FIRST BUSINESS FINANCIAL SERVICES, INC.
Form 10-Q
July 27, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
þ Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2018
OR
¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission file number 001-34095
FIRST BUSINESS FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Wisconsin	39-1576570
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

401 Charmany Drive, Madison, WI	53719
(Address of Principal Executive Offices)	(Zip Code)

(608) 238-8008
Registrant’s telephone number, including area code
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 þ No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 þ No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer þ	Non-accelerated filer ¨	Smaller reporting company ¨	Emerging growth company ¨
		(Do not check if a 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 Exchange Act). Yes ¨ No þ
The number of shares outstanding of the registrant’s sole class of common stock, par value $0.01 per share, on July 26, 2018 was 8,760,103 shares.

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PART I. Financial Information
Item 1. Financial Statements
First Business Financial Services, Inc.
Consolidated Balance Sheets

	June 30, 2018 (Unaudited)	December 31, 2017
	(In Thousands, Except Share Data)	
Assets		
Cash and due from banks	$21,433	$17,059
Short-term investments	24,370	35,480
Cash and cash equivalents	45,803	52,539
Securities available-for-sale, at fair value	135,470	126,005
Securities held-to-maturity, at amortized cost	40,946	37,778
Loans held for sale	4,976	2,194
Loans and leases receivable, net of allowance for loan and lease losses of $20,932 and $18,763, respectively	1,574,021	1,482,832
Premises and equipment, net	3,358	3,156
Foreclosed properties	1,484	1,069
Bank-owned life insurance	40,912	40,323
Federal Home Loan Bank stock, at cost	9,295	5,670
Goodwill and other intangible assets	12,380	12,652
Accrued interest receivable and other assets	31,142	29,848
Total assets	$1,899,787	$1,794,066
Liabilities and Stockholders' Equity		
Deposits	$1,337,725	$1,394,331
Federal Home Loan Bank advances and other borrowings	365,416	207,898
Junior subordinated notes	10,026	10,019
Accrued interest payable and other liabilities	12,948	12,540
Total liabilities	1,726,115	1,624,788
Stockholders' equity:		
Preferred stock, $0.01 par value, 2,500,000 shares authorized, none issued or outstanding	—	—
Common stock, $0.01 par value, 25,000,000 shares authorized, 9,018,953 and 9,021,985 shares issued, 8,760,103 and 8,763,539 shares outstanding at June 30, 2018 and December 31, 2017, respectively	90	90
Additional paid-in capital	79,126	78,620
Retained earnings	103,391	98,906
Accumulated other comprehensive loss	(1,824)	(1,238)
Treasury stock, 258,850 and 258,446 shares at June 30, 2018 and December 31, 2017, respectively, at cost	(7,111)	(7,100)
Total stockholders' equity	173,672	169,278
Total liabilities and stockholders' equity	$1,899,787	$1,794,066

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Income (Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2018	2017	2018	2017
	(In Thousands, Except Per Share Data)			
Interest income				
Loans and leases	$21,243	$18,284	$40,904	$35,806
Securities	938	776	1,794	1,555
Short-term investments	287	165	491	311
Total interest income	22,468	19,225	43,189	37,672
Interest expense				
Deposits	3,209	2,658	6,038	5,331
Federal Home Loan Bank advances and other borrowings	2,051	811	3,467	1,422
Junior subordinated notes	277	277	552	552
Total interest expense	5,537	3,746	10,057	7,305
Net interest income	16,931	15,479	33,132	30,367
Provision for loan and lease losses	2,579	3,656	5,054	4,228
Net interest income after provision for loan and lease losses	14,352	11,823	28,078	26,139
Non-interest income				
Trust and investment service fees	1,987	1,648	3,884	3,277
Gain on sale of Small Business Administration loans	274	535	543	895
Service charges on deposits	720	766	1,504	1,531
Loan fees	389	675	917	1,133
Increase in cash surrender value of bank-owned life insurance	297	316	589	627
Commercial loan swap fees	70	250	703	449
Other non-interest income	245	548	508	889
Total non-interest income	3,982	4,738	8,648	8,801
Non-interest expense				
Compensation	9,116	8,382	18,187	17,065
Occupancy	544	519	1,073	994
Professional fees	928	1,041	1,963	2,051
Data processing	626	635	1,236	1,219
Marketing	591	582	925	952
Equipment	343	300	686	583
Computer software	679	639	1,420	1,322
FDIC insurance	369	381	668	761
Collateral liquidation costs	222	77	223	185
Impairment of tax credit investments	329	112	442	225
SBA recourse provision (benefit)	99	774	(196)	780
Other non-interest expense	621	779	1,747	1,644
Total non-interest expense	14,467	14,221	28,374	27,781
Income before income tax expense	3,867	2,340	8,352	7,159
Income tax expense	578	454	1,414	1,876
Net income	$3,289	$1,886	$6,938	$5,283
Earnings per common share				
Basic	$0.38	$0.22	$0.79	$0.61

Diluted	0.38	0.22	0.79	0.61
Dividends declared per share	0.14	0.13	0.28	0.26

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Comprehensive Income (Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2018	2017	2018	2017
	(In Thousands)			
Net income	$3,289	$1,886	$6,938	$5,283
Other comprehensive loss, before tax				
Securities available-for-sale:				
Unrealized securities (losses) gains arising during the period	(531)	109	(1,890)	26
Securities held-to-maturity:				
Amortization of net unrealized losses transferred from available-for-sale	17	29	36	55
Interest rate swaps:				
Unrealized gains on interest rate swaps arising during the period	358	—	1,030	—
Income tax benefit (expense)	73	(53)	238	(50)
Total other comprehensive (loss) income	(83)	85	(586)	31
Comprehensive income	$3,206	$1,971	$6,352	$5,314

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

	Common Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
	(In Thousands, Except Share Data)						
Balance at December 31, 2016	8,715,856	$ 90	$ 77,542	$ 91,317	$ (522)	$ (6,777)	$ 161,650
Net income	—	—	—	5,283	—	—	5,283
Other comprehensive income	—	—	—	—	31	—	31
Share-based compensation - restricted shares, net	(484)	—	544	—	—	—	544
Cash dividends ($0.26 per share)	—	—	—	(2,267)	—	—	(2,267)
Treasury stock purchased	(309)	—	—	—	—	(7)	(7)
Balance at June 30, 2017	8,715,063	$ 90	$ 78,086	$ 94,333	$ (491)	$ (6,784)	$ 165,234

	Common Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
	(In Thousands, Except Share Data)						
Balance at December 31, 2017	8,763,539	$ 90	$ 78,620	$ 98,906	$ (1,238)	$ (7,100)	$ 169,278
Net income	—	—	—	6,938	—	—	6,938
Other comprehensive loss	—	—	—	—	(586)	—	(586)
Share-based compensation - restricted shares, net	(3,032)	—	506	—	—	—	506
Cash dividends ($0.28 per share)	—	—	—	(2,453)	—	—	(2,453)
Treasury stock purchased	(404)	—	—	—	—	(11)	(11)
Balance at June 30, 2018	8,760,103	$ 90	$ 79,126	$ 103,391	$ (1,824)	$ (7,111)	$ 173,672

See accompanying Notes to Unaudited Consolidated Financial Statements.

First Business Financial Services, Inc.
Consolidated Statements of Cash Flows (Unaudited)

	For the Six Months Ended June 30,	
	2018	2017
	(In Thousands)	
Operating activities		
Net income	$6,938	$5,283
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes, net	221	(149)
Impairment of tax credit investments	442	225
Provision for loan and lease losses	5,054	4,228
Depreciation, amortization and accretion, net	727	731
Share-based compensation	506	544
Increase in value of bank-owned life insurance policies	(589)	(627)
Origination of loans for sale	(43,519)	(14,153)
Sale of loans originated for sale	41,280	12,694
Gain on sale of loans originated for sale	(543)	(921)
Excess tax benefit from share-based compensation	(10)	(7)
Returns on investments in limited partnerships	—	92
Net increase in accrued interest receivable and other assets	(704)	(1,014)
Net increase in accrued interest payable and other liabilities	1,177	2,174
Net cash provided by operating activities	10,980	9,100
Investing activities		
Proceeds from maturities, redemptions and paydowns of available-for-sale securities	14,738	19,541
Proceeds from maturities, redemptions and paydowns of held-to-maturity securities	1,672	1,814
Proceeds from sale of available-for-sale securities	—	5,063
Purchases of available-for-sale securities	(26,269)	(15,930)
Purchases of held-to-maturity securities	(4,867)	(1,027)
Net increase in loans and leases	(96,620)	(10,803)
Investments in limited partnerships	—	(500)
Returns of investments in limited partnerships	316	—
Investment in historic development entities	(905)	—
Investment in Federal Home Loan Bank stock	(7,388)	(7,454)
Proceeds from the sale of Federal Home Loan Bank stock	3,763	6,770
Purchases of leasehold improvements and equipment, net	(611)	(635)
Net cash used in investing activities	(116,171)	(3,161)
Financing activities		
Net decrease in deposits	(56,606)	(64,241)
Repayment of Federal Home Loan Bank advances	(490,500)	(260,916)
Proceeds from Federal Home Loan Bank advances	648,000	309,415
Proceeds from issuance of subordinated notes payable	—	9,090
Repayment of subordinated notes payable	—	(7,877)
Net increase (decrease) in other borrowed funds	25	(2,908)
Cash dividends paid	(2,453)	(2,267)
Purchase of treasury stock	(11)	(7)
Net cash provided by (used in) financing activities	98,455	(19,711)
Net decrease in cash and cash equivalents	(6,736)	(13,772)

Cash and cash equivalents at the beginning of the period	52,539	77,517
Cash and cash equivalents at the end of the period	$45,803	$63,745
Supplementary cash flow information		
Cash paid during the period for:		
Interest paid on deposits and borrowings	$9,212	$7,359
Income taxes paid	646	339
Non-cash investing and financing activities:		
Transfer of loans from held-to-maturity to held-for-sale	—	6,966
Transfer from loans to foreclosed properties	415	—
Transfer from premises and equipment to foreclosed properties	—	1,113

See accompany Notes to Unaudited Consolidated Financial Statements

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Notes to Unaudited Consolidated Financial Statements

Note 1 — Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. The accounting and reporting practices of First Business Financial Services, Inc. (the "Corporation"), through our wholly owned subsidiary, First Business Bank ("FBB" or the "Bank"), have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). FBB operates as a commercial banking institution primarily in the Wisconsin and greater Kansas City markets. FBB also offers trust and investment services through First Business Trust & Investments ("FBTI") and investment portfolio administrative services and asset/liability management services through First Business Consulting Services ("FBCS"), both divisions of FBB. The Bank provides a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Bank is subject to competition from other financial institutions and service providers and is also subject to state and federal regulations. FBB has the following wholly owned subsidiaries: First Business Capital Corp. ("FBCC"), First Madison Investment Corp. ("FMIC"), First Business Equipment Finance, LLC ("FBEF"), ABKC Real Estate, LLC ("ABKC"), Rimrock Road Investment Fund, LLC ("Rimrock Road"), BOC Investment, LLC ("BOC"), Mitchell Street Apartments Investment, LLC ("Mitchell Street") and FBB Tax Credit Investment LLC ("FBB Tax Credit"). FMIC is located in and was formed under the laws of the state of Nevada.

