assets/liabilities.

	Three Months Ended September 30,					
	2017			2018		
	AVERAGE BALANCE	INTEREST	YIELD/ RATE (8)	AVERAGE BALANCE	INTEREST	YIELD/ RATE (8)
<i>(Dollars in thousands)</i>						
<i>(Unaudited)</i>						
Loans (1) (2)	\$ 1,733,650	\$ 19,211	4.43 %	\$ 1,973,987	\$ 22,523	4.56 %
Securities (3) (4)	50,696	396	3.12	52,166	503	3.86
Federal Reserve and other short-term investments	332,367	1,079	1.30	262,943	1,317	2.00
Total interest-earning assets	2,116,713	20,686	3.91	2,289,096	24,343	4.25
Other assets	35,471			38,380		
Total assets	\$ 2,152,184			\$ 2,327,476		
Interest-bearing deposits (5)	\$ 1,265,731	2,854	0.90	\$ 1,503,771	5,291	1.41
Borrowed funds	532,836	1,754	1.32	413,497	2,306	2.23
Total interest-bearing liabilities	1,798,567	4,608	1.02	1,917,268	7,597	1.58
Demand deposits	171,680			197,838		
Other liabilities	4,242			4,927		
Total liabilities	1,974,489			2,120,033		
Stockholders' equity	177,695			207,443		
Total liabilities and stockholders' equity	\$ 2,152,184			\$ 2,327,476		
Net interest income		\$ 16,078			\$ 16,746	
Weighted average spread			2.89 %			2.67 %
Net interest margin (6)			3.04 %			2.93 %
Average interest-earning assets to average interest-bearing liabilities (7)			117.69 %			119.39 %

- (1) Before allowance for loan losses.
- (2) Includes non-accrual loans.
- (3) Excludes the impact of the average net unrealized gain or loss on securities.
- (4) Includes Federal Home Loan Bank stock.
- (5) Includes mortgagors' escrow accounts.
- (6) Net interest income divided by average total interest-earning assets.
- (7) Total interest-earning assets divided by total interest-bearing liabilities.
- (8) Annualized.

The following table presents information regarding changes in interest and dividend income and interest expense of the Bank for the periods indicated. For each category, information is provided with respect to the change attributable to volume (change in volume multiplied by old rate) and the change in rate (change in rate multiplied by old volume). The change attributable to both volume and rate is allocated proportionally to the change due to volume and rate.

**Three Months Ended September 30, 2018  
Compared to the Three Months Ended September 30, 2017  
Increase (Decrease)**

	Due to		Total
	Volume	Rate	
(In Thousands)			
Interest and dividend income:			
Loans	\$ 2,728	\$ 584	\$ 3,312
Securities and FHLB stock	12	95	107
Federal Reserve and other short-term investments	(259)	497	238
Total interest and dividend income	<u>2,481</u>	<u>1,176</u>	<u>3,657</u>
Interest expense:			
Deposits	612	1,825	2,437
Borrowed funds	(459)	1,011	552
Total interest expense	<u>153</u>	<u>2,836</u>	<u>2,989</u>
Net interest income	<u>\$ 2,328</u>	<u>\$ (1,660)</u>	<u>\$ 668</u>

### Provision for Loan Losses

At September 30, 2018, the Bank's review of the allowance for loan losses concluded that a balance of \$13.6 million was adequate to provide for losses based upon evaluation of size and risk in the loan portfolio. During the third quarter of 2018, the Bank provided \$350,000 to the allowance for loan loss balance at September 30, 2018. The Bank recorded \$1,000 of net recoveries for the third quarter of 2018, as compared to \$1,000 net charge-offs for the same period last year. Due to the growth in the loan portfolio, the Bank added to the allowance for loan loss balance during the three months ended September 30, 2018. Comparably, for the three months ended September 30, 2017, the Bank's evaluation of the balance of the allowance for loan losses indicated the need for a provision of \$558,000.

See Notes 1 and 6 to the accompanying interim consolidated financial statements and "Loans and Foreclosed Real Estate" included in this Management's Discussion and Analysis for additional information pertaining to the allowance for loan losses.

### Other Income

Other income is comprised of gains on equity securities, net, customer service fees on deposits, increases in the cash surrender value of bank-owned life insurance policies and miscellaneous income. Beginning in 2018, unrealized gains or losses resulting from changes in fair value of the Bank's equity securities are recognized in other income, included in gain on equity securities, net. Total other income was \$867,000 for the quarter ended September 30, 2018 compared to \$327,000 for the same period in 2017. In the third quarter of 2018, the Bank recorded net gains totaling \$544,000 on equity securities, including \$435,000 of unrealized gains on equity securities held at the end of the period and \$109,000 of gains recognized on equity securities sold during the period. The Bank recorded no gains or losses on sales of investment securities in the third quarter of 2017.

Customer service fees on deposits was stable when compared to the same period in 2017. Over the last few years, there has been a decline in deposit account transaction fees as the Bank has eliminated many fees on deposit products to simplify offerings and enhance the value proposition of our consumer and business checking accounts to customers. There has been an offsetting trend in debit card interchange fees, as the size of the Bank's checking account base has increased and the Bank has benefited from a secular trend towards increasing use of debit cards in payments. The Bank's strategy does not rely on generating substantial non-interest fee-based revenue from our deposit accounts.

An increase in the cash surrender value of life insurance also contributed to other income during the third quarter of 2018 and 2017. The Bank held \$12.4 million in life insurance policies at September 30, 2018 as compared to \$12.2 million at September 30, 2017. The policies accrete at a variable rate of interest with minimum stated guaranteed rates and related income was down \$2,000 when comparing the three months ended September 30, 2018 and 2017.

### Operating Expenses

Total operating expenses were \$5.0 million, or an annualized 0.86% of average total assets for the quarter ended September 30, 2018, as compared to \$4.8 million, or an annualized 0.90% of average total assets, for the same quarter of 2017. Operating expenses include salaries and employee benefits, occupancy and equipment, data processing, deposit insurance, marketing, foreclosure, and other general and administrative expenses.

Salaries and employee benefits expenses increased \$138,000, or 5%, when compared to the same period in 2017, primarily due to annual merit-based salary increases and an increase in staffing levels in our Specialized Deposit Group.



