

EmpireBancorp, Inc.



10
YEARS

2 0 1 7 A N N U A L R E P O R T



OUR MISSION

To offer the community banking products and services shaped by emerging ideas and technologies, combined with time-honored values of trust, integrity, and commitment; to provide the highest quality service with a sense of urgency.

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**Empire National Bank
announces that Sunday,
February 25, 2018 marked
our 10th Anniversary!**

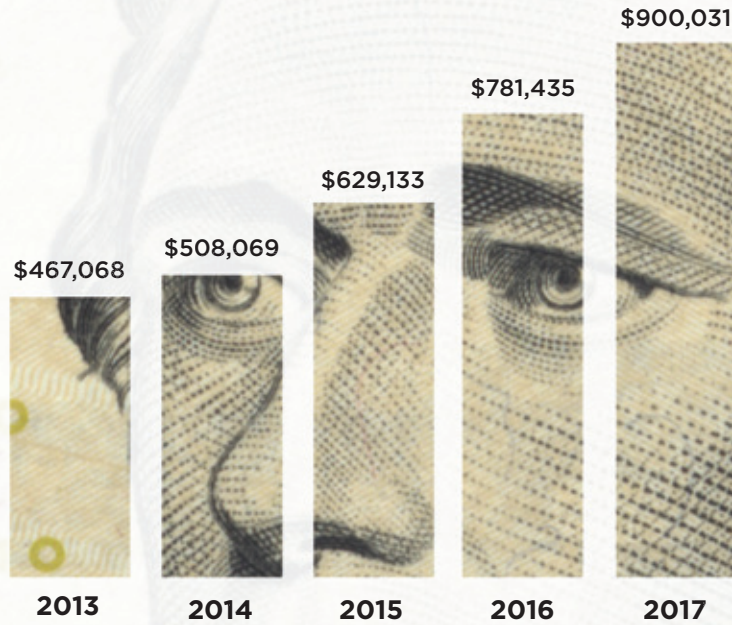
**Please join us in celebrating
the achievement of this
milestone. It was the result
of shareholders like you,
the commitment to our
customers and communities
we serve, and the hard work
of dedicated staff.**

**Thank you for being part of
making this 10th Anniversary
milestone a reality. Our first
ten years set the foundation
for now and going forward.**

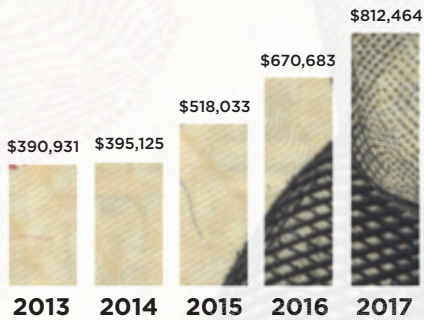
SELECTED FINANCIAL DATA

(dollars in thousands)

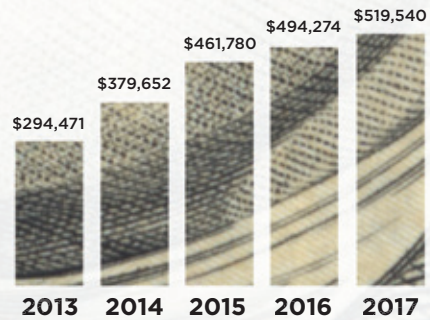
TOTAL ASSETS



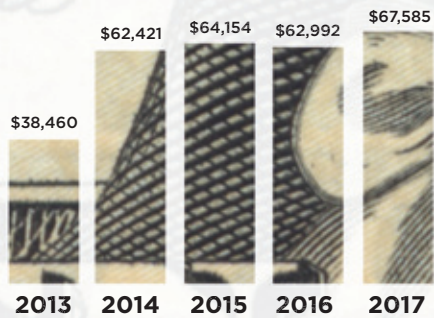
TOTAL DEPOSITS



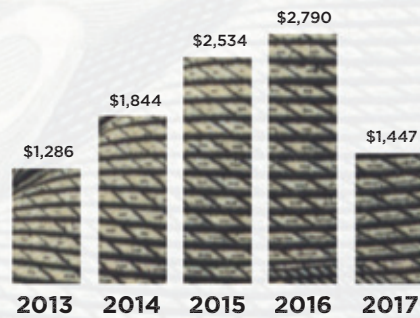
TOTAL LOANS



TOTAL STOCKHOLDERS' EQUITY



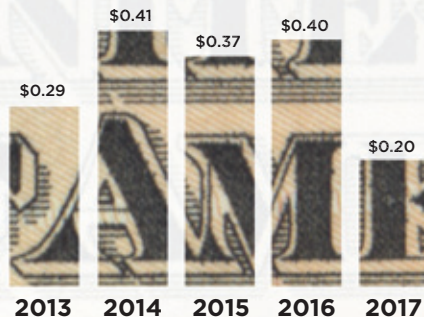
NET INCOME



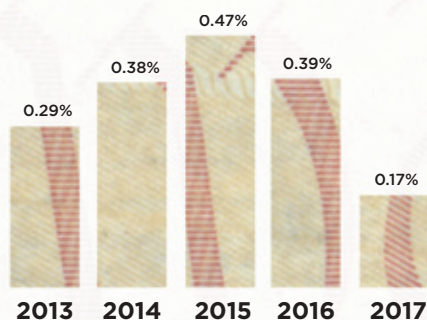
BASIC EARNINGS PER SHARE



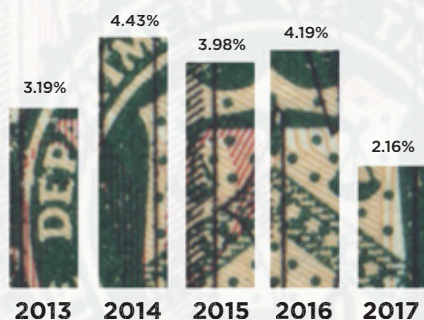
DILUTED EARNINGS PER SHARE



RETURN ON AVERAGE ASSETS



RETURN ON AVERAGE EQUITY



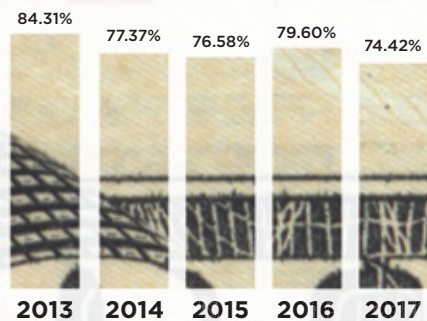
BOOK VALUE



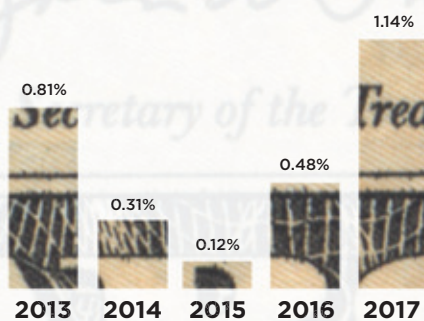
NET INTEREST MARGIN



OPERATING EFFICIENCY RATIO



NON-PERFORMING LOANS TO TOTAL LOANS



FINANCIAL HIGHLIGHTS

(in thousands, except per share data and financial ratios)

For the year ended December 31,

	2017	2016	2015	2014	2013
FINANCIAL CONDITION DATA:					
Total Assets	\$900,031	\$781,435	\$629,133	\$508,069	\$467,068
Total Loans	\$519,540	\$494,274	\$461,780	\$379,652	\$294,471
Total Deposits	\$812,464	\$670,683	\$518,033	\$395,125	\$390,931
Total Demand Deposits	\$164,790	\$177,299	\$189,200	\$189,204	\$177,252
Total Stockholders' Equity	\$ 67,585	\$ 62,992	\$ 64,154	\$ 62,421	\$ 38,460

SELECTED STATISTICAL DATA:

Net Interest Margin	2.98%	3.05%	3.75%	3.55%	3.29%
Return on Average Assets	0.17%	0.39%	0.47%	0.38%	0.29%
Return on Average Equity	2.16%	4.19%	3.98%	4.43%	3.19%
Efficiency Ratio	74.42%	79.60%	76.58%	77.37%	84.31%

RATIOS:

Net Charge-offs to Average Loans	0.11%	0.02%	0.01%	0.01%	0.08%
Non-performing Loans to Total Loans	1.14%	0.48%	0.12%	0.31%	0.81%
Non-performing Assets to Total Assets	0.66%	0.30%	0.09%	0.23%	0.51%
Allowance for Loan Losses to Total Loans	1.13%	1.17%	1.14%	1.17%	1.44%
Tier 1 Leverage Capital Ratio	9.06%	10.22%	12.22%	12.65%	9.01%
Common Equity Tier 1 Risk-Based Capital Ratio	14.93%	16.26%	16.83%	-	-
Tier 1 Risk-Based Capital Ratio	14.93%	16.26%	16.83%	16.02%	12.78%
Total Risk-Based Capital Ratio	16.01%	17.46%	18.01%	17.17%	14.03%

OPERATING DATA:

Net Interest Income	\$ 24,716	\$ 21,567	\$ 19,815	\$ 16,863	\$ 14,437
Provision for Loan Losses	\$ 644	\$ 632	\$ 867	\$ 243	-
Other (Loss) Income	\$ (118)	\$ 1,477	\$ 1,005	\$ 1,033	\$ 898
Other Expense	\$ 19,492	\$ 18,068	\$ 15,998	\$ 13,825	\$ 13,054
Net Income	\$ 1,447	\$ 2,790	\$ 2,534	\$ 1,844	\$ 1,286

PER SHARE DATA:

Diluted Earnings Per Share	\$ 0.20	\$ 0.40	\$ 0.37	\$ 0.41	\$ 0.29
Book Value, As Converted	\$ 9.26	\$ 9.07	\$ 9.32	\$ 9.07	\$ 8.78

NOTES:

- Selected financial data and financial highlights from 2013 through 2017 were derived from the audited consolidated financial statements of Empire Bancorp, Inc.
- Regulatory capital ratios are presented on a bank-only basis
- For the year ended December 31, 2014, book values, as converted, treats the Series A preferred stock as having been converted into common stock because it has been structured as a nonvoting common stock equivalent
- Efficiency ratio is the ratio of noninterest expense to net interest income and noninterest income, excluding gains and losses on sales of securities
- For the periods presented, nonperforming assets consist solely of nonperforming loans and nonperforming loans consists solely of nonaccrual loans



*Douglas C. Manditch,
Chairman & Chief Executive Officer (left)
with Thomas M. Buonaiuto,
President & Chief Operating Officer*

DEAR SHAREHOLDER

In February of 2018 we celebrated the tenth anniversary of the opening of Empire National Bank. Back when the decision was made to charter another commercial bank on Long Island, home prices in the region were spiraling upward and obtaining credit was easy. Not long after we closed our initial public offering, believed to be the highest dollar volume de novo bank raise ever completed on Long Island at \$37 million, the Great Recession hit the global economy. Our growth after the initial months of operation in 2008 and 2009 was impeded as we dealt with the fragilities and ensuing restrictive regulatory environment. We kept to our business plan constructing an infrastructure over the years that would support a financial institution with footings approaching a billion dollars in assets. At December 31, 2017 our year end assets totaled approximately \$900 million.

We stand gratified with our accomplishments over this past decade and look forward to returning greater shareholder value in upcoming years to our founding investors as well as those who have joined us along the way. As we have built our balance sheet we have likewise nurtured our corporate culture. Our Board of Directors has played a vital role from the start by understanding our business lines and customer base, providing suitable corporate governance and actively developing business. Our achievements reflect the teamwork of our employees who contend skillfully within the intense competition of our New York metropolitan market. We are mindful of the rapidly progressing financial preferences of the consumer including online, remote capture and mobile services. Broadly distributed branch networks seem less relevant as the industry evolves. Part of the formula for our success has been keeping pace with the technology rolled out by the larger financial institutions. Exemplary personal service remains our differentiator from the many other providers of financial services.

Conservative credit standards cultivated through our many years of experience have been at the core of our credit risk management from the start. We continue to closely monitor the commercial real estate rental trends and remain within our comfort zone in the market. Recently, we have expanded our Small Business Administration loan program, specifically SBA 7(a) lending, as well as our residential lending product suite into jumbo mortgages. Entry into these programs was designed to diversify our revenue streams and broaden prospects in the loan market. Reassuringly, today we maintain the same prudent underwriting standards established in our formative years.

This past year we formed an internal committee to begin preparing for the upcoming implementation of the Financial Accounting Standards Board current expected credit loss model known as CECL. This significant change in the accounting for credit losses requires us to understand the life of loan loss rate as compared to using an annual net charge off rate over lookback periods. It requires us to make reasonable and supportable forecasts about the future. During 2017 we saw an uptick in our nonaccrual loans resulting largely from one customer relationship. Nonetheless our overall credit quality remains solid; at year end the loan portfolio did not include a single past due loan delinquent for more than thirty days. We closed the year with an allowance for loan losses at 1.13% of total loans. Our provision for loan losses increased slightly by \$12 thousand year over year.

The basics of sensible credit underwriting are largely tried and true while the nuances of cybersecurity risks change daily. Personal information interconnects between numerous locations, and is repeatedly shared and transferred. Attacks such as data breaches and identity fraud are ever more complex in nature. The dark realities associated with digital enterprise threaten even the finest information technology security systems. The focus of cybersecurity is being driven to redirect from prevention to early detection, response and mitigation of losses. Small to midsized firms face the same cybersecurity risks as large organizations.

To broaden understanding of cyber threats in 2018 we rolled out a cybersecurity awareness program designed specifically for both our retail and commercial banking customers. Educating our customers, as well as our employees, improves management of cyber risks. Cybersecurity is a workplace responsibility as cybercrime affects all of us and therefore needs to be recognized as a shared responsibility. As a company we expend tremendous human and financial resources to protect our customers' personal information. We aim to remain current in our awareness and mitigation of cyber threats. This includes risks that downstream from our third party vendor relationships.

In the first quarter of 2018 the benchmark 10-year U.S. Treasury yield hit a four year high. With three Federal Reserve interest rate hikes in 2017, funding costs began to climb, especially within our public fund deposit base. Upward repricing of variable rate loans, which largely lag deposit rate increases, only partially offsets the higher cost of these deposits. Our net interest margin of 2.98% decreased from 3.05% for the year ended December 31, 2016.

With the recent tax rate reductions and heightened business outlook we anticipate healthy growth in the loan portfolio. Putting new loans on to our balance sheet at higher rates should widen our spreads and enhance earnings. Bank performance usually benefits from higher rates although the shape of the yield curve and normalized net interest margins are critical components. Gross loans grew 5.1% or \$25.3 million at December 31, 2017 as compared to the prior year end. Loan payoffs in 2017 exceeded loan payoffs in 2016 by approximately \$21 million yet revenues from prepayment penalties remained relatively flat year over year.

The passage of H.R. 1, also known as the Tax Cuts and Jobs Act, on December 22, 2017 is expected to push bank industry earnings materially higher. In February of 2018 we proudly joined the ranks of companies who reacted to reduction in corporate tax rates by compensating their employees. At the Bank we increased companywide salaries by 5 percent, upped our 401(k) match program by two percent, and gave all nonexecutive full time employees one-time bonuses

of \$1,000, also paying the federal and state taxes due for the recipient, as a result of the benefits derived from the recent federal tax overhaul. Returning a piece of our savings to the full team seemed fitting and timely as we celebrate our ten year tenure.

Trying to predict the net impact of tax reform is somewhat tricky. A portion of our tax reform cutback has already been invested in human resource initiatives. Refining our infrastructure and expanding our footprint are possibilities. Much of the reduction will be retained boosting capital levels and it is probable that a portion of corporate income tax decrease will be lost to industry wide competition.

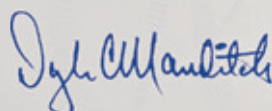
The immediate impact of H.R. 1 fell to our bottom line in the fourth quarter of 2017. Our earnings for the quarter and year end reflected a substantial one-time downward revaluation of our deferred tax assets recognized upon enactment of the legislation as the value of these assets was reduced to align with the lower current tax rate of 21%. This adjustment reduced net income by approximately \$1.8 million and was recorded as additional income tax expense for the fourth quarter of 2017. Our capital ratios remain well above all minimum regulatory capital requirements.

During the fourth quarter of 2017, we restructured our balance sheet to take advantage of the tax benefit associated with a higher corporate tax rate in 2017. This was accomplished by selling approximately \$41.6 million of investment securities out of the available for sale portfolio and incurring losses, net of tax, of \$1.0 million. Our plan is to re-leverage the balance sheet for future periods using the proceeds principally to fund loans. Going forward, net interest income earned on replacement of the assets will be subject to the new 21% marginal corporate federal income tax rate. Projections show this strategy to be accretive to earnings in 2018. Net income for 2017 decreased \$1.3 million, or 48.1%, to \$1.4 million, as compared to 2016. Adjusted for the impact of the deferred tax asset revaluation and the balance sheet restructure, net income totaled \$4.2 million, an increase of \$1.5 million. Execution of this strategy made sense as the return from the double digit decline in the corporate tax rate is projected to boost the rate of future earnings expanding our capacity to produce capital.

Lawmakers in Washington debate the rollback of restrictions placed on our industry after the financial crisis while we, as community bankers, warily await meaningful relaxation of rules and regulatory obligations. A strong argument could be made that the Dodd-Frank legislation has hurt the community banks disproportionately as larger financial institutions more readily absorb the additional expenses. Today's regulatory environment makes it almost prohibitive for new banks to form largely because the additional compliance costs are excessive. Consistent with the high costs of prior years, in 2017 we estimate we spent close to \$3.2 million on regulatory related compliance costs which as a percentage of total revenue totaled approximately 11% the fiscal year.

Over the years our strategic plan has progressed as our industry changed both locally and globally. These past ten years have been challenging yet rewarding. Once again, on behalf of our Board of Directors and management team, we close by thanking our shareholders, employees, customers and other stakeholders for their support this past year as well as this past decade. We invite you to join us at our shareholder meeting on May 17, 2018, being held at the Hyatt Regency Long Island, 1717 Motor Parkway, Hauppauge, New York.

God bless the United States of America.



Douglas C. Manditch
Chairman and Chief Executive Officer



Thomas M. Buonaiuto
President and Chief Operating Officer

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LEGAL TENDER
IN ALL COUNTRIES
FOR CASH AND PRIVATE

Escobedo Cabral

Secretary of the United States.



FORWARD LOOKING STATEMENTS

This Annual Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and 21E of the Securities Exchange Act of 1934. These forward-looking statements include statements that reflect the current views of our senior management with respect to our financial performance and future events with respect to our business and the banking industry in general. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “will continue,” “anticipate,” “seek,” “estimate,” “intend,” “plan,” “projection,” “would” and “outlook,” and similar expressions of a future or forward-looking nature. These statements involve estimates, assumptions, risks and uncertainties. Accordingly, there are or will be important factors that could cause our actual results to differ materially from those indicated in these statements.