Basis of Presentation. The accompanying unaudited Consolidated Financial Statements were prepared in accordance with GAAP and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the Corporation's Consolidated Financial Statements and footnotes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2017. The unaudited Consolidated Financial Statements include the accounts of the Corporation and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. In accordance with the provisions of Accounting Standards Codification ("ASC") Topic 810, the Corporation's ownership interest in FBFS Statutory Trust II ("Trust II") has not been consolidated into the financial statements.

Management of the Corporation is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that could significantly change in the near-term include the value of securities and interest rate swaps, level of the allowance for loan and lease losses, lease residuals, property under operating leases, goodwill, level of the Small Business Administration ("SBA") recourse reserve and income taxes. The results of operations for the six month period ended June 30, 2018 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2018. Certain amounts in prior periods may have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the date of the issuance of the unaudited Consolidated Financial Statements. No significant subsequent events have occurred through this date requiring adjustment to the financial statements or disclosures.

The Corporation has not changed its significant accounting and reporting policies from those disclosed in the Corporation's Form 10-K for the year ended December 31, 2017.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The ASU is a converged standard between the FASB and the IASB that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The primary objective of the ASU is revenue recognition that represents the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The Corporation adopted ASU 2014-09 and all subsequent amendments to the ASU (collectively, "ASC 606") in the first quarter of 2018 with no material impact on its results of operations, financial position and liquidity.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments (Subtopic 825-10)." The ASU amends certain aspects of recognition, measurement, presentation and disclosure of financial instruments. This amendment supersedes the guidance to classify equity securities with readily determinable fair values into different categories, requires equity securities to be measured at fair value with changes in the fair value recognized through net income and simplifies the impairment assessment of equity investments without readily determinable fair values. The amendment requires public business entities that are required to disclose the fair value of financial instruments measured at amortized cost on the balance sheet to measure that fair value using the exit price notion. The amendment requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option. The Corporation adopted the accounting standard during the first quarter of 2018 and modified its fair value disclosure of financial instruments to reflect an exit price notion. The adoption of the standard did not have a material impact on the Corporation's results of operations, financial position and liquidity.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." The ASU intends to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities and disclosing key information about leasing arrangements. The ASU will require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessees' obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The new lease guidance simplifies the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Corporation intends to adopt the accounting standard during the first quarter of 2019, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity. The Corporation leases office space, loan production offices and specialty financing production offices under noncancelable operating leases which expire on various dates through 2028. The Corporation also leases office equipment. Future minimum lease payments for noncancelable operating leases as of June 30, 2018 was $11.0 million.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments- Credit Losses (Topic 326)." The ASU replaces the incurred loss impairment methodology for recognizing credit losses with a methodology that reflects all expected credit losses. The ASU also requires consideration of a broader range of information to inform credit loss estimates, including such factors as past events, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures and any other financial asset not excluded from the scope that have the contractual right to receive cash. Entities will apply the amendments in the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The ASU is effective for public companies for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018. The Corporation intends to adopt the accounting standard during the first quarter of 2020, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity. A cross-functional team has been established and a third-party software solution has been obtained to assist with the implementation of the standard. Management is in the process of gathering necessary data and reviewing potential methods to calculate the expected credit losses.

In June 2018, the FASB issued ASU No. 2018-07, "Compensation- Stock Compensation (Topic 718)." The ASU expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Corporation is in the process of evaluating the impact of this standard but does not expect this standard to have a material impact on its results of operations, financial position and liquidity.

Note 2 — Earnings per Common Share

Earnings per common share are computed using the two-class method. Basic earnings per common share are computed by dividing net income allocated to common shares by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends, or dividend equivalents, at the same rate as holders of the Corporation's common stock. Diluted earnings per share are computed by dividing net income allocated to common shares, adjusted for reallocation of undistributed earnings of unvested restricted shares, by the weighted average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents using the treasury stock method.

There were no anti-dilutive employee share-based awards for the three and six month periods ended June 30, 2018 and 2017.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2018	2017	2018	2017
	(Dollars in Thousands, Except Per Share Data)			
Basic earnings per common share				
Net income	$3,289	$ 1,886	$6,938	$ 5,283
Less: earnings allocated to participating securities	48	25	102	70
Basic earnings allocated to common stockholders	$3,241	$ 1,861	$6,836	$ 5,213
Weighted-average common shares outstanding, excluding participating securities	8,631,189	8,601,379	8,631,664	8,601,002
Basic earnings per common share	$0.38	$ 0.22	$0.79	$ 0.61
Diluted earnings per common share				
Earnings allocated to common stockholders	$3,241	$ 1,861	$6,836	$ 5,213
Weighted-average diluted common shares outstanding, excluding participating securities	8,631,189	8,601,379	8,631,664	8,601,002
Diluted earnings per common share	$0.38	$ 0.22	$0.79	$ 0.61

Note 3 — Share-Based Compensation

The Corporation adopted the 2012 Equity Incentive Plan (the "Plan") during the quarter ended June 30, 2012. The Plan is administered by the Compensation Committee of the Board of Directors of the Corporation and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options, restricted stock, restricted stock units, dividend equivalent units and any other type of award permitted by the Plan. As of June 30, 2018, 214,867 shares were available for future grants under the Plan. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plan. The Corporation may issue new shares and shares from its treasury stock for shares delivered under the Plan.

Restricted Stock

Under the Plan, the Corporation may grant restricted stock, restricted stock units and other stock-based awards to plan participants, subject to forfeiture upon the occurrence of certain events until the dates specified in the participant's award agreement. While restricted stock is subject to forfeiture, restricted stock participants may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. Restricted stock units do not have voting rights and are provided dividend equivalents. The restricted stock granted under the Plan is typically subject to a vesting period. Compensation expense is recognized over the requisite service period of generally four years for the entire award on a straight-line basis. Upon vesting of restricted stock, the benefit of tax deductions in excess of recognized compensation expense is reflected as an income tax benefit in the unaudited Consolidated Statements of Income.

Restricted stock activity for the year ended December 31, 2017 and the six months ended June 30, 2018 was as follows:

	Number of Restricted Shares/Units	Weighted Average Grant-Date

		Fair Value
Nonvested balance as of December 31, 2016	116,245	$ 21.13
Granted	71,130	21.67
Vested	(48,550)	21.51
Forfeited	(8,384)	21.65
Nonvested balance as of December 31, 2017	130,441	21.43
Granted	4,870	25.69
Vested	(1,868)	23.25
Forfeited	(7,902)	22.11
Nonvested balance as of June 30, 2018	125,541	$ 21.52

As of June 30, 2018, the Corporation had $1.9 million of deferred unvested compensation expense, which the Corporation expects to recognize over a weighted-average period of approximately 2.62 years.

Share-based compensation expense related to restricted stock included in the unaudited Consolidated Statements of Income was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2018	2017	2018	2017
	(In Thousands)			
Share-based compensation expense	$220	$268	$506	$544

Note 4 — Securities

The amortized cost and fair value of securities available-for-sale and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

	As of June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale:				
U.S. government agency obligations - government-sponsored enterprises	$4,992	$ —	$ (17)	$4,975
Municipal obligations	7,137	2	(101)	7,038
Collateralized mortgage obligations - government issued	21,961	83	(502)	21,542
Collateralized mortgage obligations - government-sponsored enterprises	102,141	13	(2,619)	99,535
Other securities	2,450	—	(70)	2,380
	$138,681	$ 98	$ (3,309)	$135,470

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	As of December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale:				
U.S. government agency obligations - government-sponsored enterprises	$999	$ 1	$ —	$1,000
Municipal obligations	9,494	2	(82)	9,414
Collateralized mortgage obligations - government issued	22,313	149	(213)	22,249
Collateralized mortgage obligations - government-sponsored enterprises	91,480	24	(1,199)	90,305
Other securities	3,040	3	(6)	3,037
	$127,326	$ 179	$ (1,500)	$126,005

The amortized cost and fair value of securities held-to-maturity and the corresponding amounts of gross unrealized gains and losses were as follows:

	As of June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Held-to-maturity:				
U.S. government agency obligations - government-sponsored enterprises	$1,499	$ —	$ (5)	$1,494
Municipal obligations	21,406	50	(117)	21,339
Collateralized mortgage obligations - government issued	8,173	—	(277)	7,896
Collateralized mortgage obligations - government-sponsored enterprises	9,868	—	(257)	9,611
	$40,946	$ 50	$ (656)	$40,340

	As of December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Held-to-maturity:				
U.S. government agency obligations - government-sponsored enterprises	$1,499	$ —	$ (9)	$1,490
Municipal obligations	21,680	176	(34)	21,822
Collateralized mortgage obligations - government issued	9,072	1	(130)	8,943
Collateralized mortgage obligations - government-sponsored enterprises	5,527	—	(86)	5,441
	$37,778	$ 177	$ (259)	$37,696

U.S. government agency obligations - government-sponsored enterprises represent securities issued by the Federal Home Loan Bank (“FHLB”), the Federal Home Loan Mortgage Corporation (“FHLMC”) and the Federal National Mortgage Association (“FNMA”). Municipal obligations include securities issued by various municipalities located primarily within the State of Wisconsin and are primarily general obligation bonds that are tax-exempt in nature. Collateralized mortgage obligations - government issued represent securities guaranteed by the Government National Mortgage Association. Collateralized mortgage obligations - government-sponsored enterprises include securities guaranteed by FHLMC and FNMA. Other securities repr

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esent certificates of deposit of insured banks and savings institutions with an original maturity greater than three months. No sales of available-for-sale securities occurred during the six months ended June 30, 2018 and six sales of available-for-sale securities occurred during the six months ended June 30, 2017.

At June 30, 2018 and December 31, 2017, securities with a fair value of $2.5 million and $2.8 million, respectively, were pledged to secure interest rate swap contracts.
The amortized cost and fair value of securities by contractual maturity at June 30, 2018 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay certain obligations with or without call or prepayment penalties.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	$6,795	$6,786	$2,273	$2,267
Due in one year through five years	19,891	19,445	11,465	11,441
Due in five through ten years	29,450	28,819	20,209	19,821
Due in over ten years	82,545	80,420	6,999	6,811
	$138,681	$135,470	$40,946	$40,340

The tables below show the Corporation’s gross unrealized losses and fair value of available-for-sale investments aggregated by investment category and length of time that individual investments were in a continuous loss position at June 30, 2018 and December 31, 2017. At June 30, 2018, the Corporation held 166 available-for-sale securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. At June 30, 2018, the Corporation held 51 available-for-sale securities that had been in a continuous unrealized loss position for twelve months or greater.

The Corporation also has not specifically identified available-for-sale securities in a loss position that it intends to sell in the near term and does not believe that it will be required to sell any such securities. The Corporation reviews its securities on a quarterly basis to monitor its exposure to other-than-temporary impairment. Consideration is given to such factors as the length of time and extent to which the security has been in an unrealized loss position, changes in security ratings and an evaluation of the present value of expected future cash flows, if necessary. Based on the Corporation’s evaluation, it is expected that the Corporation will recover the entire amortized cost basis of each security. Accordingly, no other-than-temporary impairment was recorded in the unaudited Consolidated Statements of Income for the six months ended June 30, 2018 and 2017.

