

ANTARES PHARMA, INC.
Form 10-K
March 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF
1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2015

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

For transition period from _____ to _____

Commission file number 1-32302

ANTARES PHARMA, INC.

(Exact name of registrant as specified in its charter)

A Delaware corporation I.R.S. Employer Identification No. 41-1350192

100 Princeton South, Suite 300, Ewing, NJ 08628

Registrant's telephone number, including area code: (609) 359-3020

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

Title of each class	Name of each exchange on which registered
Common Stock	NASDAQ Capital Market

Securities registered pursuant to section 12(g) of the Act: None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES NO

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES NO

Aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant as of June 30, 2015, was \$294,965,000 (based upon the last reported sale price of \$2.08 per share on June 30, 2015, on the NASDAQ Capital Market).

There were 154,848,512 shares of common stock outstanding as of March 1, 2016.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the registrant's 2016 annual meeting of stockholders to be filed within 120 days after the end of the period covered by this annual report on Form 10-K are incorporated by reference into Part III of this annual report on Form 10-K.

ANTARES PHARMA, INC.

FORM 10-K

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PART I

Item 1. BUSINESS

Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and the Private Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties. You should not place undue reliance on those statements because they are subject to numerous uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control. You can identify these statements by the fact that they do not relate strictly to historical or current facts. Such statements may include words such as “anticipate,” “will,” “estimate,” “expect,” “project,” “intend,” “should,” “plan,” “believe,” “hope,” and other words and terms of similar meaning in connection with any discussion of, among other things, future operating or financial performance, strategic initiatives and business strategies, regulatory or competitive environments, our intellectual property and product development. In particular, these forward-looking statements include, among others, statements about:

- our expectations regarding commercialization of OTREXUP™ (methotrexate) injection for subcutaneous use;
- our expectations regarding product development including clinical trial results, and potential approval by the United States (“U.S.”) Food and Drug Administration (“FDA”) of VIBEX QuickShot® for Testosterone injection (“VIBEX QS T”);
- our expectations regarding product development and potential FDA approval of VIBEX® Epinephrine Pen (“epinephrine auto injector”) and Teva Pharmaceutical Industries, Ltd.’s (“Teva”) ability to successfully commercialize the epinephrine auto injector;
- our expectations regarding our, and our partner Teva’s ability to successfully commercialize and launch VIBEX® Sumatriptan (sumatriptan injection);
- our expectations regarding continued product development with our partners, including Teva and AMAG Pharmaceuticals, Inc. (“AMAG”);
- our expectations regarding trends in pharmaceutical drug delivery characteristics;
- our anticipated continued reliance on contract manufacturers to manufacture our products;
- our sales and marketing plans;
- product development and commercialization plans regarding our other products and product candidates;
- timing and results of our clinical trials;
- our future cash flow and our ability to support our operations;
- the impact of new accounting pronouncements and our expectations and estimates with regard to current accounting practices, including estimates of OTREXUP™ prescription data provided by third-party sources, which are used in our revenue recognition methods; and
 - other statements regarding matters that are not historical facts or statements of current condition.

These forward-looking statements are based on assumptions that we have made in light of our industry experience as well as our perceptions of historical trends, current conditions, expected future developments and other factors we believe are appropriate under the circumstances. As you read and consider this annual report, you should understand that these statements are not guarantees of performance results. Forward-looking statements involve known and unknown risks, uncertainties and assumptions, and other factors that may cause our or our industry’s actual results, levels of activity, performance or achievements to be materially different from the information expressed or implied by these forward-looking statements. While we believe that we have a reasonable basis for each forward-looking statement contained in this report, we caution you that these statements are based on a combination of facts and factors currently known by us and projections of the future about which we cannot be certain. Many factors may affect our ability to achieve our objectives, including:

- delays in product introduction and marketing or interruptions in supply;

- a decrease in business from our major customers and partners;
 - our inability to compete successfully against new and existing competitors or to leverage our research and development capabilities and our marketing capabilities;

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- our inability to effectively market our services or obtain and maintain arrangements with our customers, partners and manufacturers;
- our inability to effectively protect our intellectual property;
- costs associated with future litigation and the outcome of such litigation;
- our inability to attract and retain key personnel;
- changes or delays in the regulatory process;
- adverse economic and political conditions; and
- our ability to obtain additional financing, reduce expenses or generate funds when necessary.

Forward-looking statements made by us in this annual report speak only as of the date of this annual report. Actual results could differ materially from those currently anticipated as a result of a number of risk factors, including, but not limited to, the risks and uncertainties discussed under the caption “Risk Factors.” New risks and uncertainties come up from time to time, and it is impossible for us to predict these events or how they may affect us. We do not undertake to update or revise the forward-looking statements in this annual report after the date of this annual report, except as required by law. In light of these risks and uncertainties, you should keep in mind that any forward-looking statement in this annual report or elsewhere might not occur.

Overview

Antares Pharma, Inc. (“Antares,” “we,” “our,” “us” or the “Company”) is an emerging, specialty pharmaceutical company that focuses on the development and commercialization of self-administered parenteral pharmaceutical products and technologies. Our subcutaneous injection technology platforms include VIBEX[®] disposable pressure-assisted auto injectors, Vision[®] reusable needle-free injectors, and disposable multi-use pen injectors. We have multiple internal product development programs as well as significant partnership arrangements with several industry leading pharmaceutical companies. We have formed strategic alliances with Teva Pharmaceutical Industries, Ltd. (“Teva”), Ferring Pharmaceuticals Inc. and Ferring B.V. (together “Ferring”), JCR Pharmaceuticals Co., Ltd. (“JCR”), and AMAG Pharmaceuticals, Inc. (“AMAG”). We develop and apply our drug delivery systems in collaborations with these pharmaceutical partners to enhance our partners' drug compounds and delivery methods.

We develop and manufacture novel, pressure-assisted injector devices, with and without needles, which allow patients to self-inject drugs. We make a reusable, needle-free spring action injection device, known as the ZOMA-Jet[™] or Twin-Jector[®], which is marketed through our partners for use with human growth hormone (hGH). We have developed variations of the needle-free injector by adding a small shielded needle to a pre-filled, single-use disposable injector, called the VIBEX[®] pressure assisted auto injection system. This system is an alternative to the needle-free system for use with injectable drugs in unit dose containers and is suitable for various branded and generic injectables. We also developed disposable multi-dose pen injectors for use with standard cartridges. We have entered into multiple licenses for these devices mainly in the U.S., Europe and Canada with Teva.

In February 2014, we launched our proprietary product OTREXUP[™](methotrexate) injection, which was the first FDA-approved subcutaneous methotrexate for once weekly self-administration with an easy-to-use, single dose, disposable auto injector. OTREXUP[™], which utilizes our VIBEX[®] auto injector, is indicated for adults with severe active rheumatoid arthritis (“RA”), children with active polyarticular juvenile idiopathic arthritis (“pJIA”) and adults with severe recalcitrant psoriasis. To date, we have received FDA approval for dosage strengths of 7.5 mg, 10 mg, 15 mg, 20 mg and 25 mg of OTREXUP[™].

In December 2015, the FDA approved our Abbreviated New Drug Application (ANDA) for 4 mg/0.5 mL and 6 mg/0.5 mL Sumatriptan Injection USP, indicated for adults for the acute treatment of migraine and cluster headache. Sumatriptan Injection USP represents the Company’s first ANDA approval of a complex generic and second product approved using the VIBEX[®] auto injector platform. Under the terms of a license, supply and distribution arrangement, the VIBEX[®] Sumatriptan product will be distributed by Teva, and is currently expected to be launched in 2016.