We believe that these factors include, but are not limited to the following: our ability to successfully implement our growth strategy; the accuracy of the assumptions underlying the elements of our growth strategy; changes in the strength of the United States economy in general, as well as the economy in our local market areas, and the corresponding impact of those changes on the ability of our customers to transact business with us on profitable terms, including the ability of our borrowers to repay their loans according to their terms or the sufficiency of any related collateral; changes in interest rates and market prices and the corresponding impact of those changes on our net interest margin, asset valuations and expense expectations; changes in the levels of loan prepayments and the resulting effects on the value of our loan portfolio; increased competition for deposits and loans adversely affecting rates and terms; our ability to adequately measure and monitor the credit risk inherent in our loan and securities portfolios; the failure of assumptions underlying our allowance for credit losses; a determination or downgrade in the credit quality and credit agency ratings of the securities in our securities portfolio; increased asset levels and changes in the composition of assets and the resulting impact on our capital levels and regulatory capital ratios; changes in the availability of funds resulting in increased costs or reduced liquidity; the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels; our ability to adequately manage the risks associated with technology and security; our ability to access capital markets on acceptable terms as necessary to support the continued growth and safety and soundness of our organization; legislative or regulatory developments, including changes in laws and regulations concerning taxes, banking, securities, insurance and other aspects of the financial securities industry, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), and the extensive rule making undertaken by various regulatory agencies under the Dodd-Frank Act; further government intervention in the U.S. financial system; changes in statutes and government regulations or their interpretations applicable to us, including changes in tax requirements and tax rates; acts of terrorism, an outbreak of hostilities or other international or domestic calamities, weather or other acts of God and other matters beyond our control; and other risks and uncertainties listed from time to time in our reports and documents filed with the Office of the Comptroller of the Currency (“OCC”).

The foregoing factors should not be construed as exhaustive and should be read together with the other cautionary statements included in this Annual Report. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from what we anticipate. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and we cannot predict all such factors. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Unless we state otherwise or the context otherwise requires, references in this management’s discussion and analysis to “we,” “our” and “us” are to Empire Bancorp, Inc. and Empire National Bank, on a consolidated basis, and references to “Bank” or “the bank” are to Empire National Bank, on a bank-only basis.

SELECTED HISTORICAL FINANCIAL INFORMATION

The following table sets forth selected historical financial and operating data regarding our organization. The information is presented on a consolidated basis. You should review this information together with the discussion that follows and the audited financial statements and related notes included elsewhere in this Annual Report. Substantially all average balances were computed based on daily balances. Our historical results may not be indicative of our future performance. All dollars are in thousands, except per share data.

	As of and for the year ended December 31,				
	2017	2016	2015	2014	2013
Income Statement Data:					
Interest income	\$ 29,632	\$ 24,868	\$ 21,504	\$ 18,540	\$ 16,216
Interest expense	4,916	3,301	1,689	1,677	1,779
Net interest income	24,716	21,567	19,815	16,863	14,437
Provision for loan losses	644	632	867	243	-
Net interest income after provision	24,072	20,935	18,948	16,620	14,437
Other (loss) income	(118)	1,477	1,005	1,033	898
Other expense	19,492	18,068	15,998	13,825	13,054
Income before income taxes	4,462	4,344	3,955	3,828	2,281
Income tax expense ⁽¹⁾	3,015	1,554	1,421	1,984	995
Net income ⁽¹⁾	<u>\$ 1,447</u>	<u>\$ 2,790</u>	<u>\$ 2,534</u>	<u>\$ 1,844</u>	<u>\$ 1,286</u>
Period-End Balance Sheet Data:					
Investment securities, available-for-sale	\$ 299,969	\$ 264,734	\$ 151,043	\$ 100,617	\$ 152,639
Loans, net of allowance for loan losses	513,665	488,475	456,512	375,199	290,227
Allowance for loan losses	5,875	5,799	5,268	4,453	4,244
Total assets	900,031	781,435	629,133	508,069	467,068
Noninterest-bearing deposits	164,790	177,299	189,200	189,204	177,252
Interest-bearing deposits	647,674	493,384	328,833	205,921	213,679
Stockholders' equity	67,585	62,992	64,154	62,421	38,460
Per Share Data:					
Diluted earnings	\$ 0.20	\$ 0.40	\$ 0.37	\$ 0.41	\$ 0.29
Basic earnings	0.20	0.40	0.42	0.42	0.29
Book value, as converted ⁽²⁾	9.26	9.07	9.32	9.07	8.78
Performance Ratios:					
Return on average equity	2.16 %	4.19 %	3.98 %	4.43 %	3.19 %
Return on average assets	0.17	0.39	0.47	0.38	0.29
Net interest margin	2.98	3.05	3.75	3.55	3.29
Efficiency ratio ⁽³⁾	74.42	79.60	76.58	77.37	84.31
Asset Quality Ratios:					
Nonperforming assets to total assets ⁽⁴⁾	0.66 %	0.30 %	0.09 %	0.23 %	0.51 %
Nonperforming loans to total loans ⁽⁴⁾	1.14	0.48	0.12	0.31	0.81
Allowance for loan losses to total loans	1.13	1.17	1.14	1.17	1.44
Net charge-offs to average loans	0.11	0.02	0.01	0.01	0.08
Capital Ratios (bank level only)⁽⁵⁾:					
Tier 1 leverage capital	9.06 %	10.22 %	12.22 %	12.65 %	9.01 %
Common equity tier 1 risk-based capital	14.93	16.26	16.83	-	-
Tier 1 risk-based capital	14.93	16.26	16.83	16.02	12.78
Total risk-based capital	16.01	17.46	18.01	17.17	14.03

(1) For the year ended December 31, 2017, net income includes income tax expense of \$1.8 million associated with the write-down of deferred tax assets due to the enactment of the Tax Cuts and Jobs Act.

(2) For the year ended December 31, 2014, book value, as converted, treats the Series A preferred stock as having been converted into common stock because it has been structured as a nonvoting common stock equivalent.

(3) Efficiency ratio is the ratio of noninterest expense to net interest income and noninterest income, excluding gains and losses on sales of securities.

(4) For the periods presented, nonperforming assets consist solely of nonperforming loans and nonperforming loans consist solely of nonaccrual loans.

(5) Capital ratios at December 31, 2017, 2016 and 2015 are calculated under Basel III guidelines.

OUR BUSINESS

Overview

Empire Bancorp, Inc (the “Corporation”) is a bank holding company, headquartered in Islandia, New York, which offers a broad range of financial services through our wholly-owned banking subsidiary, Empire National Bank (the “Bank”). Our primary market is the counties of Suffolk, Nassau, Kings, Queens, Bronx and New York in the State of New York, which we serve from our main office located at 1707 Veterans Highway, Islandia, New York, three branch offices located in Shirley, Port Jefferson Station and Mineola, New York and a loan and private banking-style branch office located in Manhattan, New York. We believe that our market presents attractive demographic attributes and favorable competitive dynamics, providing long-term growth opportunities for our organization.

We are led by a team of experienced bankers, all of whom have substantial banking experience and relationships on Long Island and throughout New York City. We believe that our management’s long-standing presence in the area gives us insight into the local market and, as a result, the ability to tailor our products and services, particularly the structure of our loans, more closely to the needs of our targeted customers. We seek to develop comprehensive, long-term banking relationships by cross-selling loans and core deposits, offering a diverse array of products and services and delivering high quality customer service.

Our operating strategy

Our business model focuses on a traditional, relationship-based, community bank structure guided by the following principles: disciplined risk management; responsive, high-quality service; focus on building long-term relationships; credibility within our communities; and efficiency. We believe our flexible organizational structure, service philosophy, and depth of market knowledge acquired by our management over their banking careers differentiates us from other financial institutions. Our operating strategy focuses on steady, long-term growth and increased profitability.

To execute our business model, we have implemented a number of operating strategies, including:

- Hiring and retaining qualified banking officers with extensive experience in our markets;
- Utilizing technology and strategic outsourcing to provide a broad array of secure and convenient products and services in a cost-effective manner;
- Diversifying and expanding loan product offerings;
- Developing municipal relationships as a funding source;
- Developing a suite of focused products and services tailored for professional practice customers in our market;
- Operating from highly visible and accessible banking offices in close proximity to a concentration of targeted commercial businesses and professionals;
- Expanding our geographic footprint within our primary market through additional branch locations;
- Providing individualized attention with consistent, prompt local decision-making authority; and
- Leveraging the diverse community involvement, client referrals and professional expertise of our directors and officers.

Our competitive strengths

We believe that we are well-positioned to create value for our shareholders, particularly as a result of the following competitive strengths:

Each member of our senior management team has experience at growing financial institutions in the New York metropolitan area.

Cohesive core management team with extensive local banking experience. Our executive and senior management team is comprised of seasoned local bankers. For many in this group, their entrepreneurial skills steered them to our organization, attracted to the opportunity to grow and develop a de novo start up national bank. Several of them started before, or shortly after, the official opening of our bank in February 2008 while others joined as our growth demanded more leaders with different proficiencies. Our entire senior management team has experience in all facets of banking having worked at various other financial institutions that were mostly located in our market area on and around Long Island and in New York City. Their areas of expertise include strategic and tactical planning, capital management, commercial and industrial lending, real estate lending and consumer lending, as well as accounting and finance, branch and back office operations, financial technology, business development, municipal banking, human resources, risk management and regulatory compliance.

Stable and scalable platform. Throughout our operating history, we have maintained a stable banking platform with strong capital levels and sound asset quality. Because we have total consolidated assets of less than \$1 billion, our regulatory capital levels are evaluated on a bank-only basis. At December 31, 2017, the Bank had a 9.06% tier 1 leverage capital ratio, a 14.93% common equity tier 1 risk-based capital ratio, a 14.93% tier 1 risk-based capital ratio and a 16.01% total risk-based capital ratio. Contributing to our stability is our track record of sound asset quality. The highest annual ratio of net loan charge-offs to average loans over the last past five years was recorded in 2017 for 0.11%, or \$568 thousand, and the average annual rate of net loan charge-offs to average loans over the same period was 0.05%. Utilizing the prior experience of our management team at larger banks operating within our primary market, we believe that we have built a scalable corporate infrastructure, including technology and banking processes, capable of supporting continued growth, while improving operational efficiencies. We enhanced our capital strength during the fourth quarter of 2014 when we completed a private placement of our capital stock, generating \$18.7 million in net proceeds. We believe that our strong capital and asset quality levels will allow us to grow and that our operating platform will allow us to manage that growth effectively, resulting in greater efficiency and improved profitability.

Growing deposit base. A significant driver of our franchise is the growth and stability of our deposits, which we use to fund our loans and investment portfolio. At December 31, 2017, our total deposits were \$812.5 million, representing a compounded annual growth rate of 20.1% since December 31, 2013. Our deposit growth has been driven significantly by the growth in our savings, N.O.W. and money market deposits primarily from new and existing municipal banking relationships. Savings, N.O.W. and money market deposits represented approximately 76.5% of our total deposits at December 31, 2017, up from 35.7% of our total deposits at December 31, 2013. Active solicitation of municipal deposits over the past three years significantly contributed to total deposit growth. We seek to cross-sell deposit products at loan origination, which provide a basis for expanding our banking relationships and a stable source of funding.

Our challenges

In implementing our business model, we have faced, and expect to continue to face, a number of challenges that could impact our financial condition, operating results and prospects in future periods. We believe that the most consequential risks to our business include the following:

- Our business is concentrated on Long Island and in certain boroughs of New York City, and we are more sensitive than our more geographically diversified competitors to adverse changes in the local economy;
- We face significant competition to attract and retain customers;

- We operate in a highly regulated environment, which could restrain our growth and profitability;
- We depend heavily on our information technology and telecommunications systems, which are subject to system failures, interruptions and security risks;
- We may not be able to adequately measure and limit our credit risk, which could impact our profitability; and
- Our profitability largely depends on our ability to manage our assets and liabilities during periods of changing interest rates. Accordingly, the fair value of our investment securities can fluctuate due to factors outside of our control.

Our market

Our primary market is the counties of Suffolk, Nassau, Kings, Queens, Bronx and New York in the State of New York, which we serve from our main office located at 1707 Veterans Highway, Islandia, New York, three branch offices located in Shirley, Port Jefferson Station and Mineola, New York and a loan and private banking-style branch office located in Manhattan, New York. The economy of our markets reflects a diverse cross section of employment sectors, with a mix of services; wholesale/retail trade; federal, state and local government; healthcare; banking and education.

Our primary market is diverse, in terms of educational attainment, income level and ethnic background. According to data provided by the U.S. Census Bureau, the population of Suffolk County was approximately 1,492,583 residents as of July 1, 2016, which represented no material growth in population since April 1, 2010. The population of Nassau County was approximately 1,361,500 residents as of July 1, 2016, which represented a 1.6% increase in population since April 1, 2010. In addition, as of 2016, the median household incomes in Suffolk County and Nassau County were \$90,128 and \$102,044, compared to a New York state household income median of \$60,741. Further, according to data provided by the FDIC, between June 30, 2010 and June 30, 2017, FDIC-insured deposits in Suffolk County and Nassau County have increased by approximately 58.1% and 34.1%, respectively. Although overall population growth has been limited within our markets, the stability of the population levels, reducing levels of unemployment and the attractive demographics within our markets have continued to attract businesses to the area and led to growth in the local service economy, and, while it is not certain, we expect that this trend will continue. As a community bank, we are focused on serving the needs of the small-and medium-sized businesses, professionals, nonprofit organizations, municipalities, real estate investors and consumers.

We compete with a wide range of financial institutions in our market, including local, regional and national commercial banks, thrifts and credit unions. Consolidation activity involving financial institutions based outside of Long Island has altered the competitive landscape in our market within recent years. As of June 30, 2017, less than 17% of the deposits in Suffolk and Nassau counties were held in banks that were based on Long Island, due in large part to the acquisitions of locally-based financial institutions by larger banks based outside of our primary market area. Although competition within our market area is strong, we believe that the customer disruption associated with these acquisitions, as well as the loss of in-market decision-making and relationship-based banking, will continue to provide us with additional growth opportunities. We also compete with mortgage companies, investment banking firms, brokerage houses, mutual fund managers, investment advisors, and other “non-bank” companies for certain of our products and services. Some of our competitors are not subject to the degree of supervision and regulatory restrictions that we are.

Interest rates, both on loans and deposits, and prices on fee-based services are significant competitive factors among financial institutions generally. Many of our competitors are much larger financial institutions that have greater financial resources than we do and that compete aggressively for market share. These competitors attempt to gain market share through their financial product mix, pricing strategies and banking center locations. Due to the benefits of scale, our larger regional and national bank competitors can, in many cases offer pricing that is more attractive than that which we can offer, although this pricing has historically been reserved for customers of a size for which we generally would not compete. Other important competitive factors in our market area include office

locations and hours, quality of customer service, community reputation, continuity of personnel and services, capacity and willingness to extend credit, and ability to offer sophisticated cash management and other commercial banking services. Many of our competitors are organized along lines of business and use efficient but impersonal approaches to providing products and services to customers. While we seek to be competitive with respect to rates, we believe that we compete most successfully on the basis of our service and relationship-based culture.

Loans

General. Lending has the highest priority for our asset utilization. Our primary lending focus is to serve small and medium-sized businesses, professionals, nonprofit organizations, and other organizations in our primary market with a variety of financial products and services, while maintaining strong and disciplined credit policies and procedures. We offer a full array of commercial and consumer lending products to serve the needs of our customers. Commercial lending products include commercial real estate loans, multi-family loans, real estate construction and development loans and general commercial loans (such as business term loans, equipment financing, small business administration loans and lines of credit). Consumer lending products include home equity loans, lines of credit, residential mortgages and consumer installment loans, such as loans to purchase cars, boats and other recreational vehicles. We do not engage in a material amount of consumer lending, which is offered primarily as an accommodation to our commercial customers and their executives and employees. In addition, our lending policies do not provide for any loans that are highly speculative, sub-prime, or that have high loan-to-value ratios.

We market our lending products and services to qualified borrowers through conveniently located banking offices, relationship networks and high touch personal service. Our relationship managers actively target long-standing businesses operating in the communities we serve. We seek to attract new lending customers through professional service, relationship networks and competitive pricing.

Commercial real estate loans. We offer real estate loans for commercial property that is owner-occupied as well as commercial property owned by real estate investors. Commercial real estate loan terms generally are limited to ten to twenty years or less, although payments may be structured on a longer amortization basis. The interest rates on our commercial real estate loans may be fixed or adjustable, although rates typically are not fixed for a period exceeding five to ten years. We generally charge a documentation or loan processing fee for our services. With the exception of our multi-family lending, which is generally non-recourse, we require personal guarantees from the principal owners of the business supported by a review of the principal owners' personal financial statements. We may not require personal guarantees when lending to not-for-profit entities, religious organizations, condominium associations, financial institutions and municipal entities. We make efforts to limit our risks with respect to commercial real estate loans by analyzing borrowers' cash flow and collateral value. The real estate securing our existing commercial real estate loans includes a wide variety of property types, such as offices/warehouses/production facilities, office buildings, hotels, mixed-use residential/commercial, retail centers and multi-family properties.

Construction loans. We finance the construction of owner occupied and income producing properties. Construction financing generally requires preapproved permanent financing, unless made on a speculative basis. Construction and development loans are generally made with a term of one to two years and interest is paid monthly. The ratio of the loan principal to the value of the collateral, as established by independent appraisal, typically will not exceed industry standards. Any speculative loans are based on the borrower's financial strength and ability to generate cash flow. Loan proceeds are disbursed based on the percentage of completion and only after the project has been inspected by an experienced construction lender or third-party inspector.

Commercial loans. We offer a wide range of commercial loans, including business term loans, equipment financing and lines of credit either through traditional means or through our recently implemented U.S. Small Business Administration 7(a) program. Our target commercial loan market is professional establishments and small to medium-sized businesses. The terms of these loans vary by purpose and by type of underlying collateral, if any. Our commercial loans primarily are underwritten on the basis of the borrower's ability to service the loan from cash flow. We make equipment loans with conservative margins generally for a term of five years or less at fixed or variable rates, with the loan fully amortizing over the term. Loans to support working capital typically have terms not exceeding one year, unless accompanied by a guarantee from the U.S. Small Business Administration, and usually are secured by accounts receivable, inventory and personal guarantees of the principals of the business. For

loans secured by accounts receivable or inventory, principal typically is repaid as the assets securing the loan are converted into cash, and for loans secured with other types of collateral, principal amortizes over the term of the loan. The quality of the commercial borrower's management and its ability both to properly evaluate changes in the supply and demand characteristics affecting its markets for products and services and to effectively respond to such changes are significant factors in a commercial borrower's creditworthiness. Although most loans are made on a secured basis, loans may be made on an unsecured basis where warranted by the overall financial condition of the borrower. We typically hold all of our originated loans in the portfolio; however, on a case by case basis we may look to sell the guaranteed portion of the U.S. Small Business Administration 7(a) loans.

Consumer loans. We make a variety of loans to individuals for personal purposes, including secured and unsecured installment loans, home equity lines of credit and adjustable rate mortgages. The amortization of second mortgages generally does not exceed fifteen years and the rates generally are not fixed for over twelve months. Adjustable rate mortgages typically have terms of thirty years with initial fixed interest rates for three, five, seven or ten years with annual rate adjustments thereafter based upon a spread over a predetermined index. These loans may have an additional interest only period, but will be fully amortized by the thirtieth anniversary of the loan closing. We expect to hold these loans in our portfolio. Consumer loans secured by depreciable assets, such as boats, cars and trailers, are typically amortized over the useful life of the asset. We review the borrower's past credit history, past income level, debt history and, when applicable, cash flow and evaluate the impact of all these factors on the ability of the borrower to make future payments as agreed.

