UNION BANKSHARES INC
Form 10-Q
May 10, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: March 31, 2018

Commission file number: 001-15985

UNION BANKSHARES, INC.
VERMONT 03-0283552

P.O. BOX 667
20 LOWER MAIN STREET
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

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

| | |
|---|---|
| Common Stock, $2.00 par value | Nasdaq Stock Market |
| (Title of class) | (Exchanges registered on) |

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [X] No [ ]

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

| | |
|---|---|
| Large accelerated filer [ ] | Accelerated filer [ X ] |
| Non-accelerated filer [ ] (Do not check if a smaller reporting company) | Smaller reporting company [ ] |
| | Emerging growth company [ ] |

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of April 30, 2018.
Common Stock, $2 par value 4,465,661 shares

UNION BANKSHARES, INC.
TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

UNION BANKSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

| | March 31, 2018 (Unaudited) | December 31, 2017 |
|---|---|---|
| Assets | (Dollars in thousands) | |
| Cash and due from banks | $3,328 | $ 3,857 |
| Federal funds sold and overnight deposits | 9,918 | 34,651 |
| Cash and cash equivalents | 13,246 | 38,508 |
| Interest bearing deposits in banks | 9,601 | 9,352 |
| Investment securities available-for-sale | 68,440 | 65,439 |
| Investment securities held-to-maturity (fair value $999 thousand at December 31, 2017) | — | 1,000 |
| Other investments | 502 | — |
| Total investments | 68,942 | 66,439 |
| Loans held for sale | 2,938 | 7,947 |
| Loans | 591,660 | 586,615 |
| Allowance for loan losses | (5,405) | (5,408) |
| Net deferred loan costs | 797 | 795 |
| Net loans | 587,052 | 582,002 |
| Accrued interest receivable | 2,468 | 2,500 |
| Premises and equipment, net | 14,298 | 14,255 |
| Core deposit intangible | 540 | 583 |
| Goodwill | 2,223 | 2,223 |
| Investment in real estate limited partnerships | 3,028 | 3,166 |
| Company-owned life insurance | 8,865 | 8,861 |
| Other assets | 9,530 | 9,995 |
| Total assets | $722,731 | $ 745,831 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Noninterest bearing | $128,951 | $ 127,824 |
| Interest bearing | 392,027 | 418,621 |
| Time | 102,865 | 101,129 |
| Total deposits | 623,843 | 647,574 |
| Borrowed funds | 31,265 | 31,581 |
| Accrued interest and other liabilities | 8,459 | 8,015 |
| Total liabilities | 663,567 | 687,170 |
| Commitments and Contingencies | | |
| Stockholders' Equity | | |
| Common stock, $2.00 par value; 7,500,000 shares authorized; 4,940,961 shares issued at March 31, 2018 and December 31, 2017 | 9,882 | 9,882 |
| Additional paid-in capital | 803 | 755 |
| Retained earnings | 58,604 | 57,197 |
| Treasury stock at cost; 475,304 shares at March 31, 2018 and 475,385 shares at December 31, 2017 | (4,079) | (4,077) |
| Accumulated other comprehensive loss | (6,046) | (5,096) |
| Total stockholders' equity | 59,164 | 58,661 |

| | | |
|---|---|---|
| Total liabilities and stockholders' equity | $722,731 | $ 745,831 |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | (Dollars in thousands, except per share data) | |
| Interest and dividend income | | |
| Interest and fees on loans | $6,999 | $ 6,322 |
| Interest on debt securities: | | |
| Taxable | 289 | 242 |
| Tax exempt | 145 | 165 |
| Dividends | 40 | 45 |
| Interest on federal funds sold and overnight deposits | 53 | 30 |
| Interest on interest bearing deposits in banks | 45 | 35 |
| Total interest and dividend income | 7,571 | 6,839 |
| Interest expense | | |
| Interest on deposits | 533 | 422 |
| Interest on borrowed funds | 114 | 115 |
| Total interest expense | 647 | 537 |
| Net interest income | 6,924 | 6,302 |
| Provision for loan losses | — | — |
| Net interest income after provision for loan losses | 6,924 | 6,302 |
| Noninterest income | | |
| Trust income | 193 | 178 |
| Service fees | 1,487 | 1,440 |
| Net gains on sales of loans held for sale | 295 | 508 |
| Other income | 496 | 107 |
| Total noninterest income | 2,471 | 2,233 |
| Noninterest expenses | | |
| Salaries and wages | 2,649 | 2,568 |
| Pension and employee benefits | 958 | 879 |
| Occupancy expense, net | 395 | 390 |
| Equipment expense | 535 | 534 |
| Other expenses | 1,598 | 1,570 |
| Total noninterest expenses | 6,135 | 5,941 |
| Income before provision for income taxes | 3,260 | 2,594 |
| Provision for income taxes | 513 | 664 |
| Net income | $2,747 | $ 1,930 |
| Earnings per common share | $0.62 | $ 0.43 |
| Weighted average number of common shares outstanding | 4,465,600 | 4,462,057 |
| Dividends per common share | $0.30 | $ 0.29 |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | (Dollars in thousands) | |
| Net income | $2,747 | $1,930 |
| Other comprehensive (loss) income, net of tax: | | |
| Investment securities available-for-sale: | | |
| Net unrealized holding (losses) gains arising during the period on investment securities available-for-sale | (950 ) | 225 |
| Total other comprehensive (loss) income | (950 ) | 225 |
| Total comprehensive income | $1,797 | $2,155 |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Three Months Ended March 31, 2018 and 2017 (Unaudited)

| | Common Stock | | | | | | |
|---|---|---|---|---|---|---|---|
| | Shares, net of treasury | Amount | Additional paid-in capital | Retained earnings | Treasury stock | Accumulated other comprehensive loss | Total stockholders' equity |
| | (Dollars in thousands, except per share data) | | | | | | |
| Balances December 31, 2017 | 4,465,576 | $ 9,882 | $ 755 | $ 57,197 | $ (4,077) | $ (5,096) | $ 58,661 |
| Net income | — | — | — | 2,747 | — | — | 2,747 |
| Other comprehensive loss | — | — | — | — | — | (950) | (950) |
| Dividend reinvestment plan | 141 | — | 7 | — | 1 | — | 8 |
| Cash dividends declared ($0.30 per share) | — | — | — | (1,340) | — | — | (1,340) |
| Stock based compensation expense | — | — | 41 | — | — | — | 41 |
| Purchase of treasury stock | (60) | — | — | — | (3) | — | (3) |
| Balances March 31, 2018 | 4,465,657 | $ 9,882 | $ 803 | $ 58,604 | $ (4,079) | $ (6,046) | $ 59,164 |
| | | | | | | | |
| Balances, December 31, 2016 | 4,462,135 | $ 9,874 | $ 620 | $ 53,086 | $ (4,022) | $ (3,279) | $ 56,279 |
| Net income | — | — | — | 1,930 | — | — | 1,930 |
| Other comprehensive income | — | — | — | — | — | 225 | 225 |
| Dividend reinvestment plan | 117 | — | 4 | — | 1 | — | 5 |
| Cash dividends declared ($0.29 per share) | — | — | — | (1,294) | — | — | (1,294) |
| Stock based compensation expense | — | — | 34 | — | — | — | 34 |
| Purchase of treasury stock | (225) | — | — | — | (9) | — | (9) |
| Balances, March 31, 2017 | 4,462,027 | $ 9,874 | $ 658 | $ 53,722 | $ (4,030) | $ (3,054) | $ 57,170 |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | (Dollars in thousands) | |
| Cash Flows From Operating Activities | | |
| Net income | $2,747 | $1,930 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 301 | 307 |
| Deferred income tax provision | 41 | 333 |
| Net amortization of investment securities | 93 | 113 |
| Equity in losses of limited partnerships | 140 | 157 |
| Stock based compensation expense | 41 | 34 |
| Net (increase) decrease in unamortized loan costs | (2) | 5 |
| Proceeds from sales of loans held for sale | 23,384 | 29,041 |
| Origination of loans held for sale | (18,080) | (23,577) |
| Net gains on sales of loans held for sale | (295) | (508) |
| Net (gain) loss on disposals of premises and equipment | (191) | 13 |
| Net gain on sales of other real estate owned | (11) | — |
| Decrease in accrued interest receivable | 32 | 217 |
| Amortization of core deposit intangible | 43 | 43 |
| Increase in other assets | 403 | 80 |
| Contribution to defined benefit pension plan | — | (750) |
| Increase in other liabilities | 474 | 419 |
| Net cash provided by operating activities | 9,120 | 7,857 |
| Cash Flows From Investing Activities | | |
| Interest bearing deposits in banks | | |
| Proceeds from maturities and redemptions | 996 | 2,988 |
| Purchases | (1,245) | (1,992) |
| Investment securities held-to-maturity | | |
| Proceeds from maturities, calls and paydowns | 1,000 | — |
| Investment securities available-for-sale | | |
| Proceeds from maturities, calls and paydowns | 1,539 | 1,696 |
| Purchases | (6,358) | (3,551) |
| Other Investments | | |
| Proceeds from sales | 44 | — |
| Purchases | (24) | — |
| Purchase of nonmarketable stock | (105) | — |
| Net increase in loans | (5,051) | (4,298) |
| Recoveries of loans charged off | 3 | 6 |
| Purchases of premises and equipment | (357) | (67) |
| Proceeds from Company-owned life insurance death benefit | 307 | — |
| Investments in limited partnerships | — | (186) |
| Proceeds from sales of premises and equipment | 204 | — |
| Proceeds from sales of other real estate owned | 47 | — |
| Net cash used in investing activities | (9,000) | (5,404) |

| | | |
|---|---|---|
| Cash Flows From Financing Activities | | |
| Advances on long-term borrowings | 7,000 | — |
| Repayment of long-term debt | (6,072) | (70) |
| Net (decrease) increase in short-term borrowings outstanding | (1,244) | 202 |
| Net increase (decrease) in noninterest bearing deposits | 1,127 | (2,297) |
| Net decrease in interest bearing deposits | (26,594) | (12,632) |
| Net increase (decrease) in time deposits | 1,736 | (666) |
| Purchase of treasury stock | (3) | (9) |
| Dividends paid | (1,332) | (1,289) |
| Net cash used in financing activities | (25,382) | (16,761) |
| Net decrease in cash and cash equivalents | (25,262) | (14,308) |
| Cash and cash equivalents | | |
| Beginning of period | 38,508 | 39,275 |
| End of period | $13,246 | $24,967 |
| Supplemental Disclosures of Cash Flow Information | | |
| Interest paid | $647 | $540 |
| | | |
| Dividends paid on Common Stock: | | |
| Dividends declared | $1,340 | $1,294 |
| Dividends reinvested | (8) | (5) |
| | $1,332 | $1,289 |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
Note 1. Basis of Presentation
The accompanying unaudited interim consolidated financial statements of Union Bankshares, Inc. and Subsidiary (together, the Company) as of March 31, 2018, and for the three months ended March 31, 2018 and 2017, have been prepared in conformity with GAAP for interim financial information, general practices within the banking industry, and the accounting policies described in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 (2017 Annual Report). The Company's sole subsidiary is Union Bank. In the opinion of the Company’s management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein, have been made. This information should be read in conjunction with the Company’s 2017 Annual Report. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2018, or any interim period.
In addition to the definitions set forth elsewhere in this report, the acronyms, abbreviations and capitalized terms identified below are used throughout this Form 10-Q, including Part I. "Financial Information" and Part II. "Other Information". The following is provided to aid the reader and provide a reference page when reviewing this Form 10-Q.

| | | | |
|---|---|---|---|
| AFS: | Available-for-sale | IRS: | Internal Revenue Service |
| ALCO: | Asset Liability Committee | MBS: | Mortgage-backed security |
| ALL: | Allowance for loan losses | MSRs: | Mortgage servicing rights |
| ASC: | Accounting Standards Codification | OAO: | Other assets owned |
| ASU: | Accounting Standards Update | OCI: | Other comprehensive income (loss) |
| Board: | Board of Directors | OFAC: | U.S. Office of Foreign Assets Control |
| bp or bps: | Basis point(s) | OREO: | Other real estate owned |
| Branch Acquisition: | The acquisition of three New Hampshire branches in May 2011 | OTTI: | Other-than-temporary impairment |
| CDARS: | Certificate of Deposit Accounts Registry Service of the Promontory Interfinancial Network | OTT: | Other-than-temporary |
| Company: | Union Bankshares, Inc. and Subsidiary | Plan: | The Union Bank Pension Plan |
| DRIP: | Dividend Reinvestment Plan | RD: | USDA Rural Development |
| FASB: | Financial Accounting Standards Board | RSU: | Restricted Stock Unit |
| FDIC: | Federal Deposit Insurance Corporation | SBA: | U.S. Small Business Administration |
| FHA: | U.S. Federal Housing Administration | SEC: | U.S. Securities and Exchange Commission |
| FHLB: | Federal Home Loan Bank of Boston | TDR: | Troubled-debt restructuring |
| FRB: | Federal Reserve Board | Union: | Union Bank, the sole subsidiary of Union Bankshares, Inc |
| FHLMC/Freddie Mac: | Federal Home Loan Mortgage Corporation | USDA: | U.S. Department of Agriculture |
| GAAP: | Generally Accepted Accounting Principles in the United States | VA: | U.S. Veterans Administration |
| HTM: | Held-to-maturity | 2008 ISO Plan: | 2008 Incentive Stock Option Plan of the Company |
| HUD: | U.S. Department of Housing and Urban Development | 2014 Equity Plan: | 2014 Equity Incentive Plan |
| ICS: | Insured Cash Sweeps of the Promontory Interfinancial Network | 2017 Annual Report | Annual Report of Form 10-K for the year ended December 31, 2017 |
| | | | Tax Cut and Jobs Act of 2017 |

2017 Tax
Act:

Note 2. Legal Contingencies

In the normal course of business, the Company is involved in various legal and other proceedings. In the opinion of management, any liability resulting from such proceedings is not expected to have a material adverse effect on the Company's consolidated financial condition or results of operations.