We are collaborating with Teva on a combination product development project for a VIBEX[®] auto injector pen containing epinephrine. Teva submitted an amendment to the VIBEX[®] epinephrine pen ANDA in December 2014 and received a Complete Response Letter (“CRL”) from the FDA on February 23, 2016 in which, according to Teva, the FDA identified certain major deficiencies. Teva is evaluating the CRL and intends to submit a response. Due to the major nature of the CRL, Teva expects that its epinephrine product will be substantially delayed from their previously anticipated launch date in the second half of 2016 and that any launch will not take place before 2017.

Our other combination product development projects in collaboration with Teva include a VIBEX[®] exenatide multi-dose pen, and another undisclosed multi-dose pen. Teva filed an ANDA for exenatide, which was accepted by the FDA in October 2014 and is currently under FDA review.

We are currently conducting clinical studies of VIBEX[®] QS T, for testosterone replacement therapy. In February 2015, we announced positive top-line pharmacokinetic results that showed that the primary endpoint was achieved in the Company's ongoing, multi-center, phase 3 clinical study (QST-13-003) evaluating the efficacy and safety of testosterone enanthate administered once-weekly by subcutaneous injection using the QuickShot[®] auto injector in testosterone deficient adult males. In October 2015, we announced that the last patient in study QST-13-003 received their week 52 treatment, which marked the end of the treatment and follow up phase of this study. Based upon a written response we received from the FDA related to our clinical development program for QS T, we are currently conducting an additional study, QST-15-005, to support the filing of our expected 505 (b) (2) New Drug Application ("NDA") for QS T. The study includes a screening phase, a treatment titration phase and a treatment phase for evaluation of safety and tolerability assessments, including laboratory assessments, adverse events and injection site assessments. We completed enrollment in study QST-15-005 in October 2015 and anticipate that the last patient in the study will complete their final visit in the second quarter of 2016. We believe we will file the NDA for QS T in late 2016 or early 2017.

In partnership with AMAG Pharmaceuticals, Inc., we are currently developing a variation of our VIBEX[®] QuickShot[®] auto injector for use with AMAG's progestin hormone drug Makena[®] (hydroxy-progesterone caproate injection) under a license, development and supply agreement. Under this arrangement, AMAG is responsible for the clinical development and preparation, submission and maintenance of all regulatory applications, to manufacture and supply the drug, and to market, sell and distribute the product. We are responsible for the design and development of the auto-injection device, to manufacture and supply the device, and to assemble and package the final product.

We also have two gel-based products which are commercialized through partners. We have an oxybutynin gel product, Gelnique[™] for the treatment of overactive bladder ("OAB"), which is currently marketed in the U.S. under a licensing agreement with Actavis plc ("Actavis"). Elestrin[®] (estradiol gel) is currently marketed by Meda Pharmaceuticals, Inc. ("Meda") in the U.S. for the treatment of moderate-to-severe vasomotor symptoms associated with menopause.

Our products and product opportunities are summarized and briefly described below:

Product	Drug	Partners	Indication	Territory	Regulatory Status
OTREXUP [™]	Methotrexate	None	RA; pJIA Psoriasis	U.S.	Approved
ZOMA-Jet [™] Needle-free Injector	hGH (5 mg and 10 mg)	Ferring	Growth Retardation	U.S.	Approved
ZOMA-Jet [™] Needle-free Injector	hGH (4 mg and 10 mg)	Ferring	Growth Retardation	Europe, Asia Pacific	Approved
Twin-Jector [®] EZ II Needle-free Injector	hGH	JCR	Growth Retardation	Japan	Approved
Elestrin [®]	Estradiol	Meda		U.S.	Approved

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Hormone
Replacement
Therapy

Oxybutynin Gel 3%	Oxybutynin	Nine Months Ended September 30,		
	2016	2015	2016	2015
Interest and dividend income:				
Loans, including fees	\$11,579	\$11,278	\$34,656	\$32,823
Securities:				
Taxable interest	855	766	2,601	2,253
Tax-exempt interest	14	14	42	63
Dividends	171	140	504	281
Other	84	19	217	57
Total interest and dividend income	12,703	12,217	38,020	35,477
Interest expense:				
Deposits	1,703	1,403	4,907	4,150
Federal Home Loan Bank advances	790	846	2,480	2,124
Subordinated debt and other borrowings	48	84	141	251
Total interest expense	2,541	2,333	7,528	6,525
Net interest income	10,162	9,884	30,492	28,952
Provision for loan losses	880	1,017	1,773	1,712
Net interest income after provision for loan losses	9,282	8,867	28,719	27,240
Noninterest income:				
Service fees	1,585	1,699	4,798	5,039
Wealth management fees	296	303	897	916
Increase in cash surrender value of bank-owned life insurance	136	146	413	449
Net gain on sales of securities	55	14	55	146
Mortgage banking	503	139	1,172	416
Net gain (loss) on fair value of derivatives	33	(7	48	(22
Net loss on disposal of equipment	(56	(17	(92	(37
Other	101	469	650	786
Total noninterest income	2,653	2,746	7,941	7,693
Noninterest expenses:				
Salaries and employee benefits	4,992	4,986	14,813	15,059
Occupancy and equipment	1,670	1,816	5,116	5,660
	1,367	1,413	4,311	4,168

Computer and electronic banking services				
Outside professional services	403	436	1,417	1,410
Marketing and advertising	92	259	543	779
Supplies	130	149	419	441
FDIC deposit insurance and regulatory assessments	263	255	788	748
Core deposit intangible amortization	151	150	452	451
Other real estate owned operations	54	160	179	444
Other	490	521	1,420	1,452
Total noninterest expenses	9,612	10,145	29,458	30,612
Income before income tax provision	2,323	1,468	7,202	4,321
Income tax provision	767	494	2,377	1,421
Net income	\$1,556	\$974	\$4,825	\$2,900
Earnings per share:				
Basic	\$0.13	\$0.08	\$0.41	\$0.24
Diluted	\$0.13	\$0.08	\$0.41	\$0.24

See accompanying notes to unaudited interim consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net income	\$1,556	\$974	\$4,825	\$2,900
Other comprehensive income, net of tax:				
Available for sale securities:				
Net unrealized holding gains (losses)	(371)	411	985	633
Reclassification adjustment for gains recognized in net income	(36)	(9)	(36)	(96)
(1)				
Net unrealized holding gains (losses) on available for sale securities	(407)	402	949	537
Net unrealized gain on interest-rate	—	29	—	81

swap				
derivative				
Other				
comprehensive	(407)	431	949	618
income				
(loss)				
Comprehensive	\$1,149	\$1,405	\$5,774	\$3,518
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 nine months ended September 30, 2016 was \$19,000 and for the three and nine months ended September 30, 2015 was \$5,000 and \$50,000, respectively.

See accompanying notes to unaudited interim consolidated financial statements.

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

	Common Stock		Additional	Unallocated	Unearned	Retained	Accumulated	Total
	Shares	Dollars	Paid-in	Common	Restricted	Earnings	Other	Shareholders'
			Capital	Shares	Shares		Comprehens	Equity
				Held			Income	
				by ESOP			(Loss)	
Balance at December 31, 2015	12,218,818	\$ 122	\$124,997	\$ (3,648)	\$ (815)	\$33,864	\$ (190)	\$ 154,330
Comprehensive income	—	—	—	—	—	4,825	949	5,774
Cash dividends declared (\$0.12 per share)	—	—	—	—	—	(1,417)	—	(1,417)
Equity incentive plans compensation	—	—	307	—	381	—	—	688
Allocation of 36,477 ESOP shares	—	—	138	360	—	—	—	498
Tax benefit from share-based compensation	—	—	14	—	—	—	—	14
Stock options exercised	5,092	—	37	—	—	—	—	37
Common shares repurchased	(7,877)	—	(60)	—	—	(39)	—	(99)
Balance at September 30, 2016	12,216,033	\$ 122	\$125,433	\$ (3,288)	\$ (434)	\$37,233	\$ 759	\$ 159,825

See accompanying notes to unaudited interim consolidated financial statements.