Investments

In addition to our lending activities, we purchase investment securities that are principally either direct debt obligations of the United States Treasury or one of the agencies of the United States government. We may also invest in mortgage-backed securities issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Bank and the Federal Farm Credit Bureau. Each of these issuer's securities are backed by mortgages conforming to its underwriting guidelines and each issuer guarantees the timely payment of principal and interest on its securities. Our approved policies also allow for investment in both tax exempt and taxable municipal securities, corporate securities and certain equity securities as might be required to deal with various government agencies or banking associations. We regularly evaluate the composition of this category as changes occur with respect to the interest rate yield curve. Overall investment goals are established by the Bank's Investment Committee, which reviews the investment portfolio on a periodic basis, and monitors and makes adjustments as necessary based upon current market interest rates and the economic environment, as well as our established policies and strategies. The Bank's investment strategies seek to maximize long-term investment earnings through managing securities gains and losses as well as interest income. Day-to-day activities pertaining to the investment portfolio are conducted under the supervision of the Bank's President and Chief Operating Officer.

Deposits

Deposits are our primary source of funds to support our earning assets. We offer traditional depository products, including checking, savings, money market and certificates of deposit with a variety of rates. Deposit products are structured to be competitive with rates, fees, and features offered by other local institutions. The primary sources of core deposits are professional practice monies, small to medium-sized businesses and their employees, and consumers located within our primary market. We generate deposits through our business development efforts as well as referrals from our existing customers, officers and directors as well as various marketing campaigns. In 2014, we joined ICS®, an Insured Cash Sweep® service to provide an additional collateral product for our growing public fund deposit base. In 2012, we met the requirements established by the United States Trustee for deposits of bankruptcy funds. In addition, we participate in the Certificate of Deposit Account Registry Service, or CDARS®, which allows us to provide unlimited FDIC insurance for depositors by placing the portion of the deposit in excess of FDIC insurance limits with other FDIC-insured institutions that are members of the CDARS® network.

Supervision and regulation

We are subject to extensive regulation and supervision that govern almost all aspects of our operations at the holding company and bank levels. We are regulated by the Federal Reserve at the holding company level and by the Office

of the Comptroller of the Currency at the bank level. Banking laws, regulations and policies, and the supervisory framework that oversees their administration, are primarily intended to protect consumers, depositors, the Deposit Insurance Fund and the banking system as a whole, and not shareholders and counterparties. In addition, these laws, regulations and policies are subject to continual review by governmental authorities, and changes to these laws, regulations and policies, including changes in their interpretation or implementation, or the adoption of new laws, regulations or policies, can affect us in substantial and unpredictable ways.

In the aftermath of the most recent recession, new legislation has been enacted, and new regulations promulgated, that were designed to strengthen the financial system as a whole. These laws and regulations have imposed significant additional costs on all financial institutions and impacted the banking industry in numerous other ways. A number of the most significant changes in laws and regulations affecting the banking industry are discussed below. However, the discussion that follows is only a brief summary of certain of these laws and regulations, and there are many other laws and regulations that affect our operations, other than those discussed below.

Dodd-Frank Act

The Dodd-Frank Act, enacted on July 21, 2010, aimed to restore responsibility and accountability to the financial system by significantly altering the regulation of financial institutions and the financial services industry. The Act, among other things: (i) established the Consumer Financial Protection Bureau, an independent organization within the Federal Reserve dedicated to promulgating and enforcing consumer protection laws applicable to all entities offering consumer financial products or services; (ii) established the Financial Stability Oversight Council, tasked with the authority to identify and monitor institutions and systems that pose a systemic risk to the financial system, and to impose standards regarding capital, leverage, liquidity, risk management, and other requirements for financial firms; (iii) changed the base for FDIC insurance assessments; (iv) increased the minimum reserve ratio for the Deposit Insurance Fund from 1.15% to 1.35%; (v) permanently increased federal deposit insurance coverage from \$100,000 to \$250,000; (vi) directed the Federal Reserve to establish interchange fees for debit cards pursuant to a restrictive “reasonable and proportional cost” per transaction standard; (vii) limited the ability of banking organizations to sponsor or invest in private equity and hedge funds and to engage in proprietary trading; (viii) granted the U.S. government authority to liquidate or take emergency measures with respect to troubled nonbank financial companies that fall outside the existing resolution authority of the FDIC; (ix) increased regulation of asset-backed securities; (x) increased regulation of consumer protections regarding mortgage originations, including originator compensation, minimum repayment standards, and prepayment considerations; and (xi) established new disclosure and other requirements relating to executive compensation and corporate governance.

Some of these provisions have the consequence of increasing our expenses, decreasing our revenues, and changing the activities in which we choose to engage. The specific impact on our current activities or new financial activities that we may consider in the future, our financial performance and the markets in which we operate will depend on the manner in which the relevant agencies develop and implement the required rules and the reaction of market participants to these regulatory developments. Many aspects of the Dodd-Frank Act are subject to rulemaking that will take effect over the next several years, making it difficult to anticipate the overall financial impact on the financial industry, in general, and on us.

Regulatory capital requirements

Effective January 1, 2015, we became subject to new rules designed to implement the recommendations with respect to regulatory capital standards, commonly known as Basel III, approved by the International Basel Committee on Banking Supervision. The Basel III framework is applicable to all top tier bank holding companies with consolidated assets of \$1.0 billion or more and all banks, regardless of size. Accordingly, at this time, we are subject to Basel III only at the bank level.

The new Basel III rules establish the following minimum regulatory capital ratios:

- A leverage ratio of 4.0%;
- A new ratio of common equity tier 1 capital to total risk-weighted assets of not less than 4.5%;

- A tier 1 risk-based capital ratio of 6.0% (an increase from 4.0%); and
- A total risk-based capital ratio of 8.0%.

The Basel III rules also changed the regulatory capital requirements for purposes of the prompt corrective action regulations. Accordingly, to be categorized as well capitalized, the bank must have a minimum leverage capital ratio of at least 5.0%, common equity tier 1 capital ratio of at least 6.5%, a tier 1 risk-based capital ratio of at least 8.0%, and a total risk-based capital ratio of at least 10.0%. The rules also implemented a requirement for all banking organizations to maintain a capital conservation buffer above the minimum capital requirements to avoid certain restrictions on capital distributions and discretionary bonus payments to executive officers. The capital conservation buffer is being phased in over a three-year period, to be fully phased-in by January 1, 2019. The capital conservation buffer must be composed of common equity tier 1 capital. The capital conservation buffer requirement will effectively require banking organizations to maintain regulatory capital ratios at least 50 basis points higher than well capitalized levels with respect to the risk-weighted capital measures to avoid the restrictions on capital distributions and discretionary bonus payments to executive officers. In addition, the final rule establishes more conservative standards for including instruments in regulatory capital and imposes certain deductions from and adjustments to the measure of tier 1 capital and tier 2 capital. The final rule alters the method under which banking organizations must calculate risk-weighted assets in an effort to make the calculation of risk-weighted assets more risk-sensitive, to better account for risk mitigation techniques, and to create substitutes for credit ratings (in accordance with the Dodd-Frank Act).

Although management is continuing to evaluate the impact the final rule will have on our organization, we were in compliance with all applicable minimum regulatory capital requirements as of December 31, 2017 and expect to meet all minimum regulatory capital requirements under the final rule, as if fully phased in.

The final Basel III framework also requires banks and bank holding companies to measure their liquidity against specific liquidity tests. However, under the proposed rules, the Basel III liquidity framework applies only to banking organizations with \$250 billion or more in consolidated assets or \$10 billion or more in foreign exposures. As a result, unless modified, the Basel III liquidity framework does not apply to us.

MANAGEMENT'S DISCUSSION OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis presents management's perspective on our financial condition and results of operations on a consolidated basis. However, because we conduct all of our material business operations through Empire National Bank, the discussion and analysis relates to activities primarily conducted at the subsidiary level. The discussion is intended to highlight and supplement other data and information presented elsewhere in this annual report, including our audited consolidated financial statements and the related notes. Please note that the performance related to the prior periods described in this annual report may not be indicative of our future financial performance.

As a bank holding company that operates through one segment, community banking, we generate most of our revenue from interest on loans and investments, service charges and gains on the sale of investment securities. Our primary source of funding for our loans is deposits, and our largest expenses are interest of these deposits and salaries and related employee benefits. We measure our performance through our net income, net interest margin, return on average assets and return on average equity, while maintaining appropriate regulatory leverage and risk-based capital ratios.

Performance summary

Our total assets increased \$118.6 million, or 15.2%, to \$900.0 million as of December 31, 2017, compared to \$781.4 million as of December 31, 2016. Our asset growth was driven by an increase in interest earning deposits with banks of \$41.5 million, an increase of \$35.3 million or 13.3% in securities available for sale, and by an increase in loans of \$25.3 million or 5.1%. The asset base also increased as a result of our investment of \$20.3 million in bank-owned life insurance. Our asset quality remained solid, with total nonperforming loans comprising 1.14% of total loans as of December 31, 2017, compared to 0.48% as of December 31, 2016. Total deposits increased \$141.8 million, or 21.1%, to \$812.5 million as of December 31, 2017, compared to \$670.7 million as of December 31, 2016. Our deposit growth was driven primarily by savings, N.O.W. and money market growth of \$155.8 million or 33.5% to \$621.7 million as of December 31, 2017 compared to \$465.9 million for the prior year. The growth in these deposits was driven in large part by new and existing municipal banking relationships. Noninterest-bearing deposits, which represent our lowest cost of funding, decreased \$12.5 million or 7.1% to \$164.8 million as of December 31, 2017, compared to \$177.3 million as of December 31, 2016. The percentage of noninterest-bearing deposits to total deposits declined from 26.4% to 20.3% as a result of growth in savings, N.O.W. and money market accounts, comprised of primarily public fund deposits. There were no short-term borrowings as of December 31, 2017, as compared to \$26.5 million as of December 31, 2016. Total stockholders' equity increased \$4.6 million to \$67.6 million as of December 31, 2017, from \$63.0 million as of December 31, 2016. The year over year increase in stockholders' equity resulted from net decrease in the net unrealized loss on securities available for sale, net of taxes of \$2.2 million, net income of \$1.4 million, and \$934 thousand associated with stock compensation plans and the exercise of both warrants and stock options.

Net income for the year ended December 31, 2017 was \$1.4 million or \$0.20 per diluted share, compared to net income of \$2.8 million, or \$0.40 per diluted share, in 2016, a decrease of \$1.4 million, or 48.1%. The decline in net income year over year is principally attributed to two items. First, on December 22, 2017, H.R.1, also known as the Tax Cuts and Jobs Act was enacted into law. Beginning in 2018, this legislation reduces the federal marginal tax rate for corporations from 34/35% to 21% and changes or limits certain tax deductions. Consequently, we recorded a one-time downward revaluation of deferred tax assets to income tax expense for \$1.8 million. Secondly, to take advantage of the tax benefit associated with a higher corporate tax rate in 2017, we sold approximately \$41.6 million of investment securities out of the available for sale investment securities portfolio, incurring losses, net of tax, of \$1.0 million. The plan was to re-leverage the balance sheet for future periods principally to fund loans. We expect this repositioning strategy to be accretive to earnings in 2018.

Other income decreased year over year by \$1.6 million, or 108.0%, to \$(118) thousand for year ended December 31, 2017, primarily as a result of the net securities losses before tax, of \$1.6 million taxes compared to net securities gains of \$346 thousand recognized in 2016. Other expenses increased \$1.4 million, or 7.9%, to \$19.5 million as compared to \$18.1 million at the year ended December 31, 2016. The increase in other expense was primarily attributable to an increase in salaries and employee benefits of \$806 thousand, or 8.4%, to \$10.4 million in 2017 compared to \$9.6 million over the previous year, as a result of hiring of new employees to support growth and

strategic plans as well as additional cost associated with the implementation of a recognition and retention plan for key employees during 2016. The advertising and business development expenses increased \$246 thousand, or 25.0%, to \$1.2 million from \$985 thousand for the same period in 2016, and other operating expenses increased by \$290 thousand or 13.4% to \$2.5 million compared to \$2.2 million at the end of fiscal year 2016.

The increase in net interest income year over year outpaced the increase in noninterest expenses, which resulted in a lower efficiency ratio of 74.42% in 2017, as compared to 79.60% in 2016. Basic and diluted earnings per share for the year ended December 31, 2017 were \$0.20, compared to \$0.40 for 2016. The return on average assets was 0.17% for 2017, as compared to 0.39% for 2016, and our return on average equity was 2.16% for 2017, as compared to 4.19% for 2016.

Comparison of operating results for the years ended December 31, 2017 and 2016

Analysis of net interest income

Net interest income, the primary contributor to our earnings, represents the difference between the income that we earn on our interest-earning assets and the cost to us of our interest-bearing liabilities. Our net interest income depends upon the volume of interest-earning assets and interest-bearing liabilities and the interest rates that we earn or pay on them. The following table presents, for the periods indicated, the average balances of our interest-earning assets and interest-bearing liabilities, average yields and costs, and certain other information. Nonaccrual loans are included in loans, and interest on nonaccrual loans is included only to the extent reflected in the consolidated statements of income.

	Year Ended December 31,					
	2017			2016		
	Average Balance	Interest Earned/Paid	Average Yield/Cost	Average Balance	Interest Earned/Paid	Average Yield/Cost
	(in thousands)					
Interest earning assets:						
Loans (including fee income) ⁽¹⁾	\$ 496,679	\$ 21,939	4.42 %	\$ 470,380	\$ 20,275	4.31 %
Securities, taxable ⁽²⁾	312,922	7,495	2.40	227,689	4,545	2.00
Deposits with banks	19,651	198	1.01	9,014	48	0.53
Federal funds sold	6	-	-	80	-	-
Total interest-earning assets	829,258	29,632	3.57	707,163	24,868	3.52
Non interest-earning assets:						
Cash and due from banks	5,225			7,826		
Other assets	11,352			6,735		
Total assets	\$ 845,835			\$ 721,724		
Interest bearing liabilities:						
Savings, N.O.W. and money market deposits	\$ 550,531	\$ 3,454	0.63 %	\$ 394,230	\$ 1,740	0.44%
Certificates of deposit of \$100,000 or more	11,998	132	1.10	27,741	290	1.05
Other time deposits	8,497	75	0.88	10,079	118	1.17
Subordinated debentures	14,756	1,099	7.45	14,717	1,092	7.42
Borrowed funds	12,011	156	1.30	9,420	61	0.65
Total interest-bearing liabilities	597,793	4,916	0.82	456,187	3,301	0.72
Non interest-bearing liabilities:						
Demand deposits	174,925			192,121		
Other liabilities	6,164			6,866		
Total liabilities	778,882			655,174		
Stockholders' equity	66,953			66,550		
Total liabilities and stockholders' equity	\$ 845,835			\$ 721,724		
Net interest income		\$ 24,716			\$ 21,567	
Net interest spread ⁽³⁾			2.75%			2.80 %
Net interest earning assets	\$ 231,465			\$ 250,976		
Net interest margin ⁽⁴⁾			2.98 %			3.05 %

(1) Amounts are net of deferred origination costs/(fees) and the allowance for loan loss.

(2) Unrealized gains / (losses) on securities available for sale are included in other assets.

(3) Net interest spread is the weighted average yield on interest-earning assets minus the weighted average rate on interest-bearing liabilities.

(4) Net interest margin is net interest income divided by average interest-earning assets.

Net interest income increased \$3.1 million, or 14.6%, for the year ended December 31, 2017 over the prior year. Interest from loans and securities were primarily responsible for the growth in total interest income while the cost of savings, N.O.W., and money market deposits and short term borrowings made up the increase of total interest expense. Net interest margin was 2.98% for 2017, a decrease from 3.05% from the year ended December 31, 2016. The decrease of the net interest margin year over year was derived from an increase of five basis points in the average yield of interest earning assets, offset by an increase of 10 basis points in the average cost of total interest bearing liabilities. The total average interest earning assets in 2017 increased by \$122.1 million or 17.3% to \$829.3 million from \$707.2 million in 2016, yielding 3.57% compared to 3.52% the prior year. The increase in total average interest earning assets was driven primarily by an increase in average yield on loans to 4.42% from 4.31% over the same period in 2016, resulting from higher average volume and yields on loans, as well as higher prepayment penalties on loan payoffs recognized in 2017 compared to 2016. Higher average balance on investment securities and on deposits with banks also were contributing to higher total interest earning assets.

The decrease in net interest margin was impacted by an increase of 10 basis points in the cost of average interest bearing liabilities to 0.82% for the year ended December 31, 2017 from 0.72% for the prior year. In 2017, the total average interest bearing liabilities increased by \$141.6 million or 31.0% to \$597.8 million from \$456.2 million in 2016. The increase in the interest paid on average interest bearing liabilities was driven primarily by an increase of 19 basis points in average cost of funds on savings N.O.W. and money market deposits from 0.44% in 2016 to 0.63% for 2017. The increase in the average volume of these accounts was the primary driver for the increase of \$1.6 million in interest expense year over year. The other components that contributed to higher cost of funds in 2017 were an increase of five basis points on certificates of deposit of \$100,000 up to 1.10% in 2017 from 1.05% in 2016 and an increase of 65 basis points on borrowed funds up to 1.30% from 0.65% in 2016. The average balance of noninterest-bearing demand deposits decreased for the year ended December 31, 2017 by \$17.2 million or 9.0% to \$174.9 million from \$192.1 million in 2016.

Rate/volume analysis

The following table analyzes the dollar amount of changes in interest income and interest expense for the primary components of interest-earning assets and interest-bearing liabilities. The table shows the amount of the change in interest income or expense caused by either changes in outstanding balances (volume) or changes in interest rates. The effect of a change in volume is measured by applying the average rate during the first period to the volume change between the two periods. The effect of changes in rate is measured by applying the change in rate between the two periods to the average volume during the first period. Changes attributable to both rate and volume that cannot be segregated have been allocated proportionately to the absolute value of the change due to volume and the change due to rate.

	Year Ended December 31, 2017 Over 2016		
	Increase/(Decrease) Due To		
	Average Volume	Average Rate	Net Change
	(in thousands)		
Interest income on interest-earning assets:			
Loans (including fee income)	\$ 1,153	\$ 511	\$ 1,664
Securities, taxable	1,892	1,058	2,950
Deposits with banks	85	65	150
Total increase in interest income	<u>3,130</u>	<u>1,634</u>	<u>4,764</u>
Interest expense on interest-bearing liabilities:			
Savings, N.O.W. and money market deposits	831	883	1,714
Certificates of deposit of \$100,000 or more	(172)	14	(158)
Other time deposits	(17)	(26)	(43)
Borrowed money	20	75	95
Subordinated debentures	3	4	7
Total increase in interest expense	<u>665</u>	<u>950</u>	<u>1,615</u>
Total increase in net interest income	<u>\$ 2,465</u>	<u>\$ 684</u>	<u>\$ 3,149</u>

Provision for loan losses

We consider a number of factors in determining the required level of our allowance for loan losses and the provision required to achieve that level, including loan growth, loan quality rating trends, nonperforming loan levels, delinquencies, net charge-offs, industry concentrations and economic trends in our market and throughout the nation. We recorded a \$644 thousand provision for loan losses for the year ended December 31, 2017 and a \$632 thousand provision for loan losses for the year ended December 31, 2016.

Other income

Total other income comprised of customer related fees and service charges, professional practice revenue, net securities (losses) gains, and other operating income decreased \$1.6 million or 108.0% for the year ended December 31, 2017, as compared to 2016, primarily as a result of a \$1.6 million loss recognized on sale of securities in 2017 compared to a gain of \$346 thousand recorded for the same period last year. The loss on securities was offset by an increase in customer related fees and service charges of \$122 thousand or 32.2%, as well as an increase in other operating income of \$307 thousand or 67.9%. The main reason of the increase in other operating income is the \$254 thousand recorded year to date in 2017 in income from bank owned life insurance.