Note 3. Per Share Information

Earnings per common share are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed exercise of outstanding exercisable stock options and vesting of RSUs does not result in material dilution and is not included in the calculation.

Note 4. Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and liabilities (including operating leases) on the balance sheet and disclosing key information about leasing arrangements. Previous lease accounting did not require the inclusion of operating leases in the balance sheet. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. The Company is evaluating the potential impact of the ASU on its consolidated financial statements by reviewing its lease contracts.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Under the new guidance, which will replace the existing incurred loss model for recognizing credit losses, banks and other lending institutions will be required to recognize the full amount of expected credit losses. The new guidance, which is referred to as the current expected credit loss model ("CECL"), requires that expected credit losses for financial assets held at the reporting date that are accounted for at amortized cost be measured and recognized based on historical experience and current and reasonably supportable forecasted conditions to reflect the full amount of expected credit losses. A modified version of these requirements also applies to debt securities classified as AFS. The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within such years. The Company has established a CECL implementation team and developed a transition project plan. The team members have evaluated CECL implementation software providers and have selected Sageworks. The Company has entered into an agreement with Sageworks and has been compiling data to run parallel calculations during 2018. This will facilitate the implementation process and management's evaluation of the potential impact of the ASU on the Company's consolidated financial statements.

The Company adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) using a modified-retrospective transition method, as of January 1, 2018. The ASU requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. While the guidance replaces most existing revenue recognition guidance in GAAP, the ASU is not applicable to financial instruments and, therefore, did not impact a majority of the Company’s revenues, including net interest income. Through the Company's assessment, it was determined that there will be no cumulative-effect adjustment to beginning stockholders' equity under the modified retrospective transition method within the consolidated financial statements as there was no change in revenue recognition upon adoption of ASU2014-09.

Note 5. Goodwill and Other Intangible Assets

As a result of the 2011 Branch Acquisition, the Company recorded goodwill amounting to $2.2 million. The goodwill is not amortizable. Goodwill is evaluated for impairment annually, in accordance with current authoritative accounting guidance. Management assesses qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of the Company, in total, is less than its carrying amount. Management is not aware of any such events or circumstances that would cause it to conclude that the fair value of the Company is less than its carrying amount.

The Company also initially recorded $1.7 million of acquired identifiable intangible assets in connection with the 2011 Branch Acquisition, representing the core deposit intangible which is subject to straight-line amortization over the estimated 10 year average life of the core deposit base, absent any future impairment. Management will evaluate the core deposit intangible for impairment if conditions warrant.

Amortization expense for the core deposit intangible was $43 thousand for the three months ended March 31, 2018 and 2017. The amortization expense is included in other expenses on the consolidated statements of income and is deductible for tax purposes. As of March 31, 2018, the remaining amortization expense related to the core deposit intangible, absent any future impairment, is expected to be as follows:

| | (Dollars in thousands) |
|---|---|
| 2018 | $ 128 |
| 2019 | 171 |
| 2020 | 171 |
| 2021 | 70 |
| Total | $ 540 |

Note 6. Investment Securities

AFS and HTM investment securities as of the balance sheet dates consisted of the following:

| March 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| Available-for-sale | | | | |
| Debt securities: | | | | |
| U.S. Government-sponsored enterprises | $7,437 | $ 2 | $ (178 ) | $7,261 |
| Agency mortgage-backed | 33,356 | — | (796 ) | 32,560 |
| State and political subdivisions | 24,820 | 126 | (624 ) | 24,322 |
| Corporate | 4,411 | 1 | (115 ) | 4,297 |
| Total | $70,024 | $ 129 | $ (1,713 ) | $68,440 |

| December 31, 2017 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| Available-for-sale | | | | |
| Debt securities: | | | | |
| U.S. Government-sponsored enterprises | $7,805 | $ 12 | $ (122 ) | $7,695 |
| Agency mortgage-backed | 28,378 | 12 | (274 ) | 28,116 |
| State and political subdivisions | 24,704 | 249 | (239 ) | 24,714 |
| Corporate | 4,412 | 48 | (67 ) | 4,393 |
| Total debt securities | 65,299 | 321 | (702 ) | 64,918 |
| Mutual funds (1) | 521 | — | — | 521 |
| Total | $65,820 | $ 321 | $ (702 ) | $65,439 |
| Held-to-maturity | | | | |
| U.S. Government-sponsored enterprises | $1,000 | $ — | $ (1 ) | $999 |

(1) As of December 31, 2017, mutual funds were classified as AFS investment securities. Effective January 1, 2018, these investments were reclassified to other investments on the consolidated balance sheets as they are no longer eligible to be classified as AFS upon adoption of ASU 2016-01.

There were no investment securities HTM at March 31, 2018. Investment securities AFS with a carrying amount of $2.7 million and $4.6 million at March 31, 2018 and December 31, 2017, respectively, were pledged as collateral for public deposits and for other purposes as required or permitted by law.

The amortized cost and estimated fair value of debt securities by contractual scheduled maturity as of March 31, 2018 were as follows:

| Available-for-sale | Amortized Cost | Fair Value |
|---|---|---|
| | (Dollars in thousands) | |
| Due from one to five years | $4,302 | $4,325 |
| Due from five to ten years | 16,319 | 15,978 |
| Due after ten years | 16,047 | 15,577 |
| | 36,668 | 35,880 |
| Agency mortgage-backed | 33,356 | 32,560 |
| Total debt securities available-for-sale | $70,024 | $68,440 |

Actual maturities may differ for certain debt securities that may be called by the issuer prior to the contractual maturity. Actual maturities usually differ from contractual maturities on agency MBS because the mortgages underlying the securities may be prepaid, usually without any penalties. Therefore, these agency MBS are shown separately and are not included in the contractual maturity categories in the above maturity summary.

As of March 31, 2018, other investments consisted of mutual funds with a fair value of $502 thousand, a cost basis of $459 thousand and unrealized gains of $43 thousand.

Information pertaining to all investment securities with gross unrealized losses as of the balance sheet dates, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| March 31, 2018 | Less Than 12 Months | | | 12 Months and over | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
| | (Dollars in thousands) | | | | | | | | |
| Debt securities: | | | | | | | | | |
| U.S. Government-sponsored enterprises | 5 | $2,381 | $ (19) | 9 | $4,216 | $ (159) | 14 | $6,597 | $ (178) |
| Agency mortgage-backed | 38 | 27,583 | (580) | 7 | 4,977 | (216) | 45 | 32,560 | (796) |
| State and political subdivisions | 25 | 9,982 | (189) | 18 | 7,657 | (435) | 43 | 17,639 | (624) |
| Corporate | 6 | 2,826 | (86) | 2 | 971 | (29) | 8 | 3,797 | (115) |
| Total | 74 | $42,772 | $ (874) | 36 | $17,821 | $ (839) | 110 | $60,593 | $ (1,713) |

| December 31, 2017 | Less Than 12 Months | | | 12 Months and over | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
| | (Dollars in thousands) | | | | | | | | |
| Debt securities: | | | | | | | | | |
| U.S. Government-sponsored enterprises | 3 | $1,824 | $ (7) | 9 | $4,374 | $ (116) | 12 | $6,198 | $ (123) |
| Agency mortgage-backed | 26 | 19,315 | (143) | 7 | 5,222 | (131) | 33 | 24,537 | (274) |
| State and political subdivisions | 8 | 3,803 | (22) | 18 | 7,899 | (217) | 26 | 11,702 | (239) |
| Corporate | 2 | 870 | (31) | 2 | 964 | (36) | 4 | 1,834 | (67) |
| Total | 39 | $25,812 | $ (203) | 36 | $18,459 | $ (500) | 75 | $44,271 | $ (703) |

The Company evaluates all investment securities on a quarterly basis, and more frequently when economic conditions warrant, to determine if an OTTI exists. A security is considered impaired if the fair value is lower than its amortized cost basis at the report date. If impaired, management then assesses whether the unrealized loss is OTT.

An unrealized loss on a debt security is generally deemed to be OTT and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of OTTI write-down is recorded, net of tax effect, through net income as a component of net OTTI losses in the consolidated statements of income, while the remaining portion of the impairment loss is recognized in OCI, provided the Company does not intend to sell the underlying debt security and it is "more likely than not" that the Company will not have to sell the debt security prior to recovery. Declines in the fair values of individual equity securities that are deemed by management to be OTT are reflected in noninterest income when identified.

Management considers the following factors in determining whether OTTI exists and the period over which the security is expected to recover:

- The length of time, and extent to which, the fair value has been less than the amortized cost;
- Adverse conditions specifically related to the security, industry, or geographic area;
- The historical and implied volatility of the fair value of the security;

- The payment structure of the debt security and the likelihood of the issuer being able to make payments that may increase in the future;
- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency;
- Recoveries or additional declines in fair value subsequent to the balance sheet date; and
- The nature of the issuer, including whether it is a private company, public entity or government-sponsored enterprise, and the existence or likelihood of any government or third party guaranty.

The Company has the ability to hold the investment securities that had unrealized losses at March 31, 2018 and December 31, 2017 for the foreseeable future and no declines were deemed by management to be OTT.

There were no sales of AFS securities for the three months ended March 31, 2018 and March 31, 2017.

Note 7. Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their unpaid principal balances, adjusted for any charge-offs, the ALL, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

Loan interest income is accrued daily on outstanding balances. The following accounting policies, related to accrual and nonaccrual loans, apply to all portfolio segments and loan classes, which the Company considers to be the same. The accrual of interest is normally discontinued when a loan is specifically determined to be impaired and/or management believes, after considering collection efforts and other factors, that the borrower's financial condition is such that collection of interest is doubtful. Generally, any unpaid interest previously accrued on those loans is reversed against current period interest income. A loan may be restored to accrual status when its financial status has significantly improved and there is no principal or interest past due. A loan may also be restored to accrual status if the borrower makes six consecutive monthly payments or the lump sum equivalent. Income on nonaccrual loans is generally not recognized unless a loan is returned to accrual status or after all principal has been collected. Interest income generally is not recognized on impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are generally applied as a reduction of the loan principal balance. Delinquency status is determined based on contractual terms for all portfolio segments and loan classes. Loans past due 30 days or more are considered delinquent. Loans are considered in process of foreclosure when a judgment of foreclosure has been issued by the court.

Loan origination fees and direct loan origination costs are deferred and amortized as an adjustment of the related loan's yield using methods that approximate the interest method. The Company generally amortizes these amounts over the estimated average life of the related loans.

The composition of Net loans as of the balance sheet dates were as follows:

| | March 31, 2018 | December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Residential real estate | $181,850 | $ 178,999 |
| Construction real estate | 43,379 | 42,935 |
| Commercial real estate | 260,695 | 254,291 |
| Commercial | 46,885 | 50,719 |
| Consumer | 3,525 | 3,894 |
| Municipal | 55,326 | 55,777 |
| Gross loans | 591,660 | 586,615 |
| Allowance for loan losses | (5,405) | (5,408) |
| Net deferred loan costs | 797 | 795 |
| Net loans | $587,052 | $ 582,002 |

Qualifying residential first mortgage loans and certain commercial real estate loans with a carrying value of $165.0 million and $164.5 million were pledged as collateral for borrowings from the FHLB under a blanket lien at March 31, 2018 and December 31, 2017, respectively.