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

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	\$4,825	\$2,900
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,773	1,712
Employee stock ownership plan expense	498	425
Equity incentive plan expense	688	683
Excess tax benefit from share-based compensation	(14)	(5)
Amortization of investment premiums and discounts, net	614	851
Amortization of loan premiums and discounts, net	1,041	1,457
Depreciation and amortization of premises and equipment	1,814	2,036
Amortization of core deposit intangible	452	451
Amortization of deferred debt issue costs	—	16
Net gain on sales of securities	(55)	(146)
Net (gain) loss on fair value of derivatives	(48)	22
Deferred income tax (benefit) provision	(82)	53
Loans originated for sale	(33,512)	(18,807)
Proceeds from sale of loans held for sale	35,144	19,524
Net gain on sales of loans held for sale	(958)	(234)
Net loss on disposal of equipment	92	37
Net (gain) loss on sales or write-downs of other real estate owned	(1)	201
Increase in cash surrender value of bank-owned life insurance	(413)	(449)
Change in operating assets and liabilities:		
Accrued interest receivable	174	(377)
Other assets	(410)	727
Accrued expenses and other liabilities	(781)	33
Net cash provided by operating activities	10,841	11,110
Cash flows from investing activities:		
Purchases of available for sale securities	(29,493)	(35,450)
Proceeds from sales of available for sale securities	8,014	9,703
Proceeds from maturities of and principal repayments on available for sale securities	26,799	22,719
Purchases of Federal Home Loan Bank stock	—	(2,088)
Purchases of Federal Reserve Bank stock	(3)	(3,621)
Redemption of Federal Home Loan Bank stock	504	—
Loan principal originations, net	(11,155)	(4,996)
Purchases of loans	(33,660)	(96,640)
Proceeds from sales of other real estate owned	533	62
Purchases of premises and equipment	(1,127)	(2,031)
Proceeds from bank-owned life insurance	1,201	—
Net cash used in investing activities	(38,387)	(112,342)

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

	Nine Months Ended September 30,	
	2016	2015
Cash flows from financing activities:		
Net increase in deposits	78,927	32,417
Net decrease in mortgagors' and investors' escrow accounts	(1,330)	(1,654)
Proceeds from Federal Home Loan Bank advances	24,000	120,478
Repayments of Federal Home Loan Bank advances	(50,007)	(44,312)
Excess tax benefit from share-based compensation	14	5
Cash dividends on common stock	(1,417)	(1,444)
Stock options exercised	37	708
Common shares repurchased	(99)	(7,655)
Net cash provided by financing activities	50,125	98,543
Net change in cash and cash equivalents	22,579	(2,689)
Cash and cash equivalents at beginning of period	40,778	39,251
Cash and cash equivalents at end of period	\$63,357	\$36,562
Supplemental cash flow information:		
Interest paid	\$7,559	\$6,490
Income taxes paid, net	2,284	989
Transfer of loans to other real estate owned	841	333
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

SEPTEMBER 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 September 30, 2016 and for the three and nine months ended September 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 nine months ended September 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

SEPTEMBER 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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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 amount 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 related 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 debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The amended guidance was applied on a retrospective basis and effective for fiscal years, and interim periods within those years, that began after December 15, 2015. 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.

Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments (Topic 230): In August 2016, the FASB issued guidance to reduce the existing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This update provides guidance on eight specific cash flow issues. The update is effective for fiscal years beginning after December 15, 2017, and for interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments in this update should be applied using a retrospective transition method to each period presented. The Company does not expect the adoption of this guidance to have a material impact 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 153,391 for the three and nine months ended September 30, 2016, respectively, and 321,793 and 342,819 for the three and nine months ended September 30, 2015, respectively.

The computation of earnings per share is as follows:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
	(Dollars in Thousands, Except Per Share Amounts)			
Net income	\$1,556	\$ 974	\$4,825	\$ 2,900

Weighted average common shares outstanding:

Basic	11,815,311	11,793,218	11,802,574	11,403,573
Effect of dilutive stock options	53,334	21,713	57,369	28,485
Diluted	11,868,645	11,814,931	11,859,943	11,432,058

Earnings per share:

Basic	\$0.13	\$ 0.08	\$0.41	\$ 0.24
Diluted	\$0.13	\$ 0.08	\$0.41	\$ 0.24

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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 September 30, 2016 and December 31, 2015 are as follows:

September 30, 2016

Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)			
Debt securities:			
U.S.			
Government			
\$66,367	\$ 531	\$ (582)	\$66,316
agency obligations			
11,282	296	—	11,578
Government-sponsored enterprises			
Mortgage-backed securities: ⁽¹⁾			
Agency			
- 85,482	1,044	(221)	86,305
residential			
Non-agency			
- 100	—	(5)	95
residential			
Corporate			
1,000	—	—	1,000
securities			
Collateralized			
1,158	—	(8)	1,150
debt obligation			
Obligations of			
state and			
1,000	—	—	1,000
political subdivisions			
Tax-exempt securities			
3,152	95	—	3,247
\$169,541	\$ 1,966	\$ (816)	\$170,691
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 Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair 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: ⁽¹⁾			
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 September 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 Cost	Fair Value
	(In Thousands)	
Within 1 year	\$2,497	\$2,507
After 1 but within 5 years	31,319	31,667
After 5 but within 10 years	8,563	8,618
After 10 years	41,580	41,499
	83,959	84,291
Mortgage-backed securities	85,582	86,400
Total debt securities	\$169,541	\$170,691

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

	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2015	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2015
	(In Thousands)			
Gross gains on sales	\$55	\$14	\$55	\$169
Gross losses on sales	—	—	—	(23)
Net gain on sales of securities	\$55	\$14	\$55	\$146

Proceeds from the sale of available for sale securities were \$8.0 million for both the three and nine months ended September 30, 2016, respectively, and \$0 and \$9.7 million for the three and nine months ended September 30, 2015, respectively.

The following tables present information pertaining to securities with gross unrealized losses at September 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 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2016	(In Thousands)					
U.S. Government and agency obligations	\$10,731	\$96	\$20,476	\$486	\$31,207	\$582
Mortgage-backed securities:						
Agency - residential	29,660	77	10,511	144	40,171	221
Non-agency - residential	—	—	95	5	95	5
Collateralized debt obligation	—	—	1,150	8	1,150	8

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Total \$40,391 \$ 173 \$32,232 \$ 643 \$72,623 \$ 816

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	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized 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 September 30, 2016, 36 debt securities with gross unrealized losses had aggregate depreciation of 1.10% 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 nine months ended September 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 September 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 September 30, 2016 and December 31, 2015 is as follows:

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

Real estate loans:		
Residential		
-		
1 to 4 family	\$408,271	\$417,458
Multi-family	14,516	385,341
commercial	6,276	21,786
Condominium association	859,063	824,585
Total real estate loans		
Commercial business loans:		
SBA and USDA guaranteed	124,857	145,238
Time share	45,465	55,192
Condominium association	22,556	21,986
Medical loans	24,918	23,445
Other	82,851	45,588
Total commercial business	300,647	291,449

loans

Consumer

loans:

Home equity	53,852	53,779
Indirect automobile	714	1,741
Other	716	1,946
Total consumer loans	55,282	57,466

Total loans	1,215,992	1,173,500
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Deferred loan origination cost

net of fees	2,011	1,735
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Allowance for loan losses

(11,471)	(9,863)
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Loans receivable, net

\$1,206,532	\$1,165,372
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The Company purchased commercial business loans totaling \$33.7 million during the nine months ended September 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 nine months ended September 30, 2016 and 2015 are as follows:

Three Months Ended September 30, 2016	Residential - 1 to 4 Family Commercial	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
	(In Thousands)					
Balance at beginning of period	\$1,026	\$ 5,420	\$ 798	\$ 2,693	\$ 706	\$10,643
Provision for loan losses	106	183	141	442	8	880
Loans charged-off	(38)	(22)	—	—	(4)	(64)
Recoveries of loans previously charged-off	—	1	—	10	1	12
Balance at end of period	\$1,094	\$ 5,582	\$ 939	\$ 3,145	\$ 711	\$11,471

Nine Months Ended September 30, 2016	Residential - 1 to 4 Family Commercial	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
	(In Thousands)					
Balance at beginning of period	\$1,036	\$ 5,033	\$ 516	\$ 2,625	\$ 653	\$9,863
Provision for loan losses	150	485	423	534	181	1,773
Loans charged-off	(120)	(46)	—	(68)	(124)	(358)
Recoveries of loans previously charged-off	28	110	—	54	1	193
Balance at end of period	\$1,094	\$ 5,582	\$ 939	\$ 3,145	\$ 711	\$11,471

Three Months Ended September 30, 2015	Residential - 1 to 4 Family Commercial	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
	(In Thousands)					
Balance at beginning of period	\$986	\$ 3,766	\$ 434	\$ 2,618	\$ 633	\$8,437
Provision (credit) for loan losses	30	666	(7)	322	6	1,017
Loans charged-off	—	(136)	—	(140)	—	(276)
Recoveries of loans previously charged-off	41	22	—	5	—	68
Balance at end of period	\$1,057	\$ 4,318	\$ 427	\$ 2,805	\$ 639	\$9,246

Nine Months Ended September 30, 2015	Residential - 1 to 4 Family Commercial	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
	(In Thousands)					
Balance at beginning of period	\$955	\$ 3,607	\$ 254	\$ 2,382	\$ 599	\$7,797
Provision for loan losses	74	843	173	582	40	1,712

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Loans charged-off	(46)	(156)	—	(165)	—	(367)
Recoveries of loans previously charged-off	74	24	—	6	—	104
Balance at end of period	\$1,057	\$ 4,318	\$ 427	\$ 2,805	\$ 639	\$9,246

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

September 30, 2016	Residential - 1 to 4 Family (In Thousands)	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
Allowance for loans individually evaluated and deemed to be impaired	\$306	\$ 256	\$ —	\$ —	\$ 52	\$614
Allowance for loans individually or collectively evaluated and not deemed to be impaired	788	5,326	939	3,145	659	10,857
Allowance for loans acquired with deteriorated credit quality	—	—	—	—	—	—
Total loan loss allowance	\$1,094	\$ 5,582	\$ 939	\$ 3,145	\$ 711	\$11,471
Loans individually evaluated and deemed to be impaired	\$6,331	\$ 7,279	\$ —	\$ 1,035	\$ 473	\$15,118
Loans individually or collectively evaluated and not deemed to be impaired	401,544	404,272	36,276	299,612	55,809	1,197,513
Amount of loans acquired with deteriorated credit quality	396	2,965	—	—	—	3,361
Total loans	\$408,271	\$ 414,516	\$ 36,276	\$ 300,647	\$ 56,282	\$1,215,992
December 31, 2015	Residential - 1 to 4 Family (In Thousands)	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
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
	405	4,088	—	—	—	4,493

Amount of loans acquired with deteriorated
credit quality

Total loans	\$417,458	\$ 385,341	\$ 21,786	\$ 291,449	\$ 57,466	\$1,173,500
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Past Due Loans

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

	30-59 Days Past Due	60-89 Days 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 to 4 family	\$307	\$1,441	\$1,688	\$3,436	\$404,835	\$408,271	\$ —
Multi-family	1,256	204	233	1,693	412,823	414,516	—
commercial							
Construction					36,276	36,276	—
Commercial Business:							
SBA and USDA					124,857	124,857	—
guaranteed Time share					45,465	45,465	—
Condominium association					22,556	22,556	—
Medical loans					24,918	24,918	—
Other	337		925	1,656	81,195	82,851	—
Consumer:							
Home equity			179	233	53,619	53,852	—
Indirect automobile				11	703	714	—
Other				1	1,715	1,716	—
Total	\$1,023	\$1,982	\$3,025	\$7,030	\$1,208,962	\$1,215,992	\$ —

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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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Impaired and Nonaccrual Loans

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

	September 30, 2016	Unpaid Principal Investment Balance	Related Allowance	Nonaccrual Loans
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(In Thousands)

Impaired loans without valuation allowance:				
Real Estate:				
Residential				
-				
1 to 4 family	\$3,437	\$3,490	\$ —	\$ 2,585
Multi-family	1,989	6,186	—	1,531
Commercial				
Commercial business	1,035	1,035	—	925
Other Consumer:				
Home equity	193	193	—	194
Total impaired loans without valuation allowance:	10,654	10,904	—	5,235

Impaired loans with valuation allowance:

Real Estate: Residential				
-				
1 to 4 family	2,894	2,928	306	706
Multi-family and commercial	1,813	3,813	256	175
Consumer Home equity	280	378	52	179
Total impaired loans with valuation allowance	6,987	7,119	614	1,060
Total impaired loans	\$17,641	\$18,023	\$ 614	\$ 6,295

(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⁽¹⁾

December 31, 2015	Recorded Investment	Unpaid Principal Balance	Related Allowance	Nonaccrual Loans
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(In Thousands)

Impaired loans without valuation allowance:				
Real Estate: Residential				
-				
1 to 4 family	\$3,957	\$3,975	\$ —	\$ 3,748
Multi-family and commercial	1,756	6,159	—	2,167
Commercial business	666	156	—	339

-				
Other Consumer				
- 158	158	—	183	
Home equity				
Total impaired loans without valuation allowance	10,227	10,648	—	6,437
Impaired loans with valuation allowance: Real Estate: Residential				
-				
1 to	2,397	2,397	303	146
4 family Multi-family and commercial	136	1,136	35	—
Total impaired loans with valuation allowance	3,533	3,533	338	146
Total impaired loans	\$14,740	\$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 September 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 September 30, 2016			Nine Months Ended September 30, 2016		
	Average Interest Recorded Investment	Interest Income Recognized on Cash Basis		Average Interest Recorded Investment	Interest Income Recognized on Cash Basis	
(In Thousands)						
Real Estate:						
Residential - 1 to 4 family	\$6,042	\$ 32	\$ —	\$6,039	\$ 83	\$ —
Multi-family and commercial	9,866	116	13	8,555	264	13
Commercial business - Other	1,023	6	4	688	6	4
Consumer - Home equity	444	1	—	321	3	1
Total	\$17,375	\$ 155	\$ 17	\$15,603	\$ 356	\$ 18

	Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
	Average Interest Recorded Investment	Interest Income Recognized on Cash Basis		Average Interest Recorded Investment	Interest Income Recognized on Cash Basis	
(In Thousands)						
Real Estate:						
Residential - 1 to 4 family	\$5,874	\$ 32	\$ 6	\$5,726	\$ 84	\$ 7
Multi-family and commercial	6,222	72	3	6,071	219	3
Commercial business - Other	1,182	7	6	1,070	15	6
Consumer - Home equity	81	—	—	52	—	—
Total	\$13,359	\$ 111	\$ 15	\$12,919	\$ 318	\$ 16

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.

o

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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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 September 30, 2016 and December 31, 2015:

September 30, 2016	Not Rated	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(In Thousands)						
Real Estate:							
Residential - 1 to 4 family	\$—	\$398,779	\$1,948	\$7,544	\$—	\$—	—\$408,271
Multi-family and commercial	—	383,228	15,916	15,372	—	—	414,516
Construction	—	36,276	—	—	—	—	36,276
Total real estate loans	—	818,283	17,864	22,916	—	—	859,063
Commercial Business:							
SBA and USDA guaranteed	124,857	—	—	—	—	—	124,857
Time share	—	45,465	—	—	—	—	45,465
Condominium association	—	22,556	—	—	—	—	22,556
Medical loans	—	24,918	—	—	—	—	24,918
Other	—	76,503	3,569	2,779	—	—	82,851
Total commercial business loans	124,857	169,442	3,569	2,779	—	—	300,647
Consumer:							
Home equity	—	53,284	49	519	—	—	53,852
Indirect automobile	—	714	—	—	—	—	714
Other	—	1,716	—	—	—	—	1,716
Total consumer loans	—	55,714	49	519	—	—	56,282
Total loans	\$124,857	\$1,043,439	\$21,482	\$26,214	\$—	\$—	—\$1,215,992

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December 31, 2015	Not Rated	Pass	Special 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

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The following tables provide information on loans modified as TDRs during the three and nine months ended September 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.