Occupancy and equipment expenses decreased \$1,000 to \$421,000, primarily due to lower equipment service and utility expenses, offset by higher maintenance and real estate tax expenses. This line also includes income collected from two rental properties held by the Bank. When the Bank developed its Nantucket location in 2013, it built a residential apartment unit on the 2nd floor for rental purposes. In 2016, the Bank completed a residential apartment unit on the 3rd floor of the building for rental purposes. Rental income was \$2,000 lower in the third quarter of 2018, when compared to the same period last year. The Bank continues to analyze how to maximize value in its real estate portfolio.

Data processing expenses for the third quarter 2018 increased by \$32,000, or 10%, when compared to the same period in 2017, driven primarily by higher data processing charges associated with improvements made to the Bank's systems and volume increases. Technology spending is focused on three primary objectives: delivering new or improved customer experience, reducing costs through simplification and automation of internal processes, and securing customer and Bank confidential information.

Deposit insurance expense decreased by \$21,000, or 8%, when compared to the same period in 2017. The decrease in expense is due to a lower assessed rate, partially offset by an increase in the size of the balance sheet, as this charge is calculated based on total assets. The assessment rate is determined based on several factors, including capitalization, asset growth, earnings, use of brokered deposits and level of non-performing assets, among others. The Bank carefully manages its balance sheet to control the insurance expense associated with excess liquidity.

Marketing expenses increased by \$51,000, or 60%, to \$136,000 for the third quarter of 2018, due primarily to marketing efforts for the Bank's Commercial Real Estate and Specialized Deposit Groups. The Bank continues to carefully allocate resources to advertising related activities.

Foreclosure related expenses decreased by \$44,000 when comparing the quarter ended September 30, 2018 to the same period in 2017, and the Bank had no net foreclosure expense in the third quarter of 2018. The Bank recovered expenses incurred in connection with delinquent loans in the third quarter of 2018. At September 30, 2018, December 31, 2017 and September 30, 2017, the Bank did not hold any foreclosed properties. This category includes expenses associated with the foreclosure process, such as legal, appraisal, insurance and other related foreclosure expenses.

Other general and administrative expenses, which include director fees, supplies, deposit related losses and audit-related expenses, among others, increased by \$6,000, or 1%, when comparing the two periods, reflecting higher loan related and legal expenses partially offset by lower miscellaneous expenses.

#### **Income Taxes**

The Bank recognizes income taxes under the asset and liability method in which deferred tax assets and liabilities are established for the temporary difference between the accounting basis and the tax basis of the Bank's assets and liabilities at enacted tax rates expected to be in effect when the amounts related to such temporary differences are realized or settled. The Bank's deferred tax asset is reviewed quarterly by management as to the realizability of such asset.

During the third quarter of 2018, the Bank recorded \$3.4 million, or 28.0% of pre-tax income, in tax expense as compared to \$4.6 million, or 41.2%, for the same quarter in 2017. The effective tax rate was lower in the third quarter of 2018 when compared to the same period of 2017 as a result of the Tax Cut and Jobs Act enacted on December 22, 2017, which reduced the corporate federal income tax rate from 35% to 21% effective January 1, 2018. The tax rate was impacted positively by the unrealized gains on equity securities recognized during the third quarter of 2018, as these securities are held at a tax-advantaged subsidiary.

## RESULTS OF OPERATIONS

### COMPARISON OF THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017

#### General

The Bank reported net income of \$25.7 million for the nine months ended September 30, 2018 as compared to \$19.1 million for the nine months ended September 30, 2017. Net income was \$12.07 per share basic and \$11.77 per share diluted for the first nine months of 2018 as compared to \$8.94 per share basic and \$8.75 per share diluted for the same period in 2017. Earnings for the nine months ended September 30, 2018 were positively impacted by an increase of \$2.5 million in net interest income, an increase of \$1.2 million in non-interest income, a \$48,000 decrease in the provision for loan losses and a decrease of \$3.3 million in the income tax provision, partially offset by a \$387,000 increase in operating expenses.

The Bank's annualized return on average equity for the first nine months of 2018 was 17.17%, and the annualized return on average assets was 1.49%. The Bank's annualized return on average equity for the first nine months of 2017 was 14.81%, and the annualized return on average assets was 1.22%.

Excluding the after-tax gains on equity securities, both realized and unrealized, core net income for the nine months ended September 30, 2018 was \$24.7 million or \$11.60 per share basic and \$11.31 per share diluted, representing an annualized core return on average equity of 16.50% and an annualized core return on average assets of 1.43%. This compares to core net income of \$19.0 million or \$8.92 per share basic and \$8.72 per share diluted, representing an annualized core return on average equity of 14.77% and an annualized core return on average assets of 1.22% for the same period in 2017.

#### Net Interest Income

Net interest income was \$49.7 million for the first nine months of 2018 as compared to \$47.2 million for the first nine months of 2017. The \$2.5 million increase was due to a \$214.0 million, or 10%, increase in average interest-earning assets in the first nine months of 2018 compared to the same period in 2017, partially offset by a 21 basis points decline in the weighted average spread. For the first nine months of 2018, the Bank's weighted average rate spread and net interest margin were 2.72% and 2.93%, respectively, as compared to 2.93% and 3.08%, respectively, for the same period in 2017. Average interest-bearing liabilities increased by \$161.5 million, or 9%, and the rate paid on interest-bearing liabilities increased by 46 basis points.

Interest and dividend income increased by \$10.3 million to \$69.6 million for the first nine months of 2018 as compared to \$59.3 million for the first nine months of 2017. The yield on total interest-earning assets was 4.11% for the nine months ended September 30, 2018 as compared to 3.86% for the nine months ended September 30, 2017.

Interest income on loans increased \$8.6 million when comparing the two periods, primarily resulting from a 14% increase in average loans combined with a four basis points increase in overall yield. Long-term rates have increased slightly from recent historic lows; while, starting in December 2015, the Federal Reserve began increasing the overnight rate, which has also impacted many short-term rates. This has allowed the Bank to gradually increase the interest rate on new loan originations, particularly construction loan rates. Term funding for stabilized commercial real estate, particularly multifamily properties, remains highly competitive, and the Bank's ability to pass on increases in the cost of funds has been more limited for these loans.