A summary of current, past due and nonaccrual loans as of the balance sheet dates follows:

| March 31, 2018 | Current | 30-59 Days | 60-89 Days | 90 Days and Over and Accruing | Nonaccrual | Total |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| Residential real estate | $177,929 | $2,453 | $358 | $ 293 | $ 817 | $181,850 |
| Construction real estate | 42,919 | 352 | 55 | — | 53 | 43,379 |
| Commercial real estate | 258,127 | 2,267 | — | — | 301 | 260,695 |
| Commercial | 46,625 | 20 | 10 | 1 | 229 | 46,885 |
| Consumer | 3,485 | 39 | 1 | — | — | 3,525 |
| Municipal | 55,326 | — | — | — | — | 55,326 |
| Total | $584,411 | $5,131 | $424 | $ 294 | $ 1,400 | $591,660 |

| December 31, 2017 | Current | 30-59 Days | 60-89 Days | 90 Days and Over and Accruing | Nonaccrual | Total |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| Residential real estate | $173,914 | $3,047 | $750 | $ 472 | $ 816 | $178,999 |
| Construction real estate | 42,857 | — | — | 22 | 56 | 42,935 |
| Commercial real estate | 253,266 | 357 | 361 | — | 307 | 254,291 |
| Commercial | 50,675 | 21 | 11 | — | 12 | 50,719 |
| Consumer | 3,884 | 7 | 3 | — | — | 3,894 |
| Municipal | 55,777 | — | — | — | — | 55,777 |
| Total | $580,373 | $3,432 | $1,125 | $ 494 | $ 1,191 | $586,615 |

There was one residential real estate loan totaling $131 thousand in process of foreclosure at March 31, 2018. Aggregate interest on nonaccrual loans not recognized was $1.2 million and $1.3 million as of March 31, 2018 and 2017, respectively, and $1.2 million as of December 31, 2017.

Note 8. Allowance for Loan Losses and Credit Quality

The ALL is established for estimated losses in the loan portfolio through a provision for loan losses charged to earnings. For all loan classes, loan losses are charged against the ALL when management believes the loan balance is uncollectible or in accordance with federal guidelines. Subsequent recoveries, if any, are credited to the ALL.

The ALL is maintained at a level believed by management to be appropriate to absorb probable credit losses inherent in the loan portfolio as of the balance sheet date. The amount of the ALL is based on management's periodic evaluation of the collectability of the loan portfolio, including the nature, volume and risk characteristics of the portfolio, credit concentrations, trends in historical loss experience, estimated value of any underlying collateral, specific impaired loans and economic conditions. There was no change to the methodology used to estimate the ALL during the first quarter of 2018. While management uses available information to recognize losses on loans, future additions to the ALL may be necessary based on changes in economic conditions or other relevant factors.

In addition, various regulatory agencies, as an integral part of their examination process, regularly review the Company's ALL. Such agencies may require the Company to recognize additions to the ALL, with a corresponding charge to earnings, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

The ALL consists of specific, general and unallocated components. The specific component relates to the loans that are classified as impaired. Loans are evaluated for impairment and may be classified as impaired when management believes it is probable that the Company will not collect all the contractual interest and principal payments as scheduled in the loan agreement. Impaired loans may also include troubled loans that are restructured. A TDR occurs when the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that would otherwise not be granted. A TDR classification may result from the transfer of assets to the Company in partial satisfaction of a troubled loan, a modification of a loan's terms (such as reduction of stated interest rates below market rates, extension of maturity that does not conform to the Company's policies, reduction of the face amount of the loan, reduction of accrued interest, or reduction or deferment of loan payments), or a combination. A specific reserve amount is allocated to the ALL for individual loans that have been classified as impaired based on management's estimate of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows. The Company accounts for the change in present value attributable to the passage of time in the loan loss reserve. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, real estate or small balance commercial loans for impairment evaluation, unless such loans are subject to a restructuring agreement or have been identified as impaired as part of a larger customer relationship. Management has established the threshold for individual impairment evaluation for commercial loans with balances greater than $500 thousand, based on an evaluation of the Company's historical loss experience on substandard commercial loans.

The general component represents the level of ALL allocable to each loan portfolio segment with similar risk characteristics and is determined based on historical loss experience, adjusted for qualitative factors, for each class of loan. Management deems a five year average to be an appropriate time frame on which to base historical losses for each portfolio segment. Qualitative factors considered include underwriting, economic and market conditions, portfolio composition, collateral values, delinquencies, lender experience and legal issues. The qualitative factors are determined based on the various risk characteristics of each portfolio segment. Risk characteristics relevant to each portfolio segment are as follows:

- Residential real estate - Loans in this segment are collateralized by owner-occupied 1-4 family residential real estate, second and vacation homes, 1-4 family investment properties, home equity and second mortgage loans. Repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, could have an effect on the credit quality of this segment.

- Construction real estate - Loans in this segment include residential and commercial construction properties, commercial real estate development loans (while in the construction phase of the projects), land and land development loans. Repayment is dependent on the credit quality of the individual borrower and/or the underlying cash flows generated by the properties being constructed. The overall health of the economy, including unemployment rates, housing prices, vacancy rates and material costs, could have an effect on the credit quality of this segment.

- Commercial real estate - Loans in this segment are primarily properties occupied by businesses or income-producing properties. The underlying cash flows generated by the properties may be adversely impacted by a downturn in the economy as evidenced by a general slowdown in business or increased vacancy rates which, in turn, could have an effect on the credit quality of this segment. Management requests business financial statements at least annually and monitors the cash flows of these loans.

- Commercial - Loans in this segment are made to businesses and are generally secured by non-real estate assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer or business spending, could have an effect on the credit quality of this segment.

- Consumer - Loans in this segment are made to individuals for personal expenditures, such as an automobile purchase, and include unsecured loans. Repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment, could have an effect on the credit quality of this segment.

- Municipal - Loans in this segment are made to municipalities located within the Company's service area. Repayment is primarily dependent on taxes or other funds collected by the municipalities. Management considers there to be minimal risk surrounding the credit quality of this segment.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the ALL reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

All evaluations are inherently subjective as they require estimates that are susceptible to significant revision as more information becomes available or as changes occur in economic conditions or other relevant factors. Despite the allocation shown in the tables below, the ALL is general in nature and is available to absorb losses from any class of loan.

Changes in the ALL, by class of loans, for the three months ended March 31, 2018 and 2017 were as follows:

| For The Three Months Ended March 31, 2018 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | |
| Balance, December 31, 2017 | $1,361 | $ 488 | $ 2,707 | $ 395 | $ 30 | $ 64 | $ 363 | $5,408 |
| Provision (credit) for loan losses | 14 | 6 | 68 | (28) | (4) | (1) | (55) | — |
| Recoveries of amounts charged off | — | — | — | — | 3 | — | — | 3 |
| | 1,375 | 494 | 2,775 | 367 | 29 | 63 | 308 | 5,411 |
| Amounts charged off | — | — | (2) | — | (4) | — | — | (6) |
| Balance, March 31, 2018 | $1,375 | $ 494 | $ 2,773 | $ 367 | $ 25 | $ 63 | $ 308 | $5,405 |

| For The Three Months Ended March 31, 2017 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | |
| Balance, December 31, 2016 | $1,399 | $ 391 | $ 2,687 | $ 342 | $ 26 | $ 40 | $ 362 | $5,247 |
| Provision (credit) for loan losses | 29 | 48 | (26) | 4 | — | 2 | (57) | — |
| Recoveries of amounts charged off | 2 | 3 | — | — | 1 | — | — | 6 |
| | 1,430 | 442 | 2,661 | 346 | 27 | 42 | 305 | 5,253 |
| Amounts charged off | (58) | — | — | — | (3) | — | — | (61) |
| Balance, March 31, 2017 | $1,372 | $ 442 | $ 2,661 | $ 346 | $ 24 | $ 42 | $ 305 | $5,192 |

The allocation of the ALL, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

| March 31, 2018 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | |
| Individually evaluated for impairment | $44 | $ — | $ — | $ 6 | $ — | $ — | $ — | $50 |
| Collectively evaluated for impairment | 1,331 | 494 | 2,773 | 361 | 25 | 63 | 308 | 5,355 |
| Total allocated | $1,375 | $ 494 | $ 2,773 | $ 367 | $ 25 | $ 63 | $ 308 | $5,405 |

| December 31, 2017 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | |
| Individually evaluated for impairment | $47 | $ — | $ 1 | $ — | $ — | $ — | $ — | $48 |
| Collectively evaluated for impairment | 1,314 | 488 | 2,706 | 395 | 30 | 64 | 363 | 5,360 |
| Total allocated | $1,361 | $ 488 | $ 2,707 | $ 395 | $ 30 | $ 64 | $ 363 | $5,408 |

The recorded investment in loans, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

| March 31, 2018 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Total |
|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | |
| Individually evaluated for impairment | $1,793 | $ 81 | $ 1,056 | $ 374 | $ — | $ — | $3,304 |
| Collectively evaluated for impairment | 180,057 | 43,298 | 259,639 | 46,511 | 3,525 | 55,326 | 588,356 |
| Total | $181,850 | $ 43,379 | $ 260,695 | $ 46,885 | $ 3,525 | $ 55,326 | $591,660 |

| December 31, 2017 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Total |
|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | |
| Individually evaluated for impairment | $1,718 | $ 82 | $ 1,074 | $ 378 | $ — | $ — | $3,252 |
| Collectively evaluated for impairment | 177,281 | 42,853 | 253,217 | 50,341 | 3,894 | 55,777 | 583,363 |
| Total | $178,999 | $ 42,935 | $ 254,291 | $ 50,719 | $ 3,894 | $ 55,777 | $586,615 |

Risk and collateral ratings are assigned to loans and are subject to ongoing monitoring by lending and credit personnel with such ratings updated annually or more frequently if warranted. The following is an overview of the Company's loan rating system:

1-3 Rating - Pass
Risk-rating grades "1" through "3" comprise those loans ranging from those with lower than average credit risk, defined as borrowers with high liquidity, excellent financial condition, strong management, favorable industry trends or loans secured by highly liquid assets, through those with marginal credit risk, defined as borrowers that, while creditworthy, exhibit some characteristics requiring special attention by the account officer.

4/M Rating - Satisfactory/Monitor
Borrowers exhibit potential credit weaknesses or downward trends warranting management's attention. While potentially weak, these borrowers are currently marginally acceptable; no loss of principal or interest is envisioned. When warranted, these credits may be monitored on the watch list.

5-7 Rating - Substandard
Borrowers exhibit well defined weaknesses that jeopardize the orderly liquidation of debt. The loan may be inadequately protected by the net worth and paying capacity of the obligor and/or the underlying collateral is inadequate.