	Three Months Ended September 30, 2016			2015		
	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)
	(Dollars in Thousands)					
Residential - 1 to 4 family	2	\$ 379	\$ 21	3	\$ 502	\$ 33
Multi-family and commercial	—	—	235	4	1,035	—
Commercial business - other	1	95	—	2	118	—
Total	3	\$ 474	\$ 256	9	\$ 1,655	\$ 33

	Nine Months Ended September 30, 2016			2015		
	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)
	(Dollars in Thousands)					
Residential - 1 to 4 family	4	\$ 764	\$ 21	3	\$ 502	\$ 33
Multi-family and commercial	4	4,127	235	4	1,035	—
Commercial business - other	3	777	—	2	118	—
Total	11	\$ 5,668	\$ 256	9	\$ 1,655	\$ 33

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
Interest rate adjustments	\$275	\$559	\$275	\$559
Principal deferrals	104	115	190	115

Combination of rate and payment (1)	146	—	146
Combination of rate and maturity (2)	—	3,201	—
Maturity only	835	2,002	835
Total	\$1,655	\$5,668	\$1,655

(1) Terms include combination of interest rate adjustments and interest-only payment with deferral of principal.

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

During the three and nine months ended September 30, 2016, there were two commercial loans totaling \$682,000 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 nine months ended September 30, 2015.

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As of September 30, 2016, the Company held \$1.5 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.

Loans Acquired with Deteriorated Credit Quality

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

	Contractual Required Payments Receivable (In Thousands)	Cash Expected To Be Collected (In Thousands)	Non-Accrutable Discount	Accrutable Yield	Loans Receivable
Balance at December 31, 2015	\$5,076	\$4,493	\$ 583	\$ 121	\$ 4,372
Additions	—	42	(42) 42	—
Collections	(679) (666) (13) (27) (639
Dispositions	(567) (508) (59) —	(508
Balance at September 30, 2016	\$3,830	\$3,361	\$ 469	\$ 136	\$ 3,225

NOTE 5. PREMISES AND EQUIPMENT

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

	September 30, 2016	December 31, 2015
	(In Thousands)	
Land	\$4,746	\$ 4,746
Buildings	13,609	13,583
Leasehold improvements	10,728	10,717
Furniture and equipment	12,392	12,905
Construction in process	577	30
	42,052	41,981
Accumulated depreciation and amortization	(21,643) (20,793
Premises and equipment, net	\$20,409	\$ 21,188

At both September 30, 2016 and December 31, 2015, construction in process related to the relocation of a branch and a project to redesign the traffic flow at another branch. At September 30, 2016, the Company had outstanding commitments related to the construction of a new branch location totaling \$1.3 million.

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.

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

	Nine Months Ended September 30, 2016		
	Before Tax Amount	Tax Effects	Net of Tax Amount
Securities:	(In Thousands)		
Unrealized holding gains on available for sale securities	\$1,493	\$ (508)	\$ 985
Reclassification adjustment for gains recognized in net income	(55)	19	(36)
Unrealized holding gains on available for sale securities, net of taxes	1,438	(489)	949
Other comprehensive income	\$1,438	\$ (489)	\$ 949

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

	September 30, 2016		
	Before Tax Amount	Tax Effects	Net of Tax Amount
	(In Thousands)		
Net unrealized gains on available for sale securities	\$1,150	\$ (391)	\$ 759
Accumulated other comprehensive income	\$1,150	\$ (391)	\$ 759

	December 31, 2015		
	Before Tax Amount	Tax Effects	Net of Tax 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 September 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%,

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6.5%, 8.0% and 10.0%, respectively. Management believes no conditions or events have occurred since September 30, 2016 that would materially adversely change the Company's and the Bank's capital classifications.

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2016	(Dollars in Thousands)					
Tier 1 Capital to Average Assets:						
Company	\$152,462	10.11 %	\$60,320	4.00 %	\$75,400	5.00 %
Bank	140,231	9.35	59,967	4.00	74,959	5.00
Tier 1 Capital to Risk Weighted Assets:						
Company	152,462	15.49	65,203	6.63	78,736	8.00
Bank	140,231	14.29	65,033	6.63	78,530	8.00
Total Capital to Risk Weighted Assets:						
Company	164,398	16.70	84,887	8.63	98,420	10.00
Bank	152,167	15.50	84,665	8.63	98,163	10.00
Common Equity Tier 1 Capital:						
Company	144,462	14.68	50,440	5.13	63,973	6.50
Bank	140,231	14.29	50,308	5.13	63,806	6.50
				For Capital Adequacy Purposes	To Be Well Capitalized Under Prompt Corrective Action Provisions	
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 September 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

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a significant reduction in trading volume and widening spreads relative to historical levels. The Company 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.

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SEPTEMBER 30, 2016 AND 2015 AND DECEMBER 31, 2015

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.

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 September 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 nine months ended September 30, 2016.

	September 30, 2016			Total
	Level 1	Level 2	Level 3	
	(In Thousands)			
Assets:				
U.S. Government and agency obligations	\$21,213	\$45,103	\$—	\$66,316
Government-sponsored enterprises	—	11,578	—	11,578
Mortgage-backed securities	—	86,400	—	86,400
Corporate debt securities	—	1,000	—	1,000
Collateralized debt obligation	—	—	1,150	1,150
Obligations of state and political subdivisions	—	1,000	—	1,000
Tax-exempt securities	—	3,247	—	3,247
Forward loan sale commitments and derivative loan commitments	—	—	227	227
Total assets	\$21,213	\$148,328	\$1,377	\$170,918
Liabilities:				
Interest rate swap agreement	\$—	\$16	\$—	\$16
Total liabilities	\$—	\$16	\$—	\$16

	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:				

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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 Debt Obligations	Derivative Loan and Forward Loan Sale Commitments, Net
	(In Thousands)	
Balance at December 31, 2015	\$ 1,146	\$ 70
Total realized gains included in net income	—	157
Total unrealized gains included in other comprehensive income	4	—
Balance at September 30, 2016	\$ 1,150	\$ 227

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 September 30, 2016 and December 31, 2015. There were no liabilities measured at fair value on a nonrecurring basis at September 30, 2016 and December 31, 2015.

