

SI Financial Group, Inc.  
Form 10-Q  
August 08, 2016

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

FORM 10-Q  
 QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the Quarterly Period Ended June 30, 2016

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-54241

SI FINANCIAL GROUP, INC.  
(Exact name of registrant as specified in its charter)

Maryland 80-0643149  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

803 Main Street, Willimantic, Connecticut 06226  
(Address of principal executive offices) (Zip Code)

(860) 423-4581  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of August 3, 2016, there were 12,220,680 shares of the registrant's common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## SI FINANCIAL GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts / Unaudited)

|  | June 30,<br>2016 | December 31,<br>2015 |
|--|------------------|----------------------|
| <b>ASSETS:</b>   |                  |                      |
| Cash and due from banks:   |                  |                      |
| Noninterest-bearing  | \$14,069         | \$ 14,373            |
| Interest-bearing   | 60,470           | 26,405               |
| Total cash and cash equivalents  | 74,539           | 40,778               |
| Available for sale securities, at fair value   | 188,133          | 175,132              |
| Loans held for sale  | 5,146            | 1,804                |
| Loans receivable (net of allowance for loan losses of \$10,643 at June 30, 2016 and \$9,863 at December 31, 2015)  | 1,153,748        | 1,165,372            |
| Federal Home Loan Bank stock, at cost  | 12,370           | 12,874               |
| Federal Reserve Bank stock, at cost  | 3,624            | 3,621                |
| Bank-owned life insurance  | 21,000           | 21,924               |
| Premises and equipment, net  | 20,460           | 21,188               |
| Goodwill and other intangibles   | 17,795           | 18,096               |
| Accrued interest receivable  | 4,224            | 4,283                |
| Deferred tax asset, net  | 8,344            | 8,961                |
| Other real estate owned, net   | 1,166            | 1,088                |
| Other assets   | 7,068            | 6,713                |
| Total assets   | \$1,517,617      | \$ 1,481,834         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>   |                  |                      |
| Liabilities:   |                  |                      |
| Deposits:  |                  |                      |
| Noninterest-bearing  | \$169,765        | \$ 163,893           |
| Interest-bearing   | 947,067          | 894,124              |
| Total deposits   | 1,116,832        | 1,058,017            |
| Mortgagors' and investors' escrow accounts   | 4,135            | 3,508                |
| Federal Home Loan Bank advances  | 207,914          | 234,595              |
| Junior subordinated debt owed to unconsolidated trust  | 8,248            | 8,248                |
| Accrued expenses and other liabilities   | 21,673           | 23,136               |
| Total liabilities  | 1,358,802        | 1,327,504            |
| Shareholders' Equity:  |                  |                      |
| Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)  | —                | —                    |
| Common stock (\$.01 par value; 35,000,000 shares authorized; 12,220,680 and 12,218,818 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively) | 122              | 122                  |
| Additional paid-in-capital   | 125,306          | 124,997              |
| Unallocated common shares held by ESOP   | (3,408           | ) (3,648             |
| Unearned restricted shares   | (559             | ) (815               |
| Retained earnings  | 36,188           | 33,864               |

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|   |             |             |   |
|---|-------------|-------------|---|
| Accumulated other comprehensive income (loss) | 1,166       | (190        | ) |
| Total shareholders' equity                    | 158,815     | 154,330     |   |
| Total liabilities and shareholders' equity    | \$1,517,617 | \$1,481,834 |   |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(In Thousands, Except Per Share Amounts / Unaudited)

|   | Three Months<br>Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---|-----------------------------------|----------|------------------------------|----------|
|   | 2016                              | 2015     | 2016                         | 2015     |
| Interest and dividend income:                                 |                                   |          |                              |          |
| Loans, including fees   | \$11,506                          | \$10,931 | \$23,077                     | \$21,545 |
| Securities:   |                                   |          |                              |          |
| Taxable interest  | 907                               | 690      | 1,746                        | 1,450    |
| Tax-exempt interest   | 14                                | 54       | 28                           | 86       |
| Dividends   | 171                               | 96       | 333                          | 141      |
| Other   | 77                                | 19       | 133                          | 38       |
| Total interest and dividend income                            | 12,675                            | 11,790   | 25,317                       | 23,260   |
| Interest expense:   |                                   |          |                              |          |
| Deposits  | 1,655                             | 1,379    | 3,204                        | 2,747    |
| Federal Home Loan Bank advances                               | 816                               | 682      | 1,690                        | 1,278    |
| Subordinated debt and other borrowings                        | 48                                | 84       | 93                           | 167      |
| Total interest expense  | 2,519                             | 2,145    | 4,987                        | 4,192    |
| Net interest income   | 10,156                            | 9,645    | 20,330                       | 19,068   |
| Provision for loan losses                                     | 582                               | 360      | 893                          | 695      |
| Net interest income after provision for loan losses           | 9,574                             | 9,285    | 19,437                       | 18,373   |
| Noninterest income:   |                                   |          |                              |          |
| Service fees  | 1,569                             | 1,692    | 3,213                        | 3,340    |
| Wealth management fees  | 302                               | 315      | 601                          | 613      |
| Increase in cash surrender value of bank-owned life insurance | 136                               | 142      | 277                          | 303      |
| Net gain on sales of securities                               | —                                 | 132      | —                            | 132      |
| Mortgage banking  | 399                               | 130      | 669                          | 277      |
| Net gain (loss) on fair value of derivatives                  | 16                                | (10)     | 15                           | (15)     |
| Net loss on disposal of equipment                             | (35)                              | (14)     | (36)                         | (20)     |
| Other   | 199                               | 223      | 549                          | 317      |
| Total noninterest income                                      | 2,586                             | 2,610    | 5,288                        | 4,947    |
| Noninterest expenses:   |                                   |          |                              |          |
| Salaries and employee benefits                                | 4,643                             | 5,129    | 9,821                        | 10,073   |
| Occupancy and equipment                                       | 1,703                             | 1,791    | 3,446                        | 3,844    |
| Computer and electronic banking services                      | 1,476                             | 1,458    | 2,944                        | 2,755    |
| Outside professional services                                 | 379                               | 508      | 1,014                        | 974      |
| Marketing and advertising                                     | 238                               | 274      | 451                          | 520      |
| Supplies  | 121                               | 144      | 289                          | 292      |
| FDIC deposit insurance and regulatory assessments             | 253                               | 248      | 525                          | 493      |
| Core deposit intangible amortization                          | 150                               | 151      | 301                          | 301      |
| Other real estate owned operations                            | 69                                | 202      | 125                          | 284      |

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|                                    |         |         |         |         |
|------------------------------------|---------|---------|---------|---------|
| Other                              | 548     | 501     | 930     | 931     |
| Total noninterest expenses         | 9,580   | 10,406  | 19,846  | 20,467  |
| Income before income tax provision | 2,580   | 1,489   | 4,879   | 2,853   |
| Income tax provision               | 852     | 484     | 1,610   | 927     |
| Net income                         | \$1,728 | \$1,005 | \$3,269 | \$1,926 |
| Earnings per share:                |         |         |         |         |
| Basic                              | \$0.15  | \$0.08  | \$0.28  | \$0.16  |
| Diluted                            | \$0.15  | \$0.08  | \$0.28  | \$0.16  |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (In Thousands / Unaudited)

|  | Three Months   |         | Six Months     |         |
|--|----------------|---------|----------------|---------|
|  | Ended June 30, |         | Ended June 30, |         |
|  | 2016           | 2015    | 2016           | 2015    |
| Net income   | \$1,728        | \$1,005 | \$3,269        | \$1,926 |
| Other comprehensive income, net of tax:                                |                |         |                |         |
| Available for sale securities:   |                |         |                |         |
| Net unrealized holding gains (losses)                                  |                | (480 )  | 1,356          | 222     |
| Reclassification adjustment for gains recognized in net income (1)     | (87 )          |         |                | (87 )   |
| Net unrealized holding gains (losses) on available for sale securities |                | (567 )  | 1,356          | 135     |
| Net unrealized gain on interest-rate swap                              | 27             |         |                | 52      |

|               |         |       |         |         |
|---------------|---------|-------|---------|---------|
| derivative    |         |       |         |         |
| Other         |         |       |         |         |
| comprehensive | 310     | (540) | 1,356   | 187     |
| income        |         |       |         |         |
| (loss)        |         |       |         |         |
| Comprehensive | \$2,038 | \$465 | \$4,625 | \$2,113 |
| income        |         |       |         |         |

(1) Amounts are included in net gain on sales of securities in noninterest income on the consolidated statements of income. Income tax provision associated with the reclassification adjustment for both the three and six months ended June 30, 2016 was zero and for both the three and six months ended June 30, 2015 was \$45,000.

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE SIX MONTHS ENDED JUNE 30, 2016  
(In Thousands, Except Share Data / Unaudited)

|  | Common Stock |         | Unallocated                |                            | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |                            |
|--|--------------|---------|----------------------------|----------------------------|-------------------|---|----------------------------|----------------------------|
|  | Shares       | Dollars | Additional Paid-in Capital | Common Shares Held by ESOP |                   |   |                            | Unearned Restricted Shares |
| Balance at December 31, 2015               | 12,218,818   | \$ 122  | \$ 124,997                 | \$ (3,648 )                | \$ (815 )         | \$ 33,864                                     | \$ (190 )                  | \$ 154,330                 |
| Comprehensive income                       | —            | —       | —                          | —                          | —                 | 3,269   | 1,356                      | 4,625                      |
| Cash dividends declared (\$0.08 per share) | —            | —       | —                          | —                          | —                 | (945 )  | —                          | (945 )                     |
| Equity incentive plans compensation        | —            | —       | 205                        | —                          | 256               | —   | —                          | 461                        |
| Allocation of 24,318 ESOP shares           | —            | —       | 96                         | 240                        | —                 | —   | —                          | 336                        |
| Tax benefit from share-based compensation  | —            | —       | 8                          | —                          | —                 | —   | —                          | 8                          |
| Stock options exercised                    | 5,092        | —       | 37                         | —                          | —                 | —   | —                          | 37                         |
| Common shares repurchased                  | (3,230 )     | —       | (37 )                      | —                          | —                 | —   | —                          | (37 )                      |
| Balance at June 30, 2016                   | 12,220,680   | \$ 122  | \$ 125,306                 | \$ (3,408 )                | \$ (559 )         | \$ 36,188                                     | \$ 1,166                   | \$ 158,815                 |

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In Thousands / Unaudited)

|   | Six Months<br>Ended<br>June 30, |          |
|---|---------------------------------|----------|
|   | 2016                            | 2015     |
| Cash flows from operating activities:   |                                 |          |
| Net income  | \$3,269                         | \$1,926  |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                                 |          |
| Provision for loan losses   | 893                             | 695      |
| Employee stock ownership plan expense   | 336                             | 283      |
| Equity incentive plan expense   | 461                             | 352      |
| Excess tax benefit from share-based compensation                                      | (8 )                            | (5 )     |
| Amortization of investment premiums and discounts, net                                | 384                             | 586      |
| Amortization of loan premiums and discounts, net                                      | 736                             | 938      |
| Depreciation and amortization of premises and equipment                               | 1,234                           | 1,372    |
| Amortization of core deposit intangible   | 301                             | 301      |
| Amortization of deferred debt issue costs   | —                               | 13       |
| Net gain on sales of securities   | —                               | (132 )   |
| Net (gain) loss on fair value of derivatives  | (15 )                           | 15       |
| Deferred income tax (benefit) provision   | (81 )                           | 89       |
| Loans originated for sale   | (19,198)                        | (14,134) |
| Proceeds from sale of loans held for sale   | 16,073                          | 13,729   |
| Net gain on sales of loans held for sale  | (532 )                          | (156 )   |
| Net loss on disposal of equipment   | 36                              | 20       |
| Net loss on sales or write-downs of other real estate owned                           | 2                               | 122      |
| Increase in cash surrender value of bank-owned life insurance                         | (277 )                          | (303 )   |
| Change in operating assets and liabilities:   |                                 |          |
| Accrued interest receivable   | 59                              | (180 )   |
| Other assets  | (40 )                           | 568      |
| Accrued expenses and other liabilities  | (1,440 )                        | 347      |
| Net cash provided by operating activities   | 2,193                           | 6,446    |
| Cash flows from investing activities:   |                                 |          |
| Purchases of available for sale securities  | (24,401)                        | (22,407) |
| Proceeds from sales of available for sale securities                                  | —                               | 9,703    |
| Proceeds from maturities of and principal repayments on available for sale securities | 13,070                          | 14,693   |
| Purchases of Federal Home Loan Bank stock   | —                               | (629 )   |
| Purchases of Federal Reserve Bank stock   | (3 )                            | (3,621 ) |
| Redemption of Federal Home Loan Bank stock  | 504                             | —        |
| Loan principal collections (originations), net  | 21,503                          | 9,366    |
| Purchases of loans  | (11,858)                        | (67,240) |
| Proceeds from sales of other real estate owned  | 270                             | 62       |
| Purchases of premises and equipment   | (542 )                          | (1,791 ) |
| Proceeds from bank-owned life insurance   | 1,201                           | —        |
| Net cash used in investing activities   | (256 )                          | (61,864) |



SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Concluded)  
(In Thousands / Unaudited)

|  | Six Months Ended<br>June 30, |           |
|--|------------------------------|-----------|
|  | 2016                         | 2015      |
| Cash flows from financing activities:                      |                              |           |
| Net increase in deposits                                   | 58,815                       | 19,415    |
| Net increase in mortgagors' and investors' escrow accounts | 627                          | 300       |
| Proceeds from Federal Home Loan Bank advances              | 3,000                        | 78,478    |
| Repayments of Federal Home Loan Bank advances              | (29,681 )                    | (34,575 ) |
| Excess tax benefit from share-based compensation           | 8                            | 5         |
| Cash dividends on common stock                             | (945 )                       | (973 )    |
| Stock options exercised                                    | 37                           | 703       |
| Common shares repurchased                                  | (37 )                        | (7,601 )  |
| Net cash provided by financing activities                  | 31,824                       | 55,752    |
| <br>   |                              |           |
| Net change in cash and cash equivalents                    | 33,761                       | 334       |
| Cash and cash equivalents at beginning of period           | 40,778                       | 39,251    |
| Cash and cash equivalents at end of period                 | \$74,539                     | \$39,585  |
| Supplemental cash flow information:                        |                              |           |
| Interest paid  | \$5,015                      | \$4,199   |
| Income taxes paid, net                                     | 1,450                        | 470       |
| Transfer of loans to other real estate owned               | 350                          | 385       |
| Stock options exercised by net-share settlement            | —                            | 2,563     |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

NOTE 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

SI Financial Group, Inc. (the "Company") is the holding company for Savings Institute Bank and Trust Company (the "Bank"). Established in 1842, the Bank is a community-oriented financial institution headquartered in Willimantic, Connecticut. The Bank provides a variety of financial services to individuals, businesses and municipalities through its 25 offices in eastern Connecticut and Rhode Island. Its primary products include savings, checking and certificate of deposit accounts, residential and commercial mortgage loans, commercial business loans and consumer loans. In addition, wealth management services, which include trust, financial planning, life insurance and investment services, are offered to individuals and businesses through the Bank's offices. The Company does not conduct any material business other than owning all of the stock of the Bank and making payments on the subordinated debentures held by the Company.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank, and the Bank's wholly-owned subsidiaries, SI Mortgage Company and SI Realty Company, Inc. All significant intercompany accounts and transactions have been eliminated.

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information, the instructions to Form 10-Q and Rule 10.01 of Regulation S-X of the Securities and Exchange Commission ("SEC") and general practices within the banking industry. Accordingly, certain information and footnote disclosures required by GAAP for complete financial statements have been omitted. Information in the accompanying interim consolidated financial statements and notes to the financial statements of the Company as of June 30, 2016 and for the three and six months ended June 30, 2016 and 2015 is unaudited. These unaudited interim consolidated financial statements and related notes should be read in conjunction with the audited financial statements of the Company and the accompanying notes for the year ended December 31, 2015 contained in the Company's Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the periods covered herein. The results of operations for the three and six months ended June 30, 2016 are not necessarily indicative of the operating results for the year ending December 31, 2016 or for any other period.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities, as of the date of the balance sheets and reported amounts of revenues and expenses for the periods presented. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred income taxes and the impairment of long-lived assets.

Reclassifications

Amounts in the Company's prior year consolidated financial statements are reclassified to conform to the current year presentation. Such reclassifications have no effect on net income.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

Loans Receivable

Loans receivable are stated at current unpaid principal balances, net of the allowance for loan losses and deferred loan origination fees and costs. Management has the ability and intent to hold its loans receivable for the foreseeable future or until maturity or pay-off.

A loan is impaired when, based on current information and events, it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan by loan basis for residential and commercial mortgage loans and commercial business loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not typically identify individual consumer loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring ("TDR") agreement.