The following tables summarize the loan ratings applied to the Company's loans by class as of the balance sheet dates:

| March 31, 2018 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Total |
|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | |
| Pass | $167,824 | $ 35,795 | $ 173,160 | $ 35,525 | $ 3,495 | $ 55,326 | $471,125 |
| Satisfactory/Monitor | 11,099 | 7,429 | 84,478 | 10,515 | 28 | — | 113,549 |
| Substandard | 2,927 | 155 | 3,057 | 845 | 2 | — | 6,986 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Total | $181,850 | $ 43,379 | $ 260,695 | $ 46,885 | $ 3,525 | $ 55,326 | $591,660 |

| December 31, 2017 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Total |
|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | |
| Pass | $164,733 | $ 33,401 | $ 177,388 | $ 38,877 | $ 3,859 | $ 55,777 | $474,035 |
| Satisfactory/Monitor | 11,296 | 9,374 | 73,772 | 11,165 | 30 | — | 105,637 |
| Substandard | 2,970 | 160 | 3,131 | 677 | 5 | — | 6,943 |
| Total | $178,999 | $ 42,935 | $ 254,291 | $ 50,719 | $ 3,894 | $ 55,777 | $586,615 |

The following tables provide information with respect to impaired loans by class of loan as of and for the three months ended March 31, 2018 and March 31, 2017:

| | As of March 31, 2018 | | | For The Three Months Ended March 31, 2018 | |
|---|---|---|---|---|---|
| | Recorded Investment (1) | Principal Balance (1) | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| | (Dollars in thousands) | | | | |
| Residential real estate | $235 | $ 244 | $ 44 | | |
| Commercial | 13 | 13 | 6 | | |
| With an allowance recorded | 248 | 257 | 50 | | |
| | | | | | |
| Residential real estate | 1,558 | 2,074 | — | | |
| Construction real estate | 81 | 81 | — | | |
| Commercial real estate | 1,056 | 1,137 | — | | |
| Commercial | 361 | 361 | — | | |
| With no allowance recorded | 3,056 | 3,653 | — | | |
| | | | | | |
| Residential real estate | 1,793 | 2,318 | 44 | $1,755 | $ 12 |
| Construction real estate | 81 | 81 | — | 82 | 1 |
| Commercial real estate | 1,056 | 1,137 | — | 1,065 | 16 |
| Commercial | 374 | 374 | 6 | 376 | 8 |
| Total | $3,304 | $ 3,910 | $ 50 | $3,278 | $ 37 |

(1) Does not reflect government guaranties on impaired loans as of March 31, 2018 totaling $533 thousand.

| | As of March 31, 2017 | | | For The Three Months Ended March 31, 2017 | |
|---|---|---|---|---|---|
| | Recorded Investment (1) | Principal Balance (1) | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| | (Dollars in thousands) | | | | |
| Residential real estate | $1,579 | $ 2,087 | $ 61 | $1,514 | $ 11 |
| Construction real estate | 87 | 87 | — | 87 | 1 |
| Commercial real estate | 2,220 | 2,291 | 21 | 2,774 | 32 |
| Commercial | 417 | 417 | — | 424 | 7 |
| Total | $4,303 | $ 4,882 | $ 82 | $4,799 | $ 51 |

(1) Does not reflect government guaranties on impaired loans as of March 31, 2017 totaling $623 thousand.

The following table provides information with respect to impaired loans as of December 31, 2017:

| | December 31, 2017 | | |
|---|---|---|---|
| | Recorded Investment (1) | Principal Balance (1) | Related Allowance |
| | (Dollars in thousands) | | |
| Residential real estate | $238 | $ 247 | $ 47 |
| Commercial real estate | 137 | 141 | 1 |
| With an allowance recorded | 375 | 388 | 48 |
| | | | |
| Residential real estate | 1,480 | 1,983 | — |
| Construction real estate | 82 | 82 | — |
| Commercial real estate | 937 | 1,011 | — |
| Commercial | 378 | 378 | — |
| With no allowance recorded | 2,877 | 3,454 | — |
| | | | |
| Residential real estate | 1,718 | 2,230 | 47 |
| Construction real estate | 82 | 82 | — |
| Commercial real estate | 1,074 | 1,152 | 1 |
| Commercial | 378 | 378 | — |
| Total | $3,252 | $ 3,842 | $ 48 |

(1) Does not reflect government guaranties on impaired loans as of December 31, 2017 totaling $550 thousand.

The following is a summary of TDR loans by class of loan as of the balance sheet dates:

| | March 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Number of Loans | Principal Balance | Number of Loans | Principal Balance |
| | (Dollars in thousands) | | | |
| Residential real estate | 25 | $ 1,793 | 24 | $ 1,718 |
| Construction real estate | 1 | 81 | 1 | 82 |
| Commercial real estate | 10 | 1,056 | 10 | 1,074 |
| Commercial | 3 | 374 | 2 | 378 |
| Total | 39 | $ 3,304 | 37 | $ 3,252 |

The TDR loans above represent loan modifications in which a concession was provided to the borrower, including due date extensions, maturity date extensions, interest rate reductions or the forgiveness of accrued interest. Troubled loans, that are restructured and meet established thresholds, are classified as impaired and a specific reserve amount is allocated to the ALL on the basis of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows.

The following tables provide new TDR activity for the three months ended March 31, 2018 and 2017:

| New TDRs During the Three Months Ended March 31, 2018 | | | New TDRs During the Three Months Ended March 31, 2017 | | |
|---|---|---|---|---|---|
| Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | |
| Residential real estate | 1 | $ 96 | $ | 98 | 3 | $ 140 | $ | 149 |
| Commercial | 1 | 13 | | 13 | — | | — | |

There were no TDR loans modified within the previous twelve months that had subsequently defaulted during the three month periods ended March 31, 2018 or March 31, 2017. TDR loans are considered defaulted at 90 days past due.

At March 31, 2018 and December 31, 2017, the Company was not committed to lend any additional funds to borrowers whose loans were nonperforming, impaired or restructured.

Note 9. Defined Benefit Pension Plan

On October 18, 2017, the Company's Board of Directors voted to terminate Union Bank's Defined Benefit Pension Plan. In order to settle the liabilities under the Plan, the Company will offer participants the option to receive an annuity purchased from an insurance carrier, a lump-sum cash payment, or a direct rollover into a qualifying retirement plan. An estimated $1.1 million will be contributed to the Plan by the Company in 2018 to cover the lump-sum payments and annuity purchases. The amount of the final contribution is subject to a number of factors, including changes in interest rates and the exact proportion of the participants electing a lump-sum distribution versus an annuity. At this time, the Company estimates that a $3.2 million reduction in net income will be recorded in the fourth quarter of 2018 as a result of the Plan termination and settlement of Plan assets and liabilities. The Company anticipates completing the transfer of all liabilities and administrative responsibilities under the Plan by December 31, 2018. Once the process is complete, the Company will no longer have any remaining defined benefit pension plan obligations and thus no periodic pension expense.

The Company's pension benefit obligation and net periodic benefit costs for the Plan are actuarially determined based on assumptions regarding the appropriate discount rate, current and expected future return on Plan assets, and anticipated mortality rates. Weighted average assumptions used to determine the net periodic pension cost (benefit) for the three months ended March 31, 2018 and 2017 have remained consistent with assumptions disclosed in the Company's 2017 Annual Report.

Net periodic pension cost (benefit) for the three months ended March 31 consisted of the following components:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | (Dollars in thousands) | |
| Interest cost on projected benefit obligation | $ 179 | $ 172 |
| Expected return on plan assets | (161) | (243) |
| Amortization of net loss | 151 | 51 |
| Net periodic cost (benefit) | $ 169 | $ (20) |

Note 10. Stock Based Compensation

The Company's current stock based compensation plan is the Union Bankshares, Inc. 2014 Equity Incentive Plan. Under the 2014 Equity Plan, 50,000 shares of the Company's common stock are available for equity awards of incentive stock options, nonqualified stock options, restricted stock and RSUs to eligible officers and (except for awards of incentive stock options) nonemployee directors. Shares available for issuance of awards under the 2014 Equity Plan consist of unissued shares of the Company's common stock and/or shares held in treasury. As of March 31, 2018, there were outstanding grants under the plan of RSUs and incentive stock options.

RSUs. Each RSU represents the right to receive one share of the Company's common stock upon satisfaction of applicable vesting conditions. The general terms of the awards are described in the Company's 2017 Annual Report. Prior to vesting, the RSUs do not earn dividends or dividend equivalents, nor do they bear any voting rights.

The following table presents a summary of the RSUs awarded in accordance with the 2015, 2016, and 2017 Award Plan Summaries, as of March 31, 2018:

| | Number of RSUs Granted | Weighted-Average Grant Date Fair Value | Number of Unvested RSUs |
|---|---|---|---|
| 2015 Award | 5,445 | $ 27.91 | 730 |
| 2016 Award | 3,569 | 45.45 | 2,026 |
| 2017 Award | 3,225 | $ 52.95 | 3,225 |
| Total | 12,239 | | 5,981 |

Unrecognized compensation expense related to the unvested RSUs as of March 31, 2018 and March 31, 2017 was $212 thousand and $186 thousand, respectively.
During the three months ended March 31, 2018, a total of 2,645 contingent RSUs were provisionally granted in accordance with a 2018 Award Plan Summary. The estimated number of contingent RSUs provisionally granted was based on target performance-based payout amounts detailed in the 2018 Award Plan Summary approved by the Board of Directors and on the closing market price of the Company's stock on the March 21, 2018 provisional grant date ($53.95 per share). As with the 2015, 2016, and 2017 grants, one half is in the form of Time-Based RSUs and one-half is in the form of Performance-Based RSUs. The actual number of Time-Based RSUs granted (if any) will be determined as of the earned date of December 31, 2018, based on the closing market price of the Company's stock on that date, while the actual number of Performance-Based RSUs granted (if any) will be determined during the first quarter of 2019, based on actual 2018 performance. The contingent RSUs were granted on substantially the same terms and conditions as the RSUs granted under the previous Award Plan Summaries. As of March 31, 2018, the estimated unrecognized compensation expense related to the provisionally granted RSUs, based on the closing market price of the Company's stock on the provisional grant date of March 21, 2018 was $143 thousand.

Stock options. As of March 31, 2018, 4,500 incentive stock options granted in December 2014 under the 2014 Equity Plan remained outstanding and exercisable and will expire in December 2021. There was no unrecognized compensation expense related to these options as of March 31, 2018. The estimated intrinsic value of these options was $121 thousand as of March 31, 2018.

As of March 31, 2018, 3,000 incentive stock options granted under the 2008 ISO Plan remained outstanding and exercisable, with the last of such options expiring in December 2020. There was no unrecognized compensation expense related to these options as of March 31, 2018. The estimated intrinsic value of these options was $86 thousand as of March 31, 2018.

Note 11. Other Comprehensive Income (Loss)
Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income or loss. Certain changes in assets and liabilities, such as the after tax effect of unrealized gains and losses on investment securities AFS that are not OTTI and the unfunded liability for the defined benefit pension plan, are not reflected in the consolidated statements of income. The cumulative effect of such items, net of tax effect, is reported as a separate component of the equity section of the consolidated balance sheets (Accumulated OCI). OCI, along with net income, comprises the Company's total comprehensive income or loss.

As of the balance sheet dates, the components of Accumulated OCI, net of tax, were:

| | March 31, 2018 | December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Net unrealized loss on investment securities available-for-sale | $(1,251) | $ (301) |
| Defined benefit pension plan net unrealized actuarial loss | (4,795) | (4,795) |

| | | |
|---|---|---|
| Total | $(6,046) | $ (5,096) |

The following table discloses the tax effects allocated to each component of OCI for the three months ended March 31:

| | Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | March 31, 2018 | | | March 31, 2017 | | |
| | Before-Tax Amount | Tax (Expense) Benefit (1) | Net-of-Tax Amount | Before-Tax Amount | Tax (Expense) Benefit (1) | Net-of-Tax Amount |
| | (Dollars in thousands) | | | | | |
| Investment securities available-for-sale: | | | | | | |
| Net unrealized holding (losses) gains arising during the period on investment securities available-for-sale | $(1,203) | $ 253 | $ (950 ) | $341 | $ (116 ) | $ 225 |
| Total other comprehensive (loss) income | $(1,203) | $ 253 | $ (950 ) | $341 | $ (116 ) | $ 225 |

(1) Tax expense/benefit is calculated using a marginal tax rate of 21% and 34% for the three months ended March 31, 2018 and 2017, respectively.

There were no reclassification adjustments from OCI for the three months ended March 31, 2018 and 2017.

Note 12. Fair Value Measurement

The Company utilizes FASB ASC Topic 820, Fair Value Measurement, as guidance for accounting for assets and liabilities carried at fair value. This standard defines fair value as the price that would be received, without adjustment for transaction costs, to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is a market based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. The guidance in FASB ASC Topic 820 establishes a three-level fair value hierarchy, which prioritizes the inputs used in measuring fair value. A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The three levels of the fair value hierarchy are:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

The following is a description of the valuation methodologies used for the Company's assets that are measured on a recurring basis at estimated fair value:

Investment securities AFS: The Company's AFS securities have been valued utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

Mutual funds: Mutual funds have been valued using unadjusted quoted prices from active markets and therefore have been classified as Level 1.