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A summary of unrealized loss information for securities available-for-sale, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

	As of June 30, 2018					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Available-for-sale:						
U.S. government agency obligations - government-sponsored enterprises	$4,975	$ 17	$—	$ —	$4,975	$ 17
Municipal obligations	3,681	41	2,588	60	6,269	101
Collateralized mortgage obligations - government issued	10,917	232	6,353	270	17,270	502
Collateralized mortgage obligations - government-sponsored enterprises	68,892	1,552	25,464	1,067	94,356	2,619
Other securities	2,137	68	243	2	2,380	70
	$90,602	$ 1,910	$34,648	$ 1,399	$125,250	$ 3,309

	As of December 31, 2017					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Available-for-sale:						
Municipal obligations	$6,132	$ 43	$2,755	$ 39	$8,887	$ 82
Collateralized mortgage obligations - government issued	7,104	40	6,715	173	13,819	213
Collateralized mortgage obligations - government-sponsored enterprises	59,256	476	28,004	723	87,260	1,199
Other securities	1,954	6	—	—	1,954	$ 6
	$74,446	$ 565	$37,474	$ 935	$111,920	$ 1,500

The tables below show the Corporation’s gross unrealized losses and fair value of held-to-maturity investments, aggregated by investment category and length of time that individual investments were in a continuous loss position at June 30, 2018 and December 31, 2017. At June 30, 2018, the Corporation held 76 held-to-maturity securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. There were 16 held-to-maturity securities that had been in a continuous loss position for twelve months or greater as of June 30, 2018. It is expected that the Corporation will recover the entire amortized cost basis of each held-to-maturity security based upon an evaluation of aforementioned factors. Accordingly, no other-than-temporary impairment was recorded in the unaudited Consolidated Statements of Income for the six months ended June 30, 2018 and 2017.

A summary of unrealized loss information for securities held-to-maturity, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

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	As of June 30, 2018					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Held-to-maturity:						
U.S. government agency obligations - government-sponsored enterprises	$—	$ —	$1,499	$ 5	$1,499	$ 5
Municipal obligations	13,308	109	258	8	13,566	117
Collateralized mortgage obligations - government issued	4,036	131	4,137	146	8,173	277
Collateralized mortgage obligations - government-sponsored enterprises	4,857	74	5,011	183	9,868	257
	$22,201	$ 314	$10,905	$ 342	$33,106	$ 656

	As of December 31, 2017					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Held-to-maturity:						
U.S. government agency obligations - government-sponsored enterprises	$—	$ —	$1,499	$ 9	$1,499	$ 9
Municipal obligations	3,723	27	259	7	3,982	34
Collateralized mortgage obligations - government issued	3,868	51	4,677	79	8,545	130
Collateralized mortgage obligations - government-sponsored enterprises	—	—	5,527	86	5,527	86
	$7,591	$ 78	$11,962	$ 181	$19,553	$ 259

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Note 5 — Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

	June 30, 2018	December 31, 2017
	(In Thousands)	
Commercial real estate:		
Commercial real estate — owner occupied	$196,032	$ 200,387
Commercial real estate — non-owner occupied	485,962	470,236
Land development	45,033	40,154
Construction	188,036	125,157
Multi-family	137,388	136,978
1-4 family	35,569	44,976
Total commercial real estate	1,088,020	1,017,888
Commercial and industrial	447,540	429,002
Direct financing leases, net	32,001	30,787
Consumer and other:		
Home equity and second mortgages	7,962	7,262
Other	21,075	18,099
Total consumer and other	29,037	25,361
Total gross loans and leases receivable	1,596,598	1,503,038
Less:		
Allowance for loan and lease losses	20,932	18,763
Deferred loan fees	1,645	1,443
Loans and leases receivable, net	$1,574,021	$ 1,482,832

The total amount of the Corporation's ownership of SBA loans comprised of the following:

	June 30, 2018	December 31, 2017
	(In Thousands)	
Retained, unguaranteed portions of sold SBA loans	$26,030	$ 30,071
Other SBA loans(1)	23,341	22,254
Total SBA loans	$49,371	$ 52,325

(1) Primarily consisted of SBA Express loans and impaired SBA loans that were repurchased from the secondary market, all of which were not saleable as of June 30, 2018 and December 31, 2017, respectively.

As of June 30, 2018 and December 31, 2017, $9.0 million and $11.1 million of SBA loans were considered impaired, respectively.

Loans transferred to third parties consist of the guaranteed portions of SBA loans which the Corporation sold in the secondary market, participation interests in other originated loans and residential real estate loans. The total principal amount of the guaranteed portions of SBA loans sold during the three months ended June 30, 2018 and 2017 was $3.2 million and $5.9 million, respectively. The total principal amount of the guaranteed portions of SBA loans sold during the six months ended June 30, 2018 and 2017 was $6.3 million and $9.2 million, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, and therefore all of the loans transferred during the three and six months ended June 30, 2018 and 2017 have been derecognized in the unaudited Consolidated Financial Statements. The guaranteed portions of SBA loans were transferred at their fair value and the related gain was recognized upon the transfer as non-interest income in the unaudited Consolidated Financial Statements. The total outstanding balance of sold SBA loans at June 30, 2018 and December 31, 2017 was $89.5 million and $100.3 million, respectively.

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The total principal amount of transferred participation interests in other originated commercial loans during the three months ended June 30, 2018 and 2017 was $14.8 million and $8.7 million, respectively. The total principal amount of transferred participation interests in other originated commercial loans during the six months ended June 30, 2018 and 2017 was $34.4 million and $20.7 million, respectively, all of which were treated as sales and derecognized under the applicable accounting guidance at the time of transfer. No gain or loss was recognized on participation interests in other originated loans as they were transferred at or near the date of loan origination and the payments received for servicing the portion of the loans participated represents adequate compensation. The total outstanding balance of these transferred loans at June 30, 2018 and December 31, 2017 was $112.7 million and $106.4 million, respectively. As of June 30, 2018 and December 31, 2017, the total amount of the Corporation's partial ownership of these transferred loans on the unaudited Consolidated Balance Sheets was $193.7 million and $181.7 million, respectively. No loans in this participation portfolio were considered impaired as of June 30, 2018 and December 31, 2017. The Corporation does not share in the participant's portion of any potential charge-offs. The total amount of loan participations purchased on the unaudited Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017 was $610,000 and $650,000, respectively.

The following tables illustrate ending balances of the Corporation's loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators:

	June 30, 2018				
	Category				
	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	$160,650	$11,995	$13,341	$10,046	$196,032
Commercial real estate — non-owner occupied	464,794	20,072	1,065	31	485,962
Land development	41,690	1,032	—	2,311	45,033
Construction	185,439	501	217	1,879	188,036
Multi-family	137,388	—	—	—	137,388
1-4 family	32,554	1,533	721	761	35,569
Total commercial real estate	1,022,515	35,133	15,344	15,028	1,088,020
Commercial and industrial	360,855	19,636	51,091	15,958	447,540
Direct financing leases, net	30,459	225	1,317	—	32,001
Consumer and other:					
Home equity and second mortgages	7,956	5	—	1	7,962
Other	20,722	—	—	353	21,075
Total consumer and other	28,678	5	—	354	29,037
Total gross loans and leases receivable	$1,442,507	$54,999	$67,752	$31,340	$1,596,598
Category as a % of total portfolio	90.36 %	3.44 %	4.24 %	1.96 %	100.00 %

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	December 31, 2017				
	Category				
	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	$166,018	$18,442	$8,850	$7,077	$200,387
Commercial real estate — non-owner occupied	441,246	27,854	1,102	34	470,236
Land development	36,470	1,057	—	2,627	40,154
Construction	121,528	757	—	2,872	125,157
Multi-family	136,978	—	—	—	136,978
1-4 family	34,598	7,735	1,220	1,423	44,976
Total commercial real estate	936,838	55,845	11,172	14,033	1,017,888
Commercial and industrial	341,875	25,344	49,453	12,330	429,002
Direct financing leases, net	28,866	342	1,579	—	30,787
Consumer and other:					
Home equity and second mortgages	7,250	8	—	4	7,262
Other	17,745	—	—	354	18,099
Total consumer and other	24,995	8	—	358	25,361
Total gross loans and leases receivable	$1,332,574	$81,539	$62,204	$26,721	$1,503,038
Category as a % of total portfolio	88.66 %	5.42 %	4.14 %	1.78 %	100.00 %

Each credit is evaluated for proper risk rating upon origination, at the time of each subsequent renewal, upon receipt and evaluation of updated financial information from the Corporation's borrowers or as other circumstances dictate. The Corporation uses a nine grade risk rating system to monitor the ongoing credit quality of its loans and leases. The risk rating grades follow a consistent definition and are then applied to specific loan types based on the nature of the loan. Each risk rating is subjective and, depending on the size and nature of the credit, subject to various levels of review and concurrence on the stated risk rating. In addition to its nine grade risk rating system, the Corporation groups loans into four loan and related risk categories which determine the level and nature of review by management.

Category I — Loans and leases in this category are performing in accordance with the terms of the contract and generally exhibit no immediate concerns regarding the security and viability of the underlying collateral, financial stability of the borrower, integrity or strength of the borrowers' management team or the industry in which the borrower operates. The Corporation monitors Category I loans and leases through payment performance, continued maintenance of its personal relationships with such borrowers and continued review of such borrowers' compliance with the terms of their respective agreements.

Category II — Loans and leases in this category are beginning to show signs of deterioration in one or more of the Corporation's core underwriting criteria such as financial stability, management strength, industry trends or collateral values. Management will place credits in this category to allow for proactive monitoring and resolution with the borrower to possibly mitigate the area of concern and prevent further deterioration or risk of loss to the Corporation. Category II loans are considered performing but are monitored frequently by the assigned business development officer and by subcommittees of the Bank's Loan Committee.

Category III — Loans and leases in this category are identified by management as warranting special attention. However, the balance in this category is not intended to represent the amount of adversely classified assets held by the Bank. Category III loans and leases generally exhibit undesirable characteristics, such as evidence of adverse financial trends and conditions, managerial problems, deteriorating economic conditions within the related industry or evidence of adverse public filings and may exhibit collateral shortfall positions. Management continues to believe that it will collect all contractual principal and interest in accordance with the original terms of the contracts relating to the loans and leases in this category, and therefore Category III loans are considered performing with no specific reserves established for this category. Category III loans are monitored by management and subcommittees of the Bank's Loan Committee on a monthly basis and the Bank's Board of Directors at each of their regularly scheduled meetings.

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Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases, with the exception of performing troubled debt restructurings, have been placed on non-accrual as management has determined that it is unlikely that the Bank will receive the contractual principal and interest in accordance with the original terms of the agreement. Impaired loans are individually evaluated to assess the need for the establishment of specific reserves or charge-offs. When analyzing the adequacy of collateral, the Corporation obtains external appraisals at least annually for impaired loans and leases. External appraisals are obtained from the Corporation's approved appraiser listing and are independently reviewed to monitor the quality of such appraisals. To the extent a collateral shortfall position is present, a specific reserve or charge-off will be recorded to reflect the magnitude of the impairment. Loans and leases in this category are monitored by management and subcommittees of the Bank's Loan Committee on a monthly basis and the Bank's Board of Directors at each of their regularly scheduled meetings.