Troubled Debt Restructurings

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and concessions have been made to the original contractual terms that would not otherwise be considered for a borrower with similar risk characteristics, such as reductions of interest rates, deferral of interest or principal payments, or maturity extensions due to the borrower's financial condition, the modification is considered a TDR. Modified terms are dependent upon the financial position and needs of the individual borrower. If the modification agreement is violated, the loan is handled by the Company's Collections Department for resolution, which may result in foreclosure.

Management considers all nonaccrual loans, with the exception of certain consumer loans, to be impaired. Also, all TDRs are initially classified as impaired and follow the Company's nonaccrual policy. If the loan was current prior to modification, nonaccrual status would not be required. If the loan was on nonaccrual prior to modification or if the payment amount significantly increases, the loan will remain on nonaccrual for a period of at least six months. Loans qualify for return to accrual status once the borrower has demonstrated the willingness and the ability to perform in accordance with the restructured terms of the loan agreement for a period of not less than six consecutive months. In most cases, loan payments less than 90 days past due are considered minor collection delays and the related loans are generally not considered impaired.

Impaired classification may be removed after a year following the restructure if the borrower demonstrates compliance with the modified terms and the restructuring agreement specifies an interest rate equal to that which would be provided to a borrower with similar risk characteristics at the time of restructuring.

Allowance for Loan Losses

The allowance for loan losses, a material estimate which could change significantly in the near-term, is established through a provision for loan losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Loan losses are charged against the allowance for loan losses when management believes the uncollectibility of the principal loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance

for loan losses when received. In the determination of the allowance for loan losses, management may obtain independent appraisals for significant properties, when necessary.

Management's judgment in determining the adequacy of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is evaluated on a monthly basis by management and is based on the evaluation of the known and

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

inherent risk characteristics and size and composition of the loan portfolio, the assessment of current economic and real estate market conditions, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, historical loan loss experience, the level and trends of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.

The allowance for loan losses consists of the following key elements:

**Specific allowance for identified impaired loans.** For loans identified as impaired, an allowance is established when the present value of expected cash flows (or observable market price of the loan or fair value of the collateral if the loan is collateral dependent) of the impaired loan is lower than the carrying value of that loan.

**General valuation allowance.** The general component represents a valuation allowance on the remainder of the loan portfolio, after excluding impaired loans. For this portion of the allowance, loans are segregated by category and assigned an allowance percentage based on historical loan loss experience adjusted for qualitative factors stratified by the following loan segments: residential one- to four-family, multi-family and commercial real estate, construction, commercial business and consumer. Management uses a rolling average of historical losses based on the time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices; changes in international, national, regional and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments; changes in the size and composition of the loan portfolio and in the terms of the loans; changes in the experience, ability and depth of lending management and other relevant staff; changes in the volume and severity of past due loans, the amount of nonaccrual loans and the amount and severity of adversely classified or graded loans; changes in the quality of the loan review system; changes in the underlying collateral for collateral-dependent loans; the existence and effect of any concentrations of credit and changes in the level of such concentrations; the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the portfolio.

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

**Residential – One- to Four-Family –** The Bank primarily originates conventional loans with loan-to-value ratios less than 95% and generally originates loans with loan-to-value ratios in excess of 80% only when secured by first liens on owner-occupied one- to four-family residences. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance or additional collateral. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality of this segment.

**Multi-family and Commercial –** Loans in this segment are originated to acquire, develop, improve or refinance multi-family and commercial real estate where the property is the primary collateral securing the loan, and the income generated from the property is the primary repayment source. The underlying cash flows generated by the properties can be impacted by the economy as evidenced by increased vacancy rates. Payments on loans secured by

income-producing properties often depend on the successful operation and management of the properties. Management continually monitors the cash flows of these loans.

• Construction – This segment includes loans to individuals and, to a lesser extent, builders to finance the construction of residential dwellings. The Bank also originates construction loans for commercial

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development projects. Upon the completion of construction, the loan generally converts to a permanent mortgage loan. Credit risk is affected by cost overruns, correct estimates of the sale price of the property, time to sell at an adequate price and market conditions.

Commercial Business – Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. The Bank provides loans to investors in the time share industry, which are secured by consumer receivables, and provides loans for capital improvements to condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners. Additionally, the Bank purchases medical loans primarily out of our market area from a company specializing in medical loan originations, which are secured by medical equipment.

Consumer – Loans in this segment primarily include home equity lines of credit (representing both first and second liens), indirect automobile loans and, to a lesser extent, loans secured by marketable securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

In computing the allowance for loan losses, we do not assign a general valuation allowance to the Small Business Administration ("SBA") and United States Department of Agriculture ("USDA") loans that we purchase as such loans are fully guaranteed. These loans are included in commercial business loans. See Note 4 for details.

The majority of the Company's loans are collateralized by real estate located in eastern Connecticut and Rhode Island. To a lesser extent, certain commercial real estate loans are secured by collateral located outside of our primary market area with concentrations in Massachusetts and New Hampshire. Accordingly, the collateral value of a substantial portion of the Company's loan portfolio and real estate acquired through foreclosure is susceptible to changes in local market conditions.

Although management believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and the Company's results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making the determinations. Furthermore, while management believes it has established the allowance for loan losses in conformity with GAAP, our regulators, in reviewing the loan portfolio, may request us to increase our allowance for loan losses based on judgments different from ours. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, the existing allowance for loan losses may not be adequate or increases may be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.

**Interest and Fees on Loans**

Interest on loans is accrued and included in net interest income based on contractual rates applied to principal amounts outstanding. Accrual of interest is discontinued when loan payments are 90 days or more past due, based on contractual terms, or when, in the judgment of management, collectibility of the loan or loan interest becomes uncertain. Subsequent recognition of income occurs only to the extent payment is received subject to management's

assessment of the collectibility of the remaining interest and principal. A nonaccrual loan is restored to accrual status when it is no longer delinquent and collectibility of interest and principal is no longer in doubt and the borrower has made regular payments in accordance with the terms of the loan over a period of at least six months. Interest collected on nonaccrual loans is recognized only to the extent cash payments are

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received, and may be recorded as a reduction to principal if the collectibility of the principal balance of the loan is unlikely.

Loan origination fees, direct loan origination costs and loan purchase premiums are deferred, and the net amount is recognized as an adjustment of the related loan's yield utilizing the interest method over the contractual life of the loan. In addition, discounts related to fair value adjustments for loans receivable acquired in a business combination or asset purchase are accreted into earnings over the contractual term as an adjustment of the loan's yield. The Company periodically evaluates the cash flows expected to be collected for loans acquired with deteriorated credit quality. Changes in the expected cash flows compared to the expected cash flows as of the date of acquisition may impact the accretable yield or result in a charge to the provision for loan losses to the extent of a shortfall.

Common Share Repurchases

The Company is chartered in the state of Maryland. Maryland law does not provide for treasury shares, rather shares repurchased by the Company constitute authorized but unissued shares. GAAP states that accounting for treasury stock shall conform to state law. Therefore, the cost of shares repurchased by the Company is allocated to common stock, additional paid-in capital and retained earnings balances.

Recent Accounting Pronouncements

Revenue from Contracts with Customers (Topic 606) - In May 2014, the Financial Accounting Standards Board ("FASB") issued guidance that improves the revenue recognition requirements for contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve the core principle, a company should apply a five step approach to revenue recognition. In August 2015, the FASB delayed the effective date for this guidance for one year to fiscal years beginning after December 15, 2017, and we do not expect this to have a material impact on our financial statements.

Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs - In April 2015, FASB issued guidance simplifying the presentation of debt issuance costs. The amended guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The amended guidance should be applied on a retrospective basis and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. The adoption of the amended guidance on January 1, 2016 did not have a material impact on the Company's consolidated financial statements.

Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - In August 2015, the FASB issued amended guidance pursuant to the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting that the update issued in April 2015 does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within the previous update for debt issuance costs related to line-of-credit-arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there were any outstanding borrowings on the line-of-credit arrangement. The adoption of the amended guidance on January 1, 2016 did not have a material impact on the Company's consolidated

financial statements.

Financial Instruments (Subtopic 825-10): In January 2016, the FASB issued guidance addressing certain aspects of recognition, measurement, presentation and disclosure of financial instruments. Targeted improvements to generally accepted accounting principles include the requirement for equity investments (except those accounted

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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 and the elimination of the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost. The amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

**Leases (Topic 842):** In February 2016, the FASB issued amended guidance to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is still reviewing the impact the adoption of this guidance will have on its consolidated financial statements.

**Compensation - Stock Compensation (Topic 718):** In March 2016, the FASB issued guidance to simplify the accounting for share-based payment transactions, including the income tax consequences of such transactions. Under the provisions of the update, the income tax consequences of excess tax benefits and deficiencies should be recognized in income tax expense in the reporting period in which the awards vest. Currently, excess tax benefits or deficiencies impact shareholders' equity directly to the extent there is a cumulative excess tax benefit. In the event that a tax deficiency has occurred during the reporting period and a cumulative tax benefit does not exist, the tax deficiency is recognized in income tax expense under current GAAP. The update also provides entities may continue to estimate forfeitures in accounting for stock based compensation or recognize them as they occur. The provisions of this update become effective for interim and annual periods beginning after December 15, 2016. The update requires a modified retrospective transition under which cumulative effect to equity will be recognized in the period of adoption. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

**Financial Instruments - Credit Losses (Topic 326):** In June 2016, the FASB issued guidance that significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. The update will replace today's "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to (1) financial assets subject to credit losses and measured at amortized cost and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The CECL model does not apply to available for sale ("AFS") debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to current accounting guidance, except that losses will be recognized as allowances rather than reductions in the amortized cost of the securities. The update also simplifies the

accounting model for purchased credit-impaired debt securities and loans. Disclosure requirements under the update have been expanded to include the entity's assumptions, models and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by year of origination. The update is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted for interim and annual periods beginning after December 15, 2018. The update

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requires a modified retrospective transition under which a cumulative effect to equity will be recognized in the period of adoption. The Company is currently evaluating the impact the adoption of this guidance will have on its consolidated financial statements.

## NOTE 2. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the net income available to common shareholders by the weighted average number of common shares outstanding during the period. Unvested restricted shares are considered outstanding in the computation of basic earnings per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings per share is computed in a manner similar to basic earnings per share except that the weighted average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's common stock equivalents relate solely to stock options. Repurchased common shares and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings per share calculations.

Anti-dilutive shares are common stock equivalents with weighted average exercise prices in excess of the weighted average market value for the periods presented, and are not considered in diluted earnings per share calculations. The Company had anti-dilutive common shares outstanding of 157,391 and 151,391 for the three and six months ended June 30, 2016, respectively, and 333,728 and 353,332 for the three and six months ended June 30, 2015, respectively.

The computation of earnings per share is as follows:

|   | Three Months<br>Ended<br>June 30,                   |            | Six Months Ended<br>June 30, |            |
|---|---|------------|------------------------------|------------|
|   | 2016  | 2015       | 2016                         | 2015       |
|   | (Dollars in Thousands, Except Per<br>Share Amounts) |            |                              |            |
| Net income                                  | \$1,728   | \$ 1,005   | \$3,269                      | \$ 1,926   |
| Weighted average common shares outstanding: |   |            |                              |            |
| Basic                                       | 11,803,156  | 10,006,510 | 11,796,092                   | 10,160,268 |
| Effect of dilutive stock options            | 58,813  | 25,103     | 59,386                       | 31,872     |
| Diluted                                     | 11,861,969  | 10,031,613 | 11,855,478                   | 10,192,140 |
| Earnings per share:                         |   |            |                              |            |
| Basic                                       | \$0.15  | \$ 0.08    | \$0.28                       | \$ 0.16    |
| Diluted                                     | \$0.15  | \$ 0.08    | \$0.28                       | \$ 0.16    |



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## NOTE 3. SECURITIES

## Available for Sale Securities

The amortized cost, gross unrealized gains and losses and fair values of available for sale securities at June 30, 2016 and December 31, 2015 are as follows:

June 30, 2016

| Amortized<br>Cost                          | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|------------------------------|-------------------------------|---------------|
| (In Thousands)                             |                              |                               |               |
| Debt securities:                           |                              |                               |               |
| U.S.                                       |                              |                               |               |
| Government                                 |                              |                               |               |
| \$71,893                                   | \$ 678                       | \$ (552 )                     | \$72,019      |
| agency obligations                         |                              |                               |               |
| 22,276                                     | 420                          | —                             | 22,696        |
| Government-sponsored enterprises           |                              |                               |               |
| Mortgage-backed securities: <sup>(1)</sup> |                              |                               |               |
| Agency                                     |                              |                               |               |
| - 85,775                                   | 1,275                        | (137 )                        | 86,913        |
| residential                                |                              |                               |               |
| Non-agency                                 |                              |                               |               |
| - 106                                      | —                            | (5 )                          | 101           |
| residential                                |                              |                               |               |
| Corporate                                  |                              |                               |               |
| 1,000                                      | —                            | —                             | 1,000         |
| securities                                 |                              |                               |               |
| Collateralized                             |                              |                               |               |
| 157  | —                            | (27 )                         | 1,130         |
| obligation                                 |                              |                               |               |
| Obligations                                |                              |                               |               |
| of   |                              |                               |               |
| state                                      |                              |                               |               |
| 1,000                                      | —                            | —                             | 1,000         |
| and  |                              |                               |               |
| political                                  |                              |                               |               |
| subdivisions                               |                              |                               |               |
| Tax-exempt                                 |                              |                               |               |
| 3,160                                      | 114                          | —                             | 3,274         |
| securities                                 |                              |                               |               |
| \$186,367                                  | \$ 2,487                     | \$ (721 )                     | \$188,133     |
| Total available                            |                              |                               |               |

for  
sale  
securities

(1) Agency securities refer to debt obligations issued or guaranteed by government corporations or government-sponsored enterprises (“GSEs”). Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

December 31, 2015

| Amortized<br>Cost                               | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|------------------------------|-------------------------------|---------------|
| (In Thousands)                                  |                              |                               |               |
| Debt securities:                                |                              |                               |               |
| U.S. Government securities:                     |                              |                               |               |
| \$71,142  | \$ 242                       | \$ (388 )                     | \$70,996      |
| agency obligations                              |                              |                               |               |
| 25,313  | 95                           | (5 )                          | 25,403        |
| Government-sponsored enterprises                |                              |                               |               |
| Mortgage-backed securities: <sup>(1)</sup>      |                              |                               |               |
| Agency residential                              |                              |                               |               |
| - 72,248  | 680                          | (962 )                        | 71,966        |
| Non-agency residential                          |                              |                               |               |
| - 116   | —                            | (4 )                          | 112           |
| Corporate securities                            |                              |                               |               |
| 1,000   | —                            | —                             | 1,000         |
| Collateralized debt obligation                  |                              |                               |               |
| 156   | —                            | (10 )                         | 1,146         |
| Obligations of state and political subdivisions |                              |                               |               |
| 1,270   | 1                            | —                             | 1,271         |
| Tax-exempt securities                           |                              |                               |               |
| 3,175   | 64                           | (1 )                          | 3,238         |
| Total available for sale securities             |                              |                               |               |
| \$175,420                                       | \$ 1,082                     | \$ (1,370 )                   | \$175,132     |

(1) Agency securities refer to debt obligations issued or guaranteed by government corporations or GSEs. Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs

or the U.S. Government.

The amortized cost and fair value of debt securities by contractual maturities at June 30, 2016 are presented below. Maturities are based on the final contractual payment dates and do not reflect the impact of potential prepayments or early redemptions. Because mortgage-backed securities ("MBS") are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

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|                             | Amortized<br>Cost | Fair<br>Value |
|-----------------------------|-------------------|---------------|
|                             | (In Thousands)    |               |
| Within 1 year               | \$2,579           | \$2,588       |
| After 1 but within 5 years  | 45,817            | 46,377        |
| After 5 but within 10 years | 9,316             | 9,429         |
| After 10 years              | 42,774            | 42,725        |
|                             | 100,486           | 101,119       |
| Mortgage-backed securities  | 85,881            | 87,014        |
| Total debt securities       | \$186,367         | \$188,133     |

The following is a summary of realized gains and losses on the sales of securities for the three and six months ended June 30, 2016 and 2015:

|                                 | Three<br>Months<br>Ended<br>June<br>30,<br>2016 | Six<br>Months<br>Ended<br>June 30,<br>2015 |
|---------------------------------|---|--|
|                                 | (In Thousands)                                  |  |
| Gross gains on sales            | \$-\$132  | \$-\$132                                   |
| Gross losses on sales           | —   | —  |
| Net gain on sales of securities | \$-\$132  | \$-\$132                                   |

Proceeds from the sale of available for sale securities were zero for the three and six months ended June 30, 2016, respectively, and \$9.7 million for the three and six months ended June 30, 2015, respectively.