Securities, Federal Home Loan Bank stock and short-term investments, which includes the Bank's cash holdings at the Federal Reserve, accounted for 15% of the total average interest-earning assets for the nine months ended September 30, 2018 and 18% for the same period in 2017. This decrease was driven by the Bank using a portion of its cash balances to reduce outstanding FHLB advances and listing services time deposits during the first nine months of 2018, in order to minimize the carrying cost of its on-balance sheet liquidity. Income for these categories combined increased \$1.7 million when comparing the two periods, primarily due to higher yields, partially offset by a \$28.6 million decline in average balances. During the last quarter of 2017 and the first nine months of 2018, the Bank made additional purchases of marketable equity securities, some of which pay cash dividends. Additionally, the Federal Home Loan Bank has continued to pay an elevated dividend on the Bank's stock investment. At the same time, the interest on excess reserves paid by the Federal Reserve has increased over this period.

The average rate on interest-bearing liabilities increased to 1.39% for the first nine months of 2018 from 0.93% for the comparable period in 2017. Total interest expense increased by \$7.8 million when comparing the nine months ended September 30, 2018 and 2017 due to increases in the total average balances combined with higher interest rates on deposits and borrowings.

Interest expense on deposits increased by \$5.1 million when comparing the two periods, due to an increase of \$177.6 million in average interest-bearing deposits along with a 37 basis points increase in the weighted average rate. Certificate balances increased by \$201.3 million from December 31, 2017 to September 30, 2018 and non-certificate accounts increased by \$8.0 million during the same period. Non-certificate accounts represent 49.1% of total deposits at September 30, 2018 compared to 55.4% at December 31, 2017. Beginning in 2015, the Bank has seen increasing market pressure to raise rates on term deposits and some core deposits, driven largely by strong loan demand in the Bank's market area, changes in the economic environment and increasing short term rates. Given the current economic environment, management believes it is likely that deposit market rates will continue to increase in 2018.

Interest expense on borrowed funds for the first nine months of 2018 increased \$2.7 million as compared to the same period in 2017, due primarily to an increase of 79 basis points in the weighted average rate, partially offset by a \$16.0 million decrease in the average outstanding balances. During the first nine months of 2018, the Bank increased the use of more attractively priced wholesale deposits in lieu of short-term Federal Home Loan Bank advances. During the second and third quarter of 2017, the FHLB called \$330 million of long term option advances taken during 2016, and in the first nine months of 2018, the FHLB called \$85 million of option

advances taken during the first half of 2017, all of which had favorable rates and were replaced by shorter term advances at higher rates.

The following table details components of net interest income and yields/rates on average earning assets/liabilities.

	Nine Months Ended September 30,					
	2017			2018		
	AVERAGE BALANCE	INTEREST	YIELD/ RATE (8)	AVERAGE BALANCE	INTEREST	YIELD/ RATE (8)
<i>(Dollars in thousands)</i>						
<i>(Unaudited)</i>						
Loans (1) (2)	\$ 1,675,563	\$ 55,663	4.43 %	\$ 1,918,239	\$ 64,306	4.47 %
Securities (3) (4)	49,202	1,116	3.02	52,870	1,487	3.75
Federal Reserve and other short-term investments	321,335	2,515	1.04	289,018	3,814	1.76
Total interest-earning assets	2,046,100	59,294	3.86	2,260,127	69,607	4.11
Other assets	35,261			38,668		
Total assets	\$ 2,081,361			\$ 2,298,795		
Interest-bearing deposits (5)	\$ 1,252,938	8,084	0.86	\$ 1,430,524	13,202	1.23
Borrowed funds	491,114	4,017	1.09	475,050	6,689	1.88
Total interest-bearing liabilities	1,744,052	12,101	0.93	1,905,574	19,891	1.39
Demand deposits	161,037			188,441		
Other liabilities	4,613			4,954		
Total liabilities	1,909,702			2,098,969		
Stockholders' equity	171,659			199,826		
Total liabilities and stockholders' equity	\$ 2,081,361			\$ 2,298,795		
Net interest income		\$ 47,193			\$ 49,716	
Weighted average spread			2.93 %			2.72 %
Net interest margin (6)			3.08 %			2.93 %
Average interest-earning assets to average interest-bearing liabilities (7)			117.32 %			118.61 %

- (1) Before allowance for loan losses.
- (2) Includes non-accrual loans.
- (3) Excludes the impact of the average net unrealized gain or loss on securities.
- (4) Includes Federal Home Loan Bank stock.
- (5) Includes mortgagors' escrow accounts.
- (6) Net interest income divided by average total interest-earning assets.
- (7) Total interest-earning assets divided by total interest-bearing liabilities.
- (8) Annualized.

The following table presents information regarding changes in interest and dividend income and interest expense of the Bank for the periods indicated. For each category, information is provided with respect to the change attributable to volume (change in volume multiplied by old rate) and the change in rate (change in rate multiplied by old volume). The change attributable to both volume and rate is allocated proportionally to the change due to volume and rate.

	Nine Months Ended September 30, 2018		
	Compared to the Nine Months Ended September 30, 2017		
	Increase (Decrease)		
	Due to		Total
	Volume	Rate	
(In thousands)			
Interest and dividend income:			
Loans	\$ 8,131	\$ 512	\$ 8,643
Securities and FHLB stock	88	283	371
Federal Reserve and other short-term investments	(275)	1,574	1,299
Total interest and dividend income	7,944	2,369	10,313
Interest expense:			
Deposits	1,268	3,850	5,118
Borrowed funds	(136)	2,808	2,672
Total interest expense	1,132	6,658	7,790
Net interest income	\$ 6,812	\$ (4,289)	\$ 2,523

## **Provision for Loan Losses**

At September 30, 2018, the Bank's review of the allowance for loan losses concluded that a balance of \$13.6 million was adequate to provide for losses based upon evaluation of size and risk in the loan portfolio. During the first nine months of 2018, the Bank provided \$1.1 million to the allowance for loan loss balance at September 30, 2018. The Bank recorded \$1,000 in net recoveries for the first nine months of 2018, as compared to zero net charge-offs for the same period last year. The growth and composition of the loan portfolio warranted additional provisions to the Bank's allowance for loan losses. Comparably, for the nine months ended September 30, 2017, the Bank's evaluation of the balance of the allowance for loan losses also indicated the need for a provision of \$1.1 million.

See Notes 1 and 6 to the accompanying interim consolidated financial statements and "Loans and Foreclosed Real Estate" included in this Management's Discussion and Analysis for additional information pertaining to the allowance for loan losses.

