MidWestOne Financial Group, Inc.
Form 10-Q
November 05, 2018

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ______ to ______
Commission file number 001-35968

MIDWEST*ONE* FINANCIAL GROUP, INC.

(Exact name of Registrant as specified in its charter)

Iowa	**42-1206172**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

102 South Clinton Street
Iowa City, IA 52240
(Address of principal executive offices, including zip code)
319-356-5800
(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 No
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth 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
Non-accelerated filer	Smaller reporting company
	Emerging growth 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

As of October 31, 2018, there were 12,221,547 shares of common stock, $1.00 par value per share, outstanding.

MIDWEST*ONE* FINANCIAL GROUP, INC.
Form 10-Q Quarterly Report
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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements.

MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(dollars in thousands)	September 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Cash and due from banks	$ 49,229	$ 44,818
Interest-earning deposits in banks	4,150	5,474
Federal funds sold	—	680
Total cash and cash equivalents	53,379	50,972
Equity securities at fair value	2,797	2,336
Debt securities available for sale at fair value	407,766	445,324
Held to maturity securities at amortized cost (fair value of $186,057 at September 30, 2018 and $194,343 at December 31, 2017)	191,733	195,619
Loans held for sale	1,124	856
Loans held for investment, net of unearned income	2,377,649	2,286,695
Allowance for loan losses	(31,278)	(28,059)
Total loans held for investment, net	2,346,371	2,258,636
Premises and equipment, net	76,497	75,969
Interest receivable	14,800	14,732
Goodwill	64,654	64,654
Other intangible assets, net	10,378	12,046
Bank-owned life insurance	60,609	59,831
Foreclosed assets, net	549	2,010
Deferred income taxes, net	9,993	6,525
Other assets	27,315	22,761
Total assets	$ 3,267,965	$ 3,212,271
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest-bearing demand	$ 458,576	$ 461,969
Interest-bearing checking	1,236,922	1,228,112
Savings	211,591	213,430
Certificates of deposit under $100,000	348,099	324,681
Certificates of deposit $100,000 and over	377,071	377,127
Total deposits	2,632,259	2,605,319
Federal funds purchased	19,056	1,000
Securities sold under agreements to repurchase	68,922	96,229
Federal Home Loan Bank borrowings	143,000	115,000
Junior subordinated notes issued to capital trusts	23,865	23,793
Long-term debt	8,750	12,500
Deferred compensation liability	5,305	5,199
Interest payable	2,054	1,428
Other liabilities	15,565	11,499
Total liabilities	2,918,776	2,871,967
Shareholders' equity:		
Preferred stock, no par value; authorized 500,000 shares; no shares issued and outstanding at September 30, 2018 and December 31, 2017	$ —	$ —
	12,463	12,463

Common stock, $1.00 par value; authorized 30,000,000 shares at September 30, 2018 and December 31, 2017; issued 12,463,481 shares at September 30, 2018 and December 31, 2017; 12,221,107 outstanding shares at September 30, 2018 and 12,219,611 shares at December 31, 2017		
Additional paid-in capital	187,581	187,486
Treasury stock at cost, 242,374 shares as of September 30, 2018 and 243,870 shares as of December 31, 2017	(5,474)	(5,121)
Retained earnings	163,709	148,078
Accumulated other loss	(9,090)	(2,602)
Total shareholders' equity	349,189	340,304
Total liabilities and shareholders' equity	$ 3,267,965	$ 3,212,271

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(unaudited) (dollars in thousands, except per share amounts)	**2018**	**2017**	**2018**	**2017**
Interest income:				
Loans	$28,088	$26,206	$82,141	$76,135
Bank deposits	12	19	38	50
Federal funds sold	—	—	1	1
Taxable securities	2,965	2,589	8,793	7,897
Tax-exempt securities	1,395	1,547	4,452	4,699
Total interest income	32,460	30,361	95,425	88,782
Interest expense:				
Interest on deposits:				
Interest-bearing checking	1,622	913	3,998	2,623
Savings	63	53	189	155
Certificates of deposit under $100,000	1,270	893	3,399	2,638
Certificates of deposit $100,000 and over	1,670	1,041	4,584	2,953
Total interest expense on deposits	4,625	2,900	12,170	8,369
Federal funds purchased	144	81	480	152
Securities sold under agreements to repurchase	173	53	451	125
Federal Home Loan Bank borrowings	741	474	1,873	1,321
Other borrowings	3	3	9	9
Junior subordinated notes issued to capital trusts	313	243	878	704
Long-term debt	100	115	309	338
Total interest expense	6,099	3,869	16,170	11,018
Net interest income	26,361	26,492	79,255	77,764
Provision for loan losses	950	4,384	4,050	6,665
Net interest income after provision for loan losses	25,411	22,108	75,205	71,099
Noninterest income:				
Trust, investment, and insurance fees	1,526	1,454	4,703	4,594
Service charges and fees on deposit accounts	1,148	1,295	3,474	3,835
Loan origination and servicing fees	891	1,012	2,738	2,532
Other service charges and fees	1,502	1,625	4,464	4,580
Bank-owned life insurance income	399	344	1,229	990
Gain on sale or call of debt securities	192	176	197	239
Other gain	326	10	338	66
Total noninterest income	5,984	5,916	17,143	16,836
Noninterest expense:				
Salaries and employee benefits	13,051	12,039	37,647	35,712
Occupancy and equipment, net	3,951	2,986	10,440	9,323
Professional fees	1,861	933	3,614	2,991
Data processing	697	723	2,076	1,982
FDIC insurance	393	238	1,104	957
Amortization of intangibles	547	759	1,793	2,412
Other	2,311	2,066	7,026	6,666
Total noninterest expense	22,811	19,744	63,700	60,043

Income before income tax expense	8,584	8,280	28,648	27,892
Income tax expense	1,806	1,938	5,921	7,603
Net income	$6,778	$6,342	$22,727	$20,289
Per share information:				
Earnings per common share - basic	$0.55	$0.52	$1.86	$1.69
Earnings per common share - diluted	0.55	0.52	1.86	1.69
Dividends paid per common share	0.195	0.170	0.585	0.500