The following tables present information pertaining to securities with gross unrealized losses at June 30, 2016 and December 31, 2015, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

|  | Less Than 12<br>Months |                      | 12 Months or More |                      | Total         |                      |
|--|------------------------|----------------------|-------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| June 30, 2016                          | (In Thousands)         |                      |                   |                      |               |                      |
| U.S. Government and agency obligations | \$15,005               | \$ 168               | \$17,449          | \$ 384               | \$32,454      | \$ 552               |
| Mortgage-backed securities:            |                        |                      |                   |                      |               |                      |
| Agency - residential                   | 3,988                  | 9                    | 14,432            | 128                  | 18,420        | 137                  |
| Non-agency - residential               | —                      | —                    | 101               | 5                    | 101           | 5                    |
| Collateralized debt obligation         | —                      | —                    | 1,130             | 27                   | 1,130         | 27                   |
| Total                                  | \$18,993               | \$ 177               | \$33,112          | \$ 544               | \$52,105      | \$ 721               |





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|  | Less Than 12<br>Months |                      | 12 Months or More |                      | Total         |                      |
|--|------------------------|----------------------|-------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| December 31, 2015                      | (In Thousands)         |                      |                   |                      |               |                      |
| U.S. Government and agency obligations | \$9,374                | \$ 36                | \$18,715          | \$ 352               | \$28,089      | \$ 388               |
| Government-sponsored enterprises       | 8,454                  | 5                    | —                 | —                    | 8,454         | 5                    |
| Mortgage-backed securities:            |                        |                      |                   |                      |               |                      |
| Agency - residential                   | 21,956                 | 129                  | 27,210            | 833                  | 49,166        | 962                  |
| Non-agency - residential               | —                      | —                    | 112               | 4                    | 112           | 4                    |
| Collateralized debt obligation         | —                      | —                    | 1,146             | 10                   | 1,146         | 10                   |
| Tax-exempt securities                  | 582                    | 1                    | —                 | —                    | 582           | 1                    |
| Total                                  | \$40,366               | \$ 171               | \$47,183          | \$ 1,199             | \$87,549      | \$ 1,370             |

At June 30, 2016, 26 debt securities with gross unrealized losses had aggregate depreciation of 1.36% of the Company's amortized cost basis. The unrealized losses are primarily related to the Company's U.S. Government and agency obligations and agency mortgage-backed securities. There were no investments deemed other-than-temporarily impaired for the three and six months ended June 30, 2016 and 2015. The following summarizes, by security type, the basis for management's determination during the preparation of the financial statements of whether the applicable investments within the Company's securities portfolio were not other-than-temporarily impaired at June 30, 2016.

U.S. Government and Agency Obligations and Mortgage-backed Securities - Agency - Residential. The unrealized losses on the Company's U.S. Government and agency obligations and mortgage-backed agency-residential securities related primarily to a widening of the rate spread to comparable treasury securities. The Company does not expect these securities to settle at a price less than the par value of the securities.

Mortgage-backed Securities - Non-agency - Residential. The unrealized losses on the Company's non-agency - residential mortgage-backed securities relate to one investment which has been evaluated by management and no potential credit loss was identified.

Collateralized Debt Obligation. The unrealized loss on the Company's collateralized debt obligation relates to one investment in a pooled trust preferred security ("PTPS") which management does not believe will suffer from any credit-related losses, based on its senior credit profile. The unrealized loss on this security is caused by the low interest rate environment, as this security reprices quarterly to the three-month LIBOR and market spreads on similar newly issued securities have increased.



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NOTE 4. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loan Portfolio

The composition of the Company's loan portfolio at June 30, 2016 and December 31, 2015 is as follows:

June 30, 2016      December 31, 2015  
 (In Thousands)

|                             |           |           |
|-----------------------------|-----------|-----------|
| Real estate loans:          |           |           |
| Residential                 |           |           |
| -                           |           |           |
| 1 to 4 family               | \$410,235 | \$417,458 |
| Multi-family and commercial | 303,066   | 385,341   |
| Construction                | 31,794    | 21,786    |
| Total real estate loans     | 835,095   | 824,585   |

|                            |         |         |
|----------------------------|---------|---------|
| Commercial business loans: |         |         |
| SBA and USDA guaranteed    | 130,449 | 145,238 |
| Time share                 | 48,901  | 55,192  |
| Condominium association    | 20,176  | 21,986  |
| Medical loans              | 25,250  | 23,445  |
| Other                      | 6,324   | 45,588  |
| Total commercial business  | 271,100 | 291,449 |

loans

Consumer

loans:

Home equity 53,550 53,779

Indirect automobile 1,003 1,741

Other 1,776 1,946

Total consumer loans 56,329 57,466

Total loans 1,162,524 1,173,500

Deferred loan origination costs

867 1,735

net of fees

Allowance

for loan losses (10,643 ) (9,863 )

Loans

receivable, net \$1,151,748 \$1,165,372

The Company purchased commercial business loans totaling \$11.9 million during the six months ended June 30, 2016. For the twelve months ended December 31, 2015, the Company purchased commercial business loans totaling \$113.2 million.

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## Allowance for Loan Losses

Changes in the allowance for loan losses for the three and six months ended June 30, 2016 and 2015 are as follows:

| Three Months Ended<br>June 30, 2016        | Residential<br>-<br>1 to 4<br>Family<br>Commercial | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total    |
|--|--|-----------------------------------|--------------|------------------------|----------|----------|
|  | (In Thousands)                                     |                                   |              |                        |          |          |
| Balance at beginning of period             | \$1,033  | \$ 5,202                          | \$ 573       | \$ 2,674               | \$ 651   | \$10,133 |
| Provision for loan losses                  | 54   | 109                               | 225          | 22                     | 172      | 582      |
| Loans charged-off                          | (61 )  | —                                 | —            | (35 )                  | (117 )   | (213 )   |
| Recoveries of loans previously charged-off | —  | 109                               | —            | 32                     | —        | 141      |
| Balance at end of period                   | \$1,026  | \$ 5,420                          | \$ 798       | \$ 2,693               | \$ 706   | \$10,643 |

| Six Months Ended<br>June 30, 2016          | Residential<br>-<br>1 to 4<br>Family<br>Commercial | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total    |
|--|--|-----------------------------------|--------------|------------------------|----------|----------|
|  | (In Thousands)                                     |                                   |              |                        |          |          |
| Balance at beginning of period             | \$1,036  | \$ 5,033                          | \$ 516       | \$ 2,625               | \$ 653   | \$9,863  |
| Provision for loan losses                  | 44   | 302                               | 282          | 92                     | 173      | 893      |
| Loans charged-off                          | (82 )  | (24 )                             | —            | (68 )                  | (120 )   | (294 )   |
| Recoveries of loans previously charged-off | 28   | 109                               | —            | 44                     | —        | 181      |
| Balance at end of period                   | \$1,026  | \$ 5,420                          | \$ 798       | \$ 2,693               | \$ 706   | \$10,643 |

| Three Months Ended<br>June 30, 2015        | Residential<br>-<br>1 to 4<br>Family<br>Commercial | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|--|--|-----------------------------------|--------------|------------------------|----------|---------|
|  | (In Thousands)                                     |                                   |              |                        |          |         |
| Balance at beginning of period             | \$976  | \$ 3,646                          | \$ 292       | \$ 2,566               | \$ 602   | \$8,082 |
| Provision for loan losses                  | 19   | 117                               | 142          | 51                     | 31       | 360     |
| Loans charged-off                          | (11 )  | —                                 | —            | —                      | —        | (11 )   |
| Recoveries of loans previously charged-off | 2  | 3                                 | —            | 1                      | —        | 6       |
| Balance at end of period                   | \$986  | \$ 3,766                          | \$ 434       | \$ 2,618               | \$ 633   | \$8,437 |

| Six Months Ended<br>June 30, 2015 | Residential<br>-<br>1 to 4<br>Family<br>Commercial | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|-----------------------------------|--|-----------------------------------|--------------|------------------------|----------|---------|
|                                   | (In Thousands)                                     |                                   |              |                        |          |         |
| Balance at beginning of period    | \$955  | \$ 3,607                          | \$ 254       | \$ 2,382               | \$ 599   | \$7,797 |
| Provision for loan losses         | 44   | 176                               | 180          | 260                    | 35       | 695     |
| Loans charged-off                 | (46 )  | (20 )                             | —            | (25 )                  | (1 )     | (92 )   |

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|  |       |          |        |          |        |         |
|--|-------|----------|--------|----------|--------|---------|
| Recoveries of loans previously charged-off | 33    | 3        | —      | 1        | —      | 37      |
| Balance at end of period                   | \$986 | \$ 3,766 | \$ 434 | \$ 2,618 | \$ 633 | \$8,437 |

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

Further information pertaining to the allowance for loan losses at June 30, 2016 and December 31, 2015 is as follows:

|  | Residential<br>-<br>1 to 4<br>Family<br>(In Thousands) | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total       |
|--|--|-----------------------------------|--------------|------------------------|----------|-------------|
| June 30, 2016  |  |                                   |              |                        |          |             |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$266  | \$258                             | \$—          | \$—                    | \$52     | \$576       |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 760  | 5,162                             | 798          | 2,693                  | 654      | 10,067      |
| Allowance for loans acquired with deteriorated credit quality                            | —  | —                                 | —            | —                      | —        | —           |
| Total loan loss allowance  | \$1,026  | \$5,420                           | \$798        | \$2,693                | \$706    | \$10,643    |
| Loans individually evaluated and deemed to be impaired                                   | \$5,753  | \$7,348                           | \$—          | \$1,011                | \$415    | \$14,527    |
| Loans individually or collectively evaluated and not deemed to be impaired               | 404,083  | 382,691                           | 31,794       | 270,089                | 55,914   | 1,144,571   |
| Amount of loans acquired with deteriorated credit quality                                | 399  | 3,027                             | —            | —                      | —        | 3,426       |
| Total loans  | \$410,235  | \$393,066                         | \$31,794     | \$271,100              | \$56,329 | \$1,162,524 |
| December 31, 2015  |  |                                   |              |                        |          |             |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$303  | \$35                              | \$—          | \$—                    | \$—      | \$338       |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 733  | 4,998                             | 516          | 2,625                  | 653      | 9,525       |
| Allowance for loans acquired with deteriorated credit quality                            | —  | —                                 | —            | —                      | —        | —           |
| Total loan loss allowance  | \$1,036  | \$5,033                           | \$516        | \$2,625                | \$653    | \$9,863     |
| Loans individually evaluated and deemed to be impaired                                   | \$6,354  | \$3,750                           | \$—          | \$356                  | \$158    | \$10,618    |
| Loans individually or collectively evaluated and not deemed to be impaired               | 410,699  | 377,503                           | 21,786       | 291,093                | 57,308   | 1,158,389   |
| Amount of loans acquired with deteriorated credit quality                                | 405  | 4,088                             | —            | —                      | —        | 4,493       |



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|             |           |            |           |            |           |             |
|-------------|-----------|------------|-----------|------------|-----------|-------------|
| Total loans | \$417,458 | \$ 385,341 | \$ 21,786 | \$ 291,449 | \$ 57,466 | \$1,173,500 |
|-------------|-----------|------------|-----------|------------|-----------|-------------|

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

## Past Due Loans

The following represents an aging of loans at June 30, 2016 and December 31, 2015:

|  | 30-59<br>Days<br>Due | 60-89<br>Days<br>Past<br>Due | 90<br>Days<br>or<br>More<br>Past<br>Due | Total<br>30<br>Days<br>or<br>More<br>Past<br>Due | Current | Total<br>Loans | Past Due<br>90 Days<br>or More<br>and<br>Accruing |
|--|----------------------|------------------------------|---|--|---------|----------------|---|
|--|----------------------|------------------------------|---|--|---------|----------------|---|

(In Thousands)

|                          |             |                |                |                |                    |                    |                 |
|--------------------------|-------------|----------------|----------------|----------------|--------------------|--------------------|-----------------|
| Real Estate: Residential |             |                |                |                |                    |                    |                 |
| -                        |             |                |                |                |                    |                    |                 |
| 1 to 4 family            | \$25        | \$1,175        | \$1,362        | \$2,562        | \$407,673          | \$410,235          | \$ —            |
| Multi-family             |             |                |                |                |                    |                    |                 |
| commercial               |             |                | 2,623          | 3,411          | 389,655            | 393,066            | 1,460           |
| Construction             |             |                |                | 43             | 31,751             | 31,794             | —               |
| Commercial Business:     |             |                |                |                |                    |                    |                 |
| SBA and USDA guaranteed  |             |                |                | 274            | 130,175            | 130,449            | —               |
| Time share               |             |                |                |                | 48,901             | 48,901             | —               |
| Condominium association  |             |                |                |                | 20,176             | 20,176             | —               |
| Medical loans            |             |                |                |                | 25,250             | 25,250             | —               |
| Other                    | 1,427       | 301            | 1,843          | 44,481         | 46,324             | —                  | —               |
| Consumer:                |             |                |                |                |                    |                    |                 |
| Home equity              |             | 179            | 352            | 53,198         | 53,550             | —                  | —               |
| Indirect automobile      |             |                | 45             | 958            | 1,003              | —                  | —               |
| Other                    | 4           | —              | 4              | 1,772          | 1,776              | —                  | —               |
| <b>Total</b>             | <b>\$17</b> | <b>\$2,652</b> | <b>\$4,465</b> | <b>\$8,534</b> | <b>\$1,153,990</b> | <b>\$1,162,524</b> | <b>\$ 1,460</b> |

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| 30-59 Days or More Due   | 60-89 Days or More Past Due | 90 Days or More Past Due | Total 30 Days or More Past Due | Current     | Total Loans | Past Due 90 Days or More and Accruing |
|--------------------------|-----------------------------|--------------------------|--------------------------------|-------------|-------------|---------------------------------------|
| (In Thousands)           |                             |                          |                                |             |             |                                       |
| Real Estate: Residential |                             |                          |                                |             |             |                                       |
| 1                        |                             |                          |                                |             |             |                                       |
| \$5,906                  | \$1,054                     | \$1,283                  | \$8,243                        | \$409,215   | \$417,458   | \$ —                                  |
| 4                        |                             |                          |                                |             |             |                                       |
| family Multi-family      |                             |                          |                                |             |             |                                       |
| 5                        | 203                         | 1,061                    | 7,194                          | 378,147     | 385,341     | —                                     |
| commercial Construction  |                             |                          |                                |             |             |                                       |
|                          |                             | —                        | —                              | 21,786      | 21,786      | —                                     |
| Commercial Business:     |                             |                          |                                |             |             |                                       |
| SBA and USDA             |                             |                          |                                |             |             |                                       |
|                          | —                           | —                        | —                              | 145,238     | 145,238     | —                                     |
| guaranteed Time share    |                             |                          |                                |             |             |                                       |
|                          | —                           | —                        | —                              | 55,192      | 55,192      | —                                     |
| Condominium association  |                             |                          |                                |             |             |                                       |
|                          | —                           | —                        | —                              | 21,986      | 21,986      | —                                     |
| Medical loans            |                             |                          |                                |             |             |                                       |
|                          | —                           | —                        | —                              | 23,445      | 23,445      | —                                     |
| Other                    | 22                          | 339                      | 406                            | 45,182      | 45,588      | —                                     |
| Consumer:                |                             |                          |                                |             |             |                                       |
| Home equity              |                             |                          |                                |             |             |                                       |
| 130                      | —                           | 121                      | 251                            | 53,528      | 53,779      | —                                     |
| Indirect automobile      |                             |                          |                                |             |             |                                       |
| 31                       | —                           | —                        | 31                             | 1,710       | 1,741       | —                                     |
| Other                    | 3                           | 25                       | 29                             | 1,917       | 1,946       | —                                     |
| \$12,043                 | \$1,282                     | \$2,829                  | \$16,154                       | \$1,157,346 | \$1,173,500 | \$ —                                  |

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SI FINANCIAL GROUP, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at June 30, 2016 and December 31, 2015:

| June 30, 2016 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Nonaccrual Loans |
|---------------|---------------------|--------------------------|-------------------|------------------|
|---------------|---------------------|--------------------------|-------------------|------------------|

(In Thousands)

|  |         |         |      |          |
|--|---------|---------|------|----------|
| Impaired loans without valuation allowance:      |         |         |      |          |
| Real Estate:                                     |         |         |      |          |
| Residential                                      |         |         |      |          |
| -  |         |         |      |          |
| 1 to 4 family                                    | \$3,414 | \$3,490 | \$ — | \$ 2,970 |
| Multi-family                                     | 1,116   | 6,334   | —    | 1,785    |
| Commercial                                       |         |         |      |          |
| Commercial business                              | 1,011   | 1,011   | —    | 301      |
| Other Consumer:                                  |         |         |      |          |
| Home equity                                      | 136     | 136     | —    | 136      |
| Indirect automobile                              | —       | —       | —    | 8        |
| Total impaired loans without valuation allowance | 10,677  | 10,971  | —    | 5,200    |

Impaired loans with valuation

allowance:

Real

Estate:

Residential

-

1  
to  
4

|       |       |     |     |
|-------|-------|-----|-----|
| 2,339 | 2,350 | 266 | 140 |
|-------|-------|-----|-----|

family

Multi-family

and

commercial

Consumer

|     |     |    |     |
|-----|-----|----|-----|
| 279 | 377 | 52 | 179 |
|-----|-----|----|-----|

Home

equity

Total  
impaired

|       |       |     |     |
|-------|-------|-----|-----|
| 6,432 | 6,541 | 576 | 319 |
|-------|-------|-----|-----|

loans

with

valuation

allowance

Total

|          |           |        |          |
|----------|-----------|--------|----------|
| \$ 7,169 | \$ 17,512 | \$ 576 | \$ 5,519 |
|----------|-----------|--------|----------|

impaired

loans

(1) Includes loans acquired with deteriorated credit quality from the Newport Federal Savings Bank ("Newport") merger and performing troubled debt restructurings. Some loans acquired with deteriorated credit quality have not been included as a result of sustained performance.