	At September 30, 2016			At December 31, 2015		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
	(In Thousands)					
Impaired loans	\$—	—	\$599	\$—	—	\$588
Other real estate owned	—	—	1,397	—	—	1,088
Total assets	\$—	—	\$1,996	\$—	—	\$1,676

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	(In Thousands)			
Impaired loans	\$21	\$(20)	\$239	\$2
Other real estate owned	—	65	8	212

Total losses \$21 \$45 \$247 \$214

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 September 30, 2016 and December 31, 2015. The estimated fair value amounts at September 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 September 30, 2016 and December 31, 2015, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

	September 30, 2016				Total
	Carrying Fair Value				
	Amount	Level 1	Level 2	Level 3	
	(In Thousands)				
Financial Assets:					
Cash and cash equivalents	\$63,357	\$63,357	\$ —	—	—\$ 63,357
Available for sale securities	170,691	21,213	148,328	1,150	170,691
Loans held for sale	698	—	—	737	737
Loans receivable, net	1,206,532	—	—	1,229,479	1,229,479
Federal Home Loan Bank stock	12,370	—	—	12,370	12,370
Federal Reserve Bank stock	3,624	—	—	3,624	3,624
Accrued interest receivable	4,109	—	—	4,109	4,109
Financial Liabilities:					
Deposits	1,136,944	—	—	1,141,523	1,141,523
Mortgagors' and investors' escrow accounts	2,178	—	—	2,178	2,178
Federal Home Loan Bank advances	208,588	—	210,951	—	210,951
Junior subordinated debt owed to unconsolidated trust	8,248	—	5,120	—	5,120
On-balance Sheet Derivative Financial Instruments:					
Assets:					
Derivative loan commitments	171	—	—	171	171
Forward loan sale commitments	56	—	—	56	56
Liabilities:					
Interest rate swap agreement	16	—	16	—	16

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	December 31, 2015				
	Carrying Fair Value				
	Amount	Level 1	Level 2	Level 3	Total
	(In Thousands)				
Financial Assets:					
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
Financial Liabilities:					
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
On-balance Sheet Derivative Financial Instruments:					
Assets:					
Derivative loan commitments	51	—	—	51	51
Forward loan sale commitments	20	—	—	20	20
Liabilities:					
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 September 30, 2016 and

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December 31, 2015, information pertaining to the Company's interest rate swap agreement not designated as a hedge was as follows:

	September 30, 2016	December 31, 2015		
	(Dollars in Thousands)			
Notional amount	\$ 15,000	\$ 15,000		
Weighted average fixed pay rate	1.26	% 1.26	%	
Weighted average variable receive rate	0.66	% 0.32	%	
Weighted average maturity in years	0.3	1.0		
Unrealized loss relating to interest rate swap	\$ 16	\$ 64		

The Company reported a gain in fair value on the interest rate swap not designated as a hedge in noninterest income of \$33,000 and \$48,000 for the three and nine months ended September 30, 2016, respectively, and a loss in fair value of \$7,000 and \$22,000 for the three and nine months ended September 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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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 September 30, 2016 and December 31, 2015.

	Balance Sheet Location	September 30, 2016		December 31, 2015	
		Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivatives not designated as hedging instruments:					
Interest rate swap	Other Liabilities	\$15,000	\$ (16)	\$15,000	\$ (64)
Derivative loan commitments	Other Assets	12,400	171	6,170	51
Forward loan sale commitments	Other Assets	3,202	56	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 September 30, 2016 and December 31, 2015 and the results of operations for the three and nine months ended September 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 September 30, 2016 and December 31, 2015

Assets:

Summary. Assets increased \$56.2 million, or 3.8%, to \$1.54 billion at September 30, 2016, compared to \$1.48 billion at December 31, 2015, principally due to increases of \$41.2 million in net loans receivable and \$22.6 million in cash and cash equivalents, offset by decreases of \$4.4 million in available for sale securities and \$1.1 million in

loans held for sale. Securities decreased primarily as a result of the sale of U.S. government and agency obligations. Proceeds received from security sales were used to fund loan growth during 2016.

Loans Receivable, Net. Net loans increased \$41.2 million primarily due to increases of \$37.3 million, \$29.2 million and \$14.5 million in other commercial business loans, multi-family and commercial real estate loans and construction loans, respectively, offset by decreases of \$20.4 million, \$9.7 million and \$9.2 million in SBA and USDA guaranteed loans, timeshare loans and residential real estate loans, respectively. Changes in the loan portfolio consisted of the following:

Residential Real Estate. Residential mortgage loans comprised 33.6% of the total loan portfolio at September 30, 2016 and decreased \$9.2 million to \$408.3 million as compared to \$417.5 million at December 31, 2015. Residential mortgage loan originations increased \$7.3 million, or 10.1%, during the nine months ended September 30, 2016 over the comparable period in 2015 as a result of increased activity in the housing market.

Multi-family and Commercial Real Estate. Multi-family and commercial real estate loans represented 34.1% of total loans at September 30, 2016 and increased \$29.2 million, or 7.6%, during the first nine months of 2016. Loan originations for multi-family and commercial real estate loans were \$64.6 million, representing an increase of \$6.5 million, for the nine months ended September 30, 2016 compared to the same period in 2015.

Construction. Construction loans, which include both residential and commercial construction loans, increased \$14.5 million to \$36.3 million for the first nine months of 2016 as a result of increased commercial construction volume.

Commercial Business. Commercial business loans represented 24.7% of total loans at September 30, 2016. Commercial business loans increased \$9.2 million, or 3.2%, for the nine months ended September 30, 2016 primarily due to an increase of \$37.3 million in other commercial business loans, offset by decreases of \$20.4 million in SBA and USDA guaranteed loans and \$9.7 million in time share loans. Commercial business loan originations increased \$7.2 million as compared to the same period in 2015. At September 30, 2016, unfunded lines of credit related to time share lending totaled \$29.1 million as a result of focused efforts within the time share industry.

Consumer. Consumer loans represented 4.6% of the Company's total loan portfolio at September 30, 2016. Consumer loans decreased \$1.2 million during the first nine months of 2016 primarily as a result of a decrease of \$1.0 million in indirect automobile loans. Loan originations for consumer loans totaled \$19.3 million, representing an increase of \$1.5 million, for the first nine months of 2016 over the comparable period in 2015.

The allowance for loan losses totaled \$11.5 million at September 30, 2016 compared to \$9.9 million at December 31, 2015. The ratio of the allowance for loan losses to total loans increased to 0.94% at September 30, 2016 from 0.84% at December 31, 2015, primarily due to an increase in the commercial loan portfolio which carries a higher degree of risk (excluding guaranteed SBA and USDA loans) than other loans held in the portfolio.

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

September 30, 2016 December 31, 2015

Nonaccrual
(Dollars in Thousands)
loans:

Real estate loans:
Residential

-
1 to 4 family Multi-family and commercial Total real estate loans

\$3,291 \$ 3,894
706 2,167

Commercial business loans
Consumer loans:
Home equity Total consumer loans

373 183
373 183

6,295 6,583

Accruing loans past due 90 days or more Total nonperforming loans

6,295 6,583

Other real estate

1,397 1,088

1,397 1,088

owned,
 net
 (2)
 Total
 nonperforming 7,671
 assets
 Accruing
 troubled 9,638 4,659
 debt
 restructurings
 Total
 nonperforming
 assets
 and 7,330 \$ 12,330
 troubled
 debt
 restructurings

Allowance
 for
 loan
 losses
 as 182.22 % 149.83 %
 a
 percent
 of
 nonperforming
 loans
 Total
 nonperforming
 loans 0.52 % 0.56 %
 to
 total
 loans
 Total
 nonperforming
 loans 0.41 % 0.44 %
 to
 total
 assets
 Total
 nonperforming
 assets
 and
 troubled 1.13 % 0.83 %
 debt
 restructurings
 to
 total
 assets

(1) Includes nonperforming TDRs totaling \$1.6 million and \$991,000 at September 30, 2016 and December 31, 2015, respectively.

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

The decrease in nonperforming loans was primarily due to decreases in nonperforming residential real estate loans of \$603,000 and nonperforming multi-family and commercial real estate loans of \$461,000. Nonperforming commercial business loans and home equity loans increased \$586,000 and \$190,000, respectively, during the nine months ended September 30, 2016.

Other real estate owned increased \$309,000 to \$1.4 million at September 30, 2016, due to the addition of five residential properties, offset by the sale of three residential properties and two commercial properties. At September 30, 2016, other real estate owned included four residential properties and one commercial property.