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
(unaudited) (dollars in thousands)	**2018**	**2017**	**2018**	**2017**
Net income	$6,778	$6,342	$22,727	$20,289
Other comprehensive income, available for sale debt securities:				
Unrealized holding gains (losses) arising during period	(2,085)	(1,158)	(8,501)	3,154
Reclassification adjustment for gains included in net income	(192)	(176)	(201)	(196)
Income tax (expense) benefit	594	526	2,271	(1,160)
Other comprehensive income (loss) on available for sale debt securities	(1,683)	(808)	(6,431)	1,798
Other comprehensive income (loss), net of tax	(1,683)	(808)	(6,431)	1,798
Comprehensive income	$5,095	$5,534	$16,296	$22,087

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(unaudited) (dollars in thousands, except per share amounts)	Preferred Stock	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2016	$ —	$ 11,713	$ 163,667	$ (5,766)	$ 136,975	$ (1,133)	$ 305,456
Net income	—	—	—	—	20,289	—	20,289
Issuance of common stock (750,000 shares), net of expenses of $1,328	—	750	23,610	—	—	—	24,360
Dividends paid on common stock ($0.50 per share)	—	—	—	—	(5,984)	—	(5,984)
Stock options exercised (8,250 shares)	—	—	(81)	172	—	—	91
Release/lapse of restriction on RSUs (26,875 shares)	—	—	(560)	453	—	—	(107)
Stock compensation	—	—	660	—	—		660
Other comprehensive income, net of tax	—	—	—	—	—	1,798	1,798
Balance at September 30, 2017	$ —	$ 12,463	$ 187,296	$ (5,141)	$ 151,280	$ 665	$ 346,563
Balance at December 31, 2017	$ —	$ 12,463	$ 187,486	$ (5,121)	$ 148,078	$ (2,602)	$ 340,304
Cumulative effect of changes in accounting principles[1]	—	—	—	—	57	(57)	—
Net income	—	—	—	—	22,727	—	22,727
Dividends paid on common stock ($0.585 per share)	—	—	—	—	(7,153)	—	(7,153)
Stock options exercised (9,700 shares)	—	—	(68)	204	—	—	136
Release/lapse of restriction on RSUs (28,525 shares)	—	—	(609)	524	—	—	(85)
Repurchase of common stock (33,998 shares)	—	—	—	(1,081)	—	—	(1,081)
Stock compensation	—	—	772	—	—	—	772
Other comprehensive loss, net of tax	—	—	—	—	—	(6,431)	(6,431)
Balance at September 30, 2018	$ —	$ 12,463	$ 187,581	$ (5,474)	$ 163,709	$ (9,090)	$ 349,189

(1) See Note 2. "Effect of New Financial Accounting Standards" for additional information.

See accompanying notes to consolidated financial statements.

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MIDWEST*ONE* FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited) (dollars in thousands)	Nine Months Ended September 30, 2018	2017
Cash flows from operating activities:		
Net income	$22,727	$20,289
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	4,050	6,665
Depreciation of premises and equipment	3,217	3,088
Amortization of other intangibles	1,793	2,412
Amortization of premiums and discounts on investment securities, net	729	913
(Gain) loss on sale of premises and equipment	616	(2)
Deferred income taxes	(1,184)	(554)
Excess tax benefit from share-based award activity	(14)	(91)
Stock-based compensation	772	660
Net losses on equity securities	34	—
Net gain on sale or call of debt securities available for sale	(201)	(196)
Net (gain) loss on sale or call of debt securities held to maturity	4	(43)
Net gain on sale of other real estate owned	(240)	(45)
Net gain on sale of loans held for sale	(1,214)	(1,337)
Writedown of other real estate owned	5	23
Origination of loans held for sale	(49,091)	(65,078)
Proceeds from sales of loans held for sale	50,037	70,044
Increase in interest receivable	(68)	—
Increase in cash surrender value of bank-owned life insurance	(1,229)	(990)
Increase in other assets	(4,554)	(2,224)
Increase (decrease) in deferred compensation liability	106	(22)
Increase in interest payable, accounts payable, accrued expenses, and other liabilities	4,692	445
Net cash provided by operating activities	30,987	33,957
Cash flows from investing activities:		
Purchases of equity securities	(508)	(7)
Proceeds from sales of debt securities available for sale	16,494	22,546
Proceeds from maturities and calls of debt securities available for sale	51,338	53,171
Purchases of debt securities available for sale	(39,289)	(23,038)
Proceeds from sales of debt securities held to maturity	—	1,153
Proceeds from maturities and calls of debt securities held to maturity	4,220	12,370
Purchase of debt securities held to maturity	(553)	(28,546)
Net increase in loans	(92,320)	(100,880)
Purchases of premises and equipment	(5,196)	(3,035)
Proceeds from sale of other real estate owned	2,231	983
Proceeds from sale of premises and equipment	906	32
Proceeds of principal and earnings from bank-owned life insurance	452	—
Purchases of bank owned life insurance	—	(11,211)
Payments to acquire intangible assets	(125)	—
Net cash used in investing activities	(62,350)	(76,462)
Cash flows from financing activities:		
Net increase in deposits	26,940	9,967
Increase (decrease) in federal funds purchased	18,056	(18,976)
Increase (decrease) in securities sold under agreements to repurchase	(27,307)	5,777
Proceeds from Federal Home Loan Bank borrowings	110,000	145,000

Repayment of Federal Home Loan Bank borrowings	(82,000)	(115,000)
Proceeds from stock options exercised	136	1
Excess tax benefit from share-based award activity	14	91
Taxes paid relating to net share settlement of equity awards	(85)	(108)
Payments on long-term debt	(3,750)	(3,750)
Dividends paid	(7,153)	(5,984)
Proceeds from issuance of common stock	—	25,688
Payment of stock issuance costs	—	(1,328)
Repurchase of common stock	(1,081)	—
Net cash provided by financing activities	33,770	41,378
Net increase (decrease) in cash and cash equivalents	2,407	(1,127)
Cash and cash equivalents at beginning of period	50,972	43,228
Cash and cash equivalents at end of period	$ 53,379	$ 42,101

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(unaudited) (dollars in thousands)	Nine Months Ended September 30,	
	2018	2017
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	$ 15,544	$ 11,041
Cash paid during the period for income taxes	$ 4,420	$ 8,460
Supplemental schedule of non-cash investing activities:		
Transfer of loans to other real estate owned	$ 535	$ 207
Transfer due to cumulative effective of change in accounting principles. See Note 2. "Effect of New Financial Accounting Standards" for additional information.	$ 57	$ —

See accompanying notes to consolidated financial statements.