## **Other Income**

Other income is comprised of gains on equity securities, net, customer service fees on deposits, increases in the cash surrender value of bank-owned life insurance policies and miscellaneous income. Beginning in 2018, unrealized gains or losses resulting from changes in fair value of the Bank's equity securities are recognized in other income, included in gain equity securities, net. Total other income was \$2.3 million for the first nine months of 2018 compared to \$1.1 million for the same period in 2017. In the first nine months of 2018, the Bank recorded gains totaling \$1.3 million on equity securities, including \$1.2 million of unrealized gains on equity securities held at the end of the period and \$124,000 gains recognized on equity securities sold during the period. The Bank recorded gains on sales of investment securities of \$77,000 in the first nine months of 2017.

Customer service fees on deposits decreased by \$24,000 in the first nine months of 2018 compared to the same period in 2017. Over the last few years, there has been a decline in deposit account transaction fees as the Bank has eliminated many fees on deposit products to simplify offerings and enhance the value proposition of our consumer and business checking accounts to customers. There has been an offsetting trend in debit card interchange fees, as the size of the Bank's checking account base has increased and the Bank has benefited from a secular trend towards increasing use of debit cards in payments. The Bank's strategy does not rely on generating substantial non-interest fee-based revenue from our deposit accounts.

An increase in the cash surrender value of life insurance also contributed to other income during the first nine months of 2018 and 2017. The Bank held \$12.4 million in life insurance policies at September 30, 2018 as compared to \$12.2 million at September 30, 2017. The policies accrete at a variable rate of interest with minimum stated guaranteed rates and related income was down \$3,000 when comparing the two periods.

## **Operating Expenses**

Total operating expenses were \$15.1 million, or an annualized 0.88% of average total assets, for the nine months ended September 30, 2018 as compared to \$14.7 million, or an annualized 0.94% of average total assets, for the same period of 2017. Operating expenses include salaries and employee benefits, occupancy and equipment, data processing, deposit insurance, marketing, foreclosure, and other general and administrative expenses.

Salaries and employee benefits expenses increased by \$289,000, or 3%, when compared to the same period in 2017, due to annual merit-based salary increases.

Occupancy and equipment expenditures increased by \$8,000, or 1%, primarily due to lower rental income and higher utility, rent and maintenance expenses, partially offset by declining depreciation expenses and lower equipment service expenses. The rental income relates to two rental properties held by the Bank. When the Bank developed its Nantucket location in 2013, it built a residential apartment unit on the 2nd floor for rental purposes. In 2016, the Bank completed a residential apartment unit on the 3rd floor of the building for rental purposes. Rental income was lower by \$22,000 in the first nine months of 2018, when compared to the same period last year. The Bank continues to analyze how to maximize value in its real estate portfolio.

Data processing expenses for the first nine months of 2018 increased by \$113,000, or 12%, when compared to the same period in 2017, driven primarily by higher data processing charges associated with improvements made to the Bank's systems and volume increases. Technology spending is focused on three primary objectives: delivering new or improved customer experience, reducing costs through simplification and automation of internal processes, and securing customer and Bank confidential information.

Deposit insurance expense decreased \$38,000, or 5%, from \$795,000 for the first nine months of 2017 to \$757,000 in the first nine months of 2018. The decrease in expense is due to a lower assessed rate, partially offset by an increase in the size of the balance sheet, as this charge is calculated based on total assets. The assessment rate is determined based on several factors, including capitalization, asset growth, earnings, use of brokered deposits and level of non-performing assets, among others. The Bank carefully manages its balance sheet to control the insurance expense associated with excess liquidity.

Marketing expenses increased by \$103,000, or 32%, to \$428,000 for the nine months ended September 30, 2018, due primarily to marketing efforts for the Bank's Commercial Real Estate and Specialized Deposit Groups. The Bank continues to carefully allocate resources to advertising related activities.

Foreclosure related expenses decreased by \$55,000 when comparing the nine months ended September 30, 2018 to the same period in 2017, and the Bank had no net foreclosure expense in the first nine months of 2018. The decrease is primarily due to higher

recovery of expenses in connection with the resolution delinquent loans in the first nine months of 2018, partially offset by a gain of \$23,000 on sale of foreclosed property recorded in the first nine months of 2017. At September 30, 2018, December 31, 2017 and September 30, 2017, the Bank did not hold any foreclosed properties. During the first nine months of 2017, the Bank added one property and subsequently sold it. This category includes expenses associated with the foreclosure process, such as legal, appraisal, insurance and other related foreclosure expenses.

Other expenses, which include director fees, supplies, deposit related losses and audit-related expenses, among others, decreased \$33,000, or 2%, when comparing the two periods, reflecting lower loan related and miscellaneous expenses.

### **Income Taxes**

The Bank recognizes income taxes under the asset and liability method in which deferred tax assets and liabilities are established for the temporary difference between the accounting basis and the tax basis of the Bank's assets and liabilities at enacted tax rates expected to be in effect when the amounts related to such temporary differences are realized or settled. The Bank's deferred tax asset is reviewed quarterly by management as to the realizability of such asset.

During the first nine months of 2018, the Bank recorded \$10.1 million, or 28.1% of pre-tax income, in tax expense as compared to \$13.4 million, or 41.2%, for the same period in 2017. The effective tax rate was lower in the first nine months of 2018 when compared to the same period of 2017 as a result of the Tax Cut and Jobs Act enacted on December 22, 2017, which reduced the corporate federal income tax rate from 35% to 21% effective January 1, 2018. The lower tax rate was also a result of the unrealized gains on equity securities recognized during the first nine months of 2018, as these securities are held at a tax-advantaged subsidiary.

### **BALANCE SHEET ANALYSIS**

#### **COMPARISON AT SEPTEMBER 30, 2018 TO DECEMBER 31, 2017**

Assets totaled \$2.370 billion at September 30, 2018, as compared to \$2.285 billion at December 31, 2017, an increase of \$85.8 million, or 5% annualized. During the first nine months of 2018, the Bank used a portion of its cash balances to reduce outstanding Federal Home Loan Bank advances and listing service time deposits, in order to minimize the carrying cost of its on-balance sheet liquidity.

#### **Securities, Short-term Investments and FHLB Stock**

Securities were \$39.7 million at September 30, 2018, an increase of \$5.4 million when compared to \$34.3 million at December 31, 2017, reflecting equity security purchases completed during the last quarter of 2017 and the first nine months of 2018, partially offset by sales. There were no sales, maturities or calls of debt securities and principal paydowns were immaterial.