Impaired Loans<sup>(1)</sup>

| December 31, 2015 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Nonaccrual Loans |
|-------------------|---------------------|--------------------------|-------------------|------------------|
|-------------------|---------------------|--------------------------|-------------------|------------------|

(In Thousands)

Impaired

loans

without

valuation

allowance:

Real

Estate:

Residential

-

|              |         |         |      |          |
|--------------|---------|---------|------|----------|
| 1<br>to<br>4 | \$3,957 | \$3,975 | \$ — | \$ 3,748 |
|--------------|---------|---------|------|----------|

family

Multi-family

and

commercial

|     |     |   |     |
|-----|-----|---|-----|
| 356 | 356 | — | 339 |
|-----|-----|---|-----|

|   |           |           |        |          |
|---|-----------|-----------|--------|----------|
| Commercial<br>business  |           |           |        |          |
| -   |           |           |        |          |
| Other<br>Consumer   |           |           |        |          |
| -   |           |           |        |          |
| 158<br>Home<br>equity   | 158       | —         | 183    |          |
| Total<br>impaired<br>loans<br>without<br>valuation<br>allowance     | 10,227    | 10,648    | —      | 6,437    |
| Impaired<br>loans<br>with<br>valuation<br>allowance:                |           |           |        |          |
| Real<br>Estate:<br>Residential                                      |           |           |        |          |
| -   |           |           |        |          |
| 1<br>to<br>4<br>family<br>Multi-family<br>and<br>commercial         | 2,397     | 2,397     | 303    | 146      |
| 136<br>Total<br>impaired<br>loans<br>with<br>valuation<br>allowance | 1,136     | 1,136     | 35     | —        |
| Total<br>impaired<br>loans<br>with<br>valuation<br>allowance        | 3,533     | 3,533     | 338    | 146      |
| Total<br>impaired<br>loans  | \$ 14,760 | \$ 14,181 | \$ 338 | \$ 6,583 |

(1) Includes loans acquired with deteriorated credit quality from the Newport Federal Savings Bank ("Newport") merger and performing troubled debt restructurings. Some loans acquired with deteriorated credit quality have not been included as a result of sustained performance.

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The Company reviews and establishes, if necessary, an allowance for certain impaired loans for the amount by which the present value of expected cash flows (or observable market price of loan or fair value of the collateral if the loan is collateral dependent) are lower than the carrying value of the loan. At June 30, 2016 and December 31, 2015, the Company concluded that certain impaired loans required no valuation allowance as a result of management's measurement of impairment. No additional funds are advanced to those borrowers whose loans are deemed impaired without prior approval of the Loan Committee or the Board of Directors.

Additional information related to impaired loans is as follows:

|                             | Three Months Ended<br>June 30, 2016 |                                  |  | Six Months Ended<br>June 30, 2016 |                                  |  |
|-----------------------------|-------------------------------------|----------------------------------|--|-----------------------------------|----------------------------------|--|
|                             | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash<br>Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash<br>Basis |
| (In Thousands)              |                                     |                                  |  |                                   |                                  |  |
| Real Estate:                |                                     |                                  |  |                                   |                                  |  |
| Residential - 1 to 4 family | \$5,736                             | \$ 27                            | \$ —   | —\$5,930                          | \$ 51                            | \$ —   |
| Multi-family and commercial | 8,762                               | 64                               | —  | 7,738                             | 148                              | —  |
| Commercial business - Other | 680                                 | —                                | —  | 637                               | —                                | —  |
| Consumer - Home equity      | 327                                 | 1                                | —  | 222                               | 2                                | 1  |
| Total                       | \$15,505                            | \$ 92                            | \$ —   | —\$14,527                         | \$ 201                           | \$ 1   |

|                             | Three Months Ended<br>June 30, 2015 |                                  |  | Six Months Ended<br>June 30, 2015 |                                  |  |
|-----------------------------|-------------------------------------|----------------------------------|--|-----------------------------------|----------------------------------|--|
|                             | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash<br>Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash<br>Basis |
| (In Thousands)              |                                     |                                  |  |                                   |                                  |  |
| Real Estate:                |                                     |                                  |  |                                   |                                  |  |
| Residential - 1 to 4 family | \$5,659                             | \$ 26                            | \$ —   | —\$5,652                          | \$ 52                            | \$ 1   |
| Multi-family and commercial | 5,823                               | 68                               | —  | 5,996                             | 147                              | —  |
| Commercial business - Other | 1,311                               | 2                                | —  | 1,144                             | 8                                | —  |
| Consumer - Home equity      | 54                                  | —                                | —  | 32                                | —                                | —  |
| Total                       | \$12,847                            | \$ 96                            | \$ —   | —\$12,824                         | \$ 207                           | \$ 1   |

**Credit Quality Information**

The Company utilizes an eight-grade internal loan rating system for all loans in the portfolio, with the exception of its purchased SBA and USDA commercial business loans that are fully guaranteed by the U.S. government, as follows:

- o Pass (Ratings 1-4): Loans in these categories are considered low to average risk.

Special Mention (Rating 5): Loans in this category are starting to show signs of potential weakness and are being closely monitored by management.



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SI FINANCIAL GROUP, INC.

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Substandard (Rating 6): Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.

Doubtful (Rating 7): Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.

Loss (Rating 8): Loans in this category are considered uncollectible and of such little value that their continuance as assets is not warranted.

Management periodically reviews the ratings described above and the Company's internal audit function reviews components of the credit files, including the assigned risk ratings, of certain commercial loans as part of its loan review.

The following tables present the Company's loans by risk rating at June 30, 2016 and December 31, 2015:

| June 30, 2016                   | Not<br>Rated   | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total       |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-------------|
|                                 | (In Thousands) |           |                    |             |          |      |             |
| <b>Real Estate:</b>             |                |           |                    |             |          |      |             |
| Residential - 1 to 4 family     | \$—            | \$401,295 | \$1,967            | \$6,973     | \$—      | \$—  | \$410,235   |
| Multi-family and commercial     | —              | 362,122   | 15,805             | 15,139      | —        | —    | 393,066     |
| Construction                    | —              | 31,794    | —                  | —           | —        | —    | 31,794      |
| Total real estate loans         | —              | 795,211   | 17,772             | 22,112      | —        | —    | 835,095     |
| <b>Commercial Business:</b>     |                |           |                    |             |          |      |             |
| SBA and USDA guaranteed         | 130,449        | —         | —                  | —           | —        | —    | 130,449     |
| Time share                      | —              | 48,901    | —                  | —           | —        | —    | 48,901      |
| Condominium association         | —              | 20,176    | —                  | —           | —        | —    | 20,176      |
| Medical loans                   | —              | 25,250    | —                  | —           | —        | —    | 25,250      |
| Other                           | —              | 42,531    | 989                | 2,804       | —        | —    | 46,324      |
| Total commercial business loans | 130,449        | 136,858   | 989                | 2,804       | —        | —    | 271,100     |
| <b>Consumer:</b>                |                |           |                    |             |          |      |             |
| Home equity                     | —              | 53,035    | 54                 | 461         | —        | —    | 53,550      |
| Indirect automobile             | —              | 995       | —                  | 8           | —        | —    | 1,003       |
| Other                           | —              | 1,776     | —                  | —           | —        | —    | 1,776       |
| Total consumer loans            | —              | 55,806    | 54                 | 469         | —        | —    | 56,329      |
| Total loans                     | \$130,449      | \$987,875 | \$18,815           | \$25,385    | \$—      | \$—  | \$1,162,524 |

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

| December 31, 2015               | Not<br>Rated   | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total        |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|--------------|
|                                 | (In Thousands) |           |                    |             |          |      |              |
| Real Estate:                    |                |           |                    |             |          |      |              |
| Residential - 1 to 4 family     | \$—            | \$409,331 | \$2,001            | \$ 6,126    | \$       | —\$  | —\$417,458   |
| Multi-family and commercial     | —              | 356,921   | 14,187             | 14,233      | —        | —    | 385,341      |
| Construction                    | —              | 21,786    | —                  | —           | —        | —    | 21,786       |
| Total real estate loans         | —              | 788,038   | 16,188             | 20,359      | —        | —    | 824,585      |
| Commercial Business:            |                |           |                    |             |          |      |              |
| SBA and USDA guaranteed         | 145,238        | —         | —                  | —           | —        | —    | 145,238      |
| Time share                      | —              | 55,192    | —                  | —           | —        | —    | 55,192       |
| Condominium association         | —              | 21,986    | —                  | —           | —        | —    | 21,986       |
| Medical loans                   | —              | 23,445    | —                  | —           | —        | —    | 23,445       |
| Other                           | —              | 42,760    | 1,534              | 1,294       | —        | —    | 45,588       |
| Total commercial business loans | 145,238        | 143,383   | 1,534              | 1,294       | —        | —    | 291,449      |
| Consumer:                       |                |           |                    |             |          |      |              |
| Home equity                     | —              | 53,487    | 63                 | 229         | —        | —    | 53,779       |
| Indirect automobile             | —              | 1,741     | —                  | —           | —        | —    | 1,741        |
| Other                           | —              | 1,946     | —                  | —           | —        | —    | 1,946        |
| Total consumer loans            | —              | 57,174    | 63                 | 229         | —        | —    | 57,466       |
| Total loans                     | \$145,238      | \$988,595 | \$17,785           | \$ 21,882   | \$       | —\$  | —\$1,173,500 |

The following table provides information on loans modified as TDRs during the three and six months ended June 30, 2016 and 2015. During the modification process, there were no loan charge-offs or principal reductions for the loans included in the table below.

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SI FINANCIAL GROUP, INC.

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|                             | Three Months Ended June 30,<br>2016 |                        |   | 2015            |                        |   |
|-----------------------------|-------------------------------------|------------------------|---|-----------------|------------------------|---|
|                             | Number of Loans                     | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>(End of<br>Period) | Number of Loans | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>(End of<br>Period) |
|                             | (Dollars in Thousands)              |                        |   |                 |                        |   |
| Residential - 1 to 4 family | 1                                   | \$ 57                  | \$ —  | —               | \$ —                   | \$ —  |
| Multi-family and commercial | 3                                   | 2,688                  | 234   | —               | —                      | —   |
| Commercial business - other | 3                                   | 865                    | —   | —               | —                      | —   |
| Total                       | 7                                   | \$ 3,610               | \$ 234  | —               | \$ —                   | \$ —  |

|                             | Six Months Ended June 30,<br>2016 |                        |   | 2015            |                        |   |
|-----------------------------|-----------------------------------|------------------------|---|-----------------|------------------------|---|
|                             | Number of Loans                   | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>(End of<br>Period) | Number of Loans | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>(End of<br>Period) |
|                             | (Dollars in Thousands)            |                        |   |                 |                        |   |
| Residential - 1 to 4 family | 2                                 | \$ 143                 | \$ —  | —               | \$ —                   | \$ —  |
| Multi-family and commercial | 4                                 | 4,128                  | 234   | —               | —                      | —   |
| Commercial business - other | 3                                 | 865                    | —   | 1               | 24                     | —   |
| Total                       | 9                                 | \$ 5,136               | \$ 234  | 1               | \$ 24                  | \$ —  |

The following table provides the recorded investment, by type of modification, during the three and six months ended June 30, 2016 and 2015 for modified loans identified as TDRs.

|   | Three<br>Months<br>Ended June<br>30,<br>2016 |        | Six Months<br>Ended June<br>30,<br>2015 |      |
|---|--|--------|---|------|
|   | 2016   | 2015   | 2016                                    | 2015 |
| Principal<br>deferrals                              | \$ —   | \$ —86 | \$ —                                    | \$ — |
| Combination<br>of<br>rate<br>and<br>maturity<br>(1) | 3,382  | —      | 3,382                                   | 24   |
|   | 228  | —      | 1,668                                   | —    |

Maturity

only

Total \$ — \$5,136 \$ 24

(1) Terms include combination of interest rate adjustments and extensions of maturity.

During the three and six months ended June 30, 2016, there were two commercial loans totaling \$330,000 that were modified as TDRs that were in payment default (defined as 90 days or more past due) within twelve months of restructure. There were no TDRs in payment default within twelve months of restructure for the three and six months ended June 30, 2015.

As of June 30, 2016, the Company held \$1.3 million in consumer mortgage loans collateralized by residential real estate properties that are in the process of foreclosure according to local requirements of the applicable jurisdiction.

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## Loans Acquired with Deteriorated Credit Quality

The following is a summary of loans acquired with evidence of credit deterioration from Newport as of June 30, 2016 and December 31, 2015.

|                              | Contractual<br>Required<br>Payments<br>Receivable<br>(In Thousands) | Cash<br>Expected<br>To Be<br>Collected<br>(In Thousands) | Non-Accrutable<br>Discount | Accrutable<br>Yield | Loans<br>Receivable |
|------------------------------|---|--|----------------------------|---------------------|---------------------|
| Balance at December 31, 2015 | \$5,076   | \$ 4,493   | \$ 583                     | \$ 121              | \$ 4,372            |
| Collections                  | (561 )  | (559 )   | (2 )                       | (19 )               | (540 )              |
| Dispositions                 | (567 )  | (508 )   | (59 )                      | —                   | (508 )              |
| Balance at June 30, 2016     | \$3,948   | \$ 3,426   | \$ 522                     | \$ 102              | \$ 3,324            |

## NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at June 30, 2016 and December 31, 2015 are summarized as follows:

|   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
|   | (In Thousands)   |                      |
| Land                                      | \$4,746          | \$ 4,746             |
| Buildings                                 | 13,607           | 13,583               |
| Leasehold improvements                    | 10,717           | 10,717               |
| Furniture and equipment                   | 13,194           | 12,905               |
| Construction in process                   | 159              | 30                   |
|   | 42,423           | 41,981               |
| Accumulated depreciation and amortization | (21,963 )        | (20,793 )            |
| Premises and equipment, net               | \$20,460         | \$ 21,188            |

At both June 30, 2016 and December 31, 2015, construction in process related to a project to redesign traffic flow at an existing branch and relocation of another branch.

## NOTE 6. OTHER COMPREHENSIVE INCOME

Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of shareholders' equity on the balance sheet, such items, along with net income, are components of comprehensive income.

Components of other comprehensive income and related tax effects are as follows:

| Six Months Ended June<br>30, 2016 |                |                         |
|-----------------------------------|----------------|-------------------------|
| Before<br>Tax<br>Amount           | Tax<br>Effects | Net of<br>Tax<br>Amount |

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| Securities:   | (In Thousands)           |
|---|--------------------------|
| Unrealized holding gains on available for sale securities               | \$2,054 \$(698) \$ 1,356 |
| Unrealized holding gains on available for sale securities, net of taxes | 2,054 (698 ) 1,356       |
| Other comprehensive income  | \$2,054 \$(698) \$ 1,356 |

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The components of accumulated other comprehensive income (loss) included in shareholders' equity are as follows:

|   | June 30, 2016           |                |                         |
|---|-------------------------|----------------|-------------------------|
|   | Before<br>Tax<br>Amount | Tax<br>Effects | Net of<br>Tax<br>Amount |
|   | (In Thousands)          |                |                         |
| Net unrealized gains on available for sale securities | \$ 1,766                | \$(600)        | \$ 1,166                |
| Accumulated other comprehensive income                | \$ 1,766                | \$(600)        | \$ 1,166                |

|  | December 31, 2015       |                |                         |
|--|-------------------------|----------------|-------------------------|
|  | Before<br>Tax<br>Amount | Tax<br>Effects | Net of<br>Tax<br>Amount |
|  | (In Thousands)          |                |                         |
| Net unrealized losses on available for sale securities | \$(288)                 | \$ 98          | \$(190 )                |
| Accumulated other comprehensive loss                   | \$(288)                 | \$ 98          | \$(190 )                |

## NOTE 7. REGULATORY CAPITAL

The Company and the Bank are subject to regulatory capital adequacy requirements promulgated by federal bank regulatory agencies. Failure by the Company or the Bank to meet minimum capital requirements could result in certain mandatory and discretionary actions by regulators that could have a material adverse effect on our consolidated financial statements. The following tables present regulatory capital information for the Company and the Bank. Under Basel III capital requirements, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation require the Company and the Bank to maintain certain minimum capital amounts and ratios. Federal bank regulators require the Company and the Bank to maintain minimum ratios of core capital to adjusted average assets, common equity tier 1 capital to risk-weighted assets, tier 1 capital to risk-weighted assets and total risk-based capital to risk-weighted assets. At June 30, 2016, the Company and the Bank met all the capital adequacy requirements to which they were subject and were "well capitalized" under the regulatory requirements. To be "well capitalized," the Company and the Bank must maintain minimum leverage, common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios of at least 5.0%, 6.5%, 8.0% and 10.0%, respectively. Management believes no conditions or events have occurred since June 30, 2016 that would materially adversely change the Company's and the Bank's capital classifications.