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MidWest*One* Financial Group, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

1. Principles of Consolidation and Presentation

MidWest*One* Financial Group, Inc. (the "Company," which is also referred to herein as "we," "our" or "us") is an Iowa corporation incorporated in 1983, a bank holding company under the Bank Holding Company Act of 1956, as amended, and a financial holding company under the Gramm-Leach-Bliley Act of 1999. Our principal executive offices are located at 102 South Clinton Street, Iowa City, Iowa 52240.

On August 21, 2018, the Company entered into a merger agreement with ATBancorp, an Iowa corporation, pursuant to which ATBancorp will merge with and into the Company. In connection with the merger, American Trust & Savings Bank, an Iowa state chartered bank and wholly owned subsidiary of ATBancorp, and American Bank & Trust Wisconsin, a Wisconsin state chartered bank and wholly owned subsidiary of ATBancorp, will merge with and into MidWest*One* Bank, which will continue as the surviving bank. The merger agreement also provides that each of the outstanding shares of ATBancorp common stock will be converted into the right of ATBancorp shareholders to receive 117.5500 shares of Company common stock and $992.51 in cash. The corporate headquarters of the combined company will be in Iowa City, Iowa. The merger is anticipated to be completed in the first quarter of 2019. For further information, please refer to the Current Report on Form 8-K filed by the Company with the SEC on August 22, 2018.

The Company owns all of the common stock of MidWest*One* Bank, an Iowa state non-member bank chartered in 1934 with its main office in Iowa City, Iowa (the "Bank"), and all of the common stock of MidWest*One* Insurance Services, Inc., Oskaloosa, Iowa. We operate primarily through MidWest*One* Bank, our bank subsidiary, and MidWest*One* Insurance Services, Inc., our wholly owned subsidiary that operates an insurance agency business through six offices located in central and east-central Iowa.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all the information and notes necessary for complete financial statements in conformity with U.S. generally accepted accounting principles ("GAAP"). The information in this Quarterly Report on Form 10-Q is written with the presumption that the users of the interim financial statements have read or have access to the most recent Annual Report on Form 10-K of the Company, filed with the Securities and Exchange Commission (SEC) on March 1, 2018, which contains the latest audited financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2017 and for the year then ended. Management believes that the disclosures in this Form 10-Q are adequate to make the information presented not misleading. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the Company's financial position as of September 30, 2018 and December 31, 2017, and the results of operations and cash flows for the three and nine months ended September 30, 2018 and 2017. All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect: (1) the reported amounts of assets and liabilities, (2) the disclosure of contingent assets and liabilities at the date of the financial statements, and (3) the reported amounts of revenues and expenses during the reporting period. These estimates are based on information available to management at the time the estimates are made. Actual results could differ from those estimates. The results for the three and nine months ended September 30, 2018 may not be indicative of results for the year ending December 31, 2018, or for any other period.

All significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the Annual Report on Form 10-K for the year ended December 31, 2017.

In the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits in banks, and federal funds sold.

Certain reclassifications have been made to prior periods' consolidated financial statements to present them on a basis comparable with the current period's consolidated financial statements.

2. Effect of New Financial Accounting Standards

Accounting Guidance Adopted in 2018

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contract with Customers (Topic 606).* Subsequent to the issuance of ASU 2014-09, the FASB

issued targeted updates to clarify specific implementation issues including ASU No. 2016-08, "*Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*," ASU No. 2016-10, "*Identifying Performance Obligations and Licensing,*" ASU No. 2016-12, "*Narrow-Scope Improvements and Practical Expedients,*" and ASU No. 2016-20 "*Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.*" For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other sections of GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, service charges on deposit accounts, sales of other real estate, and debit card interchange fees. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross versus net). Based on its evaluation, the Company determined that ASU 2014-09 also did not materially change the method in which the Company currently recognizes costs for these revenue streams. The Company adopted this update on January 1, 2018, utilizing the modified retrospective transition method. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary. See Note 14 "Revenue Recognition" for more information.

In January 2016, the FASB issued Accounting Standards Update No. 2016-01, *Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities.* The guidance in this update makes changes to the current GAAP model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is largely unchanged. The treatment of gains and losses for all equity securities, including those without a readily determinable market value, is expected to result in additional volatility in the income statement, with the loss of mark to market via equity for these investments. Additionally, changes in the allowable method for determining the fair value of financial instruments in the financial statement footnotes ("exit price" only) require changes to current methodologies of determining these values, and how they are disclosed in the financial statement footnotes. The new standard applies to public business entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this update on January 1, 2018. With the elimination of the classification of available for sale equity securities, the net unrealized gain or loss on these securities that had been included in accumulated other comprehensive income at December 31, 2017, in the amount of $57,000, has been transferred to retained earnings, as shown in the consolidated statements of shareholders' equity. Changes in the fair value of equity securities with readily determinable fair values are now reflected in the noninterest income portion of the consolidated statements of income, in the other gains (losses) line item. In accordance with the ASU requirements, the Company measured the fair value of its loan portfolio as of September 30, 2018 using an exit price notion. See Note 13. "Estimated Fair Value of Financial Instruments and Fair Value Measurements" to our consolidated financial statements.

Accounting Guidance Pending Adoption at September 30, 2018

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases (Topic 842)*. The guidance in this update is meant to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset

and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases. Disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To meet that objective, qualitative disclosures along with specific quantitative disclosures are required. The new standard applies to public business entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore not recognized on the Company's consolidated balance sheets. The Company expects the new guidance will require these lease agreements to now be recognized on the consolidated balance sheets as right-of-use assets and a corresponding lease liability. Therefore, the Company's preliminary evaluation indicates the provisions of ASU No. 2016-02 are expected to impact the Company's consolidated statements of income, along with the Company's regulatory capital ratios. However, the Company continues

to evaluate the extent of potential impact the new guidance will have on the Company's consolidated financial statements, and does not expect to early adopt the standard.