Other expense

Total other expenses consist primarily of salaries and employee benefits, occupancy and other expenses related to our operation and expansion. Total other expenses increased by approximately \$1.4 million, or 7.9%, during 2017, as compared to 2016, primarily from expenses associated with our continued growth. The largest component of the increase in other expenses was salaries and benefits, which increased \$806 thousand, or 8.4%, during 2017, largely due to base salary increases, benefit plans to support strategic plans and employee recognition and retention, and new employees. Assets per employee increased to \$12.3 million as of December 31, 2017 from \$10.9 million as of December 31, 2016. Advertising and business development increased \$246 thousand or 25.0% and professional fees increased \$125 thousand or 18.8%. Net occupancy and equipment costs increased \$17 thousand, or 0.6%. Offsetting these increases, FDIC insurance expense decreased \$72 thousand or 20.5%. Costs associated with the collateralization of municipal deposits increased \$69 thousand over the same period last year.

Provision for income taxes

The Tax Cuts and Jobs Act (“the Act”) was enacted on December 22, 2017. The income tax effects of changes in tax laws are recognized in the period when enacted. The Act provides for numerous significant tax law changes and modifications with varying effective dates, which includes reducing the U.S. federal corporate income tax rate from 34/35% to 21%. We premeasured our deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. The provisional amount recorded related to the remeasurement of deferred tax balance was a net tax expense of \$1.8 million.

The year to date 2017 effective income tax rate was 67.6% as compared to 35.8% for the year ended December 31, 2016. Notwithstanding the additional income tax recorded on the revaluation of the deferred tax assets, the effective tax rate for 2017 would have been 28.2%. Additionally, we recognized excess tax benefits relative to the exercise of stock options by employees in the fourth quarter of 2017. There were no excess tax benefits recognized by us in 2016.

Financial condition

Our total assets increased \$118.6 million, or 15.2%, to \$900.0 million as of December 31, 2017, compared to \$781.4 million as of December 31, 2016. Net loans increased \$25.2 million, or 5.2%, to \$513.7 million as of December 31, 2017, compared to \$488.5 million as of December 31, 2016. As a result of management’s assessment of the credit quality of the loan portfolio, the allowance for loan losses to total loans was 1.13%, or \$5.9 million, at December 31, 2017 as compared to 1.17%, or \$5.8 million, as of December 31, 2016. Securities available for sale increased \$35.3 million, or 13.3%, to \$300.0 million as of December 31, 2017, from \$264.7 million as of December 31, 2016.

Our asset growth for the year ended December 31, 2017 was funded primarily by deposit growth. Total deposits increased \$141.8 million, or 21.1%, to \$812.5 million as of December 31, 2017, compared to \$670.7 million as of December 31, 2016. Demand deposits, which represent a value funding source, decreased \$12.5 million or 7.06% to \$164.8 million as of December 31, 2017, compared to \$177.3 million as of December 31, 2016. The average balance of these noninterest-bearing deposits decreased \$17.2 million or 9%. Savings, N.O.W. and money market deposits increased \$155.8 million, or 33.5%, to \$621.7 million as of December 31, 2017 compared to \$465.9 million over the same period in 2016. The growth in these deposits was driven in large part by new and existing municipal banking relationships. Certificates of deposit of \$100,000 or more increased slightly to \$0.2 million, or 1.2%, to \$18.3 million compared to \$18.1 million in 2016, while other time deposits decreased by \$1.7 million, or 18.8%, to \$7.7 million at December 31, 2017 compared to \$9.4 million in 2016. As of December 31, 2017, our loan to deposit ratio was 63.9%, as compared to 73.7% as of December 31, 2016. The balance of subordinated debentures, net of debt issuance costs, increased \$0.1 million or 0.29% to \$14.8 million at December 31, 2017 compared to \$14.7 million from 2016.

Total stockholders' equity increased \$4.6 million to \$67.6 million as of December 31, 2017, from \$63.0 million as of December 31, 2016. The year over year increase in stockholders' equity resulted from net decrease in the net unrealized loss on securities available for sale, net of taxes of \$2.2 million, net income of \$1.4 million, and \$934 thousand associated with stock compensation plans and the exercise of both warrants and stock options. At December 31, 2017, the bank was "well capitalized" as defined by OCC regulation, with tier 1 leverage, common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios of 9.06%, 14.93%, 14.93% and 16.01%, respectively.

Loans

Our primary source of income is interest on loans. Our primary target market is small and medium-sized businesses and real estate investors in our market area. Our loan portfolio consists primarily of commercial and industrial loans and real estate loans secured by multi-family and commercial real estate properties located in our primary area. Our loan portfolio represents the highest yielding component of our earning asset base.

The following table sets forth the amount of loans, by category, as of the respective periods:

	December 31, 2017		December 31, 2016	
	Amount	Percent	Amount	Percent
	(in thousands)			
Commercial real estate - multi-family	\$ 195,571	37.6 %	\$ 192,168	38.9 %
Commercial real estate mortgages	155,204	29.9	133,432	27.0
Commercial and industrial	77,373	14.9	87,649	17.7
One-to-four family	68,374	13.2	59,801	12.1
Real estate - construction	14,457	2.8	13,540	2.7
Home equity lines of credit	6,436	1.2	5,068	1.0
Lease financing	1,490	0.3	2,319	0.5
Installment/consumer	635	0.1	297	0.1
Total	519,540	100.0 %	494,274	100.0 %
Allowance for loan losses	(5,875)		(5,799)	
Net loans	<u>\$ 513,665</u>		<u>\$ 488,475</u>	

We continued to experience growth in our loan portfolio, and the composition of our loan portfolio continues to evolve primarily maintaining focus on commercial real estate mortgages and multi-family lending, while also increasing the percentage of commercial and industrial loans as well as one-to-four family loans in our overall mix.

The following table sets forth the contractual maturity ranges, and the amount of loans with fixed and variable rates, in each maturity range as of December 31, 2017:

	Within One	After One But	After Five	Total
	Year	Within Five	Years	
	(in thousands)			
Commercial real estate - multi-family	\$ 4,889	\$ 18,654	\$ 172,028	\$ 195,571
Commercial real estate mortgages	8,214	38,298	108,692	155,204
Commercial and industrial	38,651	19,298	19,424	77,373
One-to-four family	3,268	3,188	61,918	68,374
Real estate - construction	8,263	6,194	-	14,457
Home equity lines of credit	-	2,991	3,445	6,436
Lease financing	242	1,248	-	1,490
Installment/consumer	255	380	-	635
Total	<u>\$ 63,782</u>	<u>\$ 90,251</u>	<u>\$ 365,507</u>	<u>\$ 519,540</u>
Rate provisions:				
Amounts with variable interest rates	56,235	39,476	357,244	452,955
Amounts with fixed interest rates	7,547	50,775	8,263	66,585
Total	<u>\$ 63,782</u>	<u>\$ 90,251</u>	<u>\$ 365,507</u>	<u>\$ 519,540</u>

Asset Quality

We have identified certain assets as risk elements. These assets include nonaccrual loans, loans that are contractually 90 days or more past due as to principal or interest payments and still accruing and troubled debt restructurings (“TDRs”). These assets present more than the normal risk. Information about these risk elements is set forth below:

	December 31,	
	2017	2016
	(in thousands)	
Nonaccrual loans		
Troubled debt restructuring	\$ 772	\$ 317
Other	5,159	2,033
Total nonaccrual loans	<u>5,931</u>	<u>2,350</u>
Loans past due 90 days or more and still accruing	-	-
Other real estate owned	-	-
Total nonperforming assets	<u>5,931</u>	<u>2,350</u>
Troubled debt restructurings - performing	<u>1,871</u>	<u>2,198</u>
Total risk elements	<u>\$ 7,802</u>	<u>\$ 4,548</u>

Gross interest income on nonaccrual loans and troubled debt restructurings:

Amount that has not been paid or recorded during the year under original terms	\$ 148	\$ 49
Actual amount recorded during the year	250	273

The allowance for loan losses to total loans (reserve coverage ratio) was 1.13% at December 31, 2017 compared to 1.17% at year-end 2016. The decline was the result of the growth in the portfolio, relative movement in the criticized/classified portfolio as well as a shift in the makeup of the overall portfolio. Loans outstanding at the end of 2017 were \$519.5 million representing an increase of \$25.2 million compared to \$494.3 million at the end of the 2016. Notwithstanding the increase in overall portfolio, our commercial and industrial lending segment decreased \$10.3 million year over year. Since this is the segment that maintains the largest allocation at 2.10%, a decrease in this segment will result in a lower overall reserve relative to the total portfolio. Credit quality remained sound as we have not wavered from our rigorous underwriting standards despite improving economic conditions. At December 31, 2017 we had no delinquencies over thirty days past due in the loan portfolio. The nonaccrual loans at December 31, 2017 were \$5.9 million or 1.14% of total loans outstanding. Troubled debt restructurings totaled \$2.6 million at

December 31, 2017. Of this amount, \$1.9 million were performing in accordance with their modified terms and \$0.7 million were nonaccrual and included in the aforementioned amount of nonaccrual loans.

The credit quality of our securities portfolio also remained strong at December 31, 2017. The portfolio consisted of U.S. government agency obligations, U.S Treasury securities, and mortgage-backed securities backed by the full faith and credit obligations of the U.S. government, or by obligations of U.S. government sponsored entities. The portfolio contains three corporate debt obligations as of December 31, 2017.

We have maintained low levels of nonperforming assets since our inception in 2008. Our nonaccrual loans comprised 1.14% of total loans as of December 31, 2017, compared to 0.48% as of December 31, 2016. The year over year increase in total non-accrual loans was attributable to management's decision to place a single relationship on non-accrual status, notwithstanding the fact that these loans are collateralized and we are working with a cooperative borrower who remains current on all payment obligations. We believe that our historically low level of nonperforming assets reflects our long-term knowledge and relationships with a significant percentage of our borrowers, management's experience and knowledge with respect to our market and our underwriting discipline. In 2017, we had charge-offs of \$633 thousand and recoveries of \$65 thousand. We had net charge-offs of \$568 thousand and \$101 thousand for the years ended December 31, 2017 and 2016, respectively. However, historical performance is not necessarily an indicator of future performance, particularly considering our limited operating history. Future results could differ materially. However, management believes, based upon known factors, management's judgment and regulatory methodologies, that the current methodology used to determine the adequacy of the allowance for loan losses is reasonable. An analysis of our allowance for loan losses and net charge-offs is presented in the notes to our consolidated financial statements, which are included in this Annual Report.

Allowance for Loan Losses

We maintain an allowance for loan losses that represents management's best estimate of the probable incurred loan losses and risks inherent in the loan portfolio. In determining the allowance for loan losses, we estimate losses on specific loans, or groups of loans, where the probable incurred loss can be identified and reasonably determined. The balance of the allowance for loan losses is based on internally assigned risk classifications of loans, historical loan loss rates, changes in the nature of the loan portfolio, overall portfolio quality, industry concentrations, delinquency trends, current economic factors and the estimated impact of current economic conditions on certain historical loan loss rates, among other things. The allowance for loan losses consists of specific and general components, as well as an unallocated component. The unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. In 2017, we had an unallocated portion totaling \$54 thousand. The allowance for loan losses is increased by our loan loss provision, which was discussed above, and reduced by net loan charge-offs. Loans are charged-off when we determine that collection has become unlikely. Recoveries are recorded only when cash payments are received. We held no other real estate owned at any of the reported periods.

We consider a loan to be impaired when, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans for which the terms have been modified as a concession to the borrower due to the borrower experiencing financial difficulties are considered troubled debt restructurings and are classified as impaired. Loans considered to be troubled debt restructurings can be categorized as nonaccrual or performing. The impairment of a loan is measured at the value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral less costs to sell if the loan is collateral dependent. Generally, we measure impairment of such loans by reference to the fair value of the collateral less costs to sell. Loans that experience minor payment delays and payment shortfall generally are not classified as impaired.

The following table sets forth changes in the allowance for loan losses:

	<u>Year ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
	(in thousands)	
Beginning balance	\$ 5,799	\$ 5,268
Charge-offs:		
Commercial real estate mortgages	-	-
Commercial and industrial	(616)	(111)
Installment/consumer	(17)	-
Total	<u>(633)</u>	<u>(111)</u>
Recoveries:		
Commercial real estate mortgages	-	10
Commercial and industrial	65	-
Installment/consumer	-	-
Total	<u>65</u>	<u>10</u>
Net charge-offs	(568)	(101)
Provision for loan losses charged to operations	644	632
Ending balance	<u>\$ 5,875</u>	<u>\$ 5,799</u>
Ratio of net charge-offs during period to average loans outstanding	<u>0.11%</u>	<u>0.02%</u>

The following table sets forth the allocation of the total allowance for loan losses by loan type and sets forth the percentage of loans in each category to gross loans. The allocation of the allowance for loan losses as shown in the table should neither be interpreted as an indication of future charge-offs, nor as an indication that charge-offs in future periods will necessarily occur in these amounts or in the indicated proportions.

	<u>2017</u>		<u>2016</u>	
	<u>Amount</u>	<u>Percentage of Loans to Total Loans</u>	<u>Amount</u>	<u>Percentage of Loans to Total Loans</u>
	(in thousands)			
Commercial real estate - multi-family	\$ 1,658	37.6 %	\$ 1,705	38.9 %
Commercial real estate mortgages	1,949	29.9	1,373	27.0
Commercial and industrial	1,581	14.9	2,110	17.7
One-to-four family	477	13.2	417	12.1
Real estate - construction	116	2.8	109	2.7
Home equity lines of credit	16	1.2	10	1.0
Lease financing	13	0.3	20	0.5
Installment/consumer	11	0.1	1	0.1
Unallocated	54	-	54	-
Total	<u>\$ 5,875</u>	<u>100.0 %</u>	<u>\$ 5,799</u>	<u>100.0 %</u>

Although we believe that our allowance for loan losses was adequate to provide for probable incurred losses in our loan portfolio as of December 31, 2017, future provisions will be subject to ongoing evaluations of the risks in our loan portfolio.

Securities

Our securities portfolio is used to make various term investments, to provide a source of liquidity, and to serve as collateral for certain types of deposits and borrowings and to provide interest income. We manage our investment portfolio according to a written investment policy approved by our Board of Directors. Investment balances in our securities portfolio are subject to change over time based on our funding needs and interest rate risk management objectives. Our liquidity levels take into account anticipated future cash flows and all available sources of credits and are maintained at levels management believes are appropriate to assure future flexibility in meeting our anticipated funding needs.

As of December 31, 2017, our securities portfolio consisted primarily of government agency obligations, mortgage-backed securities with varying contractual maturities, and U.S. treasuries, and corporate debt securities. However, these maturities do not necessarily represent the expected life of the securities as many of the securities may be called or paid down without penalty. No investment in any of those instruments exceeds any applicable limitation imposed by law or regulation. The Investment Committee reviews the investment portfolio on an ongoing basis in order to ensure that the investments conform to our investment policy as approved by the Board of Directors. As of December 31, 2017, our investment portfolio consisted almost entirely of available for sale securities. During 2017, we added two corporate debt obligations to the portfolio. The carrying values of our available for sale investment securities are adjusted for unrealized gain or loss as a valuation allowance, and any gain or loss is reported on an after-tax basis as a component of stockholders' equity.

The following table presents a summary of the amortized cost and estimated fair value of our investment portfolio as of the dates presented:

	December 31, 2017		December 31, 2016	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
	(in thousands)			
Available for sale:				
Mortgage backed securities – residential	\$ 131,704	\$ 129,738	\$ 143,496	\$ 139,385
U.S. government agency securities	154,001	151,415	129,191	125,349
U.S. treasury	18,866	18,816	-	-
Total available for sale	<u>\$ 304,571</u>	<u>\$ 299,969</u>	<u>\$ 272,687</u>	<u>\$ 264,734</u>
Held to maturity:				
Corporate bonds	\$ 4,750	\$ 4,848	\$ 3,000	\$ 3,032
Total held to maturity	<u>\$ 4,750</u>	<u>\$ 4,848</u>	<u>\$ 3,000</u>	<u>\$ 3,032</u>

All of our mortgage-backed securities are agency securities. We do not hold any Fannie Mae or Freddie Mac preferred stock, collateralized debt obligations, collateralized loan obligations, structured investment vehicles, private label collateralized mortgage obligations, sub-prime, Alt-A, or second lien elements in our investment portfolio. At December 31, 2017, our investment portfolio did not contain any securities that are directly backed by subprime or Alt-A mortgages.

The expected maturities presented below will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The following table sets forth the amortized cost, the estimated fair value, maturities and approximated weighted average yield based on estimated annual income divided by the average amortized cost of our securities portfolio at December 31, 2017.

	Amortized Cost	Estimated Fair Value	Yield
		(in thousands)	
Available for sale:			
Due in one year or less	\$ 18,866	\$ 18,816	1.20 %
Due from one to five years	8,996	8,853	2.06
Due from five to ten years	145,005	142,562	2.45
Due after ten years	-	-	-
Mortgage backed securities – residential	131,704	129,738	2.81
Total available for sale	<u>\$ 304,571</u>	<u>\$ 299,969</u>	<u>2.52 %</u>
Held to maturity:			
Due from five to ten years	\$ 4,750	\$ 4,848	5.21 %
Total held to maturity	<u>\$ 4,750</u>	<u>\$ 4,848</u>	<u>5.21 %</u>

Deposits

Deposits are our primary source of funds to support our earning assets. Total deposits were \$812.5 million as of December 31, 2017 compared to \$670.7 million as of December 31, 2016. To expand and diversify our deposit base, we deployed the following strategies:

- Expansion of our suite of products and services targeting professional practices;
- Strategic initiative to increase municipal deposit relationships in our market area;
- Focus on developing and maintaining long-term relationships between our relationship bankers and customers through high quality service; and
- Commitment to the implementation of technology to enhance customer access to banking products and services.

In addition to our deposit growth, the composition of our deposit base has changed substantially since our inception in 2008. In our initial years of operation, we relied significantly on certificates of deposit, including brokered deposits, due to our limited branch network, deposit pricing and the timing of our funding needs. Since that time, we have expanded our geographic footprint with three additional branch locations. We experienced significant growth in savings, N.O.W. and money market deposits during 2017 and 2016 as a result of our strategic initiatives focused on municipal deposit growth.

The following table shows the average balances and weighted average interest rates for each type of deposit at December 31, 2017 and December 2016 respectively:

	For the year ended December 31,					
	2017			2016		
	Average Balance	Percent	Weighted Average Rate	Average Balance	Percent	Weighted Average Rate
	(in thousands)					
Savings, N.O.W. and money market deposits	\$ 550,531	73.8 %	0.63 %	\$ 394,230	63.2 %	0.44 %
Demand deposits	174,925	23.5	-	192,121	30.8	-
Certificates of deposit of \$100,000 or more	11,998	1.6	1.10	27,741	4.4	1.05
Other time deposits	8,497	1.1	0.88	10,079	1.6	1.17
Total deposits	<u>\$ 745,951</u>	<u>100.0 %</u>	<u>0.49 %</u>	<u>\$ 624,171</u>	<u>100.0 %</u>	<u>0.34 %</u>

The following table presents a summary of the Corporation's time deposits in amounts of \$100,000 or more by remaining term to maturity at December 31, 2017:

Time Deposits of \$100,000 or More Maturing Within				
0-3 Months	Over 3 to 6 Months	Over 6 to 12 Months	Over 12 Months	Total
(in thousands)				
\$ 1,120	\$ 1,518	\$ 8,804	\$ 6,835	\$ 18,277

Capital resources

Stockholders' equity totaled \$67.6 million at December 31, 2017, an increase of \$4.6 million from \$63.0 million at December 31, 2016. The year over year increase in stockholders' equity resulted from net decrease in the net unrealized loss on securities available for sale, net of taxes of \$2.2 million, net income of \$1.4 million, and \$934 thousand associated with stock compensation plans and the exercise of both warrants and stock options. As of December 31, 2017, our equity structure consisted entirely of shares of common stock. Historically, we have not paid cash dividends on our common stock, but instead have retained our earnings to support the continued growth of our organization. We expect to continue this practice for the foreseeable future.