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|   | Actual                 |        | Minimum Capital Requirement |                               | Minimum To Be Well Capitalized                                   |        |
|---|------------------------|--------|-----------------------------|-------------------------------|--|--------|
|   | Amount                 | Ratio  | Amount                      | Ratio                         | Amount   | Ratio  |
| June 30, 2016                           | (Dollars in Thousands) |        |                             |                               |  |        |
| Tier 1 Capital to Average Assets:       |                        |        |                             |                               |  |        |
| Company                                 | \$ 150,935             | 9.97 % | \$ 60,543                   | 4.000 %                       | \$ 75,678  | 5.00 % |
| Bank                                    | 138,336                | 9.28   | 59,615                      | 4.000                         | 74,519   | 5.00   |
| Tier 1 Capital to Risk Weighted Assets: |                        |        |                             |                               |  |        |
| Company                                 | 150,935                | 15.80  | 63,272                      | 6.625                         | 76,404   | 8.00   |
| Bank                                    | 138,336                | 14.53  | 63,076                      | 6.625                         | 76,167   | 8.00   |
| Total Capital to Risk Weighted Assets:  |                        |        |                             |                               |  |        |
| Company                                 | 162,067                | 16.97  | 82,373                      | 8.625                         | 95,505   | 10.00  |
| Bank                                    | 149,468                | 15.70  | 82,118                      | 8.625                         | 95,209   | 10.00  |
| Common Equity Tier 1 Capital:           |                        |        |                             |                               |  |        |
| Company                                 | 142,935                | 14.97  | 48,947                      | 5.125                         | 62,079   | 6.50   |
| Bank                                    | 138,336                | 14.53  | 48,795                      | 5.125                         | 61,886   | 6.50   |
|   |                        |        |                             |                               | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|   |                        |        |                             | For Capital Adequacy Purposes |  |        |
| December 31, 2015                       | (Dollars in Thousands) |        |                             |                               |  |        |
| Tier 1 Capital to Average Assets:       |                        |        |                             |                               |  |        |
| Company                                 | \$ 140,862             | 9.73 % | \$ 57,896                   | 4.00 %                        | \$ 72,370  | 5.00 % |
| Bank                                    | 134,992                | 9.38   | 57,550                      | 4.00                          | 71,937   | 5.00   |
| Tier 1 Capital to Risk Weighted Assets: |                        |        |                             |                               |  |        |
| Company                                 | 140,862                | 14.86  | 56,861                      | 6.00                          | 75,814   | 8.00   |
| Bank                                    | 134,992                | 14.27  | 56,773                      | 6.00                          | 75,698   | 8.00   |
| Total Capital to Risk Weighted Assets:  |                        |        |                             |                               |  |        |
| Company                                 | 151,327                | 15.97  | 75,814                      | 8.00                          | 94,768   | 10.00  |
| Bank                                    | 145,457                | 15.37  | 75,698                      | 8.00                          | 94,622   | 10.00  |
| Common Equity Tier 1 Capital:           |                        |        |                             |                               |  |        |
| Company                                 | 140,862                | 14.86  | 42,645                      | 4.50                          | 61,599   | 6.50   |
| Bank                                    | 134,992                | 14.27  | 42,580                      | 4.50                          | 61,504   | 6.50   |

Effective January 1, 2016, Basel III implemented a requirement for all banking organizations to maintain a capital conservation buffer above the minimum risk-based capital requirements in order to avoid certain limitations on capital distributions, stock repurchases and discretionary bonus payments to executive officers. The capital conservation



buffer is exclusively composed of common equity tier 1 capital. The capital conservation buffer increases the three risk-based capital ratios by 0.625% each year through 2019, at which point, the minimum common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios will be 7.0%, 8.5% and 10.5%, respectively. Also, certain new deductions from, and adjustments to, regulatory capital will be phased in over several years. As of June 30, 2016, the Company and the Bank complied with the capital conservation buffer requirement.

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NOTE 8. FAIR VALUE OF ASSETS AND LIABILITIES

Fair Value Hierarchy

The Company groups its assets and liabilities in three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Transfers between levels are recognized at the end of a reporting period, if applicable.

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

Level 2: Valuation is based on 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 for substantially the full term of the assets or liabilities.

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

Determination of Fair Value

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

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

• **Cash and cash equivalents.** The carrying amounts of cash and cash equivalents approximate the fair values based on the short-term nature of the assets.

• **Securities available for sale.** Included in the available for sale category are debt securities. The securities measured at fair value in Level 1 are based on quoted market prices in an active exchange market. Securities measured at fair value in Level 2 are based on pricing models that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. The Company utilizes a nationally-recognized third-party pricing service to estimate fair value measurements for the majority of its

portfolio. The pricing service evaluates each asset class based on relevant market information considering observable data, but these prices do not represent binding quotes. The fair value prices on all investments are reviewed for reasonableness by management. Securities measured at fair value in Level 3 include one collateralized debt obligation that was backed by a trust preferred security issued by banks and insurance companies. Management determined that an orderly and active market for this security and similar securities did not exist based on a significant reduction in trading volume and widening spreads relative to historical levels. The Company

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estimates future cash flows discounted using a rate management believes is representative of current market conditions. Factors in determining the discount rate include the current level of deferrals and/or defaults, changes in credit rating and the financial condition of the debtors within the underlying securities, broker quotes for securities with similar structure and credit risk, interest rate movements and pricing for new issuances.

• Federal Home Loan Bank stock. The carrying value of Federal Home Loan Bank ("FHLB") stock approximates fair value based on the redemption provisions of the FHLB.

• Federal Reserve Bank stock. The carrying value of Federal Reserve Bank ("FRB") stock approximates fair value based on the redemption provisions of the FRB.

• Loans held for sale. The fair value of loans held for sale is estimated using quoted market prices.

Loans receivable. For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans are estimated by discounting the future cash flows using the rates at the end of the period in which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

• Accrued interest receivable. The carrying amount of accrued interest approximates fair value.

Deposits. The fair value of demand deposits, negotiable orders of withdrawal, regular savings, certain money market deposits and mortgagors' and investors' escrow accounts is the amount payable on demand at the reporting date. The fair value of certificates of deposit and other time deposits is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities to a schedule of aggregated expected maturities on such deposits.

• Federal Home Loan Bank advances. The fair value of the advances is estimated using a discounted cash flow calculation that applies current FHLB interest rates for advances of similar maturity to a schedule of maturities of such advances.

• Junior subordinated debt owed to unconsolidated trust. Rates currently available for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

• Interest rate swap agreement. The fair value of the Company's interest rate swap is obtained from a third-party pricing service and is determined using a discounted cash flow analysis on the expected cash flows of the derivative. The pricing analysis is based on observable inputs for the contractual term of the derivative, including the period to maturity, credit component and interest rate curves.

• Forward loan sale commitments and derivative loan commitments. Forward loan sale commitments and derivative loan commitments are based on the fair values of the underlying mortgage loans, including the servicing rights for derivative loan commitments, and the probability of such commitments being exercised. Significant management judgment and estimation is required in determining these fair value measurements.

Off-balance sheet instruments. Fair values for off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings.

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

The following tables present assets and liabilities measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the three and six months ended June 30, 2016.

|   | June 30, 2016  |           |         | Total     |
|---|----------------|-----------|---------|-----------|
|   | Level 1        | Level 2   | Level 3 |           |
|   | (In Thousands) |           |         |           |
| Assets:   |                |           |         |           |
| U.S. Government and agency obligations                        | \$25,314       | \$46,705  | \$—     | \$72,019  |
| Government-sponsored enterprises                              | —              | 22,696    | —       | 22,696    |
| Mortgage-backed securities                                    | —              | 87,014    | —       | 87,014    |
| Corporate debt securities                                     | —              | 1,000     | —       | 1,000     |
| Collateralized debt obligation                                | —              | —         | 1,130   | 1,130     |
| Obligations of state and political subdivisions               | —              | 1,000     | —       | 1,000     |
| Tax-exempt securities   | —              | 3,274     | —       | 3,274     |
| Forward loan sale commitments and derivative loan commitments | —              | —         | 260     | 260       |
| Total assets  | \$25,314       | \$161,689 | \$1,390 | \$188,393 |
| Liabilities:  |                |           |         |           |
| Interest rate swap agreement                                  | \$—            | \$49      | \$—     | \$49      |
| Total liabilities   | \$—            | \$49      | \$—     | \$49      |

|   | December 31, 2015 |           |         | Total     |
|---|-------------------|-----------|---------|-----------|
|   | Level 1           | Level 2   | Level 3 |           |
|   | (In Thousands)    |           |         |           |
| Assets:   |                   |           |         |           |
| U.S. Government and agency obligations                        | \$25,045          | \$45,951  | \$—     | \$70,996  |
| Government-sponsored enterprises                              | —                 | 25,403    | —       | 25,403    |
| Mortgage-backed securities                                    | —                 | 72,078    | —       | 72,078    |
| Corporate debt securities                                     | —                 | 1,000     | —       | 1,000     |
| Collateralized debt obligation                                | —                 | —         | 1,146   | 1,146     |
| Obligations of state and political subdivisions               | —                 | 1,271     | —       | 1,271     |
| Tax-exempt securities   | —                 | 3,238     | —       | 3,238     |
| Forward loan sale commitments and derivative loan commitments | —                 | —         | 71      | 71        |
| Total assets  | \$25,045          | \$148,941 | \$1,217 | \$175,203 |
| Liabilities:  |                   |           |         |           |
| Forward loan sale commitments and derivative loan commitments | \$—               | \$—       | \$1     | \$1       |
| Interest rate swap agreement                                  | —                 | 64        | —       | 64        |
| Total liabilities   | \$—               | \$64      | \$1     | \$65      |



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The following table shows a reconciliation of the beginning and ending balances for Level 3 assets:

|  | Collateralized<br>Debt<br>Obligations | Derivative<br>Loan and<br>Forward Loan<br>Sale<br>Commitments,<br>Net |
|--|---------------------------------------|---|
|  | (In Thousands)                        |   |
| Balance at December 31, 2015                                   | \$1,146                               | \$ 70   |
| Total realized gains included in net income                    | —                                     | 190   |
| Total unrealized losses included in other comprehensive income | (16 )                                 | —   |
| Balance at June 30, 2016                                       | \$1,130                               | \$ 260  |

## Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Company may also be required, from time to time, to measure certain other financial assets on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following table summarizes the fair value hierarchy used to determine each adjustment and the carrying value of the related individual assets at June 30, 2016 and December 31, 2015. There were no liabilities measured at fair value on a nonrecurring basis at June 30, 2016 and December 31, 2015.

|                         | At June 30,<br>2016 |            |            | At December<br>31, 2015 |            |            |
|-------------------------|---------------------|------------|------------|-------------------------|------------|------------|
|                         | Level<br>1          | Level<br>2 | Level<br>3 | Level<br>1              | Level<br>2 | Level<br>3 |
|                         | (In Thousands)      |            |            |                         |            |            |
| Impaired loans          | \$—                 | —          | \$796      | \$—                     | —          | \$588      |
| Other real estate owned | —                   | —          | 1,166      | —                       | —          | 1,088      |
| Total assets            | \$—                 | —          | \$1,962    | \$—                     | —          | \$1,676    |

The following table summarizes losses (gains) resulting from fair value adjustments for assets measured at fair value on a nonrecurring basis.

|                         | Three<br>Months<br>Ended June<br>30,<br>2016 |        | Six Months<br>Ended June<br>30,<br>2015 |       |
|-------------------------|--|--------|---|-------|
|                         | (In<br>Thousands)                            |        |   |       |
| Impaired loans          | \$167  | \$(71) | \$239                                   | \$148 |
| Other real estate owned | —  | 122    | 8                                       | 122   |



Total losses                    \$167 \$51    \$247 \$270

The Company measures the impairment of loans that are collateral dependent based on the fair value of the collateral (Level 3). The fair value of collateral used by the Company represents the amount expected to be received from the sale of the property, net of selling costs, as determined by an independent, licensed or certified appraiser using observable market data. This data includes information such as selling price of similar properties, expected future cash flows or earnings of the subject property based on current market expectations, and relevant legal, physical and economic factors. The appraised values of collateral are adjusted as necessary by management based on observable inputs for specific properties. Losses applicable to write-downs of impaired loans are based on the appraised market value of the underlying collateral, assuming foreclosure of these loans is imminent, and are recorded through the provision for loan losses.

The amount of other real estate owned represents the carrying value of the collateral based on the appraised value of the underlying collateral less estimated selling costs. The loss on foreclosed assets represents adjustments in the valuation recorded during the time period indicated and not for losses incurred on sales.

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## Summary of Fair Values of Financial Instruments

The estimated fair values and related carrying or notional amounts of the Company's financial instruments are presented in the following table. Certain financial instruments and all nonfinancial instruments are exempt from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates presented herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction at June 30, 2016 and December 31, 2015. The estimated fair value amounts at June 30, 2016 and December 31, 2015 have been measured as of each respective date, and have not been re-evaluated or updated for purposes of the consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end. The information presented should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only required for a limited portion of the Company's assets. Due to the wide range of valuation techniques and the degree of subjectivity used in making the estimate, comparisons between the Company's disclosures and those of other banks may not be meaningful.

As of June 30, 2016 and December 31, 2015, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

|   | June 30, 2016  |          |         |           |            |
|---|----------------|----------|---------|-----------|------------|
|   | Carrying       | Level 1  | Level 2 | Level 3   | Total      |
|   | Amount         |          |         |           |            |
|   | (In Thousands) |          |         |           |            |
| Financial Assets:                                     |                |          |         |           |            |
| Cash and cash equivalents                             | \$74,539       | \$74,539 | \$ —    |           | —\$ 74,539 |
| Available for sale securities                         | 188,133        | 25,314   | 161,689 | 1,130     | 188,133    |
| Loans held for sale                                   | 5,146          | —        | —       | 5,265     | 5,265      |
| Loans receivable, net                                 | 1,153,748      | —        | —       | 1,164,778 | 1,164,778  |
| Federal Home Loan Bank stock                          | 12,370         | —        | —       | 12,370    | 12,370     |
| Federal Reserve Bank stock                            | 3,624          | —        | —       | 3,624     | 3,624      |
| Accrued interest receivable                           | 4,224          | —        | —       | 4,224     | 4,224      |
| Financial Liabilities:                                |                |          |         |           |            |
| Deposits  | 1,116,832      | —        | —       | 1,121,773 | 1,121,773  |
| Mortgagors' and investors' escrow accounts            | 4,135          | —        | —       | 4,135     | 4,135      |
| Federal Home Loan Bank advances                       | 207,914        | —        | 210,654 | —         | 210,654    |
| Junior subordinated debt owed to unconsolidated trust | 8,248          | —        | 5,029   | —         | 5,029      |
| On-balance Sheet Derivative Financial Instruments:    |                |          |         |           |            |
| Assets:   |                |          |         |           |            |
| Derivative loan commitments                           | 141            | —        | —       | 141       | 141        |
| Forward loan sale commitments                         | 119            | —        | —       | 119       | 119        |
| Liabilities:  |                |          |         |           |            |
| Interest rate swap agreement                          | 49             | —        | 49      | —         | 49         |



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|   | December 31, 2015 |          |         |           |            |
|---|-------------------|----------|---------|-----------|------------|
|   | Carrying          | Level 1  | Level 2 | Level 3   | Total      |
|   | Amount            |          |         |           |            |
|   | (In Thousands)    |          |         |           |            |
| <b>Financial Assets:</b>                                  |                   |          |         |           |            |
| Cash and cash equivalents                                 | \$40,778          | \$40,778 | \$ —    | —         | —\$ 40,778 |
| Available for sale securities                             | 175,132           | 25,045   | 148,941 | 1,146     | 175,132    |
| Loans held for sale                                       | 1,804             | —        | —       | 1,825     | 1,825      |
| Loans receivable, net                                     | 1,165,372         | —        | —       | 1,179,487 | 1,179,487  |
| Federal Home Loan Bank stock                              | 12,874            | —        | —       | 12,874    | 12,874     |
| Federal Reserve Bank stock                                | 3,621             | —        | —       | 3,621     | 3,621      |
| Accrued interest receivable                               | 4,283             | —        | —       | 4,283     | 4,283      |
| <b>Financial Liabilities:</b>                             |                   |          |         |           |            |
| Deposits  | 1,058,017         | —        | —       | 1,062,884 | 1,062,884  |
| Mortgagors' and investors' escrow accounts                | 3,508             | —        | —       | 3,508     | 3,508      |
| Federal Home Loan Bank advances                           | 234,595           | —        | 234,504 | —         | 234,504    |
| Junior subordinated debt owed to unconsolidated trust     | 8,248             | —        | 5,442   | —         | 5,442      |
| <b>On-balance Sheet Derivative Financial Instruments:</b> |                   |          |         |           |            |
| <b>Assets:</b>  |                   |          |         |           |            |
| Derivative loan commitments                               | 51                | —        | —       | 51        | 51         |
| Forward loan sale commitments                             | 20                | —        | —       | 20        | 20         |
| <b>Liabilities:</b>                                       |                   |          |         |           |            |
| Forward loan sale commitments                             | 1                 | —        | —       | 1         | 1          |
| Interest rate swap agreement                              | 64                | —        | 64      | —         | 64         |

**NOTE 9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES****Derivative Financial Instruments**

The Company has a stand-alone derivative financial instrument in the form of an interest rate swap agreement, which derives its value from underlying interest rates. This transaction involves both credit and market risk. The notional amount is an amount on which calculations, payments and the value of the derivative is based. The notional amount does not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instrument, is reflected on the Company's balance sheets as other assets and other liabilities. The Company is exposed to credit-related losses in the event of nonperformance by the counterparty to this agreement. The Company controls the credit risk of its financial contract through credit approvals, limits and monitoring procedures and does not expect any counterparty to fail its obligations.