Assets measured at fair value on a recurring basis at March 31, 2018 and December 31, 2017, segregated by fair value hierarchy level, are summarized below:

| | Fair Value Measurements | | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| March 31, 2018: | (Dollars in thousands) | | | |
| Debt securities AFS: | | | | |
| U.S. Government-sponsored enterprises | $7,261 | $ — | $ 7,261 | $ — |
| Agency mortgage-backed | 32,560 | — | 32,560 | — |
| State and political subdivisions | 24,322 | — | 24,322 | — |
| Corporate | 4,297 | — | 4,297 | — |
| Total debt securities | $68,440 | $ — | $ 68,440 | $ — |
| | | | | |
| Other investments: | | | | |
| Mutual funds | $502 | $ 502 | $ — | $ — |
| | | | | |
| December 31, 2017: | | | | |
| Debt securities AFS: | | | | |
| U.S. Government-sponsored enterprises | $7,695 | $ — | $ 7,695 | $ — |
| Agency mortgage-backed | 28,116 | — | 28,116 | — |
| State and political subdivisions | 24,714 | — | 24,714 | — |
| Corporate | 4,393 | — | 4,393 | — |
| Total debt securities | 64,918 | — | 64,918 | — |
| Mutual funds | 521 | 521 | — | — |
| Total | $65,439 | $ 521 | $ 64,918 | $ — |

There were no significant transfers in or out of Levels 1 and 2 during the three months ended March 31, 2018, nor were there any Level 3 assets at any time during either period. Certain other assets and liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Assets and liabilities measured at fair value on a nonrecurring basis in periods after initial recognition, such as collateral-dependent impaired loans, HTM securities, MSRs and OREO, were not considered material at March 31, 2018 or December 31, 2017. The Company has not elected to apply the fair value method to any financial assets or liabilities other than those situations where other accounting pronouncements require fair value measurements.

FASB ASC Topic 825, Financial Instruments, requires disclosure of the estimated fair value of financial instruments. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company’s various financial instruments. 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. Management’s estimates and assumptions are inherently subjective and involve uncertainties and matters of significant judgment. Changes in assumptions could dramatically affect the estimated fair values.

Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments may be excluded from disclosure requirements. Thus, the aggregate fair value amounts presented may not necessarily represent the actual underlying fair value of such instruments of the Company.

The following methods and assumptions were used by the Company in estimating the fair value of its significant financial instruments:

Cash and cash equivalents: The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values and are classified as Level 1.

Interest bearing deposits in banks: Fair values for interest bearing deposits in banks are based on discounted present values of cash flows and are classified as Level 2.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair value measurements consider observable data which may include market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows. Mutual funds have been valued using unadjusted quoted prices from active markets. Investment securities are classified as Level 1 or Level 2 depending on availability of recent trade information.

Loans held for sale: The fair value of loans held for sale is estimated based on quotes from third party vendors, resulting in a Level 2 classification.

Loans: The fair values of loans are estimated for portfolios of loans with similar financial characteristics and segregated by loan class or segment. For variable-rate loan categories that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts adjusted for credit risk. The fair values for other loans (for example, fixed-rate residential, commercial real estate, and rental property mortgage loans as well as commercial and industrial loans) are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future cash flows, future expected loss experience and risk characteristics. As of March 31, 2018, the Company implemented exit pricing valuation methodologies which incorporate a liquidity premium adjustment into the fair value estimate of all loan portfolios. This adjustment factors the costs/market inefficiencies associated with the sale of a financial instrument into the fair value estimate. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable. The fair value methods and assumptions that utilize unobservable inputs as defined by current accounting standards are classified as Level 3.

Accrued interest receivable and payable: The carrying amounts of accrued interest approximate their fair values and are classified as Level 1, 2, or 3 in accordance with the classification of the related principal's valuation.

Nonmarketable equity securities: It is not practical to determine the fair value of the nonmarketable securities, such as FHLB stock, due to restrictions placed on their transferability.

Deposits: The fair values disclosed for noninterest bearing deposits and other interest bearing nontime deposits are, by definition, equal to the amount payable on demand at the reporting date, resulting in a Level 1 classification. The fair values for time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar deposits to a schedule of aggregated expected maturities on such deposits, resulting in a Level 2 classification.

Borrowed funds: The fair values of the Company’s long-term debt are estimated using discounted cash flow analysis based on interest rates currently being offered on similar debt instruments, resulting in a Level 2 classification. The fair values of the Company’s short-term debt approximate the carrying amounts reported in the balance sheet, resulting in a Level 1 classification.

Off-balance-sheet financial instruments: Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties’ credit standing. The only commitments to extend credit that are normally longer than one year in duration are the home equity lines whose interest rates are variable quarterly. The only fees collected for commitments are an annual fee on credit card arrangements and often a flat fee on commercial lines of credit and standby letters of credit. The fair value of off-balance-sheet financial instruments as of the balance sheet dates was not significant.

As of the balance sheet dates, the estimated fair values and related carrying amounts of the Company's significant financial instruments were as follows:

| | March 31, 2018 | | | | |
|---|---|---|---|---|---|
| | Fair Value Measurements | | | | |
| | Carrying Amount | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (Dollars in thousands) | | | | |
| Financial assets | | | | | |
| Cash and cash equivalents | $13,246 | $13,246 | $13,246 | $ — | $ — |
| Interest bearing deposits in banks | 9,601 | 9,510 | — | 9,510 | — |
| Investment securities | 68,942 | 68,942 | 502 | 68,440 | — |
| Loans held for sale | 2,938 | 2,969 | — | 2,969 | — |
| Loans, net | | | | | |
| Residential real estate | 180,720 | 179,098 | — | — | 179,098 |
| Construction real estate | 42,943 | 42,231 | — | — | 42,231 |
| Commercial real estate | 257,965 | 257,596 | — | — | 257,596 |
| Commercial | 46,581 | 45,339 | — | — | 45,339 |
| Consumer | 3,505 | 3,521 | — | — | 3,521 |
| Municipal | 55,338 | 55,143 | — | — | 55,143 |
| Accrued interest receivable | 2,468 | 2,468 | — | 393 | 2,075 |
| Nonmarketable equity securities | 2,331 | N/A | N/A | N/A | N/A |
| Financial liabilities | | | | | |
| Deposits | | | | | |
| Noninterest bearing | $128,951 | $128,951 | $128,951 | $ — | $ — |
| Interest bearing | 392,027 | 392,027 | 392,027 | — | — |
| Time | 102,865 | 101,406 | — | 101,406 | — |
| Borrowed funds | | | | | |
| Short-term | 122 | 122 | 122 | — | — |
| Long-term | 31,143 | 30,951 | — | 30,951 | — |
| Accrued interest payable | 97 | 97 | — | 97 | — |

| | December 31, 2017 Fair Value Measurements | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (Dollars in thousands) | | | | |
| Financial assets | | | | | |
| Cash and cash equivalents | $38,508 | $38,508 | $38,508 | $ — | $ — |
| Interest bearing deposits in banks | 9,352 | 9,333 | — | 9,333 | — |
| Investment securities | 66,439 | 66,438 | 521 | 65,917 | — |
| Loans held for sale | 7,947 | 8,111 | — | 8,111 | — |
| Loans, net | | | | | |
| Residential real estate | 177,880 | 178,818 | — | — | 178,818 |
| Construction real estate | 42,505 | 42,069 | — | — | 42,069 |
| Commercial real estate | 251,566 | 248,746 | — | — | 248,746 |
| Commercial | 50,393 | 49,132 | — | — | 49,132 |
| Consumer | 3,869 | 3,919 | — | — | 3,919 |
| Municipal | 55,789 | 55,778 | — | — | 55,778 |
| Accrued interest receivable | 2,500 | 2,500 | — | 395 | 2,105 |
| Nonmarketable equity securities | 2,331 | N/A | N/A | N/A | N/A |
| Financial liabilities | | | | | |
| Deposits | | | | | |
| Noninterest bearing | $127,824 | $127,824 | $127,824 | $ — | $ — |
| Interest bearing | 418,621 | 418,621 | 418,621 | — | — |
| Time | 101,129 | 99,967 | — | 99,967 | — |
| Borrowed funds | | | | | |
| Short-term | 1,365 | 1,364 | 1,364 | — | — |
| Long-term | 30,216 | 29,039 | — | 29,039 | — |
| Accrued interest payable | 97 | 97 | — | 97 | — |

The carrying amounts in the preceding tables are included in the consolidated balance sheets under the applicable captions.

Note 13. Subsequent Events

Subsequent events represent events or transactions occurring after the balance sheet date but before the financial statements are issued. Financial statements are considered “issued” when they are widely distributed to shareholders and others for general use and reliance in a form and format that complies with GAAP. Events occurring subsequent to March 31, 2018 have been evaluated as to their potential impact to the consolidated financial statements.

On April 18, 2018, the Company declared a regular quarterly cash dividend of $0.30 per share, payable May 10, 2018, to stockholders of record on April 30, 2018.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The following discussion and analysis focuses on those factors that, in management's view, had a material effect on the financial position of the Company as of March 31, 2018 and December 31, 2017, and its results of operations for the three months ended March 31, 2018 and 2017. This discussion is being presented to provide a narrative explanation of the consolidated financial statements and should be read in conjunction with the consolidated financial statements and related notes and with other financial data appearing elsewhere in this filing and with the Company's 2017 Annual Report In the opinion of the Company's management, the interim unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments and disclosures necessary to fairly present the Company's consolidated financial position and results of operations for the interim periods presented. Management is not aware of the occurrence of any events after March 31, 2018 which would materially affect the information presented.

Please refer to Note 1 in the Company's unaudited interim consolidated financial statements at Part I, Item 1 of this Report for definitions of acronyms, abbreviations and capitalized terms used throughout the following discussion and analysis.

CAUTIONARY ADVICE ABOUT FORWARD LOOKING STATEMENTS

The Company, "we," "us," "our," may from time to time make written or oral statements that are considered “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may include financial projections, statements of plans and objectives for future operations, estimates of future economic performance or conditions and assumptions relating thereto. The Company may include forward-looking statements in its filings with the SEC, in its reports to stockholders, including this quarterly report, in press releases, other written materials, and in statements made by senior management to analysts, rating agencies, institutional investors, representatives of the media and others.

Forward-looking statements reflect management's current expectations and are subject to uncertainties, both general and specific, and risk exists that actual results will differ from those predictions, forecasts, projections and other estimates contained in forward-looking statements. These risks cannot be readily quantified. When management uses any of the words “believes,” “expects,” “anticipates,” “intends,” "projects," “plans,” “seeks,” “estimates,” "targets," "goals," “n "might," “could,” “would,” “should,” or similar expressions, they are making forward-looking statements. Many possible events or factors, including those beyond the control of management, could affect the future financial results and performance of the Company.

Factors that may cause results or performance to differ materially from those expressed in forward-looking statements include, but are not limited to:

- General economic conditions and financial instability, either nationally, internationally, regionally or locally;
- Increased competitive pressures, including those from tax-advantaged credit unions and other financial service providers in our northern Vermont and New Hampshire market area or in the financial services industry generally, from increasing consolidation and integration of financial service providers, and from changes in technology and delivery systems;
- Interest rates change in a way that puts pressure on the Company's margins, or that results in lower fee income and lower gain on sale of real estate loans, or that increases our interest costs;
- Changes in laws or government rules, or the way in which courts or government agencies interpret or implement those laws or rules, that increase our costs of doing business or otherwise adversely affect our business;
- Further changes in federal or state tax policy;
- Changes in our level of nonperforming assets and charge-offs;
- Changes in depositor behavior resulting in movement of funds out of bank deposits and into the stock market or other higher-yielding investments;

- Changes in estimates of future reserve requirements based upon relevant regulatory and accounting requirements;
- Changes in information technology that require increased capital spending or that result in new or increased risks;
- Changes in consumer and business spending, borrowing and savings habits;
- Changes in accounting principles, including those governing the manner of estimating our credit risk and calculating our loan loss reserve;
- Changes affecting the calculation of the amount of the contribution that will be required to settle our obligations in connection with termination of our defined benefit pension plan and the impact of such termination on our net income in 2018;
- Further changes to the regulations governing the calculation of the Company's regulatory capital ratios;
- Increased cybersecurity threats; and
- The effect of and changes in the United States monetary and fiscal policies, including interest rate policies and regulation of the money supply by the FRB.

When evaluating forward-looking statements to make decisions about the Company and our stock, investors and others are cautioned to consider these and other risks and uncertainties, and are reminded not to place undue reliance on such statements. Investors should not consider the foregoing list of factors to be a complete list of risks or uncertainties. Forward-looking statements speak only as of the date they are made and the Company undertakes no obligation to update them to reflect new or changed information or events, except as may be required by federal securities laws.

## Non-GAAP Financial Measures

Under SEC Regulation G, public companies making disclosures containing financial measures that are not in accordance with GAAP must also disclose, along with each non-GAAP financial measure, certain additional information, including a reconciliation of the non-GAAP financial measure to the closest comparable GAAP financial measure, as well as a statement of the company’s reasons for utilizing the non-GAAP financial measure. The SEC has exempted from the definition of non-GAAP financial measures certain commonly used financial measures that are not based on GAAP. However, two non-GAAP financial measures commonly used by financial institutions, namely tax-equivalent net interest income and tax-equivalent net interest margin (as presented in the tables in the section labeled Yields Earned and Rates Paid), have not been specifically exempted by the SEC, and may therefore constitute non-GAAP financial measures under Regulation G. We are unable to state with certainty whether the SEC would regard those measures as subject to Regulation G. Management believes that these non-GAAP financial measures are useful in evaluating the Company’s financial performance and facilitate comparisons with the performance of other financial institutions. However, that information should be considered supplemental in nature and not as a substitute for related financial information prepared in accordance with GAAP.