Utilizing regulatory classification terminology, the Corporation identified $42.5 million and $32.7 million of loans and leases as Substandard as of June 30, 2018 and December 31, 2017, respectively. No loans and leases were identified as Doubtful as of June 30, 2018. The Corporation identified $4.7 million of loans and leases as Doubtful as of December 31, 2017. Additionally, no loans were considered Special Mention or Loss as of either June 30, 2018 or December 31, 2017. The population of Substandard loans is a subset of Category III and Category IV loans.

The delinquency aging of the loan and lease portfolio by class of receivable was as follows:

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	June 30, 2018					
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans and Leases
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$—	$—	$186,038	$186,038
Non-owner occupied	—	—	—	—	485,931	485,931
Land development	—	—	—	—	42,722	42,722
Construction	—	—	—	—	186,157	186,157
Multi-family	—	—	—	—	137,388	137,388
1-4 family	—	—	—	—	35,000	35,000
Commercial and industrial	1,995	—	—	1,995	429,591	431,586
Direct financing leases, net	—	—	—	—	32,001	32,001
Consumer and other:						
Home equity and second mortgages	—	—	—	—	7,962	7,962
Other	—	—	—	—	20,722	20,722
Total	1,995	—	—	1,995	1,563,512	1,565,507
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	—	—	3,353	3,353	6,641	9,994
Non-owner occupied	31	—	—	31	—	31
Land development	—	—	—	—	2,311	2,311
Construction	—	—	1,879	1,879	—	1,879
Multi-family	—	—	—	—	—	—
1-4 family	—	—	529	529	40	569
Commercial and industrial	1,557	1,222	9,378	12,157	3,797	15,954
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	—	—	—	—	—	—
Other	—	—	304	304	49	353
Total	1,588	1,222	15,443	18,253	12,838	31,091
Total loans and leases						
Commercial real estate:						
Owner occupied	—	—	3,353	3,353	192,679	196,032
Non-owner occupied	31	—	—	31	485,931	485,962
Land development	—	—	—	—	45,033	45,033
Construction	—	—	1,879	1,879	186,157	188,036
Multi-family	—	—	—	—	137,388	137,388
1-4 family	—	—	529	529	35,040	35,569
Commercial and industrial	3,552	1,222	9,378	14,152	433,388	447,540
Direct financing leases, net	—	—	—	—	32,001	32,001
Consumer and other:						
Home equity and second mortgages	—	—	—	—	7,962	7,962
Other	—	—	304	304	20,771	21,075
Total	$3,583	$1,222	$15,443	$20,248	$1,576,350	$1,596,598
Percent of portfolio	0.22 %	0.08 %	0.97 %	1.27 %	98.73 %	100.00 %

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	December 31, 2017					
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans and Leases
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$—	$—	$193,366	$193,366
Non-owner occupied	—	—	—	—	470,202	470,202
Land development	—	—	—	—	37,528	37,528
Construction	—	196	—	196	122,089	122,285
Multi-family	—	—	—	—	136,978	136,978
1-4 family	496	—	—	496	43,319	43,815
Commercial and industrial	1,169	197	—	1,366	415,315	416,681
Direct financing leases, net	—	—	—	—	30,787	30,787
Consumer and other:						
Home equity and second mortgages	106	—	—	106	7,156	7,262
Other	—	—	—	—	17,745	17,745
Total	1,771	393	—	2,164	1,474,485	1,476,649
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	405	—	4,836	5,241	1,780	7,021
Non-owner occupied	—	—	—	—	34	34
Land development	—	—	—	—	2,626	2,626
Construction	—	—	2,872	2,872	—	2,872
Multi-family	—	—	—	—	—	—
1-4 family	—	—	948	948	213	1,161
Commercial and industrial	782	—	7,349	8,131	4,190	12,321
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	—	—	—	—	—	—
Other	—	—	345	345	9	354
Total	1,187	—	16,350	17,537	8,852	26,389
Total loans and leases						
Commercial real estate:						
Owner occupied	405	—	4,836	5,241	195,146	200,387
Non-owner occupied	—	—	—	—	470,236	470,236
Land development	—	—	—	—	40,154	40,154
Construction	—	196	2,872	3,068	122,089	125,157
Multi-family	—	—	—	—	136,978	136,978
1-4 family	496	—	948	1,444	43,532	44,976
Commercial and industrial	1,951	197	7,349	9,497	419,505	429,002
Direct financing leases, net	—	—	—	—	30,787	30,787
Consumer and other:						
Home equity and second mortgages	106	—	—	106	7,156	7,262
Other	—	—	345	345	17,754	18,099
Total	$2,958	$393	$16,350	$19,701	$1,483,337	$1,503,038
Percent of portfolio	0.20 %	0.03 %	1.09 %	1.32 %	98.68 %	100.00 %

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The Corporation's total impaired assets consisted of the following:

	June 30, 2018	December 31, 2017
	(In Thousands)	
Non-accrual loans and leases		
Commercial real estate:		
Commercial real estate — owner occupied	$9,994	$ 7,021
Commercial real estate — non-owner occupied	31	34
Land development	2,311	2,626
Construction	1,879	2,872
Multi-family	—	—
1-4 family	569	1,161
Total non-accrual commercial real estate	14,784	13,714
Commercial and industrial	15,954	12,321
Direct financing leases, net	—	—
Consumer and other:		
Home equity and second mortgages	—	—
Other	353	354
Total non-accrual consumer and other loans	353	354
Total non-accrual loans and leases	31,091	26,389
Foreclosed properties, net	1,484	1,069
Total non-performing assets	32,575	27,458
Performing troubled debt restructurings	249	332
Total impaired assets	$32,824	$ 27,790

	June 30, 2018	December 31, 2017
Total non-accrual loans and leases to gross loans and leases	1.95 %	1.76 %
Total non-performing assets to total gross loans and leases plus foreclosed properties, net	2.04	1.83
Total non-performing assets to total assets	1.71	1.53
Allowance for loan and lease losses to gross loans and leases	1.31	1.25
Allowance for loan and lease losses to non-accrual loans and leases	67.32	71.10

As of June 30, 2018 and December 31, 2017, $8.4 million and $8.8 million of the non-accrual loans and leases were considered troubled debt restructurings, respectively. There were no unfunded commitments associated with troubled debt restructured loans and leases as of June 30, 2018.

All loans and leases modified as a troubled debt restructuring are measured for impairment. The nature and extent of the impairment of restructured loans, including those which have experienced a default, is considered in the determination of an appropriate level of the allowance for loan and lease losses.

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During the six months ended June 30, 2018, no loans were modified to a troubled debt restructuring. The following table provides the number of loans modified in a troubled debt restructuring during the six months ended June 30, 2017 and the pre- and post-modification recorded investment by class of receivable:

	For the Six Months Ended June 30, 2017		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
	(Dollars in Thousands)		
Commercial and industrial	2	$ 3,714	$ 3,714
Consumer and other	1	17	17
Total	3	$ 3,731	$ 3,731

During the six months ended June 30, 2017, the troubled debt restructurings included a combination of extension of terms and interest rate concessions.

There were no loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the six months ended June 30, 2018 and 2017.

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The following represents additional information regarding the Corporation's impaired loans and leases, including performing troubled debt restructurings, by class:

	As of and for the Six Months Ended June 30, 2018						
	Recorded Investment	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment[1]	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$ 10,046	$ 11,345	$ —	$ 6,311	$ 270	$ 162	$ 108
Non-owner occupied	31	71	—	35	1	—	1
Land development	2,311	6,608	—	2,481	34	—	34
Construction	1,879	2,872	—	2,432	106	—	106
Multi-family	—	—	—	—	—	—	—
1-4 family	761	1,032	—	1,066	30	74	(44)
Commercial and industrial	3,533	5,140	—	3,031	188	149	39
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	1	1	—	2	—	29	(29)
Other	304	970	—	313	28	—	28
Total	18,866	28,039	—	15,671	657	414	243
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	—	—	—	—	—	—	—
Non-owner occupied	—	—	—	—	—	—	—
Land development	—	—	—	—	—	—	—
Construction	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	—	—	—	—	—	—	—
Commercial and industrial	12,425	14,735	4,658	8,699	831	—	831
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	—	—	—	—	—	—	—
Other	49	49	49	8	—	—	—
Total	12,474	14,784	4,707	8,707	831	—	831
Total:							
Commercial real estate:							
Owner occupied	10,046	11,345	—	6,311	270	162	108
Non-owner occupied	31	71	—	35	1	—	1
Land development	2,311	6,608	—	2,481	34	—	34
Construction	1,879	2,872	—	2,432	106	—	106
Multi-family	—	—	—	—	—	—	—
1-4 family	761	1,032	—	1,066	30	74	(44)
Commercial and industrial	15,958	19,875	4,658	11,730	1,019	149	870
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	1	1	—	2	—	29	(29)
Other	353	1,019	49	321	28	—	28

Grand total	$31,340	$42,823	$ 4,707	$ 24,378	$ 1,488	$ 414	$ 1,074

(1) Average recorded investment is calculated primarily using daily average balances.

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	As of and for the Year Ended December 31, 2017						
	Recorded Investment	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment(1)	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$7,077	$7,077	$ —	$ 5,549	$ 613	$ —	$ 613
Non-owner occupied	34	75	—	1,830	97	226	(129)
Land development	2,627	5,297	—	3,092	84	—	84
Construction	—	—	—	2,000	134	214	(80)
Multi-family	—	—	—	1	—	—	—
1-4 family	1,423	1,706	—	2,146	53	7	46
Commercial and industrial	5,465	6,502	—	3,634	858	7	851
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	4	3	—	7	—	—	—
Other	345	1,011	—	365	59	—	59
Total	16,975	21,671	—	18,624	1,898	454	1,444
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	—	—	—	—	—	—	—
Non-owner occupied	—	—	—	—	—	—	—
Land development	—	—	—	—	—	—	—
Construction	2,872	2,872	415	2,252	158	—	158
Multi-family	—	—	—	—	—	—	—
1-4 family	—	—	—	—	—	—	—
Commercial and industrial	6,865	8,813	4,067	12,288	639	—	639
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	—	—	—	—	—	—	—
Other	9	9	9	—	—	—	—
Total	9,746	11,694	4,491	14,540	797	—	797
Total:							
Commercial real estate:							
Owner occupied	7,077	7,077	—	5,549	613	—	613
Non-owner occupied	34	75	—	1,830	97	226	(129)
Land development	2,627	5,297	—	3,092	84	—	84
Construction	2,872	2,872	415	4,252	292	214	78
Multi-family	—	—	—	1	—	—	—
1-4 family	1,423	1,706	—	2,146	53	7	46
Commercial and industrial	12,330	15,315	4,067	15,922	1,497	7	1,490
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	4	3	—	7	—	—	—
Other	354	1,020	9	365	59	—	59
Grand total	$26,721	$33,365	$ 4,491	$ 33,164	$ 2,695	$ 454	$ 2,241

(1) Average recorded investment is calculated primarily using daily average balances.