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 \$11.2 million at September 30, 2016, compared to \$5.7 million at December 31, 2015. Of the TDRs, \$9.6 million and \$4.7 million were performing in accordance with their restructured terms at September 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 \$50.7 million, or 3.8%, to \$1.38 billion at September 30, 2016 compared to \$1.33 billion at December 31, 2015. Deposits increased \$78.9 million, or 7.5%, which included increases in certificates of deposit of \$49.8 million, noninterest-bearing deposits of \$15.1 million and NOW and money market accounts of \$13.2 million. Deposit growth remained strong due to marketing and promotional initiatives and competitively-

priced deposit products. Borrowings decreased \$26.0 million from \$242.8 million at December 31, 2015 to \$216.8 million at September 30, 2016, resulting from repayments of Federal Home Loan Bank advances with funds from excess deposits.

Equity:

Summary. Shareholders' equity increased \$5.5 million from \$154.3 million at December 31, 2015 to \$159.8 million at September 30, 2016. The increase in shareholders' equity was primarily attributable to net income of \$4.8 million and an increase in net unrealized gains on available for sale securities aggregating \$949,000 (net of taxes), partially offset by dividends declared of \$1.4 million.

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 \$759,000 at September 30, 2016 compared to net unrealized losses of \$190,000 at December 31, 2015.

Results of Operations for the Three and Nine Months Ended September 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 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 \$1.6 million for the three months ended September 30, 2016 compared to \$974,000 for the three months ended September 30, 2015. The Company reported net income of \$4.8 million for the nine months ended September 30, 2016 compared to \$2.9 million for the nine months ended September 30, 2015.

Interest and Dividend Income. Total interest and dividend income increased \$486,000, or 4.0%, to \$12.7 million for the quarter ended September 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. Interest income on loans and securities reflect net amortization of \$162,000 and \$179,000 for the quarters ended September 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 September 30, 2016 decreased six basis points to 3.53% compared to 3.59% for the quarter ended September 30, 2015. The average balance of interest-earning assets increased \$88.3 million to \$1.44 billion during the third quarter of 2016, due to increases of \$42.3 million in the average balance of other interest-earning assets, \$34.7 million in the average balance of loans and \$11.3 million in the average balance of securities, as compared to the same quarter in 2015.

Total interest and dividend income increased \$2.5 million, or 7.2%, to \$38.0 million for the nine months ended September 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 \$184,000 and \$543,000 for the nine months ended September 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 nine months ended September 30, 2016 decreased six basis points to 3.58% compared to 3.64% for the nine months ended September 30, 2015. The average balance of interest-earning assets increased \$119.5 million to \$1.42 billion

during the nine months of 2016, due to increases of \$75.0 million in the average balance of loans, \$32.0 million in the average balance of other interest-earning assets and \$12.5 million in the average balance of securities, as compared to the same quarter in 2015.

Interest Expense. For the quarter ended September 30, 2016, interest expense increased \$208,000, or 8.9%, primarily resulting from a higher average rate paid and higher average balances of deposits compared to the same quarter in 2015. Higher interest expense on interest-bearing liabilities reflect net accretion of \$119,000 and \$184,000 for the three months ended September 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 \$65.8 million to \$954.5 million for the quarter ended September 30, 2016 and the average rate paid increased eight basis points to 0.71%, 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 savings accounts totaled \$60.2 million and \$4.6 million, respectively. The average balance of FHLB advances decreased \$9.0 million for the three months ended September 30, 2016, and the average rate paid decreased three basis points to 1.55%. The average rate paid on subordinated debt decreased 172 basis points to 2.32%, compared to the same period in 2015, due to the maturity of a derivative financial instrument.

Interest expense increased \$1.0 million, or 15.4%, for the nine months ended September 30, 2016 primarily as a result of the 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 \$398,000 and \$825,000 for the nine months ended September 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 \$53.9 million to \$939.6 million for the nine months ended September 30, 2016 and the average rate paid increased seven basis points to 0.70%, compared to the same period in 2015. Increases in the average balance of certificates of deposit and NOW and money market deposits totaled \$47.0 million and \$9.1 million, respectively, while the average balance of savings accounts decreased \$2.7 million compared to the nine months ended September 30, 2015. The average balance of FHLB advances increased \$37.2 million for the nine months ended September 30, 2016, while the average rate paid decreased six basis points to 1.54%. The average rate paid on subordinated debt decreased 179 basis points to 2.28%, 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 September 30,					
	2016			2015		
	Average Balance	Interest & Dividends	Average Yield/ Rate ⁽⁸⁾	Average Balance	Interest & Dividends	Average Yield/ Rate ⁽⁸⁾
	(Dollars in Thousands)					
Interest-earning assets:						
Loans ^{(1) (2) (3)}	\$1,169,190	\$11,638	3.96 %	\$1,134,506	\$11,278	3.94 %
Securities ⁽³⁾	203,354	1,045	2.04	192,093	925	1.91
Other interest-earning assets	65,678	84	0.51	23,341	19	0.32
Total interest-earning assets	1,438,222	12,767	3.53	1,349,940	12,222	3.59
Noninterest-earning assets	84,374			92,527		
Total assets	\$1,522,596			\$1,442,467		
Interest-bearing liabilities:						
Deposits:						
Business checking	\$856	—	—	\$415	—	—
NOW and money market	474,736	129	0.11	474,092	128	0.11
Savings ⁽⁴⁾	35,890	24	0.27	31,312	17	0.22
Certificates of deposit ⁽⁵⁾	442,977	1,550	1.39	382,796	1,258	1.30
Total interest-bearing deposits	954,459	1,703	0.71	888,615	1,403	0.63
Federal Home Loan Bank advances	202,856	790	1.55	211,863	846	1.58
Subordinated debt	8,248	48	2.32	8,248	84	4.04
Total interest-bearing liabilities	1,165,563	2,541	0.87	1,108,726	2,333	0.83
Noninterest-bearing liabilities	196,305			180,140		
Total liabilities	1,361,868			1,288,866		
Total shareholders' equity	160,728			153,601		
Total liabilities and shareholders' equity	\$1,522,596			\$1,442,467		
Net interest-earning assets	\$272,659			\$241,214		
Tax equivalent net interest income ⁽³⁾		10,226			9,889	
Tax equivalent interest rate spread ⁽⁶⁾			2.66 %			2.76 %
Tax equivalent net interest margin as a percentage of interest-earning assets ⁽⁷⁾			2.83 %			2.91 %
Average of interest-earning assets to average interest-bearing liabilities			123.39%			121.76%
Less tax equivalent adjustment ⁽³⁾		(64)			(5)	
Net interest income		\$10,162			\$9,884	

(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 loans and 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 Nine Months Ended September 30,					
	2016			2015		
	Average Balance	Interest & Dividends	Average Yield/ Rate ⁽⁸⁾	Average Balance	Interest & Dividends	Average Yield/ Rate ⁽⁸⁾
	(Dollars in Thousands)					
Interest-earning assets:						
Loans ^{(1) (2) (3)}	\$1,168,433	\$34,826	3.98 %	\$1,093,467	\$32,823	4.01 %
Securities ⁽³⁾	200,204	3,162	2.11	187,748	2,618	1.86
Other interest-earning assets	56,124	217	0.52	24,082	57	0.32
Total interest-earning assets	1,424,761	38,205	3.58	1,305,297	35,498	3.64
Noninterest-earning assets	85,270			91,974		
Total assets	\$1,510,031			\$1,397,271		
Interest-bearing liabilities:						
Deposits:						
Business checking	\$770	—	—	\$325	—	—
NOW and money market	473,319	381	0.11	464,199	394	0.11
Savings ⁽⁴⁾	36,340	72	0.26	39,035	52	0.18
Certificates of deposit ⁽⁵⁾	429,140	4,454	1.39	382,140	3,704	1.30
Total interest-bearing deposits	939,569	4,907	0.70	885,699	4,150	0.63
Federal Home Loan Bank advances	214,423	2,480	1.54	177,196	2,124	1.60
Subordinated debt	8,248	141	2.28	8,248	251	4.07
Total interest-bearing liabilities	1,162,240	7,528	0.87	1,071,143	6,525	0.81
Noninterest-bearing liabilities	189,018			170,518		
Total liabilities	1,351,258			1,241,661		
Total shareholders' equity	158,773			155,610		
Total liabilities and shareholders' equity	\$1,510,031			\$1,397,271		
Net interest-earning assets	\$262,521			\$234,154		
Tax equivalent net interest income ⁽³⁾		30,677			28,973	
Tax equivalent interest rate spread ⁽⁶⁾			2.71 %			2.83 %
Tax equivalent net interest margin as a percentage of interest-earning assets ⁽⁷⁾			2.88 %			2.97 %
Average of interest-earning assets to average interest-bearing liabilities			122.59%			121.86%
Less tax equivalent adjustment ⁽³⁾		(185)			(21)	
Net interest income		\$30,492			\$28,952	