Derivative instruments are generally either negotiated over-the-counter contracts or standardized contracts executed on a recognized exchange. Negotiated over-the-counter derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

Derivative Instruments Not Designated As Hedging Instruments

Certain derivative instruments do not meet the requirements to be accounted for as hedging instruments. These undesignated derivative instruments are recognized on the consolidated balance sheets at fair value, with changes in fair value recorded in noninterest income.

Interest Rate Swap Agreement - In 2012, management entered into an interest rate swap agreement that does not meet the strict hedge accounting requirements of FASB's "Derivatives and Hedging" standard to manage the Company's exposure to interest rate movements and other identified risks. At June 30, 2016 and December 31,

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2015, information pertaining to the Company's interest rate swap agreement not designated as a hedge was as follows:

|  | June 30,<br>2016 | December<br>31, 2015 |                           |  |
|--|------------------|----------------------|---------------------------|--|
|  |                  |                      | (Dollars in<br>Thousands) |  |
| Notional amount                                | \$15,000         | \$15,000             |                           |  |
| Weighted average fixed pay rate                | 1.26             | % 1.26               | %                         |  |
| Weighted average variable receive rate         | 0.63             | % 0.32               | %                         |  |
| Weighted average maturity in years             | 0.5              | 1.0                  |                           |  |
| Unrealized loss relating to interest rate swap | \$49             | \$64                 |                           |  |

The Company reported a gain in fair value on the interest rate swap not designated as a hedge in noninterest income of \$16,000 and \$15,000 for the three and six months ended June 30, 2016, respectively, and a loss in fair value of \$10,000 and \$15,000 for the three and six months ended June 30, 2015, respectively.

**Derivative Loan Commitments - Mortgage loan commitments** are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. The Company enters into commitments to fund residential mortgage loans at specified times in the future, with the intention that these loans will subsequently be sold in the secondary market. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the values of these loan commitments decrease. Conversely, if interest rates decrease, the value of these loan commitments increase.

**Forward Loan Sale Commitments -** To protect against the price risk inherent in derivative loan commitments, the Company utilizes "mandatory delivery" forward loan sale commitments to mitigate the risk of potential decreases in the value of loans that would result from the exercise of the derivative loan commitments.

With a "mandatory delivery" contract, the Company commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the Company fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a "pair-off" fee, based on then-current market prices, to the investor to compensate the investor for the shortfall.

The Company expects that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments.



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2016 AND 2015 AND DECEMBER 31, 2015

## Interest Rate Risk Management - Derivative Instruments

The following table presents the fair values of derivative instruments as well as their classification on the consolidated balance sheets at June 30, 2016 and December 31, 2015.

|  | Balance Sheet Location | June 30, 2016   |                      | December 31, 2015 |                      |
|--|------------------------|-----------------|----------------------|-------------------|----------------------|
|  |                        | Notional Amount | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| (In Thousands)                                     |                        |                 |                      |                   |                      |
| Derivatives not designated as hedging instruments: |                        |                 |                      |                   |                      |
| Interest rate swap                                 | Other Liabilities      | \$15,000        | \$ (49 )             | \$15,000          | \$ (64 )             |
| Derivative loan commitments                        | Other Assets           | 10,580          | 141                  | 6,170             | 51                   |
| Forward loan sale commitments                      | Other Assets           | 7,745           | 119                  | 3,656             | 19                   |



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

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding changes in the Company's financial condition as of June 30, 2016 and December 31, 2015 and the results of operations for the three and six months ended June 30, 2016 and 2015. The information contained in this section should be read in conjunction with the consolidated financial statements and notes thereto appearing in Part I, Item 1 of this document as well as with management's discussion and analysis of financial condition and results of operations and consolidated financial statements included in the Company's 2015 Annual Report on Form 10-K.

This report may contain certain "forward-looking statements" within the meaning of the federal securities laws, which are made in good faith pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally preceded by terms such as "expects," "believes," "anticipates," "intends," "estimates," "projects" and similar expressions. These statements are not historical facts; rather, they are statements based on management's current expectations regarding our business strategies, intended results and future performance.

Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the United States government, including policies of the United States Treasury and the Federal Reserve Board, the quality and composition of the loan and investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area, changes in real estate market values in the Company's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect the Company's results are discussed in the Company's Annual Report on Form 10-K and in other reports filed with the Securities and Exchange Commission. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims, any obligation to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

### Critical Accounting Policies

The Company considers accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. The Company considers the determination of allowance for loan losses, deferred income taxes and the impairment of long-lived assets to be its critical accounting policies. Additional information about the Company's accounting policies is included in the notes to the Company's consolidated financial statements contained in Part I, Item 1 of this document and in the Company's 2015 Annual Report on Form 10-K.

### Impact of New Accounting Standards

Refer to Note 1 of the consolidated financial statements in this report for a discussion of recent accounting pronouncements.

### Comparison of Financial Condition at June 30, 2016 and December 31, 2015

#### Assets:

Summary. Assets increased \$35.8 million, or 2.4%, to \$1.52 billion at June 30, 2016, compared to \$1.48 billion at December 31, 2015, principally due to increases of \$33.8 million in cash and cash equivalents, \$13.0 million in available for sale securities and \$3.3 million in loans held for sale, offset by reductions of \$11.6 million in net loans

receivable, \$924,000 in bank-owned life insurance and \$728,000 in net premises and equipment.

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Loans Receivable, Net. Net loans decreased \$11.6 million due to reductions in SBA and USDA guaranteed loans, residential real estate loans and time share loans, offset by increases in construction loans and multi-family and commercial real estate loans. Changes in the loan portfolio consisted of the following:

**Residential Real Estate.** Residential mortgage loans comprised 35.3% of the total loan portfolio at June 30, 2016 and decreased \$7.2 million to \$410.2 million as compared to \$417.5 million at December 31, 2015. Residential mortgage loan originations decreased \$4.5 million, or 9.7%, during the first half of 2016 over the comparable period in 2015, as a result of decreased activity in the housing market.

**Multi-family and Commercial Real Estate.** Multi-family and commercial real estate loans represented 33.8% of total loans at June 30, 2016 and increased \$7.7 million, or 2.0%, during the first half of 2016. Loan originations for multi-family and commercial real estate loans were \$24.8 million, representing a decrease of \$7.3 million, during the first half of 2016 compared to the same period in 2015.

**Construction.** Construction loans, which include both residential and commercial construction loans, increased \$10.0 million to \$31.8 million for the first half of 2016 as a result of increased commercial construction volume.

**Commercial Business.** Commercial business loans represented 23.3% of total loans at June 30, 2016. Commercial business loans decreased \$20.3 million, or 7.0%, for the first half of 2016 primarily due to decreases of \$14.8 million in SBA and USDA guaranteed loans, \$6.3 million in time share loans and \$1.8 million in condominium association loans, offset by an increase of \$1.8 million in medical loans. Commercial business loan originations decreased \$5.2 million as compared to the same period in 2015. At June 30, 2016, unfunded lines of credit related to time share lending totaled \$22.6 million as a result of focused efforts within the time share industry.

**Consumer.** Consumer loans represented 4.8% of the Company's total loan portfolio at June 30, 2016. Consumer loans decreased \$1.1 million during the first half of 2016 primarily as a result of decreases of \$738,000 in indirect automobile loans and \$229,000 in home equity loans. Loan originations for consumer loans totaled \$13.1 million, representing an increase of \$1.5 million, for the first half of 2016 over the comparable period in 2015.

The allowance for loan losses totaled \$10.6 million at June 30, 2016 compared to \$9.9 million at December 31, 2015. The ratio of the allowance for loan losses to total loans increased to 0.92% at June 30, 2016 from 0.84% at December 31, 2015, primarily due to a higher provision due to increases in nonperforming loans and net loan charge-offs.

The following table provides information with respect to nonperforming assets and TDRs as of the dates indicated.

June 30 2016      December 31, 2015

Nonaccrual  
(Dollars in Thousands)  
loans:

|   |         |          |
|---|---------|----------|
| Real estate loans:                      |         |          |
| Residential                             |         |          |
| -                                       |         |          |
| 1 to 4 family                           | \$3,110 | \$ 3,894 |
| Multi-family                            |         |          |
| and commercial                          | 785     | 2,167    |
| Total real estate loans                 | 4,895   | 6,061    |
| Commercial business loans               | 301     | 339      |
| Consumer loans:                         |         |          |
| Home equity                             | 315     | 183      |
| Indirect automobile                     | 8       | —        |
| Other                                   | —       | —        |
| Total consumer loans                    | 323     | 183      |
| Total nonaccrual loans                  | 5,519   | 6,583    |
| Accruing loans past due 90 days or more | 1,460   | —        |
| Total nonperforming loans               | 6,979   | 6,583    |

(1)

Other  
real  
estate  
owned,  
net  
(2)

1,166 1,088

Total  
nonperforming  
assets

8,145 7,671

Accruing  
troubled  
debt

10,049 4,659

restructurings  
Total  
nonperforming  
assets

and  
troubled  
debt  
restructurings

\$18,194 \$ 12,330

Allowance  
for  
loan  
losses  
as  
a

152.50 % 149.83 %

percent  
of  
nonperforming  
loans

Total  
nonperforming  
loans  
to

0.60 % 0.56 %

total  
loans  
Total  
nonperforming  
loans  
to

0.46 % 0.44 %

total  
assets  
Total  
nonperforming  
assets  
and  
troubled  
debt  
restructurings  
to

2.20 % 0.83 %

total  
assets

(1) Includes nonperforming TDRs totaling \$688,000 and \$991,000 at June 30, 2016 and December 31, 2015, respectively.

(2) Other real estate owned balances are shown net of related write-downs.

At June 30, 2016, the increase in nonperforming loans was primarily due to a delinquent commercial real estate loan of \$1.5 million in the process of a refinance (shown as an accruing loan past due 90 days or more in the table above) and an increase in nonperforming home equity loans of \$132,000, offset by decreases in nonperforming residential real estate loans of \$784,000 and multi-family and commercial real estate loans of \$382,000.

Other real estate owned increased \$78,000 to \$1.2 million at June 30, 2016, due to the addition of two residential properties, offset by the sale of two residential properties and one commercial property. At June 30, 2016, other real estate owned included two commercial properties and two residential properties.

Over the past few years, the Company has sought to restructure nonperforming loans rather than pursue foreclosure or liquidation, believing this approach achieves the best economic outcome for the Company in view of the current economic environment. Modified payment terms for TDRs generally involve deferred principal payments, interest rate concessions, maturity extensions, or a combination of these items. TDRs increased to \$10.7 million at June 30, 2016, compared to \$5.7 million at December 31, 2015. Of the TDRs, \$10.0 million and \$4.7 million were performing in accordance with their restructured terms at June 30, 2016 and December 31, 2015, respectively. The Company anticipates these borrowers will repay all contractual principal and interest in accordance with the terms of their restructured loan agreements.

**Liabilities:**

Summary. Liabilities increased \$31.3 million, or 2.4%, to \$1.36 billion at June 30, 2016 compared to \$1.33 billion at December 31, 2015. Deposits increased \$58.8 million, or 5.6%, which included increases in certificates of deposit of \$43.1 million, NOW and money market accounts of \$7.9 million and noninterest-bearing deposits of \$5.9 million. Deposit growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products. Borrowings decreased \$26.7 million from \$242.8 million at December 31, 2015 to \$216.2 million at June 30, 2016, resulting from net repayments of Federal Home Loan Bank advances.

**Equity:**

Summary. Shareholders' equity increased \$4.5 million from \$154.3 million at December 31, 2015 to \$158.8 million at June 30, 2016. The increase in shareholders' equity was attributable to net income of \$3.3 million, a net unrealized gain on available for sale securities aggregating \$1.4 million (net of taxes) and \$812,000 related to equity plans, partially offset by dividends declared of \$945,000.

Accumulated Other Comprehensive Income (Loss). Accumulated other comprehensive income (loss) is comprised of the unrealized gains and losses on available for sale securities. The net unrealized gains on available for sale securities, net of taxes, totaled \$1.2 million at June 30, 2016 compared to net unrealized losses of \$190,000 at December 31, 2015.

**Results of Operations for the Three and Six Months Ended June 30, 2016 and 2015**

General. The Company's results of operations depend primarily on net interest income, which is the difference between the interest income earned on the Company's interest-earning assets, such as loans and investments, and the interest expense on its interest-bearing liabilities, such as deposits and borrowings. The Company also generates noninterest income such as gains on the sale of securities, fees earned from mortgage banking activities, fees from deposits, trust and investment management services, insurance commissions and other fees. The Company's noninterest expenses primarily consist of employee compensation and benefits, occupancy, computer services, furniture and equipment, outside professional services, electronic banking fees, FDIC deposit insurance and regulatory assessments, marketing and other general and administrative expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, governmental policies and actions of regulatory agencies.

Summary. The Company reported net income of \$1.7 million for the three months ended June 30, 2016 compared to \$1.0 million for the three months ended June 30, 2015. The Company reported net income of \$3.3 million for the six months ended June 30, 2016 compared to \$1.9 million for the six months ended June 30, 2015.

Interest and Dividend Income. Total interest and dividend income increased \$885,000, or 7.5%, to \$12.7 million for the quarter ended June 30, 2016, compared to the same period in 2015. The increase in interest and dividend income was primarily due to a higher average balance of total interest-earning assets versus the same period in 2015, offset by lower yields on loans. Interest income on loans and securities reflect net amortization of \$10,000 and \$194,000 for the quarters ended June 30, 2016 and 2015, respectively, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets for the quarter ended June 30, 2016 decreased seven basis points to 3.57% compared to 3.64% for the quarter ended June 30, 2015, as a five basis point decrease in the yield of loans was offset by a 33 basis point increase in securities. The average balance of interest-earning assets increased \$128.4 million to \$1.43 billion during the second quarter of 2016, due to increases of \$74.4 million in the average balance of loans, \$35.9 million in the average balance of other interest-earning assets and \$18.1 million in the average balance of securities, as compared to the same quarter in 2015.

Total interest and dividend income increased \$2.1 million, or 8.8%, to \$25.3 million for the six months ended June 30, 2016, compared to the same period in 2015. The increase in interest and dividend income was primarily due to the higher average balance of total interest-earning assets versus the same period in 2015. Interest income on loans and securities reflect net amortization of \$22,000 and \$364,000 for the six months ended June 30, 2016



and 2015, respectively, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets for the six months ended June 30, 2016 decreased seven basis points to 3.59% compared to 3.66% for the six months ended June 30, 2015, as an eight basis point decrease in the yield on loans was offset by a 29 basis point increase in the yield on securities. The average balance of interest-earning assets increased \$135.4 million to \$1.42 billion during the first half of 2016, due to increases of \$95.5 million in the average balance of loans, \$26.8 million in the average balance of other interest-earning assets and \$13.1 million in the average balance of securities, as compared to the same quarter in 2015.