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The difference between the recorded investment of loans and leases and the unpaid principal balance of $11.5 million and $6.6 million as of June 30, 2018 and December 31, 2017, respectively, represents partial charge-offs of loans and leases resulting from losses due to the appraised value of the collateral securing the loans and leases being below the carrying values of the loans and leases. Impaired loans and leases also included $249,000 and $332,000 of loans as of June 30, 2018 and December 31, 2017, respectively, that were performing troubled debt restructurings, and although not on non-accrual, were reported as impaired due to the concession in terms. When a loan is placed on non-accrual, interest accrual is discontinued and previously accrued but uncollected interest is deducted from interest income. Cash payments collected on non-accrual loans are first applied to such loan's principal. Foregone interest represents the interest that was contractually due on the loan but not received or recorded. To the extent the amount of principal on a non-accrual loan is fully collected and additional cash is received, the Corporation will recognize interest income.

To determine the level and composition of the allowance for loan and lease losses, the Corporation categorizes the portfolio into segments with similar risk characteristics. First, the Corporation evaluates loans and leases for potential impairment classification. The Corporation analyzes each loan and lease determined to be impaired on an individual basis to determine a specific reserve based upon the estimated value of the underlying collateral for collateral-dependent loans, or alternatively, the present value of expected cash flows. The Corporation applies historical trends from established risk factors to each category of loans and leases that has not been individually evaluated for the purpose of establishing the general portion of the allowance.

A summary of the activity in the allowance for loan and lease losses by portfolio segment is as follows:

	As of and for the Three Months Ended June 30, 2018			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Beginning balance	$9,990	$ 8,151	$ 497	$18,638
Charge-offs	(121)	(168)	(17)	(306)
Recoveries	2	17	2	21
Net charge-offs	(119)	(151)	(15)	(285)
Provision for loan and lease losses	1,276	1,237	66	2,579
Ending balance	$11,147	$ 9,237	$ 548	$20,932

	As of and for the Three Months Ended June 30, 2017			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Beginning balance	$12,817	$ 7,943	$ 906	$21,666
Charge-offs	(51)	(3,706)	—	(3,757)
Recoveries	46	66	—	112
Net charge-offs	(5)	(3,640)	—	(3,645)
Provision for loan and lease losses	(809)	4,787	(322)	3,656
Ending balance	$12,003	$ 9,090	$ 584	$21,677

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	As of and for the Six Months Ended June 30, 2018			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Beginning balance	$10,131	$ 8,225	$ 407	$18,763
Charge-offs	(2,296)	(657)	(37)	(2,990)
Recoveries	15	19	71	105
Net charge-offs	(2,281)	(638)	34	(2,885)
Provision for loan and lease losses	3,297	1,650	107	5,054
Ending balance	$11,147	$ 9,237	$ 548	$20,932

	As of and for the Six Months Ended June 30, 2017			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Beginning balance	$12,384	$ 7,970	$ 558	$20,912
Charge-offs	(118)	(3,761)	(87)	(3,966)
Recoveries	150	312	41	503
Net charge-offs	32	(3,449)	(46)	(3,463)
Provision for loan and lease losses	(413)	4,569	72	4,228
Ending balance	$12,003	$ 9,090	$ 584	$21,677

The following tables provide information regarding the allowance for loan and lease losses and balances by type of allowance methodology.

	As of June 30, 2018			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Allowance for loan and lease losses:				
Collectively evaluated for impairment	$11,147	$ 4,579	$ 499	$16,225
Individually evaluated for impairment	—	4,658	49	4,707
Loans acquired with deteriorated credit quality	—	—	—	—
Total	$11,147	$ 9,237	$ 548	$20,932
Loans and lease receivables:				
Collectively evaluated for impairment	$1,072,992	$ 463,583	$ 28,683	$1,565,258
Individually evaluated for impairment	14,697	15,953	354	31,004
Loans acquired with deteriorated credit quality	331	5	—	336
Total	$1,088,020	$ 479,541	$ 29,037	$1,596,598

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	As of December 31, 2017			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Allowance for loan and lease losses:				
Collectively evaluated for impairment	$9,716	$ 4,158	$ 398	$14,272
Individually evaluated for impairment	415	4,067	9	4,491
Loans acquired with deteriorated credit quality	—	—	—	—
Total	$10,131	$ 8,225	$ 407	$18,763
Loans and lease receivables:				
Collectively evaluated for impairment	$1,003,855	$ 447,459	$ 25,003	$1,476,317
Individually evaluated for impairment	13,506	12,324	358	26,188
Loans acquired with deteriorated credit quality	527	6	—	533
Total	$1,017,888	$ 459,789	$ 25,361	$1,503,038

Note 6 — Other Assets

The Corporation is a limited partner in several limited partnership investments. The Corporation is not the general partner, does not have controlling ownership and is not the primary beneficiary in any of these limited partnerships and the limited partnerships have not been consolidated. These investments are accounted for using the equity method of accounting and are evaluated for impairment at the end of each reporting period.

A summary of accrued interest receivable and other assets is as follows:

	June 30, 2018	December 31, 2017
	(In Thousands)	
Accrued interest receivable	$5,568	$ 5,019
Net deferred tax asset	2,273	2,584
Investment in historic development entities	1,849	1,161
Investment in a community development entity	6,336	6,591
Investment in limited partnerships	4,082	4,261
Investment in Trust II	315	315
Fair value of interest rate swaps	1,612	942
Prepaid expenses	2,982	3,091
Other assets	6,125	5,884
Total accrued interest receivable and other assets	$31,142	$ 29,848

Note 7 — Deposits

The composition of deposits is shown below. Average balances represent year-to-date averages.

	June 30, 2018			December 31, 2017		
	Balance	Average Balance	Average Rate	Balance	Average Balance	Average Rate
	(Dollars in Thousands)					
Non-interest-bearing transaction accounts	$255,521	$234,487	— %	$277,445	$230,907	— %
Interest-bearing transaction accounts	272,057	285,216	0.73	217,625	226,540	0.59
Money market accounts	450,654	494,779	0.78	515,077	583,241	0.47
Certificates of deposit	78,062	76,424	1.25	76,199	56,667	1.00
Wholesale deposits	281,431	289,614	1.80	307,985	361,712	1.70
Total deposits	$1,337,725	$1,380,520	0.87	$1,394,331	$1,459,067	0.74

Note 8 — FHLB Advances, Other Borrowings and Junior Subordinated Notes

The composition of borrowed funds at is shown below. Average balances represent year-to-date averages.

	June 30, 2018			December 31, 2017		
	Balance	Weighted Average Balance	Weighted Average Rate	Balance	Weighted Average Balance	Weighted Average Rate
	(Dollars in Thousands)					
Federal funds purchased	$—	$240	2.41 %	$—	$66	1.22 %
FHLB advances	341,000	270,445	1.95	183,500	105,276	1.40
Line of credit	—	7	4.43	10	328	3.64
Other borrowings(1)	675	675	8.09	675	1,241	14.50
Subordinated notes payable	23,741	23,725	6.66	23,713	23,161	6.93
Junior subordinated notes	10,026	10,022	11.01	10,019	10,011	11.11
	$375,442	$305,114	2.63	$217,917	$140,083	3.14
Short-term borrowings	$164,500			$37,010		
Long-term borrowings	210,942			180,907		
	$375,442			$217,917		

(1) Weighted average rate of other borrowings reflects the cost of prepaying a secured borrowing during the second quarter of 2017.

As of June 30, 2018 and December 31, 2017, the Corporation was in compliance with its debt covenants under its third-party secured senior line of credit. Per the promissory note dated February 19, 2018, the Corporation pays a commitment fee on this line of credit. During both the six months ended June 30, 2018 and 2017, the Corporation incurred interest expense due to this fee of $7,000.

Note 9 — Commitments and Contingencies

In the normal course of business, various legal proceedings involving the Corporation are pending. Management, based upon advice from legal counsel, does not anticipate any significant losses as a result of these actions. Management believes that any liability arising from any such proceedings currently existing or threatened will not have a material adverse effect on the Corporation’s financial position, results of operations and cash flows.

The Corporation sells the guaranteed portions of SBA loans, as well as participation interests in other originated loans, to third parties. The Corporation has a continuing involvement in each of the transferred lending arrangements by way of relationship

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management and servicing the loans, as well as being subject to normal and customary requirements of the SBA loan program and standard representations and warranties related to sold amounts. In the event of a loss resulting from default and a determination by the SBA that there is a deficiency in the manner in which the loan was originated, funded or serviced by the Corporation, the SBA may require the Corporation to repurchase the loan, deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of the principal loss related to the deficiency from the Corporation. The Corporation must comply with applicable SBA regulations in order to maintain the guaranty. In addition, the Corporation retains the option to repurchase the sold guaranteed portion of an SBA loan if the loan defaults.

Management has assessed estimated losses inherent in the outstanding guaranteed portions of SBA loans sold in accordance with ASC 450, Contingencies, and determined a recourse reserve based on the probability of future losses for these loans to be $2.4 million at June 30, 2018, which is reported in accrued interest payable and other liabilities on the unaudited Consolidated Balance Sheets.

The summary of the activity in the SBA recourse reserve is as follows:

	As of and for the Six Months Ended	
	June 30, 2018	June 30, 2017
	(In Thousands)	
Balance at the beginning of the period	$2,849	$1,750
SBA recourse (benefit) provision	(196)	780
Charge-offs, net	(238)	(795)
Balance at the end of the period	$2,415	$1,735

Note 10 — Fair Value Disclosures

The Corporation determines the fair values of its financial instruments based on the fair value hierarchy established in ASC Topic 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is defined as the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date and is based on exit prices. Fair value includes assumptions about risk, such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 — Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level 2 — Level 2 inputs are inputs, other than quoted prices included with Level 1, that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; 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 or liabilities.

Level 3 — Level 3 inputs are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

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Assets and liabilities measured at fair value on a recurring basis, segregated by fair value hierarchy level, are summarized below:

	June 30, 2018 Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets:				
Securities available-for-sale:				
U.S. government agency obligations - government-sponsored enterprises	$ —	$ 4,975	$ —	$ 4,975
Municipal obligations	—	7,038	—	7,038
Collateralized mortgage obligations - government issued	—	21,542	—	21,542
Collateralized mortgage obligations - government-sponsored enterprises	—	99,535	—	99,535
Other securities	—	2,380	—	2,380
Interest rate swaps	—	1,612	—	1,612
Liabilities:				
Interest rate swaps	—	704	—	704

	December 31, 2017 Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets:				
Securities available-for-sale:				
U.S. government agency obligations - government-sponsored enterprises	$ —	$ 1,000	$ —	$ 1,000
Municipal obligations	—	9,414	—	9,414
Asset backed securities	—	—	—	—
Collateralized mortgage obligations - government issued	—	22,249	—	22,249
Collateralized mortgage obligations - government-sponsored enterprises	—	90,305	—	90,305
Other securities	—	3,037	—	3,037
Interest rate swaps	—	942	—	942
Liabilities:				
Interest rate swaps	—	1,064	—	1,064

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the three and six months ended June 30, 2018 or the year ended December 31, 2017 related to the above measurements.