At December 31, 2017, the Bank's entire securities portfolio was classified as available for sale and reflected on the balance sheet at fair value with unrealized gains and losses, net of tax effect, excluded from earnings and reported in accumulated other comprehensive income ("AOCI"). The unrealized gain on securities available for sale, net of tax, was \$6.7 million at December 31, 2017 and was all related to equity securities. Beginning January 1, 2018, equity securities (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are measured at fair value with changes in fair value recognized in net income. On January 1, 2018, \$6.7 million of unrealized gains on equity securities available for sale held at December 31, 2017 were reclassified from AOCI to undivided profits as a cumulative-effect adjustment. At December 31, 2017 and September 30, 2018, there were no unrealized gains or losses on debt securities available for sale reported in accumulated other comprehensive income. The fair value of securities fluctuates with the movement of interest rates and equity markets. The primary driver in net unrealized gain on the securities portfolio is the fair value of the Bank's equity holdings.

At September 30, 2018, less than 1% of the securities were debt securities issued or guaranteed by government-sponsored enterprises. For the most part, these securities are offered at a fixed rate and term and at spreads above comparable U.S. Treasury issues.

At September 30, 2018, equity securities accounted for approximately 100% of the investment portfolio. At September 30, 2018, the Bank held a \$7.6 million investment in the CRA Fund, a mutual fund which invests in securities which qualify for Community Reinvestment Act ("CRA") securities test. Additionally, the portfolio included \$32.1 million in common equity securities. The Bank's common equity securities are not viewed as a source of liquidity and are managed to produce superior returns on capital over a longer time horizon. The Bank's process is focused on identifying businesses with strong returns on capital, owner-oriented management teams, good reinvestment opportunities or capital discipline, and reasonable valuations. The portfolio is concentrated in a relatively small number of investees in the financial services and technology areas, including other banks, diversified and specialized insurance companies, credit rating agencies, payment networks and a technology company. The Bank receives two sources of advantageous tax treatment through these investments. First, dividend distributions from these companies to the Bank are partially excluded from the Bank's taxable income due to the Dividends Received Deduction ("DRD"). Second, to the extent that these companies are capable of internal reinvestment at high rates of return or deploy capital via tax-advantaged repurchases, the deferred tax liability associated with any long-term unrealized gains on our investments constitutes an interest-free source of financing.

The Bank did not hold any FDIC-insured certificates of deposit issued by other financial institutions at September 30, 2018 and December 31, 2017. Occasionally, the Bank invests in such certificates due to the increase in yield over comparably-termed bonds issued by government-sponsored enterprises at time of purchase. Such investments are generally limited to the FDIC maximum insurance coverage of \$250,000 and, therefore, are insured in full by the FDIC.

As a member of the Federal Home Loan Bank of Boston, the Bank is required to hold a Membership Stock Investment plus an Activity-based Stock Investment in the FHLB, which is based primarily on the amount of FHLB borrowings. The Bank recorded dividends totaling \$1.1 million for the nine months ended September 30, 2018, as compared to \$752,000 for the same period in 2017. At September 30, 2018, the Bank held \$21.7 million in FHLB stock compared to \$27.1 million at December 31, 2017. The decrease was driven by the reduction of FHLB borrowings during the first nine months of 2018, as the Bank replaced a portion of its short-term FHLB advances with more attractively priced wholesale deposits.

### **Loans and Foreclosed Real Estate**

During the first nine months of 2018, net loans outstanding increased by \$142.4 million to \$1.976 billion, from \$1.834 billion at December 31, 2017, attributable primarily to originated loans of \$471.1 million, partially offset by payoffs and amortization. This includes \$56.9 million of commercial real estate loans originated in the Washington D.C. metropolitan area (“WMA”). Comparably, loan originations for the same period in 2017 were \$424.8 million, including \$43.0 million of commercial real estate loans originated in the WMA. Loans outstanding in the WMA at September 30, 2018 and December 31, 2017 were \$107.0 million and \$57.8 million, respectively. At September 30, 2018 and December 31, 2017, net loans outstanding represented 83% and 80% of assets, respectively. Mortgage loans continue to account for more than 99% of the loan portfolio.

**WMA:** The Bank began lending to commercial real estate borrowers in the WMA in November 2016, after two years of research and preparation, and the first WMA loan closed in early January 2017. The Bank identified the WMA as an attractive opportunity for three reasons. First, the region has favorable economic characteristics that will support long-term investments in commercial real estate. It is the capital of the world’s largest economy, it is an international economic gateway, it has the highest household median income of any of the nation’s major metropolitan areas, and it has a relatively high concentration of young people. Second, the commercial real estate product in the market bears significant similarity to Boston, characterized by high density, urban infill development, transit-oriented multifamily, and scarcity imposed by land supply and restrictions on vertical development. Third, we believe that the banking market in Washington, D.C. has experienced a level of consolidation and disruption that has left smaller and mid-sized real estate investors underserved as compared to the Boston market. Although we are new to this marketplace, we believe that our history as one of America’s oldest banks and our family management team provide stability and surety of execution that will be valued by our customers. We view this as an attractive opportunity for internal capital allocation and superior to geographically proximate, product-adjacent businesses like wealth management, insurance, or commercial-industrial lending in our home marketplace. The Bank is not originating any residential owner-occupied or commercial construction loans in the WMA at this time.

The Bank has approached prospective borrowers directly, via advertising programs and via intermediaries such as attorneys, accountants and mortgage brokers. The Bank also has existing Boston-based customers with real estate investment holdings in both markets. The Bank currently utilizes existing staff in the Commercial Real Estate Group with experience in the WMA, on a fly-away basis from our Main Office.

All underwriting and approval processes are identical to those utilized in the Boston marketplace and all loans are reviewed and approved by the Bank’s Executive Committee and when larger than \$1.5 million, by the Bank’s full Board of Directors. A member of the Executive Committee performs a site visit for every collateral property and the full Executive Committee performs collateral site visits at least twice annually. The Bank uses one Arlington, VA-based law firm to advise on all of its transactional needs, with oversight on each individual transaction by the Bank’s primary real estate counsel in Boston. The Bank uses the same environmental assessment firm in Boston and Washington, D.C. to ensure quality of execution and manage risk. Once closed, these loans are subject to all of the Bank’s regular quality control and portfolio management processes.