**Interest Expense.** For the quarter ended June 30, 2016, interest expense increased \$374,000, or 17.4%, resulting from higher average balances of deposits and FHLB advances compared to the same quarter in 2015. Higher interest expense on interest-bearing liabilities reflect net accretion of \$129,000 and \$296,000 for the three months ended June 30, 2016 and 2015, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. The average balance of interest-bearing deposits increased \$58.2 million to \$947.2 million for the quarter ended June 30, 2016 and the average rate paid increased eight basis points to 0.70%, compared to the same period in 2015, primarily due to increases in the average balance of certificates of deposit. Increases in the average balance of certificates of deposit and NOW and money market deposits totaled \$50.4 million and \$11.0 million, respectively, while the average balance of savings accounts decreased \$3.6 million compared to the three months ended June 30, 2015. The average balance of FHLB advances increased \$39.1 million for the three months ended June 30, 2016, while the average rate paid decreased four basis points to 1.54%. The average rate paid on subordinated debt decreased 174 basis points to 2.34%, compared to the same period in 2015, due to the maturity of a derivative financial instrument.

Interest expense increased \$795,000, or 19.0%, for the six months ended June 30, 2016 resulting from higher average balances of deposits and FHLB advances compared to the same period in 2015. Higher interest expense on interest-bearing liabilities reflect net accretion of \$279,000 and \$641,000 for the six months ended June 30, 2016 and 2015, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. The average balance of interest-bearing deposits increased \$47.8 million to \$932.0 for the six months ended June 30, 2016 and the average rate paid increased six basis points to 0.69%, compared to the same period in 2015. Increases in the average balance of certificates of deposit and NOW and money market deposits totaled \$40.3 million and \$13.6 million, respectively, while the average balance of savings accounts decreased \$6.6 million compared to the first half ended June 30, 2015. The average balance of FHLB advances increased \$60.7 million for the six months ended June 30, 2016, while the average rate paid decreased zero basis points to 1.54%. The average rate paid on subordinated debt decreased 181 basis points to 2.27%, compared to the same period in 2015 due to the maturity of a derivative financial instrument.

**Average Balance Sheet.** The following sets forth information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resulting yields and rates paid, interest rate spread, net interest margin, and the ratio of average interest-earning assets to average interest-bearing liabilities for the periods indicated.

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|  | At or For the Three Months Ended June 30, |                         |  |                    |                         |  |
|--|---|-------------------------|--|--------------------|-------------------------|--|
|  | 2016                                      |                         |  | 2015               |                         |  |
|  | Average<br>Balance                        | Interest &<br>Dividends | Average<br>Yield/<br>Rate <sup>(8)</sup> | Average<br>Balance | Interest &<br>Dividends | Average<br>Yield/<br>Rate <sup>(8)</sup> |
|  | (Dollars in Thousands)                    |                         |  |                    |                         |  |
| Interest-earning assets:   |   |                         |  |                    |                         |  |
| Loans <sup>(1) (2)</sup>   | \$1,165,270                               | \$11,506                | 3.97 %                                   | \$1,090,848        | \$10,931                | 4.02 %                                   |
| Securities <sup>(3)</sup>  | 202,556                                   | 1,097                   | 2.18                                     | 184,460            | 846                     | 1.85                                     |
| Other interest-earning assets  | 60,316                                    | 77                      | 0.51                                     | 24,405             | 19                      | 0.31                                     |
| Total interest-earning assets  | 1,428,142                                 | 12,680                  | 3.57                                     | 1,299,713          | 11,796                  | 3.64                                     |
| Noninterest-earning assets   | 85,428                                    |                         |  | 93,036             |                         |  |
| Total assets   | \$1,513,570                               |                         |  | \$1,392,749        |                         |  |
| Interest-bearing liabilities:  |   |                         |  |                    |                         |  |
| Deposits:  |   |                         |  |                    |                         |  |
| Business checking  | \$712                                     | —                       | —  | \$295              | —                       | —  |
| NOW and money market   | 476,332                                   | 126                     | 0.11                                     | 465,364            | 134                     | 0.12                                     |
| Savings <sup>(4)</sup>   | 37,240                                    | 24                      | 0.26                                     | 40,858             | 17                      | 0.17                                     |
| Certificates of deposit <sup>(5)</sup>   | 432,949                                   | 1,505                   | 1.40                                     | 382,554            | 1,228                   | 1.29                                     |
| Total interest-bearing deposits  | 947,233                                   | 1,655                   | 0.70                                     | 889,071            | 1,379                   | 0.62                                     |
| Federal Home Loan Bank advances  | 212,526                                   | 816                     | 1.54                                     | 173,438            | 682                     | 1.58                                     |
| Subordinated debt  | 8,248                                     | 48                      | 2.34                                     | 8,248              | 84                      | 4.08                                     |
| Total interest-bearing liabilities   | 1,168,007                                 | 2,519                   | 0.87                                     | 1,070,757          | 2,145                   | 0.80                                     |
| Noninterest-bearing liabilities  | 186,813                                   |                         |  | 166,907            |                         |  |
| Total liabilities  | 1,354,820                                 |                         |  | 1,237,664          |                         |  |
| Total shareholders' equity   | 158,750                                   |                         |  | 155,085            |                         |  |
| Total liabilities and shareholders' equity   | \$1,513,570                               |                         |  | \$1,392,749        |                         |  |
| Net interest-earning assets  | \$260,135                                 |                         |  | \$228,956          |                         |  |
| Tax equivalent net interest income <sup>(3)</sup>  |   | 10,161                  |  |                    | 9,651                   |  |
| Tax equivalent interest rate spread <sup>(6)</sup>   |   |                         | 2.70 %                                   |                    |                         | 2.84 %                                   |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |   |                         | 2.86 %                                   |                    |                         | 2.98 %                                   |
| Average of interest-earning assets to average interest-bearing liabilities                   |   |                         | 122.27 %                                 |                    |                         | 121.38 %                                 |
| Less tax equivalent adjustment <sup>(3)</sup>  |   | (5 )                    |  |                    | (6 )                    |  |
| Net interest income  |   | \$10,156                |  |                    | \$9,645                 |  |

(1) Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale and excludes the allowance for loan losses.

(2) Loan fees are included in interest income and are immaterial.

(3) Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amounts reported in the statements of income.

(4) Includes mortgagors' and investors' escrow accounts.

(5) Includes brokered deposits.

(6) Tax equivalent net interest rate spread represents the

difference  
between the  
weighted  
average yield on  
interest-earning  
assets and the  
weighted  
average cost of  
interest-bearing  
liabilities.

(7) Tax  
equivalent net  
interest margin  
represents tax  
equivalent net  
interest income  
divided by  
average  
interest-earning  
assets.

(8) Annualized.

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|  | At or For the Six Months Ended June 30, |                         |  |                    |                         |  |
|--|---|-------------------------|--|--------------------|-------------------------|--|
|  | 2016                                    |                         |  | 2015               |                         |  |
|  | Average<br>Balance                      | Interest &<br>Dividends | Average<br>Yield/<br>Rate <sup>(8)</sup> | Average<br>Balance | Interest &<br>Dividends | Average<br>Yield/<br>Rate <sup>(8)</sup> |
|  | (Dollars in Thousands)                  |                         |  |                    |                         |  |
| Interest-earning assets:   |   |                         |  |                    |                         |  |
| Loans <sup>(1) (2)</sup>   | \$1,168,051                             | \$23,077                | 3.97 %                                   | \$1,072,560        | \$21,545                | 4.05 %                                   |
| Securities <sup>(3)</sup>  | 198,610                                 | 2,117                   | 2.14                                     | 185,539            | 1,694                   | 1.85                                     |
| Other interest-earning assets  | 51,294                                  | 133                     | 0.52                                     | 24,459             | 38                      | 0.31                                     |
| Total interest-earning assets  | 1,417,955                               | 25,327                  | 3.59                                     | 1,282,558          | 23,277                  | 3.66                                     |
| Noninterest-earning assets   | 85,746                                  |                         |  | 91,739             |                         |  |
| Total assets   | \$1,503,701                             |                         |  | \$1,374,297        |                         |  |
| Interest-bearing liabilities:  |   |                         |  |                    |                         |  |
| Deposits:  |   |                         |  |                    |                         |  |
| Business checking  | \$727                                   | —                       | —  | \$279              | —                       | —  |
| NOW and money market   | 472,799                                 | 252                     | 0.11                                     | 459,171            | 266                     | 0.12                                     |
| Savings <sup>(4)</sup>   | 36,371                                  | 48                      | 0.27                                     | 42,960             | 35                      | 0.16                                     |
| Certificates of deposit <sup>(5)</sup>   | 422,145                                 | 2,904                   | 1.38                                     | 381,806            | 2,446                   | 1.29                                     |
| Total interest-bearing deposits  | 932,042                                 | 3,204                   | 0.69                                     | 884,216            | 2,747                   | 0.63                                     |
| Federal Home Loan Bank advances  | 220,270                                 | 1,690                   | 1.54                                     | 159,575            | 1,278                   | 1.62                                     |
| Subordinated debt  | 8,248                                   | 93                      | 2.27                                     | 8,248              | 167                     | 4.08                                     |
| Total interest-bearing liabilities   | 1,160,560                               | 4,987                   | 0.86                                     | 1,052,039          | 4,192                   | 0.80                                     |
| Noninterest-bearing liabilities  | 185,357                                 |                         |  | 165,627            |                         |  |
| Total liabilities  | 1,345,917                               |                         |  | 1,217,666          |                         |  |
| Total shareholders' equity   | 157,784                                 |                         |  | 156,631            |                         |  |
| Total liabilities and shareholders' equity   | \$1,503,701                             |                         |  | \$1,374,297        |                         |  |
| Net interest-earning assets  | \$257,395                               |                         |  | \$230,519          |                         |  |
| Tax equivalent net interest income <sup>(3)</sup>  |   | 20,340                  |  |                    | 19,085                  |  |
| Tax equivalent interest rate spread <sup>(6)</sup>   |   |                         | 2.73 %                                   |                    |                         | 2.86 %                                   |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |   |                         | 2.88 %                                   |                    |                         | 3.00 %                                   |
| Average of interest-earning assets to average interest-bearing liabilities                   |   |                         | 122.18%                                  |                    |                         | 121.91%                                  |
| Less tax equivalent adjustment <sup>(3)</sup>  |   | (10 )                   |  |                    | (17 )                   |  |
| Net interest income  |   | \$20,330                |  |                    | \$19,068                |  |

(1) Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale and excludes the allowance for loan losses.

(2) Loan fees are included in interest income and are immaterial.

(3) Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amounts reported in the statements of income.

(4) Includes mortgagors' and investors' escrow accounts.

(5) Includes brokered deposits.

(6) Tax equivalent net interest rate spread represents the

difference between the weighted average yield on interest-earning assets and the weighted average cost of interest-bearing liabilities.

(7) Tax equivalent net interest margin represents tax equivalent net interest income divided by average interest-earning assets.

(8) Annualized.

The following table sets forth the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have on the Company's interest income and interest expense for the periods presented. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the rate and volume columns. For purposes of this table, changes attributable to both changes in rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

|                                    | Three Months Ended     |        |       | Six Months Ended        |          |         |
|------------------------------------|------------------------|--------|-------|-------------------------|----------|---------|
|                                    | June 30, 2016 and 2015 |        |       | June 30, 2016 and 2015  |          |         |
|                                    | Increase (Decrease)    |        |       | Increase (Decrease) Due |          |         |
|                                    | Due To                 |        |       | To                      |          |         |
|                                    | Rate                   | Volume | Net   | Rate                    | Volume   | Net     |
|                                    | (In Thousands)         |        |       |                         |          |         |
| Interest-earning assets:           |                        |        |       |                         |          |         |
| Interest and dividend income:      |                        |        |       |                         |          |         |
| Loans <sup>(1)(2)</sup>            | \$(162)                | \$ 737 | \$575 | \$(358)                 | \$ 1,890 | \$1,532 |
| Securities <sup>(3)</sup>          | 173                    | 78     | 251   | 310                     | 113      | 423     |
| Other interest-earning assets      | 43                     | 15     | 58    | 71                      | 24       | 95      |
| Total interest-earning assets      | 54                     | 830    | 884   | 23                      | 2,027    | 2,050   |
| Interest-bearing liabilities:      |                        |        |       |                         |          |         |
| Interest expense:                  |                        |        |       |                         |          |         |
| Deposits <sup>(4)</sup>            | 121                    | 155    | 276   | 207                     | 250      | 457     |
| Federal Home Loan Bank advances    | (16 )                  | 150    | 134   | (56 )                   | 468      | 412     |
| Subordinated debt                  | (36 )                  | —      | (36 ) | (74 )                   | —        | (74 )   |
| Total interest-bearing liabilities | 69                     | 305    | 374   | 77                      | 718      | 795     |
| Change in net interest income      | \$(15 )                | \$ 525 | \$510 | \$(54 )                 | \$ 1,309 | \$1,255 |

(1) Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale.

(2) Loan fees are included in interest income and are immaterial.

(3) Municipal securities income and net interest income are presented



on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amount reported in the statements of income.

<sup>(4)</sup> Includes mortgagors' and investors' escrow accounts and brokered deposits.

Provision for Loan Losses. The provision for loan losses increased \$222,000 and \$198,000 for the three and six months ended June 30, 2016, respectively, compared to the same periods in 2015, primarily due to increases in nonperforming loans and net loan charge-offs. At June 30, 2016, nonperforming loans increased to \$7.0 million compared to \$5.9 million at June 30, 2015, resulting from increases in commercial real estate loans of \$2.0 million and home equity loans of \$233,000, offset by decreases in nonperforming commercial business loans of \$858,000 and residential loans of \$253,000. Net loan charge-offs were \$72,000 and \$113,000 for the three and six months ended June 30, 2016, respectively, consisting primarily of home equity and residential real estate loan charge-offs, compared to \$5,000 and \$55,000 for the three and six months ended June 30, 2015, respectively.

Noninterest Income. The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

|   | Three Months<br>Ended June 30, |         | Change  |         | Six Months<br>Ended June 30, |         | Change  |         |
|---|--------------------------------|---------|---------|---------|------------------------------|---------|---------|---------|
|   | 2016                           | 2015    | Dollars | Percent | 2016                         | 2015    | Dollars | Percent |
|   | (Dollars in Thousands)         |         |         |         |                              |         |         |         |
| Service fees  | \$1,569                        | \$1,692 | \$(123) | (7.3 )% | \$3,213                      | \$3,340 | \$(127) | (3.8 )% |
| Wealth management fees  | 302                            | 315     | (13 )   | (4.1 )  | 601                          | 613     | (12 )   | (2.0 )  |
| Increase in cash surrender value of bank-owned life insurance | 136                            | 142     | (6 )    | (4.2 )  | 277                          | 303     | (26 )   | (8.6 )  |
| Net gain on sales of securities                               | —                              | 132     | (132 )  | (100.0) | —                            | 132     | (132 )  | (100.0) |
| Mortgage banking  | 399                            | 130     | 269     | 206.9   | 669                          | 277     | 392     | 141.5   |
| Net gain (loss) on fair value of derivatives                  | 16                             | (10 )   | 26      | (260.0) | 15                           | (15 )   | 30      | (200.0) |
| Net loss on disposal of equipment                             | (35 )                          | (14 )   | (21 )   | 150.0   | (36 )                        | (20 )   | (16 )   | 80.0    |
| Other   | 199                            | 223     | (24 )   | (10.8 ) | 549                          | 317     | 232     | 73.2    |
| Total noninterest income                                      | \$2,586                        | \$2,610 | \$(24 ) | (0.9 )% | \$5,288                      | \$4,947 | \$341   | 6.9 %   |

Noninterest income decreased \$24,000 to \$2.6 million for the three months ended June 30, 2016 compared to the same period in 2015, primarily due to decreases in the net gain on available for sale securities of \$132,000 and service fees of \$123,000, offset by an increase in mortgage banking activities of \$269,000. For the six months ended June 30, 2016, noninterest income increased \$341,000 to \$5.3 million versus the comparable period in the prior year, primarily due to increases in mortgage banking activities of \$392,000 and other noninterest income of \$232,000, offset by decreases in the net gain on available for sale securities of \$132,000 and service fees of \$127,000. The increase in mortgage banking activities compared to the same period in 2015 was due primarily to a higher volume of loan sales. Other noninterest income increased compared to the same period in 2015, primarily as a result of profit distributions from the Bank's investments in three small business investment companies.