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Assets and liabilities measured at fair value on a non-recurring basis, segregated by fair value hierarchy are summarized below:

	June 30, 2018			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Impaired loans	$ —	$ 10,719	$ 5,833	$ 16,552
Foreclosed properties	—	1,484	—	1,484

	December 31, 2017			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Impaired loans	$ —	$ 10,063	$ 5,084	$ 15,147
Foreclosed properties	—	1,069	—	1,069

Impaired loans were written down to the fair value of their underlying collateral less costs to sell of $16.6 million and $15.1 million at June 30, 2018 and December 31, 2017, respectively, through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value of the underlying collateral of impaired loans. Valuation techniques consistent with the market approach, income approach or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as current appraisals, recent sales of similar assets or other observable market data, and are reflected within Level 2 of the hierarchy. In cases where an input is unobservable, typically when discounts are applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. The quantification of unobservable inputs for Level 3 impaired loan values range from 5% - 75% as of the measurement date of June 30, 2018. The weighted average of those unobservable inputs was 17%. The majority of the impaired loans in the Level 3 category are considered collateral dependent loans or are supported by a SBA guaranty.

Foreclosed properties, upon initial recognition, are remeasured and reported at fair value through a charge-off to the allowance for loan and lease losses, if deemed necessary, based upon the fair value of the foreclosed property. The fair value of a foreclosed property, upon initial recognition, is estimated using a market approach or Level 2 inputs based on observable market data, typically a current appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Level 3 inputs typically include unobservable inputs such as management applied discounts used to further reduce values to a net realizable value and may be used in situations when observable inputs become stale. Foreclosed property fair value inputs may transition to Level 1 upon receipt of an accepted offer for the sale of the related foreclosed property.

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Fair Value of Financial Instruments

The Corporation is required to disclose estimated fair values for its financial instruments. Fair value estimates, methods and assumptions, consistent with exit price concepts for fair value measurements, are set forth below:

	June 30, 2018				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
	(In Thousands)				
Financial assets:					
Cash and cash equivalents	$45,803	$45,802	$41,103	$4,699	$ —
Securities available-for-sale	135,470	135,470	—	135,470	—
Securities held-to-maturity	40,946	40,340	—	40,340	—
Loans held for sale	4,976	5,474	—	5,474	—
Loans and lease receivables, net	1,574,021	1,570,464	—	10,719	1,559,745
Federal Home Loan Bank stock	9,295	N/A	N/A	N/A	N/A
Accrued interest receivable	5,568	5,568	5,568	—	—
Interest rate swaps	1,612	1,612	—	1,612	—
Financial liabilities:					
Deposits	1,337,725	1,333,895	978,232	355,663	—
Federal Home Loan Bank advances and other borrowings	365,416	360,520	—	360,520	—
Junior subordinated notes	10,026	9,154	—	—	9,154
Accrued interest payable	2,940	2,940	2,940	—	—
Interest rate swaps	704	704	—	704	—
Off-balance-sheet items:					
Standby letters of credit	43	43	—	—	43

N/A = The fair value is not applicable due to restrictions placed on transferability

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	December 31, 2017				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
	(In Thousands)				
Financial assets:					
Cash and cash equivalents	$52,539	$52,539	$35,114	$17,425	$ —
Securities available-for-sale	126,005	126,005	—	126,005	—
Securities held-to-maturity	37,778	37,696	—	37,696	—
Loans held for sale	2,194	2,413	—	2,413	—
Loans and lease receivables, net	1,482,832	1,482,664	—	10,063	1,472,601
Federal Home Loan Bank stock	5,670	N/A	N/A	N/A	N/A
Accrued interest receivable	5,019	5,019	5,019	—	—
Interest rate swaps	942	942	—	942	—
Financial liabilities:					
Deposits	1,394,331	1,391,801	1,010,147	381,654	—
Federal Home Loan Bank advances and other borrowings	207,898	206,441	—	206,441	—
Junior subordinated notes	10,019	8,836	—	—	8,836
Accrued interest payable	2,095	2,095	2,095	—	—
Interest rate swaps	1,064	1,064	—	1,064	—
Off-balance-sheet items:					
Standby letters of credit	75	75	—	—	75

N/A = The fair value is not applicable due to restrictions placed on transferability

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the unaudited Consolidated Balance Sheets. 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. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Corporation.

Securities: The fair value measurements of investment securities are determined by a third-party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, credit information and the securities' terms and conditions, among other things. The fair value measurements are subject to independent verification by another pricing source on a quarterly basis to review for reasonableness. Any significant differences in pricing are reviewed with appropriate members of management who have the relevant technical expertise to assess the results. The Corporation has determined that these valuations are classified in Level 2 of the fair value hierarchy. When the independent pricing service does not provide a fair value measurement for a particular security, the Corporation will estimate the fair value based on specific information about each security. Fair values derived in this manner are classified in Level 3 of the fair value hierarchy.

Loans Held for Sale: Loans held for sale, which consist of the guaranteed portions of SBA loans, are carried at the lower of cost or estimated fair value. The estimated fair value is based on what secondary markets are currently offering for portfolios with similar characteristics.

Interest Rate Swaps: The carrying amount and fair value of existing derivative financial instruments are based upon independent valuation models, which use widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative contract. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty’s nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Corporation considers the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees.

Limitations: Fair value estimates are made at a discrete point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation’s entire holding of a particular financial instrument. Because no market exists for a significant portion of the Corporation’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and are not considered in the estimates.

Note 11 — Derivative Financial Instruments

The Corporation offers interest rate swap products directly to qualified commercial borrowers. The Corporation economically hedges client derivative transactions by entering into offsetting interest rate swap contracts executed with a third party. Derivative transactions executed as part of this program are not considered hedging instruments and are marked- to-market through earnings each period. The derivative contracts have mirror-image terms, which results in the positions’ changes in fair value primarily offsetting through earnings each period. The credit risk and risk of non-performance embedded in the fair value calculations is different between the dealer counterparties and the commercial borrowers which may result in a difference in the changes in the fair value of the mirror-image swaps. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty’s risk in the fair value measurements. When evaluating the fair value of its derivative contracts for the effects of non-performance and credit risk, the Corporation considered the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At June 30, 2018, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was $93.2 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. These interest rate swaps mature between September 2018 and July 2034. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. These commercial borrower swaps were reported on the unaudited Consolidated Balance Sheet as a derivative asset of $687,000, included in accrued interest receivable and other assets, and as a derivative liability of $704,000, included in accrued interest payable and other liabilities. As of June 30, 2018, no interest rate swaps were in default.

At June 30, 2018, the aggregate amortizing notional value of interest rate swaps with dealer counterparties was also $93.2 million. The Corporation pays fixed rates and receives floating rates based upon LIBOR on the swaps with dealer counterparties. These interest rate swaps mature in September 2018 through July 2034. Dealer counterparty swaps are subject to master netting agreements among the contracts within our Bank and are reported on the unaudited Consolidated Balance Sheet as a net derivate asset of $17,000, included in accrued interest receivable and other assets. The gross amount of dealer counterparty swaps, without regard to the enforceable master netting agreement, was a gross derivative liability of $687,000 and a gross derivative asset of $704,000. No right of offset existed with dealer counterparty swaps as of June 30, 2018.

All changes in the fair value of these instruments are recorded in other non-interest income. Given the mirror-image terms of the outstanding derivative portfolio, the change in fair value for the three and six months ended June 30, 2018 and 2017 had an insignificant impact on the unaudited Consolidated Statements of Income.

The Corporation also enters into interest rate swaps to manage interest rate risk and reduce the cost of match-funding certain long-term fixed rate loans. These derivative contracts involve the receipt of floating rate interest from a counterparty in exchange for the Corporation making fixed-rate payments over the life of the agreement, without the exchange of the underlying notional value. The instruments are designated as cash flow hedges as the receipt of floating rate interest from the counterparty is used to manage interest rate risk associated with forecasted issuances of short-term FHLB advances. The change in the fair value of these hedging instruments is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged transactions affects earnings.

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As of June 30, 2018, the aggregate notional value of interest rate swaps designated as cash flow hedges was $30.0 million. These interest rate swaps matures between June 2027 and December 2027. A pre-tax unrealized gain of $358,000 and $1.0 million was recognized in other comprehensive income for the three and six months ended June 30, 2018, respectively, and there was no ineffective portion of these hedges.
The table below provides information about the balance sheet location and fair value of the Corporation's derivative instruments:

	Interest Rate Swap Contracts			
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
	(In Thousands)			
Derivatives not designated as hedging instruments				
June 30, 2018	Accrued interest receivable and other assets	$ 704	Accrued interest payable and other liabilities	$ 704
December 31, 2017	Accrued interest receivable and other assets	$ 942	Accrued interest payable and other liabilities	$ 942
Derivatives designated as hedging instruments				
June 30, 2018	Accrued interest receivable and other assets	$ 908	Accumulated other comprehensive income (1)	$ 908
December 31, 2017	Accumulated other comprehensive income (1)	$ 122	Accrued interest payable and other liabilities	$ 122

(1) The fair value of derivatives designated as hedging instruments included in accumulated other comprehensive income represent pre-tax amounts, which are reported net of tax on the unaudited Consolidated Balance Sheets.

Note 12 — Regulatory Capital

The Corporation and the Bank are subject to various regulatory capital requirements administered by Federal and the State of Wisconsin banking agencies. Failure to meet minimum capital requirements can result in certain mandatory, and possibly additional discretionary actions on the part of regulators, that if undertaken, could have a direct material effect on the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory practices. The Corporation's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. The Corporation regularly reviews and updates, when appropriate, its Capital and Liquidity Action Plan, which is designed to help ensure appropriate capital adequacy, to plan for future capital needs and to ensure that the Corporation serves as a source of financial strength to the Bank. The Corporation's and the Bank's Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their respective capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.
As a bank holding company, the Corporation's ability to pay dividends is affected by the policies and enforcement powers of the Board of Governors of the Federal Reserve system (the "Federal Reserve"). Federal Reserve guidance urges financial institutions to strongly consider eliminating, deferring or significantly reducing dividends if: (i) net income available to common stockholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividend; (ii) the prospective rate of earnings retention is not consistent with the bank holding company's capital needs and overall current and prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital ratios. Management intends, when appropriate under regulatory guidelines, to consult with the Federal Reserve Bank of Chicago and provide it with information on the Corporation's then-current and prospective earnings and capital position in advance

of declaring any cash dividends. As a Wisconsin corporation, the Corporation is subject to the limitations of the Wisconsin Business Corporation Law, which prohibit the Corporation from paying dividends if such payment would: (i) render the Corporation unable to pay its debts as they become due in the usual course of business, or

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(ii) result in the Corporation’s assets being less than the sum of its total liabilities plus the amount needed to satisfy the preferential rights upon dissolution of any stockholders with preferential rights superior to those stockholders receiving the dividend.

The Bank is also subject to certain legal, regulatory and other restrictions on their ability to pay dividends to the Corporation. As a bank holding company, the payment of dividends by the Bank to the Corporation is one of the sources of funds the Corporation could use to pay dividends, if any, in the future and to make other payments. Future dividend decisions by the Bank and the Corporation will continue to be subject to compliance with various legal, regulatory and other restrictions as defined from time to time.

Qualitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios of Total Common Equity Tier 1 and Tier 1 capital to risk-weighted assets and of Tier 1 capital to adjusted total assets. These risk-based capital requirements presently address credit risk related to both recorded and off-balance-sheet commitments and obligations.