The Bank has made initial inroads into developing deposit relationships with WMA borrowers and services these customers remotely through the Bank’s Specialized Deposit Group in Hingham. The Bank’s Specialized Deposit Group is now servicing WMA deposit customers that do not have a lending relationship with the Bank. The Bank is still actively planning for a physical presence in the WMA, likely in the District of Columbia.

Loans are carried net of the allowance for loan losses. The allowance is maintained at a level to absorb losses within the loan portfolio. At September 30, 2018, the allowance had a balance of \$13.6 million, as compared to \$12.5 million at December 31, 2017. The allowance for loan losses represented 0.68% of gross loans at both September 30, 2018 and December 31, 2017.

At September 30, 2018, the Bank allocated \$122,000 to loans classified as impaired. At December 31, 2017, \$138,000 was allocated to impaired loans. The Bank works closely with delinquent borrowers to bring their loans current and commences foreclosure proceedings if the borrower is unable to satisfy their outstanding obligation. The Bank continues to pursue delinquencies vigorously.

At September 30, 2018, there were two loans classified as non-accrual totaling \$484,000, as compared to five non-accrual loans totaling \$1.7 million at December 31, 2017. At September 30, 2018 and December 31, 2017, there were no foreclosed properties. At September 30, 2018, non-performing assets were 0.02% of total assets, as compared to 0.07% at December 31, 2017. Management believes that its loans classified as non-accrual are significantly collateralized, pose minimal risk of loss to the Bank, and the allowance for loan loss reserves allocated to these loans is sufficient to absorb such losses, if any. However, management continues to monitor the loan portfolio and additional reserves will be recorded if necessary.

Below is a summary of non-accrual loans and foreclosed real estate:

	<b>December 31, 2017</b>	<b>September 30, 2018</b>
	<b>(Dollars in Thousands)</b>	
Non-accrual loans:		
Residential mortgages	\$ 1,301	\$ —
Commercial mortgages	155	<b>484</b>
Home equity	249	—
Total non-accrual loans	<u>1,705</u>	<u><b>484</b></u>
Foreclosed real estate	—	—
Total non-performing assets	<u>\$ 1,705</u>	<u>\$ <b>484</b></u>
Percent of non-accrual loans to:		
Total loans	0.09 %	<b>0.02 %</b>
Total assets	0.07 %	<b>0.02 %</b>
Percent of non-performing assets to:		
Total loans and foreclosed real estate	0.09 %	<b>0.02 %</b>
Total assets	0.07 %	<b>0.02 %</b>
Allowance for loan losses to total loans	0.68 %	<b>0.68 %</b>

#### Other Assets

The Bank held \$12.4 million in bank-owned life insurance at September 30, 2018, as compared to \$12.2 million at December 31, 2017. The increase during the first nine months of 2018 is due to increases in the cash surrender value of policies insuring the life of a current Bank executive. The policies accrete at a variable rate of interest with minimum stated guaranteed rates. The Bank monitors the financial strength and counterparty credit ratings of the policy issuers and has determined that at September 30, 2018, two of three issuers were rated at or above Bank guidelines. The third issuer retained a rating from A.M. Best at or above Bank guidelines, while the issuer's Standard and Poor ("S&P") rating was below Bank guidelines at BBB+ (Good). A.M. Best has recently placed this issuer's rating under review following the announcement that the issuer's parent company has entered into a definitive agreement to sell the issuer. Management will continue to monitor these developments.

#### Deposits

Deposits increased by \$209.3 million to \$1.715 billion at September 30, 2018, from \$1.506 billion at December 31, 2017. Core deposits, which include regular, money market, NOW and demand deposits, increased by \$8.0 million from the December 31, 2017 balance. Certificate accounts were \$871.7 million at September 30, 2018, as compared to \$670.4 million, at December 31, 2017, representing 51% of total deposits at September 30, 2018, as compared to 45% at December 31, 2017. The growth in certificate account balances reflects the increased use of more attractively priced brokered time deposits in lieu of short-term FHLB advances, as well as the success of special offerings launched in the Bank's retail network during 2018.

Competition for deposits is primarily from other banks and credit unions in the Bank's market area and the Internet as well as mutual funds. The Bank's ability to attract and retain deposits depends upon satisfaction of depositors' requirements with respect to insurance, product, rate and service. The Bank offers traditional deposit products, competitive rates, convenient branch locations, ATMs, debit cards and Internet-based banking for consumers and commercial account holders. The Bank offers limited certificate of deposit products using national Internet-based posting services and brokered deposits. These alternatives provide the Bank with a source of funding across different maturities at lower cost and/or longer duration than may be available via retail or other wholesale channels. At September 30, 2018, the Bank had \$454.4 million in deposits from these sources, as compared to \$316.7 million at December 31, 2017. During the first nine months of 2018, the Bank shifted a portion of its wholesale funding mix from FHLB advances to brokered deposits to mitigate the negative effect of increasing short-term market rates on the Bank's cost on interest-bearing liabilities and net interest margin.

Deposits are insured in full through the combination of the Federal Deposit Insurance Corporation and the Deposit Insurance Fund of Massachusetts ("DIF"). Generally, separately insured deposit accounts are insured up to \$250,000 by the FDIC and deposit balances in excess of this amount are insured by the DIF. DIF insurance provides an advantage for the Bank as some competitors cannot offer this coverage.

Deposit growth over the first nine months of 2018 was used to fund growth in the loan portfolio and to replace higher priced FHLB advances.

Below is a summary of deposits:

	<b>Deposit Balances by Type</b>			
	<b>December 31, 2017</b>	<b>% of Total</b>	<b>September 30, 2018</b>	<b>% of Total</b>
<b>(Dollars in Thousands)</b>				
Non-certificate accounts				
Regular	\$ 96,438	6.4 %	\$ 88,130	5.1 %
Money market deposits	518,094	34.3	529,990	30.8
NOW	35,567	2.4	4,412	0.3
Demand	185,375	12.3	220,943	12.9
Total non-certificate accounts	<u>835,474</u>	<u>55.4</u>	<u>843,475</u>	<u>49.1</u>
Term certificates of less than \$250,000	488,666	32.5	674,932	39.4
Term certificates of \$250,000 or more	181,722	12.1	196,729	11.5
Total certificate accounts	<u>670,388</u>	<u>44.6</u>	<u>871,661</u>	<u>50.9</u>
Total deposits	<u>\$ 1,505,862</u>	<u>100.0 %</u>	<u>\$ 1,715,136</u>	<u>100.0 %</u>

During the third quarter of 2018, the Bank reviewed its deposit product offerings. As a result of this process, consumer and certain business NOW accounts were consolidated into their respective Demand checking account products.