In June 2016, the FASB issued Accounting Standards Update No. 2016-13, *Financial Instruments-Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments*. The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination. The amendment requires the use of a new model covering current expected credit losses (CECL), which will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. Upon initial recognition of the exposure, the CECL model requires an entity to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses (ECL) should consider historical information, current information, and reasonable and supportable forecasts, including estimates of prepayments. The new guidance also amends the current available for sale (AFS) security other-than-temporary impairment (OTTI) model for debt securities. The new model will require an estimate of ECL only when the fair value is below the amortized cost of the asset. The length of time the fair value of an AFS debt security has been below the amortized cost will no longer impact the determination of whether a credit loss exists. As such, it is no longer an other-than-temporary model. Finally, the purchased financial assets with credit deterioration (PCD) model applies to purchased financial assets (measured at amortized cost or AFS) that have experienced more than insignificant credit deterioration since origination. This represents a change from the scope of what are considered purchased credit-impaired assets under today's model. Different than the accounting for originated or purchased assets that do not qualify as PCD, the initial estimate of expected credit losses for a PCD would be recognized through an allowance for loan and lease losses with an offset to the cost basis of the related financial asset at acquisition. The new standard applies to public business entities that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, with early adoption permitted for fiscal years beginning after December 31, 2018, including interim periods within those fiscal years, and is expected to increase the allowance for loan losses upon adoption. The Company has formed a working group to evaluate the impact of the standard's adoption on the Company's consolidated financial statements, and has selected a software vendor to assist with implementation. The team meets periodically to discuss the latest developments, ensure progress is being made, and keep current on evolving interpretations and industry practices related to ASU 2016-13. The Company's preliminary evaluation indicates the provisions of ASU No. 2016-13 are expected to impact the Company's consolidated financial statements, in particular the level of the reserve for credit losses. The Company is continuing to evaluate the extent of the potential impact.

In August 2018, the FASB issued Accounting Standards Update No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement.* The amendments in this update modify the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, including the consideration of costs and benefits. Four disclosure requirements were removed, three were modified, and two were added. In addition, the amendments eliminate "*at a minimum*" from the phrase "*an entity shall disclose at a minimum*" to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements. The amendments in this update are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The amendments on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption. All other amendments should be applied retrospectively to all periods presented upon their effective date. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures and delay adoption of the additional disclosures until their effective date. The Company is considering the early adoption of removed and modified disclosures. The adoption of this standard is not expected to have a material effect on the Company's consolidated financial statements.

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3. Investment Securities

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

	As of September 30, 2018			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies and corporations	$5,561	$ —	$ 42	$5,519
State and political subdivisions	115,251	716	831	115,136
Mortgage-backed securities	53,664	112	1,880	51,896
Collateralized mortgage obligations	179,748	3	8,874	170,877
Corporate debt securities	65,842	8	1,512	64,338
Total	$420,066	$ 839	$ 13,139	$407,766

	As of December 31, 2017			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies and corporations	$15,716	$ —	$ 90	$15,626
State and political subdivisions	139,561	2,475	197	141,839
Mortgage-backed securities	48,744	181	428	48,497
Collateralized mortgage obligations	173,339	29	5,172	168,196
Corporate debt securities	71,562	31	427	71,166
Total	$448,922	$ 2,716	$ 6,314	$445,324

The amortized cost and fair value of debt securities held to maturity, with gross unrealized gains and losses, were as follows:

	As of September 30, 2018			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
State and political subdivisions	$125,783	$ 155	$ 3,743	$122,195
Mortgage-backed securities	11,467	1	564	10,904
Collateralized mortgage obligations	19,373	—	1,104	18,269
Corporate debt securities	35,110	98	519	34,689
Total	$191,733	$ 254	$ 5,930	$186,057

	As of December 31, 2017			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government agencies and corporations	$10,049	$ —	$ —	$10,049
State and political subdivisions	126,413	804	1,631	125,586
Mortgage-backed securities	1,906	4	13	1,897
Collateralized mortgage obligations	22,115	—	707	21,408
Corporate debt securities	35,136	548	281	35,403
Total	$195,619	$ 1,356	$ 2,632	$194,343

Investment securities with a carrying value of $217.8 million and $237.4 million at September 30, 2018 and December 31, 2017, respectively, were pledged on public deposits, securities sold under agreements to repurchase and for other purposes, as required or permitted by law.

As of September 30, 2018, the Company owned $0.4 million of equity securities in banks and financial service-related companies, and $2.4 million of mutual funds invested in debt securities and other debt instruments that will cause units of the fund to be deemed to be qualified under the Community Reinvestment Act. Prior to January 1, 2018, we accounted for our marketable equity securities at fair value with unrealized gains and losses recognized in accumulated other comprehensive income on the balance sheet. Realized gains and losses on marketable equity securities sold or impaired were recognized in noninterest income. Effective with the January 1, 2018 adoption of ASU 2016-01, both the realized

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and unrealized net gains and losses on equity securities are required to be recognized in the statement of income. A breakdown between net realized and unrealized gains and losses is provided later in this financial statement footnote. These net changes are included in the other gains line item in the noninterest income section of the Consolidated Statements of Income.

The summary of investment securities shows that some of the securities in the available for sale and held to maturity investment portfolios had unrealized losses, or were temporarily impaired, as of September 30, 2018 and December 31, 2017. This temporary impairment represents the estimated amount of loss that would be realized if the securities were sold on the valuation date.