Noninterest Expenses. The following table shows the components of noninterest expenses and the dollar and percentage changes for the periods presented.

|   | Three Months<br>Ended June 30, |          | Change  |         | Six Months<br>Ended June 30, |          | Change  |         |
|---|--------------------------------|----------|---------|---------|------------------------------|----------|---------|---------|
|   | 2016                           | 2015     | Dollars | Percent | 2016                         | 2015     | Dollars | Percent |
|   | (Dollars in Thousands)         |          |         |         |                              |          |         |         |
| Salaries and employee benefits                    | \$4,643                        | \$5,129  | \$(486) | (9.5 )% | \$9,821                      | \$10,073 | \$(252) | (2.5 )% |
| Occupancy and equipment                           | 1,703                          | 1,791    | (88 )   | (4.9 )  | 3,446                        | 3,844    | (398 )  | (10.4)  |
| Computer and electronic banking services          | 1,476                          | 1,458    | 18      | 1.2     | 2,944                        | 2,755    | 189     | 6.9     |
| Outside professional services                     | 379                            | 508      | (129 )  | (25.4)  | 1,014                        | 974      | 40      | 4.1     |
| Marketing and advertising                         | 238                            | 274      | (36 )   | (13.1)  | 451                          | 520      | (69 )   | (13.3)  |
| Supplies  | 121                            | 144      | (23 )   | (16.0)  | 289                          | 292      | (3 )    | (1.0 )  |
| FDIC deposit insurance and regulatory assessments | 253                            | 248      | 5       | 2.0     | 525                          | 493      | 32      | 6.5     |
| Core deposit intangible amortization              | 150                            | 151      | (1 )    | (0.7 )  | 301                          | 301      | —       | —       |
| Other real estate operations                      | 69                             | 202      | (133 )  | (65.8)  | 125                          | 284      | (159 )  | (56.0)  |
| Other   | 548                            | 501      | 47      | 9.4     | 930                          | 931      | (1 )    | (0.1 )  |
| Total noninterest expenses                        | \$9,580                        | \$10,406 | \$(826) | (7.9 )% | \$19,846                     | \$20,467 | \$(621) | (3.0 )% |

Noninterest expenses decreased \$826,000 and \$621,000 for the three and six months ended June 30, 2016, respectively, compared to the same periods in 2015. Salaries and employee benefits decreased \$486,000 and \$252,000, for the three and six months ended June 30, 2016, respectively, compared to the same periods in 2015 primarily as a result of a reduction in deferred compensation due to a post-retirement benefit payout. A reduction in occupancy and equipment expenses of \$88,000 and \$398,000 for the three and six months ended June 30, 2016, respectively, versus the comparable periods in 2015, was in large part a result of strategic initiatives to reduce branch infrastructure costs, the reconfiguration and optimization of our telephone and data services and lower snow removal expenditures. Computer and electronic banking services increased \$189,000 for the first six months of 2016 compared to the same period in 2015 resulting from data service speed improvements and electronic banking security enhancements related to the implementation of EMV (Europay, MasterCard and Visa) technology.

**Income Tax Provision.** The provision for income taxes increased \$368,000 and \$683,000 for the three and six months ended June 30, 2016, compared to the same periods in 2015. The effective tax rate for the three months ended June 30, 2016 was 33.0% and 32.5%, respectively. The effective tax rate for the first half of 2016 and 2015 was 33.0% and 32.5%, respectively.

### Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations of a short- and long-term nature. The Bank's primary sources of funds consist of deposit inflows, loan sales and repayments, maturities and sales of securities and FHLB borrowings. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows, mortgage prepayments and loan and security sales are greatly influenced by general interest rates, economic conditions and competition.

The Bank's most liquid assets are cash and cash equivalents. The levels of these assets depend on the Bank's operating, financing, lending and investing activities during any given period. At June 30, 2016, cash and cash equivalents totaled \$74.5 million. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$188.1 million at June 30, 2016. In addition, at June 30, 2016, the Bank had the ability to borrow an additional \$53.5 million from the FHLB, which included overnight lines of credit of \$10.0 million. On that date, the Bank had FHLB advances outstanding of \$207.9 million and no overnight advances outstanding. Additionally, the Bank has the ability to access the Federal Reserve Bank's Discount Window on a collateralized basis and maintains a \$7.0 million unsecured line of credit with a financial institution to access federal funds. The Bank believes that its liquid assets combined with the available lines from the FHLB provide adequate liquidity to meet its current financial obligations.

The Bank's primary investing activities are the origination, purchase and sale of loans and the purchase and sale of securities. For the six months ended June 30, 2016, the Bank originated \$86.4 million of loans and purchased \$24.4 million of securities and \$11.9 million of loans. For the year ended December 31, 2015, the Bank originated \$266.5 million of loans and purchased \$45.4 million of securities and \$113.2 million of loans.

Financing activities consist primarily of activity in deposit accounts and in borrowed funds. The net increase in total deposits, including mortgagors' and investors' escrow accounts, was \$59.4 million for the six months ended June 30, 2016. FHLB advances decreased \$26.7 million during the six months ended June 30, 2016 and increased \$86.3 million during the year ended December 31, 2015. The decrease in borrowings for the six months ended June 30, 2016 resulted from the net repayments of FHLB advances. Certificates of deposit due within one year of June 30, 2016 totaled \$220.9 million, or 19.8% of total deposits. Management believes the amount of deposits in shorter-term certificates of deposit reflects customers' hesitancy to invest their funds in longer-term certificates of deposit due to the uncertain interest rate environment. To compensate, the Bank has increased the duration of its borrowings with the FHLB. The Bank will be required to seek other sources of funds, including other certificates of deposit and lines of

credit, if maturing certificates of deposit are not retained. Depending on market conditions, the Bank may be required to pay higher rates on such deposits or other borrowings than are currently paid on certificates of deposit. Additionally, a shorter duration in the securities portfolio may be necessary to provide

liquidity to compensate for any deposit outflows. The Bank believes, however, based on past experience, a significant portion of its certificates of deposit will be retained. The Bank has the ability, if necessary, to adjust the interest rates offered to its customers in an effort to attract and retain deposits.

Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by the Bank and its local competitors and other factors. The Bank generally manages the pricing of its deposits to be competitive and to increase core deposits and commercial banking relationships. Occasionally, the Bank offers promotional rates on certain deposit products to attract deposits.

The Company repurchased 3,230 shares of the Company's common stock at a cost of \$37,000 during the first six months of 2016 and 628,530 shares of the Company's common stock at a cost of \$7.5 million during the year ended December 31, 2015. Additional discussion about the Company's liquidity and capital resources is contained in Item 7 in the Company's 2015 Annual Report on Form 10-K.

SI Financial Group, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, SI Financial Group is responsible for paying any dividends declared to its shareholders and making payments on its subordinated debentures. SI Financial Group may continue to repurchase shares of its common stock in the future. SI Financial Group's primary sources of funds are interest and dividends on securities and dividends received from the Bank. The amount of dividends the Bank may declare and pay to SI Financial Group in any calendar year, without prior regulatory approval, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. SI Financial Group believes that such restriction will not have an impact on SI Financial Group's ability to meet its ongoing cash obligations. At June 30, 2016, SI Financial Group had cash and cash equivalents of \$2.5 million and available for sale securities of \$5.1 million.

#### Payments Due Under Contractual Obligations

Information relating to payments due under contractual obligations is presented in the Company's Form 10-K for the year ended December 31, 2015. There were no material changes in the Company's payments due under contractual obligations between December 31, 2015 and June 30, 2016.

#### Off-Balance Sheet Arrangements

As a financial services provider, we routinely are a party to various financial instruments with off-balance sheet risks, such as commitments to extend credit, standby letters of credit and unused lines of credit. While these contractual obligations represent our future cash requirements, a significant portion of the commitments to extend credit may expire without being drawn upon. The contractual amounts of commitments to extend credit represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer defaults and the value of any existing collateral becomes worthless. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.



Financial instruments whose contract amounts represent credit risk at June 30, 2016 and December 31, 2015 are as follows:

|   | June 30,<br>2016 | December<br>31, 2015 |
|---|------------------|----------------------|
|   | (In Thousands)   |                      |
| Commitments to extend credit:           |                  |                      |
| Commitments to originate loans          | \$26,153         | \$7,531              |
| Undisbursed construction loans          | 16,349           | 28,939               |
| Undisbursed home equity lines of credit | 51,417           | 46,819               |
| Undisbursed commercial lines of credit  | 55,557           | 47,354               |
| Overdraft protection lines              | 1,301            | 1,262                |
| Standby letters of credit               | 173              | 173                  |
| Total commitments                       | \$150,950        | \$132,078            |

Future loan commitments at June 30, 2016 and December 31, 2015 included fixed-rate loan commitments of \$15.9 million and \$5.3 million, respectively, at interest rates ranging from 2.75% to 5.00% and 2.88% to 5.75%, respectively.

The Bank is a limited partner in three small business investment corporations ("SBICs"). At June 30, 2016, the Bank's remaining off-balance sheet commitment for the capital investment in the SBICs was \$955,000.

For the six months ended June 30, 2016, with the exception of the aforementioned commitments, the Company did not engage in any additional off-balance sheet transactions reasonably likely to have a material effect on the Company's financial condition, results of operations or cash flows. See Notes 6 and 12 to the consolidated financial statements contained in the Company's 2015 Annual Report on Form 10-K.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

#### Qualitative Aspects of Market Risk

The primary market risk affecting the financial condition and operating results of the Company is interest rate risk. Interest rate risk is the exposure of current and future earnings and capital arising from movements in interest rates. The Company manages the interest rate sensitivity of its interest-bearing liabilities and interest-earning assets in an effort to minimize the adverse effects of changes in the interest rate environment. To reduce the volatility of its earnings, the Company has sought to improve the match between asset and liability maturities and rates, while maintaining an acceptable interest rate spread. The Company's strategy for managing interest rate risk generally is to emphasize the origination of adjustable-rate mortgage loans for retention in its loan portfolio. However, the ability to originate adjustable-rate loans depends to a great extent on market interest rates and borrowers' preferences. As an alternative to adjustable-rate mortgage loans, the Company purchases variable-rate SBA and USDA loans in the secondary market that are fully guaranteed by the U.S. government. These loans have a significantly shorter duration than fixed-rate mortgage loans. Fixed-rate mortgage loans typically have an adverse effect on interest rate sensitivity compared to adjustable-rate loans. Accordingly, the Company has sold more longer-term fixed-rate mortgage loans in the secondary market in recent periods to manage interest rate risk. The Company offers 10-year fixed-rate mortgage loans that it retains in its portfolio. The Company may offer attractive rates for existing certificates of deposit accounts to extend their maturities. The Company also uses shorter-term investment securities and longer-term borrowings from the FHLB to help manage interest rate risk.

The Company has an Asset/Liability Committee to communicate, coordinate and control all aspects involving asset/liability management. The committee establishes and monitors the volume, maturities, pricing and mix of assets

and funding sources with the objective of managing assets and funding sources to provide results that are consistent with liquidity, growth, risk limits and profitability goals.

In January 2012, the Company entered into an interest rate swap agreement with a third-party financial institution with a notional amount of \$15.0 million, whereby the counterparty will pay a variable rate equal to three-month LIBOR and the Company will pay a fixed rate of 1.26%. The agreement was effective on January 11, 2012 and terminates on January 11, 2017. This agreement was not designated as a hedging instrument.

#### Quantitative Aspects of Market Risk

The Company analyzes its interest rate sensitivity position to manage the risk associated with interest rate movements through the use of interest income simulation. The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are “interest rate sensitive.” An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period. The Company’s goal is to manage asset and liability positions to moderate the effect of interest rate fluctuations on net interest income.

#### Net Interest Income Simulation Analysis

The interest income simulations provide an estimate of the impact of changes in interest rates on net interest income under a range of assumptions and are completed quarterly. Interest income simulations and the



numerous assumptions used in the simulation process are presented and reviewed by the Asset/Liability Committee on a quarterly basis. Changes to these assumptions can significantly affect the results of the simulation. The simulation incorporates assumptions regarding the potential timing in the repricing of certain assets and liabilities when market rates change and the changes in spreads between different market rates. The simulation analysis incorporates management's current assessment of the risk that pricing margins will change adversely over time due to competition or other factors. Simulation analysis is only an estimate of the Company's interest rate risk exposure at a particular point in time. The Company continually reviews the potential effect changes in interest rates could have on the repayment of rate sensitive assets and funding requirements of rate sensitive liabilities.

The table below sets forth an approximation of the Company's exposure as a percentage of estimated net interest income for the next 12- and 24-month periods using interest income simulation. The simulation uses projected repricing of assets and liabilities at June 30, 2016 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rates can have a significant impact on interest income simulation. Because of the large percentage of loans and mortgage-backed securities the Company holds, rising or falling interest rates have a significant impact on the prepayment speeds of the Company's earning assets that in turn affect the rate sensitivity position. When interest rates rise, prepayments tend to slow. When interest rates fall, prepayments tend to rise. The Company's asset sensitivity would be reduced if prepayments slow and vice versa. While the Company believes such assumptions to be reasonable, there can be no assurance that assumed prepayment rates will approximate actual future mortgage-backed security and loan repayment activity.

The following table reflects changes in estimated net interest income for the Company at June 30, 2016.

|                                   | Percentage<br>Change in<br>Estimated<br>Net Interest<br>Income Over |              |
|-----------------------------------|---|--------------|
|                                   | 12<br>Months  | 24<br>Months |
| 100 basis point decrease in rates | (3.18)%   | (3.95)%      |
| 200 basis point increase in rates | 2.39  | 2.32         |
| 300 basis point increase in rates | 2.79  | 2.34         |

As indicated by the results of the above scenarios, net interest income would be adversely affected (within our internal guidelines) if rates decreased 100 basis points in the 12- and 24-month periods. Conversely, net interest income would be positively impacted in the 12- and 24-month periods if rates increased 200 or 300 basis points as a result of the Company's initiative to position the balance sheet for the anticipated increase in market interest rates. The Company's strategy for mitigating interest rate risk includes the purchase of adjustable-rate investment securities and SBA and USDA loans that will reprice in a rising rate environment, selling longer-term and lower fixed-rate residential mortgage loans in the secondary market, restructuring FHLB advances to current lower market interest rates while extending their duration and utilizing certain derivative instruments such as forward loan sale commitments to manage the risk of loss associated with its mortgage banking activities.

#### Item 4. Controls and Procedures.

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for ensuring that the

information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. No changes in the Company's internal control over financial reporting

occurred during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

The Company is not involved in any pending legal proceedings believed by management to be material to the Company's financial condition or results of operations. Periodically, there have been various claims and lawsuits against the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds a security interest, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. Management believes these legal proceedings would not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

### Item 1A. Risk Factors.

Except as disclosed below, there are no material changes from the risk factors set forth under Part I, Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, which could materially and adversely affect the Company's business, financial condition or future results. The risks described in the Company's Annual Report on Form 10-K are not the only risks that the Company faces. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results.

A new accounting standard will likely require us to increase our allowance for loan losses and may have a material adverse effect on our financial condition and results of operations.

The FASB has adopted a new accounting standard that will be effective for the Company and the Bank for our first fiscal year after December 15, 2019. This standard, referred to as Current Expected Credit Loss, or CECL, will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for loan losses. This will change the current method of providing allowances for loan losses that are probable, which would likely require us to increase our allowance for loan losses, and to greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for loan losses. Any increase in our allowance for loan losses or expenses incurred to determine the appropriate level of the allowance for loan losses may have a material adverse effect on our financial condition and results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The Company's repurchases of equity securities for the three months ended June 30, 2016 were as follows:

| Period             | Total Number of Shares Purchased (1) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|--------------------|--------------------------------------|------------------------------|--|--|
| April 1 - 30, 2016 | 898                                  | \$ 4.57                      | —  | —  |
| May 1 - 31, 2016   | —                                    | —                            | —  | —  |
| June 1 - 30, 2016  | —                                    | —                            | —  | —  |
| Total              | 898                                  | \$ 4.57                      | —  | —  |

(1) Consists of shares surrendered by employees to satisfy tax withholding requirements upon the vesting of stock awards. These shares were not repurchased as part of a publicly announced plan or program.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.



Item 6. Exhibits.

- 3.1 Articles of Incorporation of SI Financial Group, Inc. <sup>(1)</sup>
- 3.2 Bylaws of SI Financial Group, Inc. <sup>(2)</sup>
- 4 Specimen Stock Certificate of SI Financial Group, Inc. <sup>(1)</sup>
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32 18 U.S.C. Section 1350 Certifications

The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016, formatted in eXtensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Statement of Changes in Shareholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) related Notes to Consolidated Financial Statements.

<sup>(1)</sup> Incorporated herein by reference into this document from the Exhibits on the Registration Statement on Form S-1 (File No. 333-169302), and any amendments thereto, filed with the Securities and Exchange Commission on September 10, 2010.

<sup>(2)</sup> Incorporated herein by reference into this document from the Exhibits to the Company's Current Report on Form 8-K (File No. 000-54241) filed with the

Securities and  
Exchange  
Commission  
on January  
27, 2016.

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SIGNATURES

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

SI FINANCIAL GROUP, INC.

Date: August 8, 2016 /s/ Rheo A. Brouillard  
Rheo A. Brouillard  
President and Chief Executive Officer  
(principal executive officer)

Date: August 8, 2016 /s/ Lauren L. Murphy  
Lauren L. Murphy  
Senior Vice President and Chief Financial Officer  
(principal accounting and financial officer)