### **Borrowings**

FHLB advances were \$431.2 million, or 18% of total assets, at September 30, 2018, as compared to \$579.2 million, or 25% of total assets, at December 31, 2017. These advances are predominantly fixed rate in nature with 100% scheduled to mature in the next twelve months. During the first nine months of 2018, total borrowings decreased by \$147.9 million, as the Bank used a portion of its cash balances to reduce outstanding FHLB advances and listing services time deposits in order to minimize the carrying cost of its on-balance sheet liquidity. At the same time, the Bank replaced a portion of its short-term FHLB advances with more attractively priced wholesale deposits at longer maturities. In the second quarter of 2017, the FHLB called a \$300 million option advance taken during 2016, which had a 10-year final maturity and was callable quarterly after the first year anniversary. In the third quarter of 2017, the FHLB called a \$30 million option advance taken during 2016, which had a 15-year final maturity and was callable quarterly after the first year anniversary. In the first nine months of 2018, the FHLB called \$85 million of option advances taken during 2017, which had 10 and 15-year final maturities and were callable quarterly after the first year anniversary. The Bank replaced these funds with short-term advances.

### **Liquidity and Capital Resources**

The Bank continually assesses its liquidity position by forecasting incoming and outgoing cash flows. In some cases, contractual maturity dates are used to anticipate cash flows. However, when an asset or liability is subject to early repayment or redemption at the discretion of the issuer or customer, cash flows can be difficult to predict. Generally, these prepayment rights are exercised when it is most financially favorable to the issuer or customer.

The Bank's initial source of liquidity is cash and cash equivalents. At September 30, 2018, the Bank had \$296.5 million, or 13% of total assets, in cash or cash equivalents. A significant portion of this consists of overnight cash balances at the Federal Reserve Bank of Boston. These balances are immediately accessible for liquidity.

Mortgage-backed securities, which comprise less than 1% of the portfolio, are subject to repayment at the discretion of the underlying borrower and are not considered material to the overall balance sheet or liquidity targets.

Marketable common equity holdings, although liquid, are not viewed as a source of liquidity and are managed to produce superior returns on capital over a longer time horizon.

Investment in FHLB stock is illiquid.

Residential loans are susceptible to principal repayment at the discretion of the borrower. Commercial mortgages, while subject to significant penalties for early repayment in most cases, can also prepay at the borrower's discretion.

The Bank invests in key executive life insurance policies that are illiquid during the life of the executive. Such policies total \$12.4 million, or less than 1% of total assets, at September 30, 2018.

Non-certificate deposit balances can generally be withdrawn from the Bank at any time. Retail certificates of deposit, with predefined maturity dates and subject to early redemption penalties, can also be withdrawn subject to the discretion of the Bank. Listing service certificates are offered on the same terms as retail certificates, although the Bank generally does not permit early withdrawal. Brokered certificates generally may not be withdrawn before the stated maturity. The Bank estimates the volatility of its deposits in light of the general economic climate and recent actual experience. Over the past 10 years, deposits have exceeded



withdrawals resulting in net cash inflows from depositors.

Approximately 99% of the Bank's borrowings were fixed in terms of rate and maturity at September 30, 2018. Less than 1% of the borrowings amortize over their stated lives. Approximately 1%, or \$4.0 million, can be called for earlier repayment at the discretion of the issuer. In the current economic environment, management believes these advances are not likely to be called during 2018.

The Bank also monitors its off-balance sheet items. See "Commitments" appearing in Note 2 within the "Notes to Unaudited Consolidated Financial Statements" section of this document. At September 30, 2018, the Bank had \$263.4 million in commitments to extend credit, as compared to \$264.8 million at December 31, 2017.

The Bank considers the above information when measuring its liquidity position. Specific measurements include the Bank's cash flow position at the 30 day, 60 day and 90 day horizon, the level of volatile liabilities on earning assets and loan to deposit ratios. Additionally, the Bank "shocks" its cash flows by assuming significant cash outflows in both non-certificate and certificate deposit balances. At September 30, 2018, each measurement was within predefined Bank guidelines.

To supplement its liquidity position, should the need arise, the Bank maintains its membership in the FHLB where it is eligible to obtain both short and long-term credit advances. As of September 30, 2018, the Bank can borrow up to approximately \$1.114 billion to meet its borrowing needs, based on the Bank's available qualified collateral which consists primarily of 1-4 family residential mortgage loans, certain multifamily residential property and commercial mortgage loans. The Bank can pledge other mortgage loans and assets as collateral to secure additional borrowings. Additionally, through the Federal Reserve Bank of Boston ("FRBB"), the Bank can borrow up to \$21.1 million through the discount window based on the Bank pledging its home equity loan portfolio. The Bank can pledge other mortgage loans and assets as collateral to secure additional borrowings with the FRBB. At September 30, 2018, the Bank had \$431.2 million in advances outstanding from the FHLB and had \$682.2 million in available unused capacity (net of accrued interest on outstanding advances). This compares to an unused capacity of \$457.8 million at December 31, 2017. The FHLB unused capacity increased in the first nine months of 2018 as the Bank increased pledged collateral and used brokered deposits to replace short-term FHLB advances. At September 30, 2018, the Bank did not have any advances outstanding at the FRBB.

At September 30, 2018, the Bank had capital of \$209.7 million, or 8.8% of total assets, as compared to \$186.2 million, or 8.1% of total assets, at December 31, 2017. During the nine months ended September 30, 2018, stockholders' equity increased by \$23.6 million due primarily to net income for the period of \$25.7 million, partially offset by the declaration of dividends of \$1.05 per share, which reduced capital by \$2.2 million. Total capital at December 31, 2017 included \$6.7 million of after-tax unrealized gains in the Bank's available for sale equity securities portfolio, compared to none at September 30, 2018. Beginning January 1, 2018, equity securities (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are measured at fair value with changes in fair value recognized in net income. On January 1, 2018, \$6.7 million in unrealized gains on equity securities available for sale held at December 31, 2017 were reclassified from accumulated other comprehensive income to undivided profits as a cumulative-effect adjustment.

Massachusetts-chartered savings banks that are insured by the FDIC are subject to minimum capital maintenance requirements. Regulatory guidelines define the minimum amount of qualifying capital an institution must maintain as a percentage of risk-weighted assets and average total assets. The Bank's ratios exceeded these regulatory capital requirements at September 30, 2018 and December 31, 2017.