The following tables present information pertaining to securities with gross unrealized losses as of September 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position:

	As of September 30, 2018						
	Number of Securities	Less than 12 Months		12 Months or More		Total	
Available for Sale		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
U.S. Government agencies and corporations	2	$539	$ 14	$4,980	$ 28	$5,519	$ 42
State and political subdivisions	115	46,374	697	5,350	134	51,724	831
Mortgage-backed securities	26	40,039	1,613	7,591	267	47,630	1,880
Collateralized mortgage obligations	41	44,912	1,269	116,814	7,605	161,726	8,874
Corporate debt securities	12	50,439	1,149	12,230	363	62,669	1,512
Total	196	$182,303	$ 4,742	$146,965	$ 8,397	$329,268	$ 13,139

	As of December 31, 2017						
	Number of Securities	Less than 12 Months		12 Months or More		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
U.S. Government agencies and corporations	3	$15,626	$ 90	$—	$ —	$15,626	$ 90
State and political subdivisions	34	11,705	167	1,800	30	13,505	197
Mortgage-backed securities	20	37,964	359	3,961	69	41,925	428
Collateralized mortgage obligations	35	37,881	489	122,757	4,683	160,638	5,172
Corporate debt securities	12	55,340	298	8,778	129	64,118	427
Other equity securities	1	—	—	1,944	56	1,944	56
Total	105	$158,516	$ 1,403	$139,240	$ 4,967	$297,756	$ 6,370

	As of September 30, 2018						
	Number of Securities	Less than 12 Months		12 Months or More		Total	
Held to Maturity		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
State and political subdivisions	257	$54,969	$ 1,271	$33,512	$ 2,472	$88,481	$ 3,743
Mortgage-backed securities	6	10,016	524	820	40	10,836	564
Collateralized mortgage obligations	7	—	—	18,259	1,104	18,259	1,104
Corporate debt securities	13	18,126	345	2,722	174	20,848	519
Total	283	$83,111	$ 2,140	$55,313	$ 3,790	$138,424	$ 5,930

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		As of December 31, 2017					
	Number of Securities	Less than 12 Months		12 Months or More		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(in thousands, except number of securities)							
State and political subdivisions	167	$33,237	$ 393	$25,843	$ 1,238	$59,080	$ 1,631
Mortgage-backed securities	4	349	2	887	11	1,236	13
Collateralized mortgage obligations	7	5,221	90	16,168	617	21,389	707
Corporate debt securities	3	3,093	4	2,617	277	5,710	281
Total	181	$41,900	$ 489	$45,515	$ 2,143	$87,415	$ 2,632

The Company's assessment of OTTI is based on its reasonable judgment of the specific facts and circumstances impacting each individual debt security at the time such assessments are made. The Company reviews and considers factual information, including expected cash flows, the structure of the debt security, the creditworthiness of the issuer, the type of underlying assets and the current and anticipated market conditions.

At September 30, 2018 and December 31, 2017, the Company’s mortgage-backed securities and collateralized mortgage obligations portfolios consisted of securities predominantly backed by one- to four-family mortgage loans and underwritten to the standards of and guaranteed by the following government-sponsored agencies: the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Government National Mortgage Association. The receipt of principal, at par, and interest on mortgage-backed securities is guaranteed by the respective government-sponsored agency guarantor, such that the Company believes that its mortgage-backed securities and collateralized mortgage obligations do not expose the Company to credit-related losses.

At September 30, 2018, approximately 53% of the municipal bonds held by the Company were Iowa-based, and approximately 24% were Minnesota-based. The Company does not intend to sell these municipal obligations, and it is more likely than not that the Company will not be required to sell them until the recovery of their cost. Due to the issuers’ continued satisfaction of their obligations under the securities in accordance with their contractual terms and the expectation that they will continue to do so, management’s intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value, as well as the evaluation of the fundamentals of the issuers’ financial conditions and other objective evidence, the Company believed that the municipal obligations identified in the tables above were temporarily impaired as of September 30, 2018 and December 31, 2017.

At September 30, 2018 and December 31, 2017, all but one of the Company’s corporate bonds held an investment grade rating from Moody’s, S&P or Kroll, or carried a guarantee from an agency of the US government. We have evaluated financial statements of the company issuing the non-investment grade bond and found the company’s earnings and equity position to be satisfactory and in line with industry norms. Therefore, we expect to receive all contractual payments. The internal evaluation of the non-investment grade bond along with the investment grade ratings on the remainder of the corporate portfolio lead us to conclude that all of the corporate bonds in our portfolio will continue to pay according to their contractual terms. Since the Company has the ability and intent to hold securities until price recovery, we believe that there is no other-than-temporary-impairment in the corporate bond portfolio.

It is reasonably possible that the fair values of the Company’s investment securities could decline in the future if interest rates increase or the overall economy or the financial conditions of the issuers deteriorate. As a result, there is a risk that OTTI may be recognized in the future, and any such amounts could be material to the Company’s consolidated statements of income.

Unless certain conditions are met, investment securities classified as held to maturity may not be sold without calling into question the Company’s intent to hold other debt securities so classified (“tainting”). One acceptable condition, outlined in Accounting Standards Codification 320-10-25-6(a), is the significant deterioration of an issuer’s creditworthiness. During the first quarter of 2017, $1.2 million of debt securities from a single issuer in the state and political subdivisions category were identified by the Company as having an elevated level of credit risk and were internally classified as “watch.” Given the significant deterioration of the issuer’s creditworthiness, the Company sold the

debt securities in March 2017. The Company believes the sale was in accordance with applicable accounting guidance and did not taint the remainder of the held to maturity portfolio.

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The contractual maturity distribution of investment debt securities at September 30, 2018, is summarized as follows:

	Available For Sale		**Held to Maturity**	
(in thousands)	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**
Due in one year or less	$27,913	$27,866	$734	$736
Due after one year through five years	99,630	98,105	24,275	23,867
Due after five years through ten years	55,757	55,700	97,511	95,353
Due after ten years	3,354	3,322	38,373	36,928
Debt securities without a single maturity date	233,412	222,773	30,840	29,173
Total	$420,066	$407,766	$191,733	$186,057

Mortgage-backed securities and collateralized mortgage obligations are collateralized by mortgage loans and guaranteed by U.S. government agencies. Our experience has indicated that principal payments will be collected sooner than scheduled because of prepayments. Therefore, these securities are not scheduled in the maturity categories indicated above.

Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Realized gains (losses) on investments due to sale or call, including impairment losses for the three and nine months ended September 30, 2018 and 2017, were as follows:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(in thousands)	**2018**	**2017**	**2018**	**2017**
Debt securities available for sale:				
Gross realized gains	$194	$179	203	199
Gross realized losses	(2)	(3)	(2)	(3)
Net realized gain	$192	$176	$201	$196
Debt securities held to maturity:				
Gross realized gains	$—	$—	$—	$43
Gross realized losses	—	—	(4)	—
Net realized gain (loss)	$—	$—	$(4)	$43
Total net realized gain on sale or call of debt securities	$192	$176	$197	$239

The following tables present the net gains and losses on equity investments during the three and nine months ended September 30, 2018, disaggregated into realized and unrealized gains and losses:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(in thousands)	**2018**	**2017**	**2018**	**2017**
Net losses recognized	$ (10)	$ —	$ (34)	$ —
Less: Net gains and losses recognized due to sales	—	—	—	—
Unrealized losses on securities still held at the reporting date	$ (10)	$ —	$ (34)	$ —

Gains and losses on equity securities is included in other gain (loss) on the consolidated statements of income.

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4. Loans Receivable and the Allowance for Loan Losses

The composition of allowance for loan losses and loans by portfolio segment and based on impairment method are as follows:

Allowance for Loan Losses and Recorded Investment in Loan Receivables

As of September 30, 2018 and December 31, 2017

(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
September 30, 2018						
Loans receivable						
Individually evaluated for impairment	$ 6,711	$ 12,924	$ 17,375	$ 3,981	$ 8	$ 40,999
Collectively evaluated for impairment	96,496	510,357	1,223,311	450,246	38,788	2,319,198
Purchased credit impaired loans	—	52	13,104	4,296	—	17,452
Total	$ 103,207	$ 523,333	$ 1,253,790	$ 458,523	$ 38,796	$ 2,377,649
Allowance for loan losses:						
Individually evaluated for impairment	$ 195	$ 3,059	$ 4,183	$ 143	$ —	$ 7,580
Collectively evaluated for impairment	2,532	5,183	12,563	2,356	251	22,885
Purchased credit impaired loans	—	—	343	470	—	813
Total	$ 2,727	$ 8,242	$ 17,089	$ 2,969	$ 251	$ 31,278

(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
December 31, 2017						
Loans receivable						
Individually evaluated for impairment	$ 2,969	$ 9,734	$ 10,386	$ 3,722	$ —	$ 26,811
Collectively evaluated for impairment	102,543	493,844	1,147,133	460,475	36,158	2,240,153
Purchased credit impaired loans	—	46	14,452	5,233	—	19,731
Total	$ 105,512	$ 503,624	$ 1,171,971	$ 469,430	$ 36,158	$ 2,286,695
Allowance for loan losses:						
Individually evaluated for impairment	$ 140	$ 1,126	$ 2,157	$ 226	$ —	$ 3,649
Collectively evaluated for impairment	2,650	7,392	11,144	2,182	244	23,612
Purchased credit impaired loans	—	—	336	462	—	798
Total	$ 2,790	$ 8,518	$ 13,637	$ 2,870	$ 244	$ 28,059

As of September 30, 2018, the gross purchased credit impaired loans included above were $18.3 million, with a discount of $0.9 million.

Loans with unpaid principal in the amount of $459.1 million and $477.6 million at September 30, 2018 and December 31, 2017, respectively, were pledged to the Federal Home Loan Bank (the "FHLB") as collateral for borrowings.

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The changes in the allowance for loan losses by portfolio segment were as follows:

	Allowance for Loan Loss Activity					
	For the Three Months Ended September 30, 2018 and 2017					
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
2018						
Beginning balance	$2,656	$ 8,557	$ 16,341	$ 2,990	$ 256	$30,800
Charge-offs	(365)	(108)	(17)	—	(327)	(817)
Recoveries	41	78	77	131	18	345
Provision	395	(285)	688	(152)	304	950
Ending balance	$2,727	$ 8,242	$ 17,089	$ 2,969	$ 251	$31,278
2017						
Beginning balance	$2,666	$ 7,959	$ 9,013	$ 2,650	$ 222	$22,510
Charge-offs	(318)	(534)	—	(75)	(51)	(978)
Recoveries	150	113	201	126	4	594
Provision	67	2,157	1,166	915	79	4,384
Ending balance	$2,565	$ 9,695	$ 10,380	$ 3,616	$ 254	$26,510

	Allowance for Loan Loss Activity					
	For the Nine Months Ended September 30, 2018 and 2017					
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Total
2018						
Beginning balance	$2,790	$ 8,518	$ 13,637	$ 2,870	$ 244	$28,059
Charge-offs	(633)	(198)	(281)	(107)	(365)	(1,584)
Recoveries	56	260	193	208	36	753
Provision	514	(338)	3,540	(2)	336	4,050
Ending balance	$2,727	$ 8,242	$ 17,089	$ 2,969	$ 251	$31,278
2017						
Beginning balance	$2,003	$ 6,274	$ 9,860	$ 3,458	$ 255	$21,850
Charge-offs	(1,202)	(1,063)	(106)	(155)	(211)	(2,737)
Recoveries	164	215	216	126	11	732
Provision	1,600	4,269	410	187	199	6,665
Ending balance	$2,565	$ 9,695	$ 10,380	$ 3,616	$ 254	$26,510

Loan Portfolio Segment Risk Characteristics

Agricultural - Agricultural loans, most of which are secured by crops, livestock, and machinery, are provided to finance capital improvements and farm operations as well as acquisitions of livestock and machinery. The ability of the borrower to repay may be affected by many factors outside of the borrower's control including adverse weather conditions, loss of livestock due to disease or other factors, declines in market prices for agricultural products and the impact of government regulations. The ultimate repayment of agricultural loans is dependent upon the profitable operation or management of the agricultural entity. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial and Industrial - Commercial and industrial loans are primarily made based on the reported cash flow of

the borrower and secondarily on the underlying collateral provided by the borrower. The collateral support provided by the borrower for most of these loans and the probability of repayment are based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists. The primary repayment risks of commercial and industrial loans are that the cash flows of the borrower may be unpredictable, and the collateral securing these loans may fluctuate in value. The size of the loans the Company can offer to commercial customers is less than the size of the loans that competitors with larger lending limits can offer. This may limit the Company's ability to establish relationships with the largest businesses in the areas in which the Company operates. As a result, the Company may assume greater lending risks than financial institutions that have a lesser concentration of such loans and tend to make loans to larger businesses. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. In addition, a decline in the U.S. economy could harm or continue to harm the businesses of the Company's commercial and industrial customers and reduce the value of the collateral securing these loans.