We are subject to various regulatory capital requirements administered by the federal banking agencies. At this time, these regulatory capital requirements apply only at the bank level. As of December 31, 2017, we were in compliance with all applicable regulatory capital requirements, and the Bank was classified as "well capitalized" for purposes of the OCC's prompt corrective action regulations with leverage, common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios of 9.06%, 14.93%, 14.93% and 16.01%, respectively. "Well capitalized" is the highest capital classification for FDIC-insured financial institutions in the United States. As we employ our capital and continue to grow our operations, our capital levels may decrease depending on our level of earnings. However, we expect to monitor and control our growth in order to remain a "well capitalized" under the applicable regulatory guidelines and in compliance with all regulatory capital standards applicable to us.

CONSOLIDATED STATEMENTS OF CONDITION

	At December 31,	
	2017	2016
	(in thousands, except share and per share amounts)	
ASSETS		
Cash and due from banks	\$ 2,406	\$ 4,386
Interest earning deposits with banks	43,467	1,962
Federal funds sold	6	6
Total cash and cash equivalents	<u>45,879</u>	<u>6,354</u>
Securities available for sale, at fair value	299,969	264,734
Securities, held to maturity (fair value of \$4,848 and \$3,032, respectively)	4,750	3,000
Securities, restricted	2,946	4,131
Loans	519,540	494,274
Less: Allowance for loan losses	<u>(5,875)</u>	<u>(5,799)</u>
Loans, net	513,665	488,475
Premises and equipment, net	5,506	6,052
Bank-owned life insurance	20,254	-
Accrued interest receivable	2,933	2,610
Deferred tax asset, net	2,778	5,602
Other assets	<u>1,351</u>	<u>477</u>
Total Assets	<u>\$ 900,031</u>	<u>\$ 781,435</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Demand deposits	\$ 164,790	\$ 177,299
Savings, N.O.W. and money market deposits	621,742	465,890
Certificates of deposit of \$100,000 or more	18,277	18,068
Other time deposits	<u>7,655</u>	<u>9,426</u>
Total deposits	812,464	670,683
Short-term borrowings	-	26,477
Subordinated debentures, net	<u>14,778</u>	<u>14,735</u>
Total borrowings	14,778	41,212
Accrued interest payable	105	110
Other liabilities	<u>5,099</u>	<u>6,438</u>
Total Liabilities	832,446	718,443
Stockholders' Equity:		
Common stock, par value \$0.01 per share; 100,000,000 authorized shares; 5,470,164 issued and outstanding at December 31, 2017 and 5,015,252 issued and outstanding at December 31, 2016	55	50
Non-voting common stock, par value \$0.01 per share; 20,000,000 authorized shares; 1,831,250 issued and outstanding at December 31, 2017 and 1,931,250 issued and outstanding at December 31, 2016	18	19
Surplus	65,061	64,131
Retained earnings	<u>6,086</u>	<u>4,041</u>
	71,220	68,241
Accumulated other comprehensive loss	<u>(3,635)</u>	<u>(5,249)</u>
Total Stockholders' Equity	<u>67,585</u>	<u>62,992</u>
Total Liabilities and Stockholders' Equity	<u>\$ 900,031</u>	<u>\$ 781,435</u>

See accompanying notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF INCOME

	<u>Year Ended December 31,</u>	
	<u>2017</u>	<u>2016</u>
	(in thousands, except per share amounts)	
Interest income:		
Loans (including fee income)	\$ 21,939	\$ 20,275
Securities, taxable	7,495	4,545
Deposits with banks	198	48
Total interest income	29,632	24,868
Interest expense:		
Savings, N.O.W. and money market deposits	3,454	1,740
Certificates of deposit of \$100,000 or more	132	290
Other time deposits	75	118
Short-term borrowings	156	61
Subordinated debentures	1,099	1,092
Total interest expense	4,916	3,301
Net interest income	24,716	21,567
Provision for loan losses	644	632
Net interest income after provision for loan losses	24,072	20,935
Other income:		
Customer related fees and service charges	501	379
Professional practice revenue	218	300
Net securities (losses) gains	(1,596)	346
Other operating income	759	452
Total other (loss) income	(118)	1,477
Other expense:		
Salaries and employee benefits	10,449	9,643
Occupancy and equipment, net	2,839	2,822
Software services	1,442	1,430
Advertising and business development	1,231	985
Professional fees	789	664
FDIC insurance	280	352
Other operating expenses	2,462	2,172
Total other expenses	19,492	18,068
Income before income taxes	4,462	4,344
Income tax expense	3,015	1,554
Net income	\$ 1,447	\$ 2,790
Basic earnings per share	\$ 0.20	\$ 0.40
Diluted earnings per share	\$ 0.20	\$ 0.40

See accompanying notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Year Ended December 31,	
	2017	2016
	(in thousands)	
Net income	\$ 1,447	\$ 2,790
Other comprehensive income (loss):		
Unrealized holding gains (losses) arising during the period	4,947	(6,159)
Reclassification adjustment for losses (gains) included in net securities (losses) gains on the consolidated statements of income	1,596	(346)
Change in unrealized net gains (losses) before income taxes	3,351	(6,505)
Tax effect	(1,139)	2,213
Other comprehensive income (loss)	2,212	(4,292)
Total other comprehensive income (loss)	\$ 3,659	\$ (1,502)

See accompanying notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Voting Common Stock		Non-Voting Common Stock			Retained Earnings	Accumulated Other Comprehensive Loss	Total
	Shares Outstanding	Amount	Shares Outstanding	Amount	Surplus			
	(in thousands, except shares amounts)							
Balance at January 1, 2016	5,723,720	\$ 57	1,156,250	\$ 12	\$ 63,791	\$ 1,251	\$ (957)	\$ 64,154
Exchange of voting common stock to non-voting common stock	(775,000)	(7)	775,000	7	-	-	-	-
Exercise of stock options	5,800	-	-	-	58	-	-	58
Issuance of voting common restricted stock	60,732	-	-	-	-	-	-	-
Share based compensation expense	-	-	-	-	282	-	-	282
Net Income	-	-	-	-	-	2,790	-	2,790
Other comprehensive loss, net of deferred income taxes	-	-	-	-	-	-	(4,292)	(4,292)
Balance at December 31, 2016	5,015,252	\$ 50	1,931,250	\$ 19	\$ 64,131	\$ 4,041	\$ (5,249)	\$ 62,992
Exchange of voting common stock to non-voting common stock	100,000	1	(100,000)	(1)	-	-	-	-
Exercise of stock options	337,750	1	-	-	3,377	-	-	3,378
Repurchase and retirement of shares	(262,663)	-	-	-	(3,948)	-	-	(3,948)
Exercise of warrants	95,000	1	-	-	949	-	-	950
Issuance of voting common restricted stock	186,015	2	-	-	-	-	-	2
Forfeiture of restricted stock	(1,190)	-	-	-	-	-	-	-
Share based compensation expense	-	-	-	-	552	-	-	552
Net Income	-	-	-	-	-	1,447	-	1,447
Other comprehensive income, net of deferred income taxes	-	-	-	-	-	-	2,212	2,212
Impact of Tax Cuts and Jobs Act related to accumulated other comprehensive income reclassification	-	-	-	-	-	598	(598)	-
Balance at December 31, 2017	5,470,164	\$ 55	1,831,250	\$ 18	\$ 65,061	\$ 6,086	\$ (3,635)	\$ 67,585

CONSOLIDATED STATEMENTS OF CASH FLOW

	Year Ended December 31,	
	2017	2016
	(in thousands)	
Cash flows from operating activities:		
Net income	\$ 1,447	\$ 2,790
Adjustments to reconcile net income to net cash from operating activities:		
Provision for loan losses	644	632
Depreciation and amortization	1,023	1,062
Amortization of premium and accretion of discount on investment securities, net	620	744
Amortization of debt issuance costs	43	38
Share based compensation expense	552	282
Increase in cash surrender value of bank owned life insurance	(254)	-
Net securities losses (gains)	1,596	(346)
Increase in accrued interest receivable	(323)	(715)
(Increase) decrease in other assets	(874)	215
(Decrease) increase in accrued interest payable and other liabilities	(1,344)	363
Decrease (increase) in deferred income tax	1,687	(418)
Net cash provided by operating activities	4,817	4,647
Cash flows from investing activities:		
Purchases of securities available for sale	(135,367)	(367,937)
Sales of securities available for sale	77,609	71,910
Calls/redemptions of securities available for sale	23,658	175,433
Purchase of securities held to maturity	(1,750)	(3,000)
Purchase of securities, restricted	(20,351)	(11,694)
Sales of securities, restricted	21,536	11,275
Net increase in loans	(25,834)	(32,595)
Purchase of banking premises and equipment, net of disposals	(477)	(427)
Purchase of bank-owned life insurance	(20,000)	-
Net cash used by investing activities	(80,976)	(157,035)
Cash flows from financing activities:		
Net increase in deposits	141,781	152,650
(Decrease) increase in short-term borrowings	(26,477)	413
Proceeds from exercise of warrants	950	-
Proceeds from exercise of stock options	64	58
Repurchase and retirement of shares	(634)	-
Net cash provided by financing activities	115,684	153,121
Increase in cash and cash equivalents	39,525	733
Cash and cash equivalents at beginning of period	6,354	5,621
Cash and cash equivalents at end of period	\$ 45,879	\$ 6,354
Supplemental information-cash flows:		
Cash paid for:		
Interest	\$ 4,921	\$ 3,322
Income taxes	\$ 2,652	\$ 2,121
Supplemental non-cash disclosures:		
Net settlement of stock option exercises	\$ 3,315	\$ -

See accompanying notes to the Consolidated Financial Statements.

EMPIRE BANCORP, INC
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of Empire Bancorp, Inc. and its wholly-owned subsidiary Empire National Bank. Throughout these notes, “Corporation” refers to Empire Bancorp, Inc. and its consolidated subsidiary, except as the context otherwise requires, and “Bank” refers only to Empire National Bank.

Because the Bank is the sole material asset of the Corporation, other than cash, the Corporation’s financial condition and operating results principally reflects those of the Bank. The Bank is a national banking association domiciled in Islandia, New York, which commenced operations on February 25, 2008. The principal business office of the Corporation and the Bank is located at 1707 Veterans Highway, Islandia, New York.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) and to general practices within the financial institution industry. Certain reclassifications have been made to prior year amounts to conform to the current year presentation. The following is a description of the significant accounting policies that the Corporation follows in preparing its financial statements.

a) Use of Estimates

In preparing the financial statements, management has made estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reported periods. Such estimates are subject to change in the future as additional information becomes available or previously existing circumstances are modified. Actual future results could differ significantly from those estimates.

b) Cash Flows

Cash and cash equivalents include cash, deposits with other financial institutions with maturities fewer than 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions, and federal funds purchased and repurchase agreements.

c) Securities

Current accounting standards require that investment securities be classified as held to maturity, trading or available for sale. The trading category is not applicable to any securities in the Corporation’s portfolio because the Corporation does not buy or hold debt or equity securities principally for the purpose of selling in the near term. Debt securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities are classified as available for sale when they might be sold before maturity. Available for sale securities, or debt and equity securities which are neither held to maturity securities nor trading securities, are reported at fair value, with unrealized gains and losses, net of the related income tax effect, included in other comprehensive income, a separate component of stockholders’ equity. Restricted securities, as disclosed on the balance sheet consisting of Atlantic Community Bankers Bank stock, Federal Home Loan Bank stock, and Federal Reserve Bank stock, are carried at cost.

Interest income includes amortization of purchase premium or accretion of discount. Premiums and discounts on securities are amortized or accreted on the level-yield method. Prepayments are anticipated for mortgage-backed securities. Realized gains and losses on the sale of securities are determined using the specific identification method.

Investment securities are evaluated for other-than-temporary (“OTTI”) no less often than quarterly. In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value

has been less than cost; (2) the financial condition and near-term prospects of the issuer; (3) whether the market decline was affected by macroeconomic conditions; and (4) whether management has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time.

When other-than-temporary loss occurs, management considers whether it intends to sell, or, more likely than not, will be required to sell a security in an unrealized loss position before recovery of its amortized cost basis. If either of these criteria is met, the entire difference between amortized cost and fair value is recognized in earnings. For securities that do not meet the aforementioned criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income.

d) Federal Home Loan Bank and Federal Reserve Bank Stock

The Bank is a member of and owns stock in the Federal Home Loan Bank of New York (“FHLB”) and the Federal Reserve Bank of New York. The FHLB requires member banks to own a certain amount of stock based on the level of borrowings and other factors, and additional amounts may be invested. The stock of both entities is carried at cost, classified as restricted securities and periodically evaluated for impairment based on the prospects for the ultimate recovery of par value. Both cash and stock dividends, if any, are reported as income.

e) Bank-Owned Life Insurance

The Bank has purchased life insurance policies on certain employees. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

f) Loans and Allowance for Loan Losses

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the principal amount outstanding less any charge-offs, net of deferred origination fees and costs, and an allowance for loan losses. Interest on loans is credited to income based on the principal amount outstanding. Loan origination and commitment fees and certain direct and indirect costs incurred in connection with loan originations are deferred and amortized to income over the life of the related loans without anticipating prepayments and as an adjustment to yield. When a loan prepays, the remaining unamortized net deferred origination fees and costs are recognized immediately upon payoff.

Past due status is based on the contractual terms of the loan. Loans that are deemed uncollectable according to the terms of the loan agreement, or are 90 days past due, are placed on nonaccrual and previously accrued interest is reversed and charged against interest income. An exception is made for 90-day past due loans that are well secured and in the process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Interest received on nonaccrual loans is accounted for on the cash basis or cost-recovery method until the loans qualify for return to an accrual status. However, if the Corporation believes that the loan will be fully collectible based upon the individual loan evaluation assessing factors such as collateral and collectability, accrued interest will be recognized upon attainment of certain events. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current for a period of time, and future payments are reasonably assured. When the accrual of interest income is discontinued on a loan, any accrued but unpaid interest is reversed against current period income. Unless otherwise noted, the above policy is applied consistently to all loan classes.

The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management’s judgement, should be charged off.

The process for estimating credit losses and determining the allowance for loan losses as of any balance sheet date is subjective in nature and requires material estimates. Actual results could differ significantly from those estimates.

The allowance for loan losses is established through provisions for loan losses charged against income. When available information confirms that specific loans or portions thereof, are uncollectible, these amounts are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired when, based on current information and events, it is probably that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings (“TDRs”) and classified as impaired.

Management currently estimates the general component of the allowance based upon factors including, but not limited to, an evaluation of inherent risks in the loan portfolio, industry experience, credit risk grades assigned to loans, adverse situations that may affect the borrowers’ ability to repay, the estimated value of any underlying collateral, and current economic conditions. Future additions to the allowance may be necessary based on changes in economic conditions or other factors used in management’s determination as well as probable incurred losses. In addition, as part of their examination process, regulatory agencies may require additions to the allowance based on their judgments about information available to them. An unallocated component is maintained to cover uncertainties that could affect management’s estimate of probable incurred losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan’s existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

Troubled debt restructurings are individually evaluated for impairment and included in the separately identified impairment disclosures. TDRs are measured at the present value of estimated future cash flows using the loan’s effective rate at inception. If a TDR is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For TDRs that subsequently default, the Corporation determines the amount of the allowance on that loan in accordance with the accounting policy for the allowance for loan losses on loans individually identified as impaired.

g) Concentration of Credit Risk

The Corporation’s portfolio segments are comprised of commercial real estate - multi-family loans, commercial real estate mortgages, commercial and industrial loans, one-to-four family loans, real estate – construction loans, home equity lines of credit, lease financing, and installment/consumer loans. Risk characteristics of the Corporation’s commercial real estate and real estate construction loans tend to be subjective due to vacancy rates, cash flows and the underlying real estate values located in the Corporation’s market and primary service area of the counties of Suffolk, Nassau, Kings, Queens, Bronx and New York. Commercial and industrial and lease financing risk characteristics are driven by economic conditions and the management and capital strength of the borrower.

h) Premises and Equipment

Buildings, furniture and fixtures and equipment are stated at cost less accumulated depreciation. Equipment, computer hardware and software, and furniture and fixtures are depreciated using the straight-line method with a

range for useful lives of two to ten years. Leasehold improvements are amortized over the lives of the respective leases, including any option extensions when expected to exercise or the service lives of the improvements whichever is shorter.

Improvements and major repairs are capitalized, while the cost of ordinary maintenance, repairs and minor improvements is charged to operations.

i) Loan Commitments and Related Financial Instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and stand-by letters of credit, issued to meet customer-financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay.

j) Income Taxes

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts to be recognized for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. Temporary differences are differences between the tax basis of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recorded for deferred tax assets if the Corporation cannot determine that the benefits will more likely than not be realized.

In accordance with FASB ASU 740, “*Accounting for Uncertainty in Income Taxes*”, a tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. There are no such tax positions in the Corporation’s financial statements at December 31, 2017 and 2016.

k) Earnings per Share

Earnings per share (“EPS”) is calculated in accordance with FASB ASC 260-10, “*Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*”. This ASC addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing EPS. Basic earnings per common share is computed by dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS, which reflects the potential dilution that could occur if outstanding stock options and warrants were exercised, is computed by dividing net income attributable to common shareholders including assumed conversions by the weighted average number of common shares and common equivalent shares outstanding during the period.

l) Stock Based Compensation Plans

Stock based compensation awards are recorded in accordance with FASB ASC No. 718, “*Improvements to Employee Share-Based Payment Accounting*” which requires companies to record compensation cost for stock options, restricted stock awards and stock awards granted to employees in return for employee service. The cost is measured at the fair value of the options and awards when granted, and this cost is expensed over the employee service period, which is normally the vesting period of the options and awards.

m) Comprehensive Income

Comprehensive income includes net income and other comprehensive income. Other comprehensive income includes revenues, expenses, gains and losses that under generally accepted accounting principles are included in

comprehensive income but excluded from net income. Comprehensive income and accumulated other comprehensive income are reported net of related income taxes. Accumulated other comprehensive income for the Corporation includes unrealized holding gains or losses on available for sale securities. Such gains or losses are net of reclassification adjustments for realized gains (losses) on sales of available for sale securities.

n) Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

o) New Accounting Standards

The following are new accounting standards that are likely to be broadly applicable to financial institutions.

ASU 2016-09, Compensation- Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

In March 2016, the FASB amended existing guidance to simplify several aspects of the accounting for share-based payment award transactions, including: income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flow and policy election to estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. ASU 2016-09 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016, with early adoption permitted. The Company adopted ASU 2016-09 in the first quarter of 2017. The adoption of ASU 2016-09 did not have a material impact on the Corporation's consolidated financial statements.