In July 2013, the FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision’s capital guidelines for U.S. banks. These rules are applicable to all financial institutions that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as bank and savings and loan holding companies other than “small bank holding companies” (generally non-publicly traded bank holding companies with consolidated assets of less than $1 billion). Under the final rules, minimum requirements increased for both the quantity and quality of capital held by the Corporation. The rules include a new Common Equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. The rules also permit banking organizations with less than $15 billion in assets to retain, through a one-time election, the past treatment for accumulated other comprehensive income, which did not affect regulatory capital. The Corporation elected to retain this treatment, which reduces the volatility of regulatory capital ratios. A new capital conservation buffer, comprised of Common Equity Tier 1 capital, was also established above the regulatory minimum capital requirements. This capital conservation buffer is being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increases each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019.

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As of June 30, 2018, the Corporation's capital levels exceeded the regulatory minimums and Bank's capital levels remained characterized as well capitalized under the regulatory framework. The following table summarizes both the Corporation's and Bank's capital ratios and the ratios required by their federal regulators:

	Actual		Minimum Required for Capital Adequacy Purposes		For Capital Adequacy Purposes Plus Capital Conservation Buffer		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in Thousands)							
As of June 30, 2018								
Total capital (to risk-weighted assets)								
Consolidated	$221,068	11.87 %	$149,042	8.00 %	$183,974	9.875 %	N/A	N/A
First Business Bank	213,343	11.50	148,355	8.00	183,125	9.875	$185,444	10.00 %
Tier 1 capital (to risk-weighted assets)								
Consolidated	$174,038	9.34 %	$111,781	6.00 %	$146,713	7.875 %	N/A	N/A
First Business Bank	190,160	10.25	111,266	6.00	146,037	7.875	$148,355	8.00 %
Common equity tier 1 capital (to risk-weighted assets)								
Consolidated	$164,012	8.80 %	$83,836	4.50 %	$118,768	6.375 %	N/A	N/A
First Business Bank	190,160	10.25	83,450	4.50	118,220	6.375	$120,538	6.50 %
Tier 1 leverage capital (to adjusted assets)								
Consolidated	$174,038	9.25 %	$75,262	4.00 %	$75,262	4.00 %	N/A	N/A
First Business Bank	190,160	10.15	74,938	4.00	74,938	4.00	$93,672	5.00 %

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	Actual		Minimum Required for Capital Adequacy Purposes		For Capital Adequacy Purposes Plus Capital Conservation Buffer		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in Thousands)							
As of December 31, 2017								
Total capital (to risk-weighted assets)								
Consolidated	$214,501	11.98%	$143,219	8.00%	$165,597	9.250%	N/A	N/A
First Business Bank	207,986	11.66	142,736	8.00	165,038	9.250	$178,420	10.00%
Tier 1 capital (to risk-weighted assets)								
Consolidated	$169,176	9.45 %	$107,414	6.00%	$129,792	7.250%	N/A	N/A
First Business Bank	186,374	10.45	107,052	6.00	129,354	7.250	$142,736	8.00 %
Common equity tier 1 capital (to risk-weighted assets)								
Consolidated	$159,157	8.89 %	$80,561	4.50%	$102,939	5.750%	N/A	N/A
First Business Bank	186,374	10.45	80,289	4.50	102,591	5.750	$115,973	6.50 %
Tier 1 leverage capital (to adjusted assets)								
Consolidated	$169,176	9.54 %	$70,920	4.00%	$70,920	4.00 %	N/A	N/A
First Business Bank	186,374	10.56	70,617	4.00	70,617	4.00	$88,272	5.00 %

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

General

Unless otherwise indicated or unless the context requires otherwise, all references in this Report to the "Corporation," "we," "us," "our," or similar references mean First Business Financial Services, Inc. together with our subsidiary. "FBB" or the "Bank" refers to our subsidiary, First Business Bank.

Forward-Looking Statements

This report may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, which reflect our current views with respect to future events and financial performance. Forward-looking statements are not based on historical information, but rather are related to future operations, strategies, financial results or other developments. Forward-looking statements are based on management's expectations as well as certain assumptions and estimates made by, and information available to, management at the time the statements are made. Such statements are subject to risks and uncertainties, including among other things:

- Competitive pressures among depository and other financial institutions nationally and in our markets.
- Adverse changes in the economy or business conditions, either nationally or in our markets.
- Increases in defaults by borrowers and other delinquencies.
- Our ability to manage growth effectively, including the successful expansion of our client support, administrative infrastructure and internal management systems.
- Fluctuations in interest rates and market prices.
- The consequences of continued bank acquisitions and mergers in our markets, resulting in fewer but much larger and financially stronger competitors.
- Changes in legislative or regulatory requirements applicable to us and our subsidiary.
- Changes in tax requirements, including tax rate changes, new tax laws and revised tax law interpretations.
- Fraud, including client and system failure or breaches of our network security, including our internet banking activities.
- Failure to comply with the applicable SBA regulations in order to maintain the eligibility of the guaranteed portion of SBA loans.

These risks could cause actual results to differ materially from what we have anticipated or projected. These risk factors and uncertainties should be carefully considered by our stockholders and potential investors. See Part I, Item 1A — Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2017 for discussion relating to risk factors impacting us. Investors should not place undue reliance on any such forward-looking statements, which speak only as of the date made. The factors described within this Form 10-Q could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods.

Where any such forward-looking statement includes a statement of the assumptions or bases underlying such forward-looking statement, we caution that, while our management believes such assumptions or bases are reasonable and are made in good faith, assumed facts or bases can vary from actual results, and the differences between assumed facts or bases and actual results can be material, depending on the circumstances. Where, in any forward-looking statement, an expectation or belief is expressed as to future results is believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will be achieved or accomplished.

We do not intend to, and specifically disclaim any obligation to, update any forward-looking statements.

The following discussion and analysis is intended as a review of significant events and factors affecting our financial condition and results of operations for the periods indicated. The discussion should be read in conjunction with the unaudited Consolidated Financial Statements and the Notes thereto presented in this Form 10-Q.

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Overview

We are a registered bank holding company incorporated under the laws of the State of Wisconsin and are engaged in the commercial banking business through our wholly owned banking subsidiary, FBB. All of our operations are conducted through the Bank and its subsidiaries. We operate as a business bank focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small- to medium-sized businesses, business owners, executives, professionals and high net worth individuals. Our products and services include commercial lending, SBA lending and servicing, asset-based lending, equipment financing, factoring, trust and investment services, investment portfolio administrative services, asset/liability management services, treasury management services and a broad range of deposit products. We do not utilize a branch network to attract retail clients. Our operating philosophy is predicated on deep client relationships fostered by local expertise, combined with the efficiency of centralized administrative functions such as information technology, loan and deposit operations, finance and accounting, credit administration, compliance and human resources. Our focused model allows experienced staff to provide the level of financial expertise needed to develop and maintain long-term relationships with our clients.

Operational Summary

Results for the three and six months ended June 30, 2018 include:

- Total assets increased to $1.900 billion as of June 30, 2018 compared to $1.794 billion as of December 31, 2017.
- Net income for the three months ended June 30, 2018 was $3.3 million compared to net income of $1.9 million for the three months ended June 30, 2017. Net income for the six months ended June 30, 2018 was $6.9 million compared to net income of $5.3 million for the six months ended June 30, 2017.
- Diluted earnings per common share for the three months ended June 30, 2018 were $0.38 compared to diluted earnings per common share of $0.22 for the three months ended June 30, 2017. Diluted earnings per common share for the six months ended June 30, 2018 were $0.79 compared to diluted earnings per common share of $0.61 for the six months ended June 30, 2017.
- Annualized return on average assets (“ROAA”) and annualized return on average equity (“ROAE”) were 0.70% and 7.59%, respectively, for the three month period ended June 30, 2018, compared to 0.42% and 4.50%, respectively, for the same time period in 2017. ROAA and ROAE were 0.74% and 8.22%, respectively, for the six month period ended June 30, 2018 compared to 0.59% and 6.38%, respectively, for the same period in 2017.
- Net interest income increased 9.4% to $16.9 million for the three months ended June 30, 2018 compared to $15.5 million for the three months ended June 30, 2017. For the six months ended June 30, 2018, net interest income increased 9.1% to $33.1 million compared to $30.4 million for the six months ended June 30, 2017.
- Trust and investment services fee income increased 20.6% to $2.0 million for the three months ended June 30, 2018 compared to $1.6 million for the three months ended June 30, 2017. For the six months ended June 30, 2018, trust and investment services fee income increased 18.5% to $3.9 million compared to $3.3 million for the six months ended June 30, 2017.
- Top line revenue, the sum of net interest income and non-interest income, increased 3.4% to $20.9 million for the three months ended June 30, 2018 compared to $20.2 million for the three months ended June 30, 2017. For the six months ended June 30, 2018, top line revenue increased 6.7% to $41.8 million compared to $39.2 million for the six months ended June 30, 2017.
- Net interest margin increased 13 basis points to 3.77% for the three months ended June 30, 2018 compared to 3.64% for the three months ended June 30, 2017. Net interest margin increased 13 basis points to 3.71% for the six months ended June 30, 2018 compared to 3.58% for the six months ended June 30, 2017.
- Efficiency ratio was 67.07% for the three months ended June 30, 2018, compared to 65.39% for the three months ended June 30, 2017. For the six months ended June 30, 2018 our efficiency ratio was 67.27% compared to 68.03% for the same time period in 2017.
- Provision for loan and lease losses was $2.6 million for the three months ended June 30, 2018 compared to $3.7 million for the same period in the prior year. Provision for loan and lease losses was $5.1 million for the six months

ended June 30, 2018 compared to $4.2 million for the same time period in 2017.

- SBA recourse provision was $99,000 for the three months ended June 30, 2018, compared to $774,000 for the three months ended June 30, 2017. For the six months ended June 30, 2018, SBA recourse provision was a net benefit of $196,000 compared to an expense of $780,000 for the six months ended June 30, 2017.
- Net charge-offs of $285,000 represented an annualized 0.07% of average loans and leases for the three months ended June 30, 2018 compared to annualized net charge-offs of 0.99% for the three months ended June 30, 2017. Net charge-offs of $2.9 million represented an annualized 0.37% of average loans and leases for the six months ended June 30, 2018 compared to annualized net charge-offs of 0.47% for the six months ended June 30, 2017.

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- Gross loans and leases receivable increased $93.4 million, or 12.4% annualized, to $1.595 billion at June 30, 2018 from $1.502 billion at December 31, 2017.
- Allowance for loan and lease losses as a percentage of gross loans and leases was 1.31% at June 30, 2018 compared to 1.25% at December 31, 2017.
- Non-performing assets as a percentage of total assets was 1.71% at June 30, 2018 compared to 1.53% at December 31, 2017.
- Non-accrual loans and leases increased by $4.7 million, or 17.8%, to $31.1 million at June 30, 2018 from $26.4 million at December 31, 2017.

Results of Operations

Top Line Revenue

Top line revenue is comprised of net interest income and non-interest income. For the three and six months ended June 30, 2018, top line revenue increased 3.4% and 6.7%, respectively, compared to the same period in the prior year primarily due to higher loan yields combined with loan growth, as well as an increase in trust and investment fee income. This increase was partially offset by higher rates paid on interest-bearing liabilities amid a rising rate environment and a decline in gains on the sale of SBA loans, loan fees and other non-interest income.