## CRITICAL ACCOUNTING POLICIES

The Company has established various accounting policies which govern the application of GAAP in the preparation of the Company's consolidated financial statements. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the reported amount of assets, liabilities, capital, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require management to make its most difficult and subjective judgments, often as a result of the need to make estimates on matters that are inherently uncertain. Based on this definition, management has identified the accounting policies and judgments most critical to the Company. They include establishing the amount of ALL, evaluating our investment securities for OTTI, valuing our intangible assets and determining the amount of our defined benefit pension plan obligation and net periodic cost/(benefit) as well as the amount of our required contribution in connection with termination of the Plan.The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from estimates and have a material impact on the carrying value of assets, liabilities, or capital, and/or the results of operations of the Company.

Please refer to the Company's 2017 Annual Report on Form 10-K for a more in-depth discussion of the Company's critical accounting policies. There have been no changes to the Company's critical accounting policies since the filing of that report.

## OVERVIEW

As discussed in the Company's 2017 Annual Report , on October 18, 2017, the Company's Board of Directors voted to terminate Union Bank’s Defined Benefit Pension Plan. The Company anticipates completing the transfer of all liabilities and administrative responsibilities under the Plan by December 31, 2018. Once the process is complete, the Company will no longer have any remaining defined benefit pension plan obligations and thus no periodic pension

expense in future periods.
Additionally, passage of the 2017 Tax Act reduced the Company's federal income tax rate from 34% to 21% effective January 1, 2018. The rate reduction has had a positive impact on earnings for the first three months of 2018.(See Results of Operations, Provision for Income Taxes on page 31.)
The Company's net income was $2.7 million for the quarter ended March 31, 2018 compared to $1.9 million for the quarter ended March 31, 2017, an increase of $817 thousand, or 42.3%. These results reflected an increase in the Company's net interest income of $622 thousand, or 9.9%, an increase in noninterest income of $238 thousand, or 10.7%, and a decrease in the provision for income taxes of $151 thousand, or 22.7%. These positive changes were partially offset by an increase in noninterest expenses of $194 thousand, or 3.3%.
At March 31, 2018, the Company had total consolidated assets of $722.7 million, including gross loans and loans held for sale (total loans) of $594.6 million, deposits of $623.8 million and stockholders' equity of $59.2 million. The Company’s total assets

at March 31, 2018 decreased $23.1 million, or 3.1%, from $745.8 million at December 31, 2017, and increased $46.3 million, or 6.8%, compared to March 31, 2017. (See Financial Condition on page 31.)

The Company's total capital increased from $58.7 million at December 31, 2017 to $59.2 million at March 31, 2018. This increase primarily reflects net income of $2.7 million for the first three months of 2018, partially offset by an increase of $950 thousand in accumulated other comprehensive loss and regular cash dividends paid of $1.3 million. (See Capital Resources on page 38.)

The following unaudited per share information and key ratios depict several measurements of performance or financial condition at or for the three months ended March 31, 2018 and 2017, respectively:

| | Three Months Ended or At March 31, | | | |
|---|---|---|---|---|
| | 2018 | | 2017 | |
| Return on average assets (1) | 1.51 | % | 1.14 | % |
| Return on average equity (1) | 18.76 | % | 13.67 | % |
| Net interest margin (1)(2) | 4.15 | % | 4.15 | % |
| Efficiency ratio (3) | 64.48 | % | 67.95 | % |
| Net interest spread (4) | 4.04 | % | 4.06 | % |
| Loan to deposit ratio | 95.31 | % | 92.84 | % |
| Net loan charge-offs to average loans not held for sale (1) | — | % | 0.04 | % |
| Allowance for loan losses to loans not held for sale | 0.91 | % | 0.97 | % |
| Nonperforming assets to total assets (5) | 0.23 | % | 0.49 | % |
| Equity to assets | 8.19 | % | 8.45 | % |
| Total capital to risk weighted assets | 13.96 | % | 13.40 | % |
| Book value per share | $13.25 | | $12.81 | |
| Earnings per share | $0.62 | | $0.43 | |
| Dividends paid per share | $0.30 | | $0.29 | |
| Dividend payout ratio (6) | 48.39 | % | 67.44 | % |

(1) Annualized.
(2) The ratio of tax equivalent net interest income to average earning assets. See page 28 for more information.
(3) The ratio of noninterest expense to tax equivalent net interest income and noninterest income, excluding securities gains (losses).
(4) The difference between the average yield on earning assets and the average rate paid on interest bearing liabilities. See page 28 for more information.
(5) Nonperforming assets are loans or investment securities that are in nonaccrual or 90 or more days past due as well as OREO or OAO.
(6) Cash dividends declared and paid per share divided by consolidated net income per share.

## RESULTS OF OPERATIONS

Net Interest Income. The largest component of the Company’s operating income is net interest income, which is the difference between interest and dividend income received from earning assets and interest expense paid on interest bearing liabilities. Net interest income is affected by various factors including, but not limited to changes in interest rates, loan and deposit pricing strategies, the volume and mix of interest earning assets and interest bearing liabilities, and the level of nonperforming assets. Net interest margin is calculated as the net interest income on a fully tax equivalent basis as a percentage of average earning assets. As a result of the 2017 Tax Act, our corporate tax rate has declined from 34% in prior years to 21% in 2018. Accordingly, the factor utilized in calculating tax equivalent interest income has declined, resulting in lower yields on the tax advantaged earning assets.

The Company’s net interest income increased $622 thousand, or 9.9%, to $6.9 million for the three months ended March 31, 2018 from $6.3 million for the three months ended March 31, 2017. The net interest spread decreased two bps to 4.04% for the first quarter of 2018, from 4.06% for the same period last year, reflecting a six bp increase in the average rate paid on interest bearing liabilities, partially offset by a four bp increase in the average yield earned on interest earning assets between periods. Interest income on loans increased $677 thousand to $7.0 million for the three months ended March 31, 2018 from $6.3 million for the three months ended March 31, 2017 due to an increase in the average volume of loans outstanding of $53.2 million during the 20

18 comparison period. Interest income on investment securities increased $17 thousand between periods despite a slight decline in average volume and a 15 bp decrease in the average yield as a result of a decrease in the tax equivalent factor.

The average rate paid on interest bearing liabilities increased six bps, to 0.49% for the first quarter of 2018 compared to 0.43% for the first quarter of 2017. Average rates paid increased in all deposit categories while the average rate paid on borrowed funds remained unchanged. The Company may need to continue to increase rates paid on deposit accounts to remain competitive as short term interest rates and competition for deposit monies continues to increase. Additionally, funding sources other than core deposits may be necessary to fund loan demand which may have a higher cost. These changes could result in increased pressure on our net interest spread. The net interest margin was unchanged at 4.15% for the three months ended March 31, 2018 and March 31, 2017.

The following table shows for the periods indicated the total amount of income recorded from average interest earning assets, the related average tax equivalent yields, the interest expense associated with average interest bearing liabilities, the related average rates paid, and the resulting tax equivalent net interest spread and margin.

| | Three Months Ended March 31, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2018 | | | | 2017 | | | |
| | Average Balance | Interest Earned/ Paid | Average Yield/ Rate | | Average Balance | Interest Earned/ Paid | Average Yield/ Rate | |
| | (Dollars in thousands) | | | | | | | |
| Average Assets: | | | | | | | | |
| Federal funds sold and overnight deposits | $16,457 | $53 | 1.28 | % | $19,217 | $30 | 0.63 | % |
| Interest bearing deposits in banks | 9,957 | 45 | 1.83 | % | 9,252 | 35 | 1.54 | % |
| Investment securities (1), (2) | 68,413 | 445 | 2.81 | % | 68,456 | 428 | 2.96 | % |
| Loans, net (1), (3) | 590,321 | 6,999 | 4.87 | % | 537,117 | 6,322 | 4.87 | % |
| Nonmarketable equity securities | 2,362 | 29 | 4.95 | % | 2,354 | 24 | 4.16 | % |
| Total interest earning assets (1) | 687,510 | 7,571 | 4.53 | % | 636,396 | 6,839 | 4.49 | % |
| Cash and due from banks | 3,945 | | | | 4,123 | | | |
| Premises and equipment | 14,177 | | | | 13,416 | | | |
| Other assets | 22,359 | | | | 22,062 | | | |
| Total assets | $727,991 | | | | $675,997 | | | |
| Average Liabilities and Stockholders' Equity: | | | | | | | | |
| Interest bearing checking accounts | $145,091 | 47 | 0.13 | % | $140,253 | 39 | 0.11 | % |
| Savings/money market accounts | 258,066 | 298 | 0.47 | % | 230,935 | 211 | 0.37 | % |
| Time deposits | 101,793 | 188 | 0.75 | % | 103,723 | 172 | 0.67 | % |
| Borrowed funds | 32,343 | 114 | 1.41 | % | 32,720 | 115 | 1.41 | % |
| Total interest bearing liabilities | 537,293 | 647 | 0.49 | % | 507,631 | 537 | 0.43 | % |
| Noninterest bearing deposits | 124,875 | | | | 106,794 | | | |
| Other liabilities | 7,265 | | | | 5,109 | | | |
| Total liabilities | 669,433 | | | | 619,534 | | | |
| Stockholders' equity | 58,558 | | | | 56,463 | | | |
| Total liabilities and stockholders’ equity | $727,991 | | | | $675,997 | | | |
| Net interest income | | $6,924 | | | | $6,302 | | |
| Net interest spread (1) | | | 4.04 | % | | | 4.06 | % |
| Net interest margin (1) | | | 4.15 | % | | | 4.15 | % |

(1) Average yields reported on a tax equivalent basis using a marginal tax rate of 21% and 34% for the three months ended March 31, 2018 and 2017, respectively.

(2)

Average balances of investment securities are calculated on the amortized cost basis and include nonaccrual securities, if applicable.

(3) Includes loans held for sale as well as nonaccrual loans, unamortized costs and unamortized premiums and is net of the allowance for loan losses.

Tax exempt interest income amounted to $506 thousand and $433 thousand for the three months ended March 31, 2018 and 2017, respectively. The following table presents the effect of tax exempt income on the calculation of net interest income, using a marginal tax rate of 21% and 34% for the three months ended March 31, 2018 and 2017, respectively:

| | For the Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | (Dollars in thousands) | |
| Net interest income, as presented | $6,924 | $6,302 |
| Effect of tax-exempt interest | | |
| Investment securities | 34 | 79 |
| Loans | 85 | 130 |
| Net interest income, tax equivalent | $7,043 | $6,511 |

Rate/Volume Analysis. The following table describes the extent to which changes in average interest rates (on a fully tax-equivalent basis) and changes in volume of average interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. For each category of interest earning assets and interest bearing liabilities, information is provided on changes attributable to:

- changes in volume (change in volume multiplied by prior rate);
- changes in rate (change in rate multiplied by prior volume); and
- total change in rate and volume.

Changes attributable to both rate and volume have been allocated proportionately to the change due to volume and the change due to rate.

| | Three Months Ended March 31, 2018 Compared to Three Months Ended March 31, 2017 Increase/(Decrease) Due to Change In | | |
|---|---|---|---|
| | Volume (1) | Rate (1) | Net |
| | (Dollars in thousands) | | |
| Interest earning assets: | | | |
| Federal funds sold and overnight deposits | $(4) | $27 | $23 |
| Interest bearing deposits in banks | 3 | 7 | 10 |
| Investment securities | — | 17 | 17 |
| Loans, net | 677 | — | 677 |
| Nonmarketable equity securities | — | 5 | 5 |
| Total interest earning assets | $676 | $56 | $732 |
| Interest bearing liabilities: | | | |

| | | | |
|---|---|---|---|
| Interest bearing checking accounts | $2 | $6 | $8 |
| Savings/money market accounts | 27 | 60 | 87 |
| Time deposits | (3) | 19 | 16 |
| Borrowed funds | (1) | — | (1) |
| Total interest bearing liabilities | $25 | $85 | $110 |
| Net change in net interest income | $651 | $(29) | $622 |

(1) Tax equivalent interest income is calculated using a marginal tax rate of 21% and 34% for the three months ended March 31, 2018 and 2017, respectively.