ASU 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In February 2018, the FASB amended existing guidance to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act ("Tax Act"). Consequently, the amendments eliminate the stranded tax effects resulting from the Tax Act and will improve the usefulness of information reported to financial statement users. However, because the amendments only relate to the reclassification of the income tax effects of the Tax Act, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. The amendments in this update are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption, including adoption in an interim period, permitted. The Corporation adopted ASU 2018-02 at December 31, 2017 and reclassified \$598 thousand from accumulated other comprehensive income to retained earnings.

p) Impact of Issued but Not Yet Effective Accounting Standards

ASU 2014-09, Revenue from Contracts with Customers (Topic 606)

In May 2014, the FASB amended existing guidance related to revenue from contracts with customers. This amendment supersedes and replaces nearly all existing revenue recognition guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, the amendment specifies the accounting for some costs to obtain or fulfill a contract with a customer. These amendments are effective for public business entities for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that period. The amendments allow for one of two transition methods: full retrospective or modified retrospective. The full retrospective approach requires application to all periods presented. The modified retrospective transition requires application to uncompleted contracts at the date of adoption. Periods prior to the date of adoption are not retrospectively revised, but a cumulative effect is recognized at the date of initial application on uncompleted contracts. While the guidance in ASU 2014-09 supersedes most existing industry-specific revenue recognition accounting guidance, much of the Corporation's revenue comes from financial instruments such as debt securities

and loans, which are scoped-out of the guidance. The Corporation determined its service charges on deposit accounts and fees for other customer services within non-interest income are in scope of the amended guidance. As a result of the Corporation's assessment of revenue recognition, it has determined the recognition, measurement and presentation of services charges on deposit accounts and fees for other customer services will not change. The Corporation has not identified any material differences in the amount and timing of revenue recognition for these revenue streams that are within the scope of ASU 2014-09. The Corporation adopted the guidance in the first quarter of 2018. The Corporation's adoption did not have a material impact on its consolidated financial statements.

Accounting Standards Update ("ASU") 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

In January 2016, the FASB amended existing guidance that requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. It requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. It requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. It eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in ASU 2016-01 for public entities such as the Corporation is effective for interim and annual reporting beginning after December 15, 2017. The Corporation adopted ASU 2016-01 as of effective date at December 15, 2017 and the adoption of this standard did not have a material effect on the Corporation's financial position, results of operations and disclosures.

ASU 2016-02, *Leases (Topic 842)*

In February 2016, the FASB amended existing guidance that requires lessees recognize the following for all leases (with the exception of short-term leases) at the commencement date (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, the lessor accounting model and Topic 606, *Revenue from Contracts with Customers*. ASU 2016-02 is effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Corporation is currently evaluating the impact of ASU 2016-02 on the consolidated financial statements. Based on leases outstanding at December 31, 2017, the Corporation does not expect the updates to have a material impact on the income statement, but does anticipate the adoption of ASU 2016-02 will result in an increase in the Corporation's consolidated balance sheet as a result of recognizing right-of-use assets and lease liabilities.

ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326)*

In June 2016, FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss ("CECL") model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. For debt securities with other-than temporary impairment (OTTI), the guidance will be applied prospectively. For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective. The ASU 2016-13 for public business entities such as the Corporation is effective for interim and annual reporting periods beginning after December 15, 2020. The Corporation has created a cross-functional committee responsible for evaluating the impact of adopting ASU 2016-13, assessing data and system needs, and implementing required changes to loss estimation methods under the CECL model. The Corporation cannot yet determine the overall impact this guidance will have on the Corporation's consolidated financial statements.

ASU 2017-09, Compensation – Stock Compensation (Topic 718) – Scope of Modification Accounting

In May 2017, the FASB provided guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. The current disclosure requirements in Topic 718 apply regardless of whether an entity is required to apply modification accounting under the amendments in ASU 2017-09. The amendments in ASU 2017-09 are effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for reporting periods for which financial statements have not yet been issued. The amendments should be applied prospectively to an award modified on or after the adoption date. The adoption of ASU 2017-09 at January 1, 2018 had no material effect on the Corporation's operating results or financial condition.

q) Subsequent Events

The Corporation has evaluated subsequent events for recognition and disclosure through March 30, 2018, which is the date the financial statements were available to be issued.

2. SECURITIES

The following tables summarize the amortized cost and estimated fair value of available-for-sale and held-to-maturity securities and the corresponding amounts of gross unrealized/unrecognized gains and losses at December 31, 2017 and 2016:

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Available for sale:				
Mortgage-backed securities-residential	\$ 131,704	\$ 186	\$ (2,152)	\$ 129,738
U.S. government agency securities	154,001	-	(2,586)	151,415
U.S. treasury	18,866	-	(50)	18,816
Total available for sale	<u>\$ 304,571</u>	<u>\$ 186</u>	<u>\$ (4,788)</u>	<u>\$ 299,969</u>

	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Estimated Fair Value
	(in thousands)			
Held to maturity:				
Corporate bonds	\$ 4,750	\$ 98	\$ -	\$ 4,848
Total held to maturity	<u>\$ 4,750</u>	<u>\$ 98</u>	<u>\$ -</u>	<u>\$ 4,848</u>

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Available for sale:				
Mortgage-backed securities-residential	\$ 143,496	\$ 95	\$ (4,206)	\$ 139,385
U.S. government agency securities	129,191	-	(3,842)	125,349
U.S. treasury	-	-	-	-
Total available for sale	<u>\$ 272,687</u>	<u>\$ 95</u>	<u>\$ (8,048)</u>	<u>\$ 264,734</u>

	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Estimated Fair Value
	(in thousands)			
Held to maturity:				
Corporate bonds	\$ 3,000	\$ 32	\$ -	\$ 3,032
Total held to maturity	<u>\$ 3,000</u>	<u>\$ 32</u>	<u>\$ -</u>	<u>\$ 3,032</u>

Securities with gross unrealized losses at December 31, 2017 and 2016 aggregated by category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

	December 31, 2017					
	Less than 12 months		Greater than 12 months		Total	
	Gross		Gross		Gross	
Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	
(in thousands)						
Available for sale:						
Mortgage-backed securities-residential	\$ 20,075	\$ (101)	\$ 83,990	\$ (2,051)	\$ 104,065	\$ (2,152)
U.S. government agency securities	97,187	(1,105)	54,228	(1,481)	151,415	(2,586)
U.S. treasury	18,816	(50)	-	-	18,816	(50)
Total available for sale	<u>\$ 136,078</u>	<u>\$ (1,256)</u>	<u>\$ 138,218</u>	<u>\$ (3,532)</u>	<u>\$ 274,296</u>	<u>\$ (4,788)</u>

	December 31, 2016					
	Less than 12 months		Greater than 12 months		Total	
	Gross		Gross		Gross	
Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	
(in thousands)						
Available for sale:						
Mortgage-backed securities-residential	\$ 117,762	\$ (3,661)	\$ 10,774	\$ (545)	\$ 128,536	\$ (4,206)
U.S. government agency securities	125,349	(3,842)	-	-	125,349	(3,842)
U.S. treasury	-	-	-	-	-	-
Total available for sale	<u>\$ 243,111</u>	<u>\$ (7,503)</u>	<u>\$ 10,774</u>	<u>\$ (545)</u>	<u>\$ 253,885</u>	<u>\$ (8,048)</u>

At December 31, 2017, all of the mortgage-backed securities and U.S. government agency securities held by the Corporation were issued by U.S. government-sponsored entities and agencies, primarily Ginnie Mae and Fannie Mae, institutions which the government has affirmed its commitment to support. Because the decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Corporation does not have the intent to sell these mortgage-backed securities and U.S. government agency securities, and it is likely that it will not be required to sell the securities before their anticipated recovery, the Corporation does not consider these securities to be other-than-temporarily impaired at December 31, 2017.

The fair estimated value of debt securities and carrying amount, if different, at December 31, 2017 by contractual maturity were as follows. Securities not due at a single maturity date, solely mortgage-backed securities, are shown separately.

	December 31, 2017	
	Available for Sale	
	Amortized Cost	Estimated Fair Value
(in thousands)		
Due in one year or less	\$ 18,866	\$ 18,816
Due from one to five years	8,996	8,853
Due from five to ten years	145,005	142,562
Due after ten years	-	-
Mortgage-backed securities-residential	131,704	129,738
Total available for sale	<u>\$ 304,571</u>	<u>\$ 299,969</u>

	Held to Maturity	
	Amortized Cost	Estimated Fair Value
	(in thousands)	
Due from five to ten years	\$ 4,750	\$ 4,848
Total held to maturity	<u>\$ 4,750</u>	<u>\$ 4,848</u>

Proceeds from sales and calls of securities available for sale were \$101.3 million and \$247.3 million for the years ended December 31, 2017 and 2016, respectively. There were gross gains of \$37 thousand realized on the sale and call of securities during 2017 as compared to \$406 thousand in 2016. There were gross losses on the sale and call of securities in 2016 and 2015 of \$1.6 million and \$60 thousand, respectively.

At December 31, 2017, investment securities with a carrying value of \$272.8 million were pledged as collateral to secure public and bankruptcy deposits.

3. LOANS

The following table sets forth the major classifications of loans:

	December 31,	
	2017	2016
	(in thousands)	
Commercial real estate-multi family	\$ 195,571	\$ 192,168
Commercial real estate mortgages	155,204	133,432
Commercial and industrial	77,373	87,649
One-to-four family	68,374	59,801
Real estate - construction	14,457	13,540
Home equity lines of credit	6,436	5,068
Lease financing	1,490	2,319
Installment/consumer	635	297
Total	<u>\$ 519,540</u>	<u>\$ 494,274</u>
Allowance	<u>(5,875)</u>	<u>(5,799)</u>
Net loans	<u>\$ 513,665</u>	<u>\$ 488,475</u>

Allowance for Loan Losses

An evaluation of the allowance for loan losses is performed on a quarterly basis. To adequately assess the allowance for loan losses the following quantitative and qualitative factors are considered:

Quantitative factors:

- Delinquency trends of the Corporation;
- Historical loss experience of the Corporation; and
- Results of internal and external loan reviews.

Qualitative factors:

- Allowance levels and trends for peer banks;
- Changes in lending policies, procedures, underwriting criteria, as well as collection, charge-off and recovery practices;
- Changes in international, national, regional, and local economic and business conditions;
- Changes in portfolio nature and volume;
- Changes in the experience, ability, and depth of lending management and related staff;
- Changes in the volume and severity of past due loans, nonaccrual loans, criticized and classified loans;
- Changes in the quality of the Corporation's loan review system;
- Changes in the value of underlying collateral for collateral-dependent loans;

- Existence and effect of any concentrations of credit and changes in the level of each such concentration;
- Effect of other external factors such as competition and legal and regulatory requirements;
- Comparison of the Corporation's performance versus that of its peer group; and
- Delinquency trends for peer banks.

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment methods as of December 31, 2017 and 2016:

2017	Commercial real estate-multi family	Commercial real estate mortgages	Commercial and industrial loans	One-to-four family	Real estate-construction loans	Home equity lines of credit	Lease financing	Installment/consumer loans	Unallocated	Total
	(in thousands)									
Beginning balance	\$ 1,705	\$ 1,373	\$ 2,110	\$ 417	\$ 109	\$ 10	\$ 20	\$ 1	\$ 54	\$ 5,799
Provision for loan losses	(47)	577	38	60	7	6	(7)	10	-	644
Charge-offs	-	-	(633)	-	-	-	-	-	-	(633)
Recoveries	-	-	65	-	-	-	-	-	-	65
Net charge-offs/recoveries	-	-	(568)	-	-	-	-	-	-	(568)
Ending balance	\$ 1,658	\$ 1,950	\$ 1,580	\$ 477	\$ 116	\$ 16	\$ 13	\$ 11	\$ 54	\$ 5,875
Ending balance: individually evaluated for impairment	-	472	79	-	-	-	-	-	-	551
Ending balance: collectively evaluated for impairment	\$ 1,658	\$ 1,478	\$ 1,501	\$ 477	\$ 116	\$ 16	\$ 13	\$ 11	\$ 54	\$ 5,324
Loans	\$ 195,571	\$ 155,204	\$ 77,373	\$ 68,374	\$ 14,457	\$ 6,436	\$ 1,490	\$ 635	\$ -	\$ 519,540
Ending balance: individually evaluated for impairment	-	5,767	2,035	-	-	-	-	-	-	7,802
Ending balance: collectively evaluated for impairment	\$ 195,571	\$ 149,437	\$ 75,338	\$ 68,374	\$ 14,457	\$ 6,436	\$ 1,490	\$ 635	\$ -	\$ 511,738

2016	Commercial real estate-multi family	Commercial real estate mortgages	Commercial and industrial loans	One-to-four family	Real estate-construction loans	Home equity lines of credit	Lease financing	Installment/consumer loans	Unallocated	Total
	(in thousands)									
Beginning balance	\$ 1,852	\$ 1,289	\$ 1,446	\$ 379	\$ 150	\$ 10	\$ 23	\$ 2	\$ 117	\$ 5,268
Provision for loan losses	(147)	74	775	38	(41)	-	(3)	(1)	(63)	632
Charge-offs	-	-	(111)	-	-	-	-	-	-	(111)
Recoveries	-	10	-	-	-	-	-	-	-	10
Net charge-offs/recoveries	-	10	(111)	-	-	-	-	-	-	(101)
Ending balance	\$ 1,705	\$ 1,373	\$ 2,110	\$ 417	\$ 109	\$ 10	\$ 20	\$ 1	\$ 54	\$ 5,799
Ending balance: individually evaluated for impairment	-	-	538	-	-	-	-	-	-	538
Ending balance: collectively evaluated for impairment	\$ 1,705	\$ 1,373	\$ 1,572	\$ 417	\$ 109	\$ 10	\$ 20	\$ 1	\$ 54	\$ 5,261
Loans	\$ 192,168	\$ 133,432	\$ 87,649	\$ 59,801	\$ 13,540	\$ 5,068	\$ 2,319	\$ 297	\$ -	\$ 494,274
Ending balance: individually evaluated for impairment	2,198	854	1,496	-	-	-	-	-	-	4,548
Ending balance: collectively evaluated for impairment	\$ 189,970	\$ 132,578	\$ 86,153	\$ 59,801	\$ 13,540	\$ 5,068	\$ 2,319	\$ 297	\$ -	\$ 489,726

Troubled Debt Restructurings

A restructuring constitutes a troubled debt restructuring when the restructuring includes a concession by the Bank and the borrower is experiencing financial difficulty. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without modification. The Bank performs the evaluation under its internal underwriting policy.

As of December 31, 2017 and 2016, the Corporation had a recorded investment in seven troubled debt restructurings loans totaling \$2.6 million and \$2.5 million, respectively. The Corporation had allocated \$79 thousand and \$38 thousand of specific allowances for those loans at December 31, 2017 and 2016, respectively, and has not committed to lend additional amounts.

In 2017 there were five new relationships in new troubled debt restructuring totaling \$2.4 million. During 2017 one troubled debt restructuring totaling \$8 thousand went in default and was subsequently fully charged off. Additionally another troubled debt restructuring was partially charged off in the amount of \$608 thousand. There were no troubled debt restructurings for which there was a payment default during 2016 that were modified during the twelve-month period prior to default. A loan is typically declared to be in payment default once it is contractually past due and reaches 90 days or it is deemed uncollectable under the modified terms.

To determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's internal underwriting policy.

Past Due and Nonaccrual Loans

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2017 and 2016:

	2017		2016	
	Nonaccrual	Loan Past Due Over 90 Days still Accruing	Nonaccrual	Loan Past Due Over 90 Days still Accruing
	(in thousands)			
Commercial real estate- multi-family	\$ -	\$ -	\$ -	\$ -
Commercial real estate mortgages	5,159	-	854	-
Commercial and industrial	772	-	1,496	-
One-to-four family	-	-	-	-
Real estate - construction	-	-	-	-
Home equity lines of credit	-	-	-	-
Lease financing	-	-	-	-
Installment/consumer	-	-	-	-
Total	<u>\$ 5,931</u>	<u>\$ -</u>	<u>\$ 2,350</u>	<u>\$ -</u>

The following table presents information related to impaired loans by class of loans as of and for the year ended December 31, 2017 and 2016:

December 31, 2017					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
(in thousands)					
With no related allowance recorded:					
Commercial real estate mortgages	\$ 1,385	\$ 1,438	\$ -	\$ 1,455	\$ 38
Commercial and industrial	1,753	2,422	-	2,446	44
Subtotal	<u>3,138</u>	<u>3,860</u>	<u>-</u>	<u>3,901</u>	<u>82</u>
With an allowance recorded:					
Commercial real estate mortgages	4,382	4,400	472	4,323	168
Commercial and industrial	282	551	79	552	-
Subtotal	<u>4,664</u>	<u>4,951</u>	<u>551</u>	<u>4,875</u>	<u>168</u>
Total	<u>\$ 7,802</u>	<u>\$ 8,811</u>	<u>\$ 551</u>	<u>\$ 8,776</u>	<u>\$ 250</u>

December 31, 2016					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
(in thousands)					
With no related allowance recorded:					
Commercial real estate-multi family	\$ 2,198	\$ 2,258	\$ -	\$ 2,278	\$ 160
Commercial real estate mortgages	854	854	-	866	53
Subtotal	<u>3,052</u>	<u>3,112</u>	<u>-</u>	<u>3,144</u>	<u>213</u>
With an allowance recorded:					
Commercial and industrial	1,496	1,732	538	1,873	60
Subtotal	<u>1,496</u>	<u>1,732</u>	<u>538</u>	<u>1,873</u>	<u>60</u>
Total	<u>\$ 4,548</u>	<u>\$ 4,844</u>	<u>\$ 538</u>	<u>\$ 5,017</u>	<u>\$ 273</u>

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by rating the loans based on credit risk. A loan is assigned a risk rating as part of the underwriting process. A risk rating for a loan is reviewed periodically in conjunction with annual credit reviews, external loan review or when one or more events occur such as an event requiring credit approval, changes to an existing credit facility or whenever material favorable or unfavorable information regarding the credit is obtained. The Corporation uses the following definitions for risk ratings:

Pass - Non-criticized and non-classified asset.

Special Mention - A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset, or, in the institutions credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. A special mention loan is not a "classified" asset.

Substandard - A substandard asset is inadequately protected by the current creditworthiness and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful - An asset classified as doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss - An asset classified as loss is considered uncollectible and of such little value that continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

The following tables present risk grades for all loans including classified loans by product class as of December 31, 2017 and 2016. Classified loans included loans in risk categories of Special Mention, Substandard, Doubtful and Loss.

	December 31, 2017				
	Pass	Special Mention	Sub- standard	Doubtful	Loss
	(in thousands)				
Commercial real estate - multi-family	\$ 195,571	\$ -	\$ -	\$ -	\$ -
Commercial real estate mortgages	147,119	1,838	6,247	-	-
Commercial and industrial loans	74,293	745	2,335	-	-
One-to-four family	68,374	-	-	-	-
Real estate - construction loans	14,457	-	-	-	-
Home equity lines of credit	6,436	-	-	-	-
Lease financing	1,490	-	-	-	-
Installment/consumer loans	635	-	-	-	-
	\$ 508,375	\$ 2,583	\$ 8,582	\$ -	\$ -

	December 31, 2016				
	Pass	Special Mention	Sub- standard	Doubtful	Loss
	(in thousands)				
Commercial real estate - multi-family	\$ 189,970	\$ 2,198	\$ -	\$ -	\$ -
Commercial real estate mortgages	128,334	2,403	2,695	-	-
Commercial and industrial loans	82,523	1,926	3,200	-	-
One-to-four family	59,801	-	-	-	-
Real estate - construction loans	13,540	-	-	-	-
Home equity lines of credit	5,068	-	-	-	-
Lease financing	2,319	-	-	-	-
Installment/consumer loans	297	-	-	-	-
	\$ 481,852	\$ 6,527	\$ 5,895	\$ -	\$ -

Related Party Loans

Certain directors and their related parties, including their immediate families and companies in which they are principal owners, were loan customers of the Corporation during 2017. The balances of related party loans for the years ended December 31, 2017 and December 31, 2016 were \$7.0 million and \$7.6 million, respectively. There were no loans to directors or executive officers in nonaccrual, and there were \$3.7 million in unadvanced lines of credit as of December 31, 2017.