The components of top line revenue were as follows:

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2018	2017	Change	2018	2017	Change
	(Dollars in Thousands)					
Net interest income	$16,931	$15,479	9.4 %	$33,132	$30,367	9.1 %
Non-interest income	3,982	4,738	(16.0)	8,648	8,801	(1.7)
Total top line revenue	$20,913	$20,217	3.4	$41,780	$39,168	6.7

Annualized Return on Average Assets and Annualized Return on Average Equity

ROAA for the three months ended June 30, 2018 increased to 0.70% compared to 0.42% for the three months ended June 30, 2017. ROAA for the six months ended June 30, 2018 increased to 0.74% compared to 0.59% for the six months ended June 30, 2017. The increase in ROAA for both periods was primarily due to an increase in net interest income, trust and investment fee income and a reduction to the corporate federal income tax rate from 35% to 21% effective January 1, 2018. This improvement in profitability was partially offset by an increase in compensation expense and moderate decreases in certain non-interest income items, including gains on the sale of SBA loans and other non-interest income. ROAA is a critical metric used by us to measure the profitability of our organization and how efficiently our assets are deployed. It is a measurement that allows us to better benchmark our profitability to our peers without the need to consider different degrees of leverage that can ultimately influence return on equity measures.

ROAE for the three months ended June 30, 2018 was 7.59% compared to 4.50% for the three months ended June 30, 2017. ROAE for the six months ended June 30, 2018 was 8.22% compared to 6.38% for the six months ended June 30, 2017. The reasons for the increase in ROAE are consistent with the explanations discussed above with respect to ROAA. We view ROAE to be an important measure of profitability and we continue to focus on improving the return to our stockholders by enhancing the overall profitability of our client relationships, controlling expenses and seeking to minimize credit costs.

Efficiency Ratio

Efficiency ratio is a non-GAAP measure representing non-interest expense excluding the effects of the SBA recourse provision, impairment of tax credit investments, losses or gains on foreclosed properties, amortization of other intangible assets and other discrete items, if any, divided by operating revenue, which is equal to net interest income plus non-interest income less realized gains or losses on securities, if any.

The efficiency ratio was 67.07% and 67.27% for the three and six months ended June 30, 2018, respectively, compared to 65.39% and 68.03% for the three and six months ended June 30, 2017, respectively. We continue to progress towards enhancing the Corporation’s long-term efficiency ratio through both proactive expense management and revenue growth efforts. These efforts include the recently completed charter consolidation and core conversion, an expected

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normalization of loan workout costs, as well as long-term revenue initiatives. These initiatives include efforts to increase SBA lending production and to increase commercial banking market share, particularly in our less mature markets, by continuing to invest in production talent. Management will continue to take proactive measures to drive positive operating leverage with the objective of moving the efficiency ratio back within the Corporation’s long-term operating goal of 58-62%.

We believe the efficiency ratio allows investors and analysts to better assess the Corporation’s operating expenses in relation to its operating revenue by removing the volatility that is associated with certain non-recurring or discrete items. The efficiency ratio also allows management to benchmark performance of our model to our peers without the influence of the loan loss provision and tax considerations, which will ultimately influence other traditional financial measurements, including ROAA and ROAE. The information provided below reconciles the efficiency ratio to its most comparable GAAP measure.

Please refer to both the Non-Interest Income and Non-Interest Expense sections below for discussion on the primary drivers of the year-over-year improvement in the efficiency ratio.

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2018	2017	$ Change	% Change	2018	2017	$ Change	% Change
	(Dollars in Thousands)							
Total non-interest expense	$14,467	$14,221	$246	1.7 %	$28,374	$27,781	$593	2.1 %
Less:								
Amortization of other intangible assets	12	14	(2)	(14.3)	24	28	(4)	(14.3)
SBA recourse provision (benefit)	99	774	(675)	(87.2)	(196)	780	(976)	(125.1)
Impairment of tax credit investments	329	112	217	193.8	442	225	217	96.4
Deconversion fees	—	101	(101)	(100.0)	—	101	(101)	(100.0)
Total operating expense	$14,027	$13,220	$807	6.1	$28,104	$26,647	$1,457	5.5
Net interest income	$16,931	$15,479	$1,452	9.4	$33,132	$30,367	2,765	9.1
Total non-interest income	3,982	4,738	(756)	(16.0)	8,648	8,801	(153)	(1.7)
Less:								
Gain on sale of securities	—	1	(1)	(100.0)	—	1	(1)	(100.0)
Total operating revenue	$20,913	$20,216	$697	3.4	$41,780	$39,167	$2,613	6.7
Efficiency ratio	67.07 %	65.39 %			67.27 %	68.03 %		

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Net Interest Income

Net interest income levels depend on the amount of and yield on interest-earning assets as compared to the amount of and rate paid on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the asset/liability management processes to prepare for and respond to such changes.

The following table provides information with respect to (1) the change in net interest income attributable to changes in rate (changes in rate multiplied by prior volume) and (2) the change in net interest income attributable to changes in volume (changes in volume multiplied by prior rate) for the three and six months ended June 30, 2018 compared to the same periods in 2017. The change in net interest income attributable to changes in rate and volume (changes in rate multiplied by changes in volume) has been allocated to the rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each.

	Increase (Decrease) for the Three Months Ended June 30, 2018 Compared to 2017			Increase (Decrease) for the Six Months Ended June 30, 2018 Compared to 2017		
	Rate	Volume	Net	Rate	Volume	Net
	(In Thousands)					
Interest-earning assets						
Commercial real estate and other mortgage loans(1)	$1,306	$1,338	$2,644	$2,180	$2,486	$4,666
Commercial and industrial loans(1)	570	(304)	266	853	(479)	374
Direct financing leases(1)	(19)	26	7	(36)	24	(12)
Consumer and other loans(1)	28	14	42	44	26	70
Total loans and leases receivable	1,885	1,074	2,959	3,041	2,057	5,098
Mortgage-related securities	174	(14)	160	324	(95)	229
Other investment securities	17	(15)	2	34	(24)	10
FHLB and FRB Stock	12	30	42	10	57	67
Short-term investments	93	(13)	80	108	5	113
Total net change in income on interest-earning assets	2,181	1,062	3,243	3,517	2,000	5,517
Interest-bearing liabilities						
Transaction accounts	281	59	340	300	216	516
Money market accounts	556	(148)	408	881	(282)	599
Certificates of deposit	56	50	106	92	121	213
Wholesale deposits	132	(435)	(303)	249	(870)	(621)
Total deposits	1,025	(474)	551	1,522	(815)	707
FHLB advances	244	1,114	1,358	449	1,760	2,209
Other borrowings	(127)	9	(118)	(143)	(21)	(164)
Junior subordinated notes	—	—	—	(1)	1	—
Total net change in expense on interest-bearing liabilities	1,142	649	1,791	1,827	925	2,752
Net change in net interest income	$1,039	$413	$1,452	$1,690	$1,075	$2,765

(1) Includes non-accrual loans and leases and loans held for sale.

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The table below shows our average balances, interest, average yields/rates, net interest margin and the spread between the combined average yields earned on interest-earning assets and average rates on interest-bearing liabilities for the three and six months ended June 30, 2018 and 2017. The average balances are derived from average daily balances.

	For the Three Months Ended June 30,					
	2018			2017		
	Average Balance	Interest	Average Yield/Rate[4]	Average Balance	Interest	Average Yield/Rate[4]
	(Dollars in Thousands)					
Interest-earning assets						
Commercial real estate and other mortgage loans[1]	$1,073,326	$13,264	4.94 %	$959,176	$10,620	4.43 %
Commercial and industrial loans[1]	434,657	7,347	6.76	453,578	7,081	6.24
Direct financing leases[1]	31,284	313	4.00	28,728	306	4.26
Consumer and other loans[1]	29,914	319	4.27	28,580	277	3.88
Total loans and leases receivable[1]	1,569,181	21,243	5.42	1,470,062	18,284	4.98
Mortgage-related securities[2]	136,982	775	2.26	140,086	615	1.76
Other investment securities[3]	34,391	163	1.90	37,765	161	1.70
FHLB and FRB stock	8,392	66	3.15	4,229	24	2.26
Short-term investments	45,473	221	1.94	49,584	141	1.14
Total interest-earning assets	1,794,419	22,468	5.01	1,701,726	19,225	4.52
Non-interest-earning assets	94,923			81,798		
Total assets	$1,889,342			$1,783,524		
Interest-bearing liabilities						
Transaction accounts	$272,840	628	0.92	$231,720	288	0.50
Money market accounts	474,943	1,067	0.90	588,787	659	0.45
Certificates of deposit	71,994	239	1.33	54,530	133	0.98
Wholesale deposits	278,496	1,275	1.83	375,530	1,578	1.68
Total interest-bearing deposits	1,098,273	3,209	1.17	1,250,567	2,658	0.85
FHLB advances	322,791	1,637	2.03	87,386	279	1.28
Other borrowings	24,889	414	6.65	24,494	532	8.69
Junior subordinated notes	10,023	277	11.05	10,009	277	11.08
Total interest-bearing liabilities	1,455,976	5,537	1.52	1,372,456	3,746	1.09
Non-interest-bearing demand deposit accounts	240,352			229,051		
Other non-interest-bearing liabilities	19,752			14,531		
Total liabilities	1,716,080			1,616,038		
Stockholders' equity	173,262			167,486		
Total liabilities and stockholders' equity	$1,889,342			$1,783,524		
Net interest income		$16,931			$15,479	
Interest rate spread			3.49 %			3.43 %
Net interest-earning assets	$338,443			$329,270		
Net interest margin			3.77 %			3.64 %
Average interest-earning assets to average interest-bearing liabilities	123.25 %			123.99 %		
Return on average assets[4]	0.70			0.42		
Return on average equity[4]	7.59			4.50		
Average equity to average assets	9.17			9.39		
Non-interest expense to average assets[4]	3.06			3.19		

(1)

The average balances of loans and leases include non-accrual loans and leases and loans held for sale. Interest income related to non-accrual loans and leases is recognized when collected. Interest income includes net loan fees collected in lieu of interest.

(2) Includes amortized cost basis of assets available-for-sale and held-to-maturity.
(3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.
(4) Represents annualized yields/rates.

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	For the Six Months Ended June 30,							
	2018				2017			
	Average Balance	Interest	Average Yield/Rate[4]		Average Balance	Interest	Average Yield/Rate[4]	
	(Dollars in Thousands)							
Interest-earning assets								
Commercial real estate and other mortgage loans[1]	$1,060,112	$25,605	4.83	%	$952,679	$20,939	4.40	%
Commercial and industrial loans[1]	437,061	14,049	6.43		452,570	13,675	6.04	
Direct financing leases[1]	30,582	617	4.04		29,422	629	4.28	
Consumer and other loans[1]	29,639	633	4.27		28,392	563	3.97	
Total loans and leases receivable[1]	1,557,394	40,904	5.25		1,463,063	35,806	4.89	
Mortgage-related securities[2]	132,546	1,462	2.21		142,929	1,233	1.73	
Other investment securities[3]	35,386	332	1.88		38,157	322	1.69	
FHLB and FRB stock	7,559	114	3.02		3,693	47	2.57	
Short-term investments	51,349							