Provision for Loan Losses. There was no loan loss provision recorded for three month periods ended March 31, 2018 or March 31, 2017. No provision for the first three months of 2018 was deemed appropriate by management based on the size and mix of the loan portfolio, the level of nonperforming loans, the results of the qualitative factor review and prevailing existing economic conditions. For further details, see FINANCIAL CONDITION- Allowance for Loan Losses and Asset Quality below.

Noninterest Income. Noninterest income was $2.5 million for the three months ended March 31, 2018, compared to $2.2 million, for the three months ended March 31, 2017. The following table sets forth the components of noninterest income and changes from 2017 to 2018:

| | For The Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | $ Variance | % Variance |
| | (Dollars in thousands) | | | |
| Trust income | $193 | $178 | $ 15 | 8.4 |
| Service fees | 1,487 | 1,440 | 47 | 3.3 |
| Net gains on sales of loans held for sale | 295 | 508 | (213 ) | (41.9 ) |
| Income from Company-owned life insurance | 312 | 60 | 252 | 420.0 |
| Other income | 184 | 47 | 137 | 291.5 |
| Total noninterest income | $2,471 | $2,233 | $ 238 | 10.7 |

The significant changes in noninterest income for the three months ended March 31, 2018 compared to the same period of 2017 are described below:

- Service fees. Total service fees increased $47 thousand for the three months ended March 31, 2018 compared to the same period in 2017 due to increases of $23 thousand in overdraft fees and $31 thousand in loan servicing income, partially offset by nominal decreases in other miscellaneous fee income.
- Net gains on sales of loans held for sale. Continuing the Company's strategy to mitigate long-term interest rate risk, residential and commercial loans totaling $23.1 million were sold during the first quarter of 2018, versus residential loan sales of $28.5 million during the first quarter of 2017. The decline in net gains on sales of real estate loans is due to a combination of lower volumes of loans sold and lower average premiums on sold loans between periods reflecting a rising interest rate environment.
- Income from Company-owned life insurance. Proceeds from the death benefit on an insurance policy on the life of a former director resulted in $252 thousand of additional income during the first quarter of 2018.
- Other income. Other income increased between periods due to the gain on the sale of a bank owned branch building of $191 thousand during the first quarter of 2018, partially offset by decreases of $43 thousand in MSR income and $11 thousand of miscellaneous noninterest income.

Noninterest Expense. Noninterest expense increased $194 thousand, or 3.3%, for the three months ended March 31, 2018 compared to the same period in 2017. The following table sets forth the components of noninterest expense and changes between the three month comparison periods of 2018 and 2017:

| | For The Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | $ Variance | % Variance |
| | (Dollars in thousands) | | | |
| Salaries and wages | $2,649 | $2,568 | $ 81 | 3.2 |
| Pension and employee benefits | 958 | 879 | 79 | 9.0 |
| Occupancy expense, net | 395 | 390 | 5 | 1.3 |
| Equipment expense | 535 | 534 | 1 | 0.2 |
| Electronic banking expenses | 68 | 28 | 40 | 142.9 |
| Other expenses | 1,530 | 1,542 | (12 ) | (0.8 ) |
| Total noninterest expense | $6,135 | $5,941 | $ 194 | 3.3 |

The significant changes in noninterest expense for the three months ended March 31, 2018 compared to the same period of 2017 are described below:

- 

Salaries and wages. Salaries and wages increased $81 thousand for the three months ended March 31, 2018 compared to the same period of 2017 due to normal salary increases, partially offset by a reduction in commissions paid to mortgage loan originators.

- Pension and employee benefits. Pension and employee benefits increased $79 thousand for the three months ended March 31, 2018 compared to the same period in 2017. The increase is the result of an increase in pension expense of $190 thousand, partially offset by a reduction in the cost of the Company's medical plan of $119 thousand. The reduction in the Company's medical plan costs in 2018 reflects a $242 thousand plan credit due to favorable 2017 claims experience. A similar experience based credit received in 2017 was $130 thousand. As discussed in Note 9, the Company plans to terminate its defined benefit pension plan during 2018 with the settlement of assets and liabilities expected to occur during the fourth quarter of 2018. The Company will continue to recognize pension related costs during its interim periods until the plan has been settled.

- Electronic banking expenses. During the first quarter of 2018 Union changed its service provider for its internet and mobile banking product. The new product was selected to provide a more robust product to Union's customers that includes additional functionality. The utilization of the product resulted in an increase in electronic banking expenses of $40 thousand between periods.

Provision for Income Taxes. The Company has provided for current and deferred federal income taxes for the three months ended March 31, 2018 and 2017. The Company's net provision for income taxes was $513 thousand for the three months ended March 31, 2018, compared to $664 thousand for the same period in 2017. The Company's effective tax rate was 15.7% and 25.6% for the three months ended March 31, 2018, and 2017, respectively. The reduction in the effective tax rate was primarily due to a decrease in the corporate income tax rate from 34% to 21% as a result of the 2017 Tax Act.

Amortization expense related to limited partnership investments is included as a component of tax expense and amounted to $140 thousand and $157 thousand for the three months ended March 31, 2018, and 2017 respectively. These investments provide tax benefits, including tax credits. Low income housing tax credits with respect to limited partnership investments are also included as a component of income tax expense and amounted to $148 thousand for the three months ended March 31, 2018, and $158 thousand for the three months ended March 31, 2017.

FINANCIAL CONDITION

At March 31, 2018, the Company had total consolidated assets of $722.7 million, including gross loans and loans held for sale (total loans) of $594.6 million, deposits of $623.8 million and stockholders' equity of $59.2 million. The Company’s total assets at March 31, 2018 decreased $23.1 million, or 3.1%, from $745.8 million at December 31, 2017, and increased $46.3 million, or 6.8%, compared to March 31, 2017.

Net loans and loans held for sale totaled $590.0 million, or 81.6% of total assets at March 31, 2018, compared to $589.9 million, or 79.1% of total assets at December 31, 2017. (See Loans Held for Sale and Loan Portfolio below.)

Total deposits decreased $23.7 million, or 3.7%, to $623.8 million at March 31, 2018, from $647.6 million at December 31, 2017. Interest bearing deposits decreased $26.6 million, or 6.4%, which was partially offset by increases in noninterest bearing deposits of $1.1 million, or 0.9%, and time deposits of $1.7 million, or 1.7%. The decline in total deposits between periods is related to seasonal fluctuations in municipal deposit account balances. (See average balances and rates in the Yields Earned and Rates Paid tables on page 28.)

Total borrowed funds decreased $316 thousand, or 1.0%, from $31.6 million at December 31, 2017 to $31.3 million at March 31, 2018. Customer overnight collateralized repurchase sweeps decreased $1.2 million, while FHLB advances increased $928 thousand between December 31, 2017 and March 31, 2018. (See Borrowings on page 36.)

Total stockholders’ equity increased $503 thousand to $59.2 million at March 31, 2018 from $58.7 million at December 31, 2017. (See Capital Resources on page 38.)

Loans Held for Sale and Loan Portfolio. Total loans (including loans held for sale) was $594.6 million, unchanged from December 31, 2017, and represented 82.3% of assets at March 31, 2018 and 79.7% of assets at December 31, 2017. The total loan portfolio at March 31, 2018 increased $54.2 million compared to the March 31, 2017 level of $540.4 million, representing 79.9% of assets. The Company’s loans consist primarily of adjustable-rate and fixed-rate mortgage loans secured by one-to-four family, multi-family residential or commercial real estate. Real estate secured loans represented $488.9 million, or 82.2% of total loans at March 31, 2018 and $484.2 million, or 81.4% of total loans at December 31, 2017. Although competition for good loans is strong, especially in the commercial sector, the Company has been able to originate loans to both current and new customers while maintaining credit quality. The composition of the Company's loan portfolio remained relatively unchanged from December 31, 2017. There was no material change in the Company's lending programs or terms during the three months ended March 31, 2018.

The composition of the Company's loan portfolio as of March 31, 2018 and December 31, 2017 was as follows:

| | March 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| Loan Class | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Residential real estate | $181,850 | 30.6 | $178,999 | 30.1 |
| Construction real estate | 43,379 | 7.3 | 42,935 | 7.2 |
| Commercial real estate | 260,695 | 43.8 | 254,291 | 42.8 |
| Commercial | 46,885 | 7.9 | 50,719 | 8.5 |
| Consumer | 3,525 | 0.6 | 3,894 | 0.7 |
| Municipal | 55,326 | 9.3 | 55,777 | 9.4 |
| Loans held for sale | 2,938 | 0.5 | 7,947 | 1.3 |
| Total loans | 594,598 | 100.0 | 594,562 | 100.0 |
| Allowance for loan losses | (5,405 ) | | (5,408 ) | |
| Unamortized net loan costs | 797 | | 795 | |
| Net loans and loans held for sale | $589,990 | | $589,949 | |

The Company originates and sells qualified residential mortgage loans in various secondary market avenues, with a majority of sales made to the FHLMC/Freddie Mac, generally with servicing rights retained. At March 31, 2018, the Company serviced a $675.6 million residential real estate mortgage portfolio, of which $2.9 million was held for sale and approximately $490.8 million was serviced for unaffiliated third parties.

The Company sold $23.1 million of qualified residential real estate loans primarily originated during the first three months of 2018 to the secondary market to mitigate long-term interest rate risk and to generate fee income, compared to sales of $28.5 million during the first three months of 2017. The Company originates and sells FHA, VA, and RD residential mortgage loans, and also has an Unconditional Direct Endorsement Approval from HUD which allows the Company to approve FHA loans originated in any of its Vermont or New Hampshire locations without needing prior HUD underwriting approval. The Company sells VA and FHA loans as originated with servicing released. Some of the government backed loans qualify for zero down payments without geographic or income restrictions. These loan products increase the Company's ability to serve the borrowing needs of residents in the communities we serve, including low and moderate income borrowers, while the government guaranty mitigates our exposure to credit risk.

The Company also originates commercial real estate and commercial loans under various SBA, USDA and State sponsored programs that provide a government agency guaranty for a portion of the loan amount. There was $4.3 million guaranteed under these various programs at March 31, 2018 on an aggregate balance of $5.5 million in subject loans. The Company occasionally sells the guaranteed portion of the loan to other financial concerns and retains servicing rights, which generates fee income. There were no commercial loans sold in the first three months of 2018 and $27 thousand of commercial loans sold in the first three months of 2017. The Company recognizes gains and losses on the sale of the principal portion of these loans as they occur.

The Company serviced $13.9 million of commercial and commercial real estate loans for unaffiliated third parties as of March 31, 2018. This includes $11.6 million of commercial or commercial real estate loans the Company has participated out to other financial institutions, in the ordinary course of business on a nonrecourse basis, for liquidity or credit concentration management purposes.

As of March 31, 2018, there were $1.1 billion in total loans serviced, an increase of $5.6 million compared to December 31, 2017. Total loans serviced at March 31, 2018 included total loans on the balance sheet of $594.6 million as well as total loans sold with servicing retained of $504.8 million.

The Company capitalizes MSRs for all loans sold with servicing retained and recognizes gains and losses on the sale of the principal portion of these loans as they occur. The unamortized balance of MSRs on loans sold with servicing retained was $1.7 million at March 31, 2018, with an estimated market value in excess of the carrying value as of such date. Management periodically evaluates and measures the servicing assets for impairment.

Qualifying residential first mortgage loans and certain commercial real estate loans with a carrying value of $165.0 million were pledged as collateral for borrowings from the FHLB under a blanket lien at March 31, 2018.

Asset Quality. The Company, like all financial institutions, is exposed to certain credit risks, including those related to the value of the collateral that secures its loans and the ability of borrowers to repay their loans. Consistent application of the Company’s conservative loan policies has helped to mitigate this risk and has been prudent for both the Company and its customers. Renewed market volatility, high unemployment rates or weakness in the general economic condition of the country or our market area, may have a negative effect on our customers’ ability to make their loan payments on a timely basis and/or on underlying collateral values. Management closely monitors the Company’s loan and investment portfolios, OREO and OAO for potential problems and reports to the Company’s and Union’s Board at regularly scheduled meetings. Board approved policies set forth portfolio diversification levels to mitigate concentration risk and the Company participates large credits out to other financial institutions to further mitigate that risk.