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Commercial Real Estate - The Company offers mortgage loans to commercial and agricultural customers for the acquisition of real estate used in their businesses, such as offices, warehouses and production facilities, and to real estate investors for the acquisition of apartment buildings, retail centers, office buildings and other commercial buildings. The market value of real estate securing commercial real estate loans can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in one or more of the Company’s markets could increase the credit risk associated with its loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts than other loans, and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the Company’s control or that of the borrower could negatively impact the future cash flow and market values of the affected properties.

Residential Real Estate - The Company generally retains short-term residential mortgage loans that are originated for its own portfolio but sells most long-term loans to other parties while retaining servicing rights on the majority of those loans. The market value of real estate securing residential real estate loans can fluctuate as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in one or more of the Company’s markets could increase the credit risk associated with its loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts than other loans, and the repayment of the loans generally is dependent, in large part, on the borrower’s continuing financial stability, and is therefore more likely to be affected by adverse personal circumstances.

Consumer - Consumer loans typically have shorter terms, lower balances, higher yields and higher risks of default than real estate-related loans. Consumer loan collections are dependent on the borrower’s continuing financial stability, and are therefore more likely to be affected by adverse personal circumstances. Collateral for these loans generally includes automobiles, boats, recreational vehicles, mobile homes, and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to recover and may fluctuate in value based on condition. In addition, a decline in the United States economy could result in reduced employment, impacting the ability of customers to repay their obligations.

Purchased Loans Policy

All purchased loans (nonimpaired and impaired) are initially measured at fair value as of the acquisition date in accordance with applicable authoritative accounting guidance. Credit discounts are included in the determination of fair value. An allowance for loan losses is not recorded at the acquisition date for loans purchased.

Individual loans acquired through the completion of a transfer, including loans that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments receivable, are referred to herein as “purchased credit impaired loans.” In determining the acquisition date fair value and estimated credit losses of purchased credit impaired loans, and in subsequent accounting, the Company accounts for loans individually. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the “nonaccretable difference,” are not recognized as a yield adjustment or as a loss accrual or valuation allowance. Expected cash flows at the purchase date in excess of the fair value of loans, if any, are recorded as interest income over the expected life of the loans if the timing and amount of future cash flows are reasonably estimable. Subsequent to the purchase date, increases in cash flows over those expected at the purchase date are recognized as interest income prospectively. The present value of any decreases in expected cash flows after the purchase date is recognized by recording an allowance for loan losses and a provision for loan losses. If the Company does not have the information necessary to reasonably estimate cash flows to be expected, it may use the cost-recovery method or cash-basis method of income recognition.

Charge-off Policy

The Company requires a loan to be charged-off, in whole or in part, as soon as it becomes apparent that some loss will be incurred, or when its collectability is sufficiently questionable that it no longer is considered a bankable asset. The primary considerations when determining if and how much of a loan should be charged-off are as follows: (1) the potential for future cash flows; (2) the value of any collateral; and (3) the strength of any co-makers or guarantors.

When it is determined that a loan requires a partial or full charge-off, a request for approval of a charge-off is submitted to the Company's President, Executive Vice President and Chief Credit Officer, and the Senior Regional Loan officer. The Bank's board of directors formally approves all loan charge-offs. Once a loan is charged-off, it cannot be restructured and returned to the Company's books.

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Allowance for Loan and Lease Losses

The Company requires the maintenance of an adequate allowance for loan and lease losses ("ALLL") in order to cover estimated probable losses without eroding the Company's capital base. Calculations are done at each quarter end, or more frequently if warranted, to analyze the collectability of loans and to ensure the adequacy of the allowance. In line with FDIC directives, the ALLL calculation does not include consideration of loans held for sale or off-balance-sheet credit exposures (such as unfunded letters of credit). Determining the appropriate level for the ALLL relies on the informed judgment of management, and as such, is subject to inexactness. Given the inherently imprecise nature of calculating the necessary ALLL, the Company's policy permits the actual ALLL to be between 20% above and 5% below the "indicated reserve."

Loans Reviewed Individually for Impairment

The Company identifies loans to be reviewed and evaluated individually for impairment based on current information and events and the probability that the borrower will be unable to repay all amounts due according to the contractual terms of the loan agreement. Specific areas of consideration include: size of credit exposure, risk rating, delinquency, nonaccrual status, and loan classification.

The level of individual impairment is measured using one of the following methods: (1) the fair value of the collateral less costs to sell; (2) the present value of expected future cash flows, discounted at the loan's effective interest rate; or (3) the loan's observable market price. Loans that are deemed fully collateralized or have been charged down to a level corresponding with any of the three measurements require no assignment of reserves from the ALLL.

A loan modification is a change in an existing loan contract that has been agreed to by the borrower and the Bank, which may or may not be a troubled debt restructure or "TDR." All loans deemed TDR are considered impaired. A loan is considered a TDR when, for economic or legal reasons related to a borrower's financial difficulties, a concession is granted to the borrower that would not otherwise be considered. Both financial distress on the part of the borrower and the Bank's granting of a concession, which are detailed further below, must be present in order for the loan to be considered a TDR.

All of the following factors are indicators that the debtor is experiencing financial difficulties (one or more items may be present):

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- There is significant doubt as to whether the debtor will continue to be a going concern.
- Currently, the debtor has securities being held as collateral that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled debtor.