Loans to principal officers, directors, and their affiliates during 2017 were as follows:

	2017
	(in thousands)
Beginning Balance:	\$ 7,627
New Loans	1,833
Advances on existing loans	131
Paydowns	(2,618)
Ending Balance	\$ 6,973

4. PREMISES AND EQUIPMENT

Premises and equipment consisted of:

	December 31,	
	2017	2016
	(in thousands)	
Furniture and fixtures	\$ 6,682	\$ 6,516
Leasehold improvements	7,060	7,060
	13,742	13,576
Less: accumulated depreciation and amortization	(8,236)	(7,524)
	<u>\$ 5,506</u>	<u>\$ 6,052</u>

Depreciation and amortization expense was \$1.0 million and \$1.1 million for 2017 and 2016, respectively.

Leases

The Corporation is obligated to make minimum annual rental payments under non-cancelable operating leases on its premises. Projected minimum rentals under existing leases are as follows:

	December 31, 2017	
	(in thousands)	
2018	\$	1,282
2019		1,310
2020		1,311
2021		1,329
2022		1,375
Thereafter		10,670

Certain leases contain renewal options and rent escalation clauses. In addition, certain leases provide for additional payments based upon real estate taxes, interest and other charges. Rental expenses under these leases for the years ended December 31, 2017 and 2016 approximated \$1.2 million and \$1.1 million, respectively. The above chart includes the minimum annual rental payments through lease renewal periods based upon management's intentions to execute the renewal options.

5. DEPOSITS

Time Deposits

The following table sets forth the remaining maturities of the Corporation's time deposits at December 31, 2017:

	Less than \$100,000	\$100,000 or Greater	Total
	(in thousands)		
2018	\$ 5,144	\$ 11,442	\$ 16,586
2019	2,088	2,711	4,799
2020	293	3,478	3,771
2021	102	251	353
2022	28	395	423
	<u>\$ 7,655</u>	<u>\$ 18,277</u>	<u>\$ 25,932</u>

The total amounts of time deposits that met or exceeded the FDIC insurance limit of \$250,000 at December 31, 2017 and 2016 were \$4.7 million and \$6.2 million, respectively.

The total amounts of brokered deposits at December 31, 2017 and 2016 were \$155.6 million and \$108.5 million, respectively. Deposits from principal officers, directors, and their affiliates at year-end 2017 and 2016 were \$13.9 million and \$17.3 million, respectively.

6. SHORT-TERM BORROWINGS

At December 31, 2017, the Corporation had no short-term borrowings compared to \$26.5 million outstanding with the Federal Home Loan Bank (“FHLB”) at December 31, 2016. FHLB advances were collateralized by a blanket lien on commercial mortgages with a lendable value of \$240.9 million at December 31, 2017 and \$232.8 million at December 31, 2016.

During 2017, the Bank maintained an overnight line of credit with the FHLB. The Bank has the ability to borrow against its unencumbered mortgages and investment securities owned by the Bank.

As a member of the Federal Reserve Bank, the Bank may borrow on a collateralized basis at the discount window. There were no borrowings from the discount window at December 31, 2017.

At December 31, 2017, the Bank had aggregate lines of credit of \$40.0 million with unaffiliated correspondent banks to provide short-term credit for liquidity requirements. Of these aggregate lines of credit, \$36.0 million were available on an unsecured basis. As of December 31, 2017, the Bank had no such borrowings outstanding.

7. SUBORDINATED DEBENTURES

In December 2015, the Corporation issued \$15.3 million in aggregate principal amount of fixed and fixed-to-floating rate subordinated debentures (“Notes”). \$7.5 million of the Notes have a stated maturity of December 17, 2025 and bear interest at a fixed annual rate of 7.375% per year, from and including December 17, 2015 up to but excluding December 17, 2025. The fixed rate Notes are subject to redemption beginning on December 17, 2020 at an amount equal to 103% of the principal amount outstanding, plus accrued and unpaid interest, with the redemption premium decreasing by 50 basis points on each subsequent anniversary. The remaining \$7.75 million of the Notes have a stated maturity of December 17, 2025 and bear interest at a rate of 6.50% per year, from and including December 17, 2015 up to but excluding December 20, 2020. From and including December 20, 2020 to the maturity date or early redemption date, the interest rate will reset quarterly to an annual interest rate equal to the then-current three-month LIBOR plus 488 basis points. The fixed-to-floating Notes are subject to redemption beginning on December 17, 2020 at par. The fixed and fixed-to-floating Notes are subject to redemption under certain limited circumstances at par prior to December 17, 2020. The Notes were structured to qualify as Tier 2 capital under Federal Reserve regulations. The Notes are recorded net of unamortized issuance costs of \$472 thousand and \$515 thousand at December 31, 2017 and December 31, 2016, respectively.

8. INCOME TAXES

Income tax expense components were the following:

	For the years ended December 31,	
	2017	2016
	(in thousands)	
Current:		
Federal	\$ 1,393	\$ 1,973
State and local	-	-
Total current	1,393	1,973
Deferred:		
Federal	1,622	(419)
State and local	(966)	(920)
Total deferred	656	(1,339)
Change in valuation allowance	966	920
Total income tax expense	<u>\$ 3,015</u>	<u>\$ 1,554</u>

The Tax Cuts and Jobs Act (“the Act”) was enacted on December 22, 2017. The income tax effects of changes in tax laws are recognized in the period when enacted. The Act provides for numerous significant tax law changes and modifications with varying effective dates, which includes reducing the U.S. federal corporate income tax rate from 34/35% to 21%. In response to the enactment of the Act in late 2017, the U.S. Securities and Exchange Commission issued Staff Accounting Bulletin No. 118 (“SAB 118”) to address situations where the accounting is incomplete for certain income tax effects of the Act upon issuance of an entity’s financial statements for the reporting period in which the Act was enacted. Under SAB 118, a company may record provisional amounts during a measurement period for specific income tax effects of the Act for which the accounting is incomplete but a reasonable estimate can be determined, and when unable to determine a reasonable estimate for any income tax effects, report provisional amounts in the first reporting period in which a reasonable estimate can be determined.

The Corporation has recorded the impact of the tax effects of the Act, relying on reasonable estimates where the accounting is incomplete as of December 31, 2017. As guidance and technical corrections are issued in the upcoming quarters, the Corporation will record updates to its original provisional estimates. The Corporation remeasured its deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. The provisional amount recorded related to the remeasurement of deferred tax balance was a net tax expense of \$1.8 million.

The reconciliation of the expected federal income tax expense at the statutory tax rate to the actual provision follows:

	For the years ended December 31,			
	2017		2016	
	Amount	Percentage of Pre-tax Earnings	Amount	Percentage of Pre-tax Earnings
	(dollars in thousands)			
Federal income tax benefit computed by applying the statutory rate to income before income taxes	\$ 1,517	34.0 %	\$ 1,477	34.0 %
State and local tax, net of federal	(966)	(21.6)	(920)	(21.2)
Corporate tax rate change	1,759	39.4	-	-
Incentive stock options	(235)	(5.3)	13	0.3
Other	(26)	(0.6)	64	1.5
Valuation allowance	966	21.7	920	21.2
Provision for income taxes	<u>\$ 3,015</u>	<u>67.6 %</u>	<u>\$ 1,554</u>	<u>35.8 %</u>

Deferred tax assets and liabilities are comprised of the following:

	For the years ended December 31,	
	2017	2016
	(in thousands)	
Deferred tax assets:		
NYS and NYC net operating loss	\$ 1,754	\$ 927
Allowance for loan losses	1,704	2,298
Net unrealized losses on available for sale securities	966	2,704
Deferred rent expense	567	769
Organizational and start-up costs	258	430
Other	187	237
Stock compensation expense	144	83
Nonaccrual loan interest income	117	104
Depreciation	84	-
Nonqualified stock options	-	240
Total deferred tax assets	<u>5,781</u>	<u>7,792</u>
Deferred tax liabilities:		
Net deferred loan costs	(326)	(499)
Other	(141)	(88)
Depreciation	-	(33)
Total deferred tax liabilities	<u>(467)</u>	<u>(620)</u>
Valuation allowance	(2,536)	(1,570)
Net deferred tax asset	<u>\$ 2,778</u>	<u>\$ 5,602</u>

At December 2017, the Corporation had no federal net operating loss carryforwards. The Corporation had New York State and New York City net operating loss carryforwards of \$17.4 million and \$8.7 million, respectively, which will expire between 2035 to 2037. Deferred tax assets are not recognized for New York State and New York City net operating losses, as the benefit of such losses is not more likely not to be realized.

At December 31, 2017 and December 31, 2016, the Corporation had no unrecognized tax benefits. The Corporation does not expect the amount of unrecognized tax benefits to significantly change within the next twelve months. The Corporation is not currently under Federal or New York State audit. The Corporation is subject to U.S. Federal and New York state income tax. The tax years 2013 through 2017 remain open to examination by the Internal Revenue Services and 2014 through 2017 by New York State.

9. STOCKHOLDERS' EQUITY

The non-voting common stock is mandatorily convertible into voting common stock of the Corporation on a one-for-one basis upon (i) the consummation of the transfer by a holder of non-voting common stock to third parties in a widely dispersed offering or (ii) in the case of an investor whose ownership of the common stock issuable upon a proposed conversion is conditioned upon the execution of passivity commitments in a form acceptable to the Board of Governors of the Federal Reserve System (acting itself or on delegated authority), upon the execution of such passivity commitments. Holders of non-voting common stock have no voting rights, except as required by law.

During 2017, 100,000 shares of voting common stock were exchanged for non-voting common stock.

10. EMPLOYEE BENEFITS

401(K) Plan

The Corporation participates in a contributory retirement and savings plan, which meets the requirements of Section 401(k) of the Internal Revenue Code and covers substantially all current employees. Newly hired employees can elect to participate in the savings plan after completing one year and 1,000 hours of service. Under the provisions of the savings plan, employee contributions are partially matched by the Corporation with cash contributions. Participants can invest their account balances into several investment alternatives. As of December 31, 2017, the savings plan did not allow for investment in the common stock of the Corporation. During the years ended December 31, 2017 and 2016, the Corporation recorded compensation expense related to the plan of approximately \$339 thousand and \$158 thousand, respectively.

Stock Based Compensation

The Corporation maintains the Empire National Bank 2008 Stock Incentive Plan (“2008 Plan”), which authorizes the issuance of an aggregate of 600,000 stock options to such individuals and in such amounts as may be designated by the Board of Directors or its Compensation Committee. This plan provides for the issuance of “incentive stock options” and “nonqualified stock options” to certain qualified individuals. All stock options issued by the Bank prior to the holding company reorganization transaction were assumed by the Corporation as of the effective date of the reorganization. All stock options that have been issued under the plan have a ten-year term and vest at a rate of twenty percent on each of the first five annual anniversary dates from the date of grant. Each option entitles the holder to purchase one share of the Corporation’s common stock at an exercise price not less than fair market value at the time of issuance. Since the effectiveness of the 2015 Plan discussed below, no further awards have been issued under this plan.

In 2015, the Empire Bancorp, Inc. 2015 Omnibus Stock and Incentive Plan (“2015 Plan”) was adopted, effective May 21, 2015 which authorizes the issuance of an aggregate of 303,700 stock options, restricted stock, restricted stock units, stock appreciation rights and other cash and equity-based awards to such individuals and in such amounts as may be designated by the Board of Directors or its Compensation Committee.

Stock Options

A summary of the status of the Corporation’s stock options as of December 31, 2017 follows:

	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Aggregate Intrinsic Value</u> (in thousands)
Outstanding, beginning of year	436,500	\$ 10.00		
Granted	-	-		
Exercised	337,750	10.00		
Forfeited	-	-		
Outstanding, end of year	<u>98,750</u>	\$ 10.00	2.55 years	\$ 481
Exercisable, end of year	98,750	10.00	2.55 years	481
Vested or expected to vest	98,750	10.00	2.55 years	481
	<u>Number of Shares</u>	<u>Price</u>		
Range of exercise prices	98,750	\$ 10.00		

Compensation expense attributable to these options was \$20 thousand and \$37 thousand for the years ended December 31, 2017 and 2016, respectively. As of December 31, 2017, there are no unrecognized compensation costs related to nonvested stock options granted under the Plan.

A summary of activity related to the stock options follows:

	December 31,	
	2017	2016
	(in thousands)	
Intrinsic value of options exercised	\$ 1,645	\$ 16
Cash received from options exercised	64	58
Tax benefit realized from option exercised	1,246	-
Weighted average fair value of options granted	-	-

Restricted Stock Awards

The 2015 Omnibus Plan provides for the issuance of shares to directors and officers. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date. The fair value of the stock was determined using the fair value on the date of the grant. Of the shares granted in 2017, 15,470 shares vest over twelve months, 101,559 vests ratably over five years and 67,796 shares vest ratably over ten years. There were 1,190 shares forfeited in 2017. Of the shares granted in 2016, 37,990 shares vest ratably over five years and 22,742 shares vest over one year. Such shares are subject to restrictions based on continued service as employees of the Corporation or its subsidiaries.

A summary of the status of the Corporation's shares of unvested restricted stock for the year ended December 31, 2017 follows:

	Shares	Weighted Average Grant-Date Fair Value
Unvested, January 1, 2017	60,732	\$ 9.21
Granted	186,015	13.53
Vested	30,340	9.22
Forfeited	1,190	12.60
Unvested, December 31, 2017	<u>215,217</u>	\$ 12.93

Compensation expense attributable to these awards was approximately \$532 thousand and \$245 thousand for the years ended December 31, 2017 and 2016. The total fair value of shares unvested during the year ended December 31, 2017 and December 31, 2016 was \$2.8 million and \$559 thousand respectively. As of December 31, 2017, there was \$2.3 million of total unrecognized compensation costs related to unvested restricted stock awards granted under the Plan. This cost is expected to be recognized over a weighted-average period of 5.5 years. The tax benefit from stock compensation awards were \$292 thousand and \$0 in 2017 and 2016, respectively.

11. WARRANTS

At December 31, 2017, the Corporation had 499,376 warrants issued and outstanding. Of this amount, 312,500 warrants were issued by the Bank at inception to the members of its organizational group in exchange for amounts advanced during the organizational stage. Additionally, 52,500 warrants were issued by the Bank at inception to two vendors in exchange for services rendered in connection with the Bank's organization. The warrants originally issued by the Bank were assumed by the Corporation at the time of the holding company reorganization, and have an exercise price of \$10.00 per share. Through February 24, 2018, the expiration date of the warrants, a total of 205,500 warrants had been exercised. These warrants may be subject to exercise or forfeiture in the event that the Corporation's capital levels have fallen below regulatory minimums (or higher levels as the regulatory agencies may

determine). On December 19, 2014, the Corporation issued a total of 229,376 warrants to certain institutional investors as a part of their respective equity investments in the Corporation made on the same date. These warrants have an exercise price of \$9.00 per share and a term of five years from the grant date. At December 31, 2017 the issued and outstanding warrants have an aggregate intrinsic value of \$2.7 million.

12. EARNINGS PER SHARE

Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”) No. 260-10-45 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (“EPS”). The restricted stock awards and certain restricted stock units granted by the Corporation contain non-forfeitable rights to dividends and therefore are considered participating securities. The two-class method for calculating basic EPS excludes dividends paid to participating securities and any undistributed earnings attributable to participating securities. The following is a reconciliation of earnings per share for December 31, 2017 and 2016.

	For the years ended December 31,	
	2017	2016
	(in thousands, except per share amounts)	
Net income	\$ 1,447	\$ 2,790
Earnings allocated to participating securities	(31)	(23)
Income attributable to common stock	<u>\$ 1,416</u>	<u>\$ 2,767</u>
Weighted average common shares outstanding, including participating securities	7,109,671	6,936,561
Weighted average participating securities	<u>(153,444)</u>	<u>(56,338)</u>
Weighted average common shares outstanding	6,956,227	6,880,223
Basic earnings per share	<u>\$ 0.20</u>	<u>\$ 0.40</u>
Income attributable to common stock	<u>\$ 1,416</u>	<u>\$ 2,767</u>
Weighted average common shares outstanding	6,956,227	6,880,223
Incremental shares from conversions of stock options	91,287	-
Incremental shares from conversion of stock warrants	166,885	19,432
Weighted average common shares outstanding	<u>7,214,399</u>	<u>6,899,655</u>
Diluted earnings per share	<u>\$ 0.20</u>	<u>\$ 0.40</u>

FASB ASC No. 260-10-45 addresses whether instruments granted in share based payment transactions are participating securities prior to vesting and therefore, need to be included in the earnings allocation in computing EPS. The restricted stock awards granted by the Corporation have the same rights as common stockholders and are considered participating securities whereas the Corporation is required to calculate basic and diluted EPS using the two class method. Under the two-class method, net income for the period is allocated between the common stockholders and participating securities according to participation rights in undistributed earnings.

As of the end of the 2017 fiscal year, there were no anti-dilutive stock options or warrants. There are 98,750 options and 499,376 warrants outstanding at December 31, 2017. There were 435,500 options and 664,376 warrants outstanding at December 31, 2016 that were not included in the computation of diluted earnings per share because the exercise prices were greater than the average market price of common stock and were, therefore, antidilutive.

13. OTHER OPERATING EXPENSES

Expenses included in other operating expenses that exceed one percent of the aggregate of total interest income and noninterest income in the years shown are as follows:

	<u>2017</u>	<u>2016</u>
	(in thousands)	
Directors compensation	\$ 536	\$ 531

14. COMMITMENTS, CONTINGENCIES AND OTHER MATTERS

In the normal course of business, the Corporation has various outstanding commitments and contingent liabilities, such as claims and legal actions, minimum annual rental payments under non-cancelable operating leases, guarantees and commitments to extend credit, which are not reflected in Corporation's financial statements. No material losses are anticipated as a result of these actions or claims.

Loan Commitments

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, often including obtaining collateral at exercise of the commitment.

The following represents commitments outstanding:

	<u>December 31,</u>			
	<u>2017</u>		<u>2016</u>	
	<u>Fixed Rate</u>	<u>Variable Rate</u>	<u>Fixed Rate</u>	<u>Variable Rate</u>
	(in thousands)			
Standby letters of credit	\$ 1,035	\$ 1,755	\$ 1,544	\$ 1,755
Unused loan commitments	-	103,740	-	63,424
Commitments to make loans	20,938	1,000	796	17,200
Total commitments outstanding	<u>\$ 21,973</u>	<u>\$ 106,495</u>	<u>\$ 2,340</u>	<u>\$ 82,379</u>

15. ESTIMATED FAIR VALUE MEASUREMENTS

FAS ASC, "Fair Value Measurements and Disclosures," establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used within the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

Assets and liabilities measured at fair value on a recurring basis are summarized below:

Fair Value Measurements at December 31, 2017 using:				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
(in thousands)				
Assets:				
Mortgage-backed securities-residential	\$ -	\$ 129,738	\$ -	\$ 129,738
U.S government agency securities	-	151,415	-	151,415
U.S treasury	-	18,816	-	18,816
Total	\$ -	\$ 299,969	\$ -	\$ 299,969

Fair Value Measurements at December 31, 2016 using:				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
(in thousands)				
Assets:				
Mortgage-backed securities-residential	\$ -	\$ 139,385	\$ -	\$ 139,385
U.S government agency securities	-	125,349	-	125,349
Total	\$ -	\$ 264,734	\$ -	\$ 264,734

At December 31, 2017 and 2016, there were no material impaired loans carried at fair value.