The following table details the Bank's actual capital ratios and minimum regulatory ratios as of December 31, 2017 and September 30, 2018.

	Actual		Minimum Capital Requirement*		Minimum To Be Well Capitalized Under Prompt Corrective Actions Provisions	
	Amounts	Ratio	Amounts	Ratio	Amounts	Ratio
(Dollars in Thousands)						
<b>December 31, 2017</b>						
Total Capital to Risk-Weighted Assets	\$ 195,871	12.76 %	\$ 141,948	9.250 %	\$ 153,457	10.00 %
Common Equity Tier 1 Capital to Risk-Weighted Assets	179,479	11.70	88,238	5.750	99,747	6.50
Tier 1 Capital to Risk-Weighted Assets	179,479	11.70	111,257	7.250	122,766	8.00
Tier 1 Capital to Average Assets	179,479	7.97	90,092	4.000	112,615	5.00
<b>September 30, 2018</b>						
Total Capital to Risk-Weighted Assets	\$ 223,335	13.30 %	\$ 165,852	9.875 %	\$ 167,951	10.00 %
Common Equity Tier 1 Capital to Risk-Weighted Assets	209,747	12.49	107,069	6.375	109,168	6.50
Tier 1 Capital to Risk-Weighted Assets	209,747	12.49	132,261	7.875	134,361	8.00
Tier 1 Capital to Average Assets	209,747	9.05	92,725	4.000	115,906	5.00

\* Minimum risk-based regulatory capital ratios and amounts at September 30, 2018 and December 31, 2017 include the applicable minimum risk-based capital ratios and capital conservation buffer of 1.875% and 1.25%, respectively.

### **Item 3 – Quantitative and Qualitative Disclosures About Market Risk**

The earnings of most banking institutions are exposed to interest rate risk because their balance sheets, both assets and liabilities, are predominantly interest-bearing. It is the Bank's objective to minimize, to the degree prudently possible, its exposure to interest rate risk, bearing in mind that the Bank, by its very nature, will always be in the business of taking on interest rate risk. Interest rate risk is monitored on a quarterly basis by the Asset Liability Committee (the "ALCO") and Board of Directors of the Bank. The ALCO is comprised of members of Bank Management and the Executive Committee of the Board. The ALCO establishes and monitors the various components of the balance sheet including volume, maturities, pricing and mix of assets along with funding sources. The goal is to balance liquidity, interest rate risk and profitability. The primary tool used in managing interest rate risk is income simulation modeling. Income simulation modeling measures changes in net interest income by projecting the future composition of the Bank's balance sheet and applying different interest rate scenarios. Management incorporates numerous assumptions into the simulation model, such as asset prepayment speeds, balance sheet growth and non-maturity deposits elasticity. Management believes that there has been no material changes in the interest rate risk reported in the Bank's Annual Report on Form 10-K for the fiscal year ended December 31, 2017, filed with the Federal Deposit Insurance Corporation. The information is contained in the Form 10-K within the section "Quantitative and Qualitative Disclosures About Market Risk."

### **Item 4 – Controls and Procedures**

#### **(a) Disclosure Controls and Procedures**

An evaluation was carried out under the supervision and with the participation of the Bank's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness, as of September 30, 2018, of the Bank's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934, as amended. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Bank's disclosure controls and procedures as of September 30, 2018, the CEO and CFO concluded that, as of such date, the Bank's disclosure controls and procedures were effective at the reasonable assurance level.

#### **(b) Changes in Internal Control**

There were no significant changes in the Bank's internal control over financial reporting, as defined in Rules 13a-15(e) and 15d-15(e), during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Bank's internal control over financial reporting.

## **PART II – OTHER INFORMATION**

### **Item 1 – Legal Proceedings**

Legal claims arise from time to time in the normal course of business, which, in the opinion of management, will have no material effect on the Bank's consolidated financial statements.

### **Item 1A – Risk Factors**

There have been no material changes to the risk factors previously disclosed in the Bank's most recently filed Form 10-K.

### **Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds**

None.

### **Item 3 – Defaults Upon Senior Securities**

None.

### **Item 4 – Mine Safety Disclosures**

Not applicable.

### **Item 5 – Other Information**

None.

### **Item 6 – Exhibits**

#### Exhibit No.

31.1	Certifications – Chief Executive Officer
31.2	Certifications – Chief Financial Officer
32.1	Certification Pursuant to 18 U.S.C. §1350 – Chief Executive Officer
32.2	Certification Pursuant to 18 U.S.C. §1350 – Chief Financial Officer

## SIGNATURES

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

### HINGHAM INSTITUTION FOR SAVINGS

Date: November 6, 2018

/s/  
Robert H. Gaughen, Jr.  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 6, 2018

/s/  
Cristian A. Melej  
Chief Financial Officer  
(Principal Financial Officer and  
Principal Accounting Officer)

CERTIFICATIONS

EXHIBIT 31.1

I, Robert H. Gaughen, Jr., certify that:

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

Date: November 6, 2018

/s/  
Robert H. Gaughen, Jr.  
Chief Executive Officer  
(Principal Executive Officer)

CERTIFICATIONS

EXHIBIT 31.2

I, Cristian A. Melej, certify that:

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

Date: November 6, 2018

/s/  
Cristian A. Melej  
Chief Financial Officer  
(Principal Financial Officer and  
Principal Accounting Officer)

CERTIFICATION PURSUANT TO  
18 U.S.C. §1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Hingham Institution for Savings (the “Bank”) for the fiscal quarter ended September 30, 2018, as filed with the Federal Deposit Insurance Corporation on the date hereof (the “Report”), the undersigned Robert H. Gaughen, Jr., Chief Executive Officer of the Bank, hereby certifies pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/

Robert H. Gaughen, Jr.  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 6, 2018

CERTIFICATION PURSUANT TO  
18 U.S.C. §1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Hingham Institution for Savings (the “Bank”) for the fiscal quarter ended September 30, 2018, as filed with the Federal Deposit Insurance Corporation on the date hereof (the “Report”), the undersigned Cristian A. Melej, Chief Financial Officer of the Bank, hereby certifies pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/

Cristian A. Melej  
Chief Financial Officer  
(Principal Financial Officer  
and Principal Accounting Officer)

Date: November 6, 2018