The following factors are potential indicators that a concession has been granted (one or multiple items may be present):

- The borrower receives a reduction of the stated interest rate for the remaining original life of the debt.
- The borrower receives an extension of the maturity date or dates at a stated interest rate lower that the current market interest rate for new debt with similar risk characteristics.
- The borrower receives a reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
- The borrower receives a deferral of required payments (principal and/or interest).
- The borrower receives a reduction of the accrued interest.

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The following table sets forth information on the Company's TDRs by class of loan occurring during the stated periods:

	Three Months Ended September 30,					
	2018			2017		
(dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings[(1)]:						
Total	—	$ —	$ —	—	$ —	$ —

	Nine Months Ended September 30,					
	2018			2017		
(dollars in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings[(1)]:						
Commercial and industrial						
Extended maturity date	—	$ —	$ —	6	$ 2,037	$ 2,083
Commercial real estate:						
Farmland						
Extended maturity date	1	86	86	2	176	176
Commercial real estate-other						
Extended maturity date	—	—	—	1	968	968
Other	—	—	—	1	10,546	10,923
Total	1	$ 86	$ 86	10	$ 13,727	$ 14,150

(1) TDRs may include multiple concessions, and the disclosure classifications are based on the primary concession provided to the borrower.

Loans by class modified as TDRs within 12 months of modification and for which there was a payment default during the stated periods were as follows:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2018		2017		2018		2017	
(dollars in thousands)	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Troubled Debt Restructurings[(1)] That Subsequently Defaulted:								
Commercial and industrial								
Extended maturity date	—	$ —	—	$ —	—	$ —	4	$ 1,504
Commercial real estate:								
Commercial real estate-other								
Extended maturity date	—	—	—	—	—	—	1	968
Total	—	$ —	—	$ —	—	$ —	5	$ 2,472

(1) TDRs may include multiple concessions, and the disclosure classifications are based on the primary concession provided to the borrower.

Loans Reviewed Collectively for Impairment

All loans not evaluated individually for impairment will be separated into homogeneous pools to be collectively evaluated. Loans will be first grouped into the various loan types (i.e. commercial, agricultural, consumer, etc.) and further segmented within each subset by risk classification (i.e. pass, special mention/watch, and substandard).

Homogeneous loans past due 60-89 days and 90 days or more are classified special mention/watch and substandard, respectively, for allocation purposes.
The Company's historical loss experience for each group segmented by loan type is calculated for the prior 20 quarters as a starting point for estimating losses. In addition, other prevailing qualitative or environmental factors likely to cause probable losses to vary from historical data are incorporated in the form of adjustments to increase or decrease the loss rate applied to each group. These adjustments are documented and fully explain how the current information, events, circumstances, and conditions impact the historical loss measurement assumptions.
Although not a comprehensive list, the following are considered key factors and are evaluated with each calculation of the ALLL to determine if adjustments to historical loss rates are warranted:

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- Changes in national and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments.
- Changes in the quality and experience of lending staff and management.
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses.
- Changes in the volume and severity of past due loans, classified loans and non-performing loans.
- The existence and potential impact of any concentrations of credit.
- Changes in the nature and terms of loans such as growth rates and utilization rates.
- Changes in the value of underlying collateral for collateral-dependent loans, considering the Company's disposition bias.
- The effect of other external factors such as the legal and regulatory environment.

The Company may also consider other qualitative factors for additional allowance allocations, including changes in the Company's loan review process. Changes in the criteria used in this evaluation or the availability of new information could cause the allowance to be increased or decreased in future periods. In addition, bank regulatory agencies, as part of their examination process, may require adjustments to the allowance for loan losses based on their judgments and estimates.

The items listed above are used to determine the pass percentage for loans evaluated under ASC 450, and as such, are applied to the loans risk rated pass. Due to the inherent risks associated with special mention/watch risk-rated loans (i.e. early stages of financial deterioration, technical exceptions, etc.), this subset is reserved at a level that will cover losses above a pass allocation for loans that had a loss in the last 20 quarters in which the loan was risk-rated special mention/watch at the time of the loss. Substandard loans carry greater risk than special mention/watch loans, and as such, this subset is reserved at a level that will cover losses above a pass allocation for loans that had a loss in the last 20 quarters in which the loan was risk-rated substandard at the time of the loss. Ongoing analysis is performed to support these factor multiples.

The following tables set forth the risk category of loans by class of loans and credit quality indicator based on the most recent analysis performed, as of September 30, 2018 and December 31, 2017:

(in thousands)	Pass	Special Mention/ Watch	Substandard	Doubtful	Loss	Total
September 30, 2018						
Agricultural	$78,007	$ 17,266	$ 7,934	$ —	$ —	$103,207
Commercial and industrial	482,136	21,166	20,027	4	—	523,333
Commercial real estate:						
Construction and development	221,114	1,078	1,132	—	—	223,324
Farmland	69,824	6,970	8,941	—	—	85,735
Multifamily	124,092	1,391	1,180	—	—	126,663
Commercial real estate-other	748,837	44,603	24,628	—	—	818,068
Total commercial real estate	1,163,867	54,042	35,881	—	—	1,253,790
Residential real estate:						
One- to four- family first liens	333,974	2,289	6,492	—	—	342,755
One- to four- family junior liens	113,526	687	1,555	—	—	115,768
Total residential real estate	447,500	2,976	8,047	—	—	458,523
Consumer	38,621	148	—	27	—	38,796
Total	$2,210,131	$ 95,598	$ 71,889	$ 31	$ —	$2,377,649

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(in thousands)	Pass	Special Mention/ Watch	Substandard	Doubtful	Loss	Total
December 31, 2017						
Agricultural	$ 80,377	$ 21,989	$ 3,146	$ —	$ —	$ 105,512
Commercial and industrial	453,363	23,153	27,102	6	—	503,624
Commercial real estate:						
Construction and development	162,968	1,061	1,247	—	—	165,276
Farmland	76,740	10,357	771	—	—	87,868
Multifamily	131,507	2,498	501	—	—	134,506
Commercial real estate-other	731,231	34,056	19,034	—	—	784,321
Total commercial real estate	1,102,446	47,972	21,553	—	—	1,171,971
Residential real estate:						
One- to four- family first liens						