As of December 31, 2017 and 2016, the carrying amounts and estimated fair values of financial instruments, not previously presented, were as follows:

	Level of Fair Value Hierarchy	December 31, 2017	
		Carrying Amount	Fair Value
(in thousands)			
Financial assets:			
Cash and cash equivalents	Level 1	\$ 45,879	\$ 45,879
Securities, held to maturity	Level 2	4,750	4,848
Securities, restricted	Level 1	2,946	N/A
Loans	Level 3	513,665	502,053
Accrued interest receivable:			
Investment securities	Level 2	1,253	1,253
Loans	Level 3	1,680	1,680
Financial liabilities:			
Demand, savings, N.O.W. and money market deposits	Level 1	\$ 786,532	\$ 786,532
Certificates of deposits of \$100,000 or more and other time deposits	Level 2	25,932	25,868
Subordinated debentures	Level 3	14,778	15,362
Accrued interest payable:			
Demand, savings, N.O.W. and money market deposits	Level 1	14	14
Certificates of deposits of \$100,000 or more and other time deposits	Level 2	59	59
Subordinated debentures	Level 3	32	32

	Level of Fair Value Hierarchy	December 31, 2016	
		Carrying Amount	Fair Value
(in thousands)			
Financial assets:			
Cash and cash equivalents	Level 1	\$ 6,354	\$ 6,354
Securities, held to maturity	Level 2	3,000	3,032
Securities, restricted	Level 1	4,131	N/A
Loans	Level 3	488,475	482,906
Accrued interest receivable:			
Investment securities	Level 2	1,018	1,018
Loans	Level 3	1,592	1,592
Financial liabilities:			
Demand, savings, N.O.W. and money market deposits	Level 1	\$ 643,189	\$ 643,189
Certificates of deposits of \$100,000 or more and other time deposits	Level 2	27,494	27,453
Short-term borrowings	Level 1	26,477	26,477
Subordinated debentures	Level 3	14,735	15,342
Accrued interest payable:			
Demand, savings, N.O.W. and money market deposits	Level 1	12	12
Certificates of deposits of \$100,000 or more and other time deposits	Level 2	66	66
Subordinated debentures	Level 3	32	32

The carrying amounts of cash and cash equivalents approximate fair values and are classified as Level 1. It is not practical to determine the fair value of restricted securities due to restrictions placed on its transferability. The fair value of loans is computed by calculating the new present value of estimated future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the remaining maturities and terms, resulting in a Level 3 classification. The fair values disclosed for demand, savings, N.O.W. and money market deposits are, by definition, equal to the amount payable on demand at the reporting date resulting in Level 1 classification. The fair value for certificates of deposit is computed by calculating the net present value of estimated future cash flows, using the current rates at which similar certificates of deposit would be issued to depositors, resulting in a Level 2 classification. The short term borrowings generally maturing within 90 days approximate their fair values resulting in a Level 2 classification. For accrued interest receivable and payable, the recorded book value is a reasonable estimate of fair value and the fair value level follows the underlying contract.

16. REGULATORY MATTERS

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, tier 1, and common equity tier 1 capital to risk weighted assets, and of tier 1 capital to average assets, as those terms are defined in applicable OCC regulations.

Banks are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2017 is 1.25%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2017, the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2017 and December 31, 2016, the Bank was classified as “well capitalized,” for purposes of the OCC’s prompt corrective action regulations. “Well capitalized” is the highest capital classification for FDIC-insured financial institutions in the United States. To be categorized as “well capitalized,” the Bank must maintain minimum total risk-based, tier 1 risk-based, common equity tier 1 risk-based and tier 1 leverage capital ratios as set forth in the table below.

The Bank’s actual capital amounts and ratios are presented in the following table:

As of December 31,

	2017					
	Actual		To be Adequately Capitalized Under Prompt Corrective Action Provisions		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(in thousands)					
Tier 1 leverage capital ratio	\$ 81,293	9.06 %	\$ 35,907	4.00 %	\$ 44,883	5.00 %
Common equity tier 1 risk-based capital ratio	81,293	14.93	24,500	4.50	35,389	6.50
Tier 1 risk-based capital ratio	81,293	14.93	32,667	6.00	43,556	8.00
Total risk-based capital ratio	87,186	16.01	43,556	8.00	54,445	10.00
	2016					
	(in thousands)					
Tier 1 leverage capital ratio	\$ 78,532	10.22 %	\$ 30,745	4.00 %	\$ 38,432	5.00 %
Common equity tier 1 risk-based capital ratio	78,532	16.26	21,733	4.50	31,392	6.50
Tier 1 risk-based capital ratio	78,532	16.26	28,978	6.00	38,637	8.00
Total risk-based capital ratio	84,334	17.46	38,637	8.00	48,296	10.00

17. PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

Condensed parent company only financial information of Empire Bancorp, Inc. is shown below. The parent company has no significant operating activities.

CONDENSED STATEMENTS OF CONDITION

	At December 31,	
	2017	2016
	(in thousands)	
ASSETS		
Cash	\$ 4,730	\$ 4,472
Investment in the Bank	77,657	73,283
Other assets	43	43
Total Assets	\$ 82,430	\$ 77,798
LIABILITIES AND STOCKHOLDERS' EQUITY		
Subordinated debentures, net	\$ 14,778	\$ 14,735
Accrued interest payable	32	32
Other liabilities	35	39
Total Liabilities	14,845	14,806
Total Stockholders' Equity	67,585	62,992
Total Liabilities and Stockholders' Equity	\$ 82,430	\$ 77,798

CONDENSED STATEMENTS OF INCOME

	Year Ended December 31,	
	2017	2016
	(in thousands)	
Interest expense	\$ 1,099	\$ 1,092
Other expense	108	104
Loss before income taxes and equity in undistributed earnings of the Bank	(1,207)	(1,196)
Income tax benefit	410	407
Loss before equity in undistributed earnings of the Bank	(797)	(789)
Equity in undistributed earnings of the Bank	2,244	3,579
Net income	\$ 1,447	\$ 2,790

CONDENSED STATEMENTS OF CASH FLOW

	Year Ended December 31,	
	2017	2016
	(in thousands)	
Operating activities:		
Net income	\$ 1,447	\$ 2,790
Adjustments to reconcile net cash (used by) provided by operating activities:		
Amortization of debt issuance costs	43	38
Equity in undistributed earnings of the Bank	(2,244)	(3,579)
Decrease (increase) in other assets	-	(15)
(Decrease) increase in accrued interest payable	-	(12)
Decrease in other liabilities	(2)	(30)
Net cash used in operating activities	(756)	(808)
Investing activities:		
Investments in the Bank	-	-
Net cash used by investing activities	-	-
Financing activities:		
Proceeds from exercise of warrants	950	58
Proceeds from exercise of stock options	64	-
Net proceeds from issuance of subordinated debentures	-	-
Net cash provided by financing activities	1,014	58
Increase in cash and cash equivalents	258	(750)
Cash and cash equivalents at beginning of period	4,472	5,222
Cash and cash equivalents at end of period	\$ 4,730	\$ 4,472



Crowe Horwath LLP
Independent Member Crowe
Horwath International

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Stockholders
Empire Bancorp, Inc.
Islandia, New York

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Empire Bancorp, Inc., which comprise the consolidated statements of condition as of December 31, 2017 and 2016, and the related consolidated statements of operations, comprehensive (loss) income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Empire Bancorp, Inc. as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Crowe Horwath LLP

Crowe Horwath LLP

New York, New York
March 30, 2018

INVESTOR RELATIONS

Empire Bancorp, Inc. is a registered bank holding company for Empire National Bank. Empire Bancorp, Inc.'s, common stock is listed on the OTCQB marketplace, which is the middle tier of the OTC market, under the symbol "EMPK." Empire National Bank is a Long Island-based independent bank that specializes in serving the financial needs of small and medium-sized businesses, professionals, nonprofit organizations, municipalities, real estate investors, and consumers. The bank has four full-service banking offices located in Islandia, Shirley, Port Jefferson Station and Mineola and a private banking branch office in Manhattan, New York. The bank takes pride in understanding the needs of each and every customer so that it can deliver the highest quality service with a sense of urgency.

Additional copies of Empire Bancorp, Inc.'s Annual Report can be obtained in PDF form from the Bank's website (www.empirenb.com) in the Investor Relations section.

INVESTOR RELATIONS DIRECTOR

William T. Franz, Senior Vice President

Islandia, NY
631-881-5375

LEGAL COUNSEL

Geoffrey Scot Kay

Fenimore, Kay, Harrison & Ford, LLP
Austin, TX

INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS

Crowe Horwath LLP

New York, NY

TRANSFER AGENT

Broadridge Corporate Issuer Solutions, Inc.

Brentwood, NY
877-830-4936

BOARD OF DIRECTORS



Douglas C. Manditch
Chairman of the Board &
Chief Executive Officer
Empire National Bank



Thomas M. Buonaiuto, CPA
President &
Chief Operating Officer
Empire National Bank



John D. Caffrey, Jr.
Organizer & Vice Chairman
of the Board
*Owner, Castle Financial
Advisors, LLC & Castle Asset
Management, LLC*



John P. Bracken, Esq.
Organizer & Director
*Managing Partner, Bracken
Margolin Besunder, LLP, Retired*



Francis F. Boulton
Organizer & Director
*CEO, Long Island Ducks
Professional Baseball Club, LLC*



John L. Ciarelli, Esq.
Organizer & Director
President, John L. Ciarelli P.C.



Dr. Alan M. Coren
Organizer & Director
*President, West Hills Animal
Hospital P.C.*



Larry R. Davis, Esq.
Organizer & Director
Principal, Davis & Prager, P.C.



Frank A. DiFazio
Organizer & Director
President, Dekal Services, Inc.



Robert D. Falese, Jr.
Director
*Owner & President
Falese Investments, LLC*



Salvatore Ferro
Organizer & Director
*Owner, President/CEO, Alure
Home Improvements & Alure
Designs; President & CEO
Fusion Commercial Contracting*



Mukeshkumar Patel
Organizer & Director
*Managing Member PSA Realty
Corp. DBA La Quinta Hotels &
Priya Hospitality LLC*



Charles C. Russo, Esq.
Organizer & Director
*Senior Partner, Russo Karl
Widmaier & Cordano, PLLC*



Joseph S. Tantillo, Jr.
Organizer & Director
*Founder & CEO, Nassau Suffolk
Electrical & Mechanical*



Paul J. Tonna
Organizer & Director
*Molloy College's Executive
Director for the Energeia
Partnership*

*Each director serves on the Boards of Empire National Bank and Empire Bancorp, Inc.

EXECUTIVE TEAM

EMPIRE BANCORP, INC. **EXECUTIVE OFFICERS**

Douglas C. Manditch
Chairman of the Board, Chief Executive Officer & Secretary

John D. Caffrey, Jr.
Vice Chairman of the Board

Thomas M. Buonaiuto, CPA
President, Chief Operating Officer & Assistant Secretary

John Pinna
Vice President

Janet T. Verneuille, CPA
Vice President & Chief Financial Officer

Diane L. Murray, CPA
Assistant Secretary

EMPIRE NATIONAL BANK **EXECUTIVE OFFICERS**

Douglas C. Manditch
Chairman of the Board & Chief Executive Officer

Thomas M. Buonaiuto, CPA
President & Chief Operating Officer

Michael P. Locorriere
Executive Vice President & Director of Municipal Banking

Susanne Pheffer
Executive Vice President, Chief Technology Officer
& Security Officer

John Pinna
Executive Vice President & Chief Information Officer

Janet T. Verneuille, CPA
Executive Vice President & Chief Financial Officer

William T. Franz
Senior Vice President & Director of Marketing
& Investor Relations

Diane L. Murray, CPA
Senior Vice President & Chief Risk Officer

Raffaella Palazzo
Senior Vice President & Co-Chief Credit Officer

Matthew Ruppert
Senior Vice President & Co-Chief Credit Officer

Robert S. Schepis
Senior Vice President & Chief Lending Officer

SENIOR VICE PRESIDENTS

Craig Goldstein
Commercial Loan Officer

William Guiducci
Branch Manager, *Shirley*

Brian Handler
Residential Loan Officer

Adi Hecht
Senior Commercial Loan Officer

Edy Meyer
Branch Manager, *Port Jefferson Station*

Dorothy Overton
Branch Manager, *Islandia*

VICE PRESIDENTS

Philip T. Amico
Senior SBA Commercial Loan Officer

Richard Corrado
Senior Credit Analyst

Frank DeRosa
Commercial Loan Officer

Danielle DiGrazia
Operations Officer

Catherine Giamundo, CPA
Controller

Erik Griemsmann
IT Manager

Steven Post
Electronic Banking Manager

Jane Reid
Human Resources

Jeffrey B. Reid
Commercial Loan Officer

Neil Roberts
Senior Credit Analyst

Marguerite Smith
BSA & Compliance Officer



EXECUTIVE OFFICERS Left to Right: Matthew Ruppert, Raffaella Palazzo, Michael P. Locorriere, William T. Franz, Thomas M. Buonaiuto, Douglas C. Manditch, Janet T. Verneuille, Diane L. Murray, Robert S. Schepis, Susanne Pheffer, John Pinna

ASSISTANT VICE PRESIDENTS

Linda Carman
Electronic Banking

Krista M. Classie
Branch Manager, *Mineola*

Tracey Cullen
Senior Credit Analyst

Jeanne M. Dahl
Assistant Branch Manager, *Port Jefferson Station*

Miranda M. D'Angelis
Assistant Controller

Ana Dezso
Financial Reporting Analyst

Margaret Downing
Assistant Branch Manager, *Shirley*

Gregory Durso
Senior Credit Analyst

Suzanne Fox
Assistant Branch Manager, *Islandia*

Nancy Leonard
Deposit Operations

Yi Lu
Loan Administration

Deborah McCullough
Assistant Branch Manager, *Mineola*

Jessica M. Michalski
Staff Accountant

Janet Weissman
Assistant Branch Manager, *Islandia*

MANAGERS ASSISTANT BRANCH MANAGERS

Dorothy Lamboy
Assistant Branch Manager, *Shirley*

Theresa Naumann
Assistant Branch Manager, *Shirley*

Sueann Rando
Assistant Branch Manager, *Port Jefferson Station*

PRIVATE BANKING

Michael Wilk
Private Banking Officer

BRANCH LOCATIONS



ISLANDIA

Headquarters

1707 Veterans Highway

Islandia, NY 11749

631-348-4444



MINEOLA

170 Old Country Road, Suite 1WA
Mineola, NY 11501

516-741-0444



PORT JEFFERSON STATION

4747 Nesconset Highway, Unit 36
Port Jefferson Station, NY 11776

631-928-4444



SHIRLEY

1044 William Floyd Parkway
Shirley, NY 11967

631-395-9500



MANHATTAN

99 Park Ave, Suite 1510
New York, NY 10016

212-986-4444

SUPPORTING OUR COMMUNITY

We are well aware that a large part of our success is tied to the strength of the local economy. As a community bank, we embrace our position within each community and look to facilitate helping businesses and individuals grow and prosper.

Our commitment to community is in everyone's best interest. We are proud to work with so many important, local organizations.

A Woman Alive	Christmas Magic Inc.	Island Harvest
Accountants Attorneys Networking Group	Clark Gilles Foundation	i-tri
ACIT	Colonial Youth & Family Services Inc.	James V. Kavanaugh Knight of Columbus
AHRC	Community Development Corporation of LI	Jewish Children's Museum
ALS Ride For Life	Community Family Literacy Project	JTM Foundation
American Cancer Society	Community Housing Innovations	Kelly Memorial Charitable Fund
American Heart Association Inc.	Community Mainstreaming Associates	Kings College - Presidential Scholarship Fund
American Kidney Fund	Cooley's Anemia Foundation Inc.	LI Against Domestic Violence Inc.
American Red Cross	Doc Fallot Scholarship Fund	Long Island University Gala
Ancient Order of Hibernians	Ducks Unlimited Inc.	LI Village Clerks & Treasurers Association
Arthritis Foundation - LI Chapter	East End Arts & Humanities Council Inc.	Lions Club of Medford-Patchogue
Ascent Funding Organization	EJ Autism Fund	Long Island Builders Institute
Association for Children with Down Syndrome	The Energeia Partnership	Long Island Business News
Boy Scouts of America	Families in Arms	Long Island Council on Alcoholism
Brookhaven Great South Bay Lions Club	Friends of Chris Barnes	Long Island Ducks
Central Nassau Guidance & Counseling	Girl Scouts of Suffolk County	Long Island Hispanic Chamber of Commerce
Central Islip-Hauppauge Ambulance	Great River Fire Department	Long Island Imagine Awards
Chamber of Commerce of the Mastics	Greenport Harbor Brewing Company	Marcum Workplace Challenge
Chief Petty Officers of Miami Inc.	Holocaust Memorial & Tolerance Center	Mastic Beach Yacht Club
Child Care Council of Suffolk Inc.	Hope House Ministries Inc.	Mastic Fire Department
Children's Medical Fund of NY	Independent Bankers Association of NYS Inc.	
	Interfaith Nutrition Network	

Mercy Haven Inc.	Resurrection	Town of North Hempstead
Middle Country Library Foundation	SCWBEC Treasurer	UCP Suffolk
Miller Place Athletic Booster Club	St. Jude RC Church	United Veterans Beacon House
Miller Place Touchdown Club	St. Charles Hospital Foundation	United Way of Long Island
NABT	St. Louis de Montfort Church	Variety Child Learning Center
Nassau Suffolk Chapter of the Autism	Scope Education Services	Village Community Chest
Nassau County Firefighters Museum & Education Center	Shanti Fund	Village of Islandia Inc.
New Ground Inc.	Shootout for Soldiers	The Ward Melville Heritage Organization
New York Bankers Association	Stony Brook Foundation	WearRedorgoNaked Inc.
Never Alone Never Afraid Inc.	Suffolk Community College Foundation	William Floyd Alumni Association
NYS GFOA	Suffolk County Fire District Officers Association	William Floyd Community Summit
NYSSCPA - Suffolk County Chapter	Suffolk County Village Officials Association	William Floyd High School
Ocean Arts	Suffolk Sports Hall of Fame	William Floyd School District
Our Lady Queen of Apostles	The Crohn's & Colitis Foundation	YMCA of Long Island Inc.
Pal-O-Mine Equestrian Inc.	The Fuoco Memorial Golf Festival	
Port Jefferson Village Charles Dickens Festival	The Leukemia & Lymphoma Society	
Public Library Directors' Association	The Long Island Museum	
Reboli Center for Art & History	The Lustgarten Foundation	
Ronald McDonald House New York	The Richard J. O'Brien Foundation	
Rotary Club of Shirley & The Mastics	Three Village Chamber of Commerce	
Rotary Club of the Ronkonkomas	Theodore Roosevelt Association	



HEADQUARTERS

1707 Veterans Highway

Islandia, NY 11749

631-348-4444

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