Repossessed assets and loans or investments that are 90 days or more past due are considered to be nonperforming assets.The following table shows the composition of nonperforming assets at the dates indicated and trends in certain ratios monitored by the Company's management in reviewing asset quality:

| | As of or for the three months ended March 31, 2018 | | As of or for the year ended December 31, 2017 | | As of or for the three months ended March 31, 2017 | |
|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | |
| Nonaccrual loans | $1,400 | | $ 1,191 | | $3,083 | |
| Accruing loans 90+ days delinquent | 294 | | 494 | | 257 | |
| Total nonperforming loans (1) | 1,694 | | 1,685 | | 3,340 | |
| OREO | — | | 36 | | — | |
| Total nonperforming assets (1) | $1,694 | | $ 1,721 | | $3,340 | |
| ALL to loans not held for sale | 0.91 | % | 0.92 | % | 0.97 | % |
| ALL to nonperforming loans | 319.07 | % | 320.95 | % | 155.45 | % |
| Nonperforming loans to total loans | 0.28 | % | 0.28 | % | 0.62 | % |
| Nonperforming assets to total assets | 0.23 | % | 0.23 | % | 0.49 | % |
| Delinquent loans (30 days to nonaccruing) to total loans | 1.22 | % | 1.05 | % | 1.64 | % |
| Net charge-offs (annualized) to average loans not held for sale | — | % | 0.01 | % | 0.04 | % |

(1) The Company had guarantees of U.S. or state government agencies on the above nonperforming loans totaling $129 thousand at March 31, 2018, $131 thousand at December 31, 2017, and $333 thousand at March 31, 2017.

The level of nonaccrual loans increased $209 thousand, or 17.5%, since December 31, 2017, and accruing loans delinquent 90 days or more decreased $200 thousand, or 40.5%, during the same time period. There was one residential real estate loan totaling $131 thousand in process of foreclosure at March 31, 2018. The aggregate interest income not recognized on nonaccrual loans amounted to approximately $1.2 million and $1.3 million as of March 31, 2018 and 2017, respectively, and $1.2 million as of December 31, 2017.

At March 31, 2018, the Company had loans rated substandard that were on performing status totaling $3.2 million, compared to $3.0 million at December 31, 2017. In management's view, substandard loans represent a higher degree of risk of becoming nonperforming loans in the future. The Company’s management is focused on the impact that the economy may have on its borrowers and closely monitors industry and geographic concentrations for evidence of financial problems. The past two winter seasons have brought cold temperatures and snowfall to the area, which appears to have improved the related business' financial performance. Improvement in local economic indicators have also been identified over the past two years. The unemployment rate has stabilized in Vermont and was 2.8% for March 2018 compared to 3.0% for March 2017. The New Hampshire unemployment rate was 2.6% for March 2018

compared to 2.8% for March 2017. These rates compare favorably with the nationwide unemployment rate of 4.1% and 4.5% for the comparable periods. Management will continue to monitor the national, regional and local economic environment and its impact on unemployment, business failures and real estate values in the Company's market area.
On occasion, the Company acquires residential or commercial real estate properties through or in lieu of loan foreclosure. These properties are held for sale and are initially recorded as OREO at fair value less estimated selling costs at the date of the Company's acquisition of the property, with fair value based on an appraisal for more significant properties and on a broker's price opinion for less significant properties. Holding costs and declines in the fair value of properties acquired are expensed as incurred. Declines in the fair value after acquisition of the property result in charges against income before tax. There were no such declines for the three months ended March 31, 2018, or March 31, 2017. The Company evaluates each OREO property at least quarterly for

changes in the fair value. The Company had no properties classified as OREO at March 31, 2018 or March 31, 2017 and one residential real estate property valued at $36 thousand classified as OREO at December 31, 2017.

Allowance for Loan Losses. Some of the Company’s loan customers ultimately do not make all of their contractually scheduled payments, requiring the Company to charge off a portion or all of the remaining principal balance due. The Company maintains an ALL to absorb such losses. The ALL is maintained at a level believed by management to be appropriate to absorb probable credit losses inherent in the loan portfolio as of the evaluation date; however, actual loan losses may vary from current estimates. The Company's policy and methodologies for establishing the ALL, described in the Company's 2017 Annual Report did not change during the first three months of 2018.

Impaired loans were $3.3 million at March 31, 2018, with government guaranties of $533 thousand and a specific reserve amount allocated of $50 thousand. Impaired loans at December 31, 2017 were $3.3 million, with government guaranties of $550 thousand and a specific reserve amount allocated of $48 thousand. All of the impaired loans were also TDR loans at March 31, 2018 and December 31, 2017. Based on management's evaluation of the Company's historical loss experience on substandard commercial loans, commercial loans with balances greater than $500 thousand was established as the threshold for individual impairment evaluation with a specific reserve allocated when warranted. Commercial loans with balances under this threshold are collectively evaluated for impairment as a homogeneous pool of loans, unless such loans are subject to a restructuring agreement or have been identified as impaired as part of a larger customer relationship. The specific reserve amount allocated to individually identified impaired loans increased $2 thousand as a result of the March 31, 2018 impairment evaluation.

The following table reflects activity in the ALL for the three months ended March 31, 2018 and 2017:

| | For the Three Months Ended March 31, | |
|---|---|---|
| | 2018 | 2017 |
| | (Dollars in thousands) | |
| Balance at beginning of period | $5,408 | $5,247 |
| Charge-offs | (6) | (61) |
| Recoveries | 3 | 6 |
| Net charge-offs | (3) | (55) |
| Provision for loan losses | — | — |
| Balance at end of period | $5,405 | $5,192 |

The following table (net of loans held for sale) shows the internal breakdown by risk component of the Company's ALL and the percentage of loans in each category to total loans in the respective portfolios at the dates indicated:

| | March 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Residential real estate | $1,375 | 30.7 | $1,375 | 30.5 |
| Construction real estate | 494 | 7.3 | 494 | 7.3 |
| Commercial real estate | 2,773 | 44.1 | 2,773 | 43.4 |
| Commercial | 367 | 7.9 | 367 | 8.6 |
| Consumer | 25 | 0.6 | 25 | 0.7 |
| Municipal | 63 | 9.4 | 63 | 9.5 |
| Unallocated | 308 | — | 308 | — |
| Total | $5,405 | 100.0 | $5,405 | 100.0 |

Notwithstanding the categories shown in the table above or any specific allocation under the Company's ALL methodology, all funds in the ALL are available to absorb loan losses in the portfolio, regardless of loan category or specific allocation.

There were no changes to the reserve factors assigned to any of the loan portfolios based on the qualitative factor reviews performed during the first three months of 2018. Management of the Company believes, in its best estimate, that the ALL at March 31, 2018 is appropriate to cover probable credit losses inherent in the Company's loan portfolio as of such date. However, there can be no assurance that the Company will not sustain losses in future periods which could be greater than the size of the ALL at March 31, 2018. In addition, our banking regulators, as an integral part of their examination process, periodically review our ALL. Such agencies may require us to recognize adjustments to the ALL based on their judgments about information available to them at the time of their examination. A large adjustment to the ALL for losses in future periods could require increased provisions to replenish the ALL, which could negatively affect earnings. Management continues to be cautiously optimistic about the collectability of the Company's loan portfolio.

Investment Activities. At March 31, 2018, investment securities classified as AFS totaled $68.4 million, comprising 9.5% of total assets, compared to $65.4 million, or 8.8% of total assets at December 31, 2017 . Total investment securities decreased $2.0 million, or 3.0%, from $66.4 million, or 8.9% of total assets at December 31, 2017. Net unrealized losses for the Company’s AFS investment securities portfolio were $1.6 million as of March 31, 2018, compared to net unrealized losses of $381 thousand as of December 31, 2017. Net unrealized losses of $1.3 million, net of income tax effect, were reflected in the Company’s accumulated OCI component of stockholders’ equity at March 31, 2018. There were no securities classified as HTM at March 31, 2018 and $1.0 million in investment securities classified as HTM at December 31, 2017. No declines in value were deemed by management to be OTT at March 31, 2018. Deterioration in credit quality and/or imbalances in liquidity that may exist in the financial marketplace might adversely affect the fair values of the Company’s investment portfolio and the amount of gains or losses ultimately realized on the sale of such securities, and may also increase the potential that certain resulting unrealized losses will be designated as OTT in future periods, resulting in write-downs and charges to earnings. There was $2.7 million of investment securities pledged to secure various public deposits or customer repurchase agreements as of March 31, 2018, compared to $4.6 million at December 31, 2017.

Deposits. The following table shows information concerning the Company's average deposits by account type and weighted average nominal rates at which interest was paid on such deposits for the three months ended March 31, 2018 and year ended December 31, 2017:

| | Three Months Ended March 31, 2018 | | | | Three Months Ended March 31, 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | Average Amount | Percent of Total Deposits | Average Rate | | Average Amount | Percent of Total Deposits | Average Rate | |
| | (Dollars in thousands) | | | | | | | |
| Nontime deposits: | | | | | | | | |
| Noninterest bearing deposits | $124,875 | 19.8 | — | | $106,794 | 18.4 | — | |
| Interest bearing checking accounts | 145,091 | 23.0 | 0.13 | % | 140,253 | 24.1 | 0.11 | % |
| Money market accounts | 154,704 | 24.6 | 0.68 | % | 132,652 | 22.8 | 0.53 | % |
| Savings accounts | 103,362 | 16.4 | 0.15 | % | 98,283 | 16.9 | 0.15 | % |
| Total nontime deposits | 528,032 | 83.8 | 0.26 | % | 477,982 | 82.2 | 0.21 | % |
| Time deposits: | | | | | | | | |
| Less than $100,000 | 60,009 | 9.5 | 0.67 | % | 62,330 | 10.7 | 0.66 | % |
| $100,000 and over | 41,784 | 6.7 | 0.86 | % | 41,393 | 7.1 | 0.69 | % |
| Total time deposits | 101,793 | 16.2 | 0.75 | % | 103,723 | 17.8 | 0.67 | % |
| Total deposits | $629,825 | 100.0 | 0.34 | % | $581,705 | 100.0 | 0.29 | % |

During the first three months of 2018, average total deposits grew $48.1 million, or 8.3%, compared to the three months ended March 31, 2017, with growth in all categories except time deposits.

The Company participates in CDARS, which permits the Company to offer full deposit insurance coverage to its customers by exchanging deposit balances with other CDARS participants. CDARS also provides the Company with an additional source of funding and liquidity through the purchase of deposits. There were $12.3 million of time deposits of $250,000 or less on the balance sheet at March 31, 2018 and $11.5 million at December 31, 2017, which were exchanged with other CDARS participants and are therefore considered for certain regulatory purposes to be “brokered” deposits. There were no purchased CDARS deposits at March 31, 2018 or December 31, 2017.

The Company also participates in the ICS program, a service through which Union can offer its customers a savings product with access to unlimited FDIC insurance, while receiving reciprocal deposits from other FDIC-insured banks. Like the exchange of certificate of deposit accounts through CDARS, exchange of savings deposits through ICS provides a depositor with full deposit insurance coverage of excess balances, thereby helping Union retain the full amount of the deposit on its balance sheet. As with the CDARS program, in addition to reciprocal deposits, participating banks may also purchase one-way ICS deposits. There were

$45.5 million and $67.0 million in exchanged ICS money market deposits on the balance sheet at March 31, 2018 and December 31, 2017, respectively. There were no purchased ICS deposits at March 31, 2018 or December 31, 2017.

At March 31, 2018, there was $998 thousand in retail brokered deposits issued under a master certificate of deposit program with a deposit broker for the purpose of providing a supplemental source of funding and liquidity. These deposits will mature in February 2019. There were $2.0 million of retail brokered deposits at December 31, 2017.

The following table provides a maturity distribution of the Company's time deposits in amounts of $100,000 and over at March 31, 2018 and December 31, 2017:

| | March 31, 2018 | December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Within 3 months | $9,363 | $ 5,345 |
| 3 to 6 months | 9,410 | 9,752 |
| 6 to 12 months | 13,826 | 13,737 |
| Over 12 months | 10,649 | 12,348 |
| | $43,248 | $ 41,182 |

A provision of the Dodd-Frank Act permanently raised FDIC deposit insurance coverage to $250 thousand per depositor per insured depository institution for each account ownership category. At March 31, 2018, the Company had deposit accounts with less than $250 thousand totaling $463.1 million, or 74.2% of its deposits, with FDIC insurance protection. An additional $2.5 million of municipal deposits were over the FDIC insurance coverage limit at March 31, 2018 and were collateralized by Union under applicable state regulations by investment securities.

Borrowings. Total borrowed funds at March 31, 2018 were $31.3 million compared to $31.6 million at December 31, 2017, a net decrease of $316 thousand, or 1.0%. The FHLB option advance borrowings were $31.1 million at