(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 loans and 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 September 30, 2016 and 2015			Nine Months Ended September 30, 2016 and 2015		
	Increase (Decrease) Due To			Increase (Decrease) Due To		
	Rate	Volume	Net	Rate	Volume	Net
	(In Thousands)					
Interest-earning assets:						
Interest and dividend income:						
Loans ⁽¹⁾⁽²⁾	\$42	\$ 318	\$360	\$(234)	\$ 2,237	\$2,003
Securities ⁽³⁾	66	54	120	378	166	544
Other interest-earning assets	46	19	65	117	43	160
Total interest-earning assets	154	391	545	261	2,446	2,707
Interest-bearing liabilities:						
Interest expense:						
Deposits ⁽⁴⁾	106	194	300	319	438	757
Federal Home Loan Bank advances	(21)	(35)	(56)	(78)	434	356
Subordinated debt	(36)	36	—	(110)	—	(110)
Total interest-bearing liabilities	49	195	244	131	872	1,003
Change in net interest income	\$105	\$ 196	\$301	\$130	\$ 1,574	\$1,704

⁽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.

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

Provision for Loan Losses. The provision for loan losses decreased \$137,000 and increased \$61,000 for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. At September 30, 2016, nonperforming loans decreased to \$6.3 million compared to \$7.3 million at September 30, 2015, resulting from decreases in nonperforming multi-family and commercial real estate loans of \$988,000 and nonperforming residential real estate loans of \$129,000, offset by an increase in nonperforming commercial business loans of \$111,000. Net loan charge-offs were \$53,000 and \$165,000 for the three and nine months ended September 30, 2016, respectively, consisting primarily of residential real estate and multi-family and commercial real estate loan charge-offs, compared to \$208,000 and \$263,000 for the three and nine months ended September 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				Nine Months			
	Ended		Change		Ended		Change	
	September 30,	September 30,	Dollars	Percent	September 30,	September 30,	Dollars	Percent
	2016	2015			2016	2015		
	(Dollars in Thousands)							
Service fees	\$1,585	\$1,699	\$(114)	(6.7)%	\$4,798	\$5,039	\$(241)	(4.8)%
Wealth management fees	296	303	(7)	(2.3)	897	916	(19)	(2.1)
Increase in cash surrender value of bank-owned life insurance	136	146	(10)	(6.8)	413	449	(36)	(8.0)
Net gain on sales of securities	55	14	41	292.9	55	146	(91)	(62.3)
Mortgage banking	503	139	364	261.9	1,172	416	756	181.7
Net gain (loss) on fair value of derivatives	33	(7)	40	(571.4)	48	(22)	70	(318.2)
Net loss on disposal of equipment	(56)	(17)	(39)	229.4	(92)	(37)	(55)	148.6
Other	101	469	(368)	(78.5)	650	786	(136)	(17.3)
Total noninterest income	\$2,653	\$2,746	\$(93)	(3.4)%	\$7,941	\$7,693	\$248	3.2 %

Noninterest income decreased \$93,000 to \$2.7 million and increased \$248,000 to \$7.9 million for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. Decreases in other noninterest income of \$368,000 and \$136,000 for the three and nine months ended September 30, 2016, respectively, was primarily a result of profit distributions from our investment in two small business investment companies during the same periods in 2015. Service fees decreased \$114,000 and \$241,000 for the three and nine months ended September 30, 2016, respectively, due to lower overdraft charges and interchange fees. Mortgage banking activities increased \$364,000 and \$756,000 for the three and nine months ended September 30, 2016, respectively, versus the comparable periods in 2015 as a result of increased volume of residential mortgage loan sales and gains on loans sold.

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

	Three Months				Nine Months			
	Ended		Change		Ended		Change	
	September 30,	September 30,	Dollars	Percent	September 30,	September 30,	Dollars	Percent
	2016	2015			2016	2015		
	(Dollars in Thousands)							
Salaries and employee benefits	\$4,992	\$4,986	\$6	0.1 %	\$14,813	\$15,059	\$(246)	(1.6)%
Occupancy and equipment	1,670	1,816	(146)	(8.0)	5,116	5,660	(544)	(9.6)
Computer and electronic banking services	1,367	1,413	(46)	(3.3)	4,311	4,168	143	3.4
Outside professional services	403	436	(33)	(7.6)	1,417	1,410	7	0.5
Marketing and advertising	92	259	(167)	(64.5)	543	779	(236)	(30.3)
Supplies	130	149	(19)	(12.8)	419	441	(22)	(5.0)
FDIC deposit insurance and regulatory assessments	263	255	8	3.1	788	748	40	5.3
Core deposit intangible amortization	151	150	1	0.7	452	451	1	0.2
Other real estate operations	54	160	(106)	(66.3)	179	444	(265)	(59.7)
Other	490	521	(31)	(6.0)	1,420	1,452	(32)	(2.2)
Total noninterest expenses	\$9,612	\$10,145	\$(533)	(5.3)%	\$29,458	\$30,612	\$(1,154)	(3.8)%

Noninterest expenses decreased \$533,000 and \$1.2 million for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. Marketing and advertising expenses decreased \$167,000 and

\$236,000 for the three and nine months ended September 30, 2016, respectively, primarily as a

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result of a realignment of marketing initiatives with strategic goals of the Bank. A reduction in occupancy and equipment expenses of \$146,000 and \$544,000 for the three and nine months ended September 30, 2016, respectively, versus the comparable periods in 2015, was in large part a result of strategic plans to reduce branch infrastructure costs, the reconfiguration and optimization of our telephone and data services and lower snow removal expenditures. Costs related to other real estate operations decreased \$106,000 and \$265,000 for the three and nine months ended September 30, 2016, respectively. During the nine months of 2016 compared to the same period in 2015, salaries and employee benefits decreased by \$246,000 due to lower deferred compensation and equity award compensation expense, partially offset by an increase of \$143,000 in computer and electronic banking services due to 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 \$273,000 and \$956,000 for the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. The effective tax rate for the three months ended September 30, 2016 and 2015 was 33.0% and 33.7%, respectively. The effective tax rate for the nine months ended September 30, 2016 and 2015 was 33.0% and 32.9%, 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 September 30, 2016, cash and cash equivalents totaled \$63.4 million. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$170.7 million at September 30, 2016. In addition, at September 30, 2016, the Bank had the ability to borrow an additional \$57.0 million from the FHLB, which included overnight lines of credit of \$10.0 million. On that date, the Bank had FHLB advances outstanding of \$208.6 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 nine months ended September 30, 2016, the Bank originated \$191.1 million of loans and purchased \$29.5 million of securities and \$33.7 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 \$77.6 million for the nine months ended September 30, 2016. FHLB advances decreased \$26.0 million during the nine months ended September 30, 2016 and increased \$86.3 million during the year ended December 31, 2015. The decrease in borrowings for the nine months ended September 30, 2016 resulted from the net repayments of FHLB advances with excess deposits. Certificates of deposit due within one year of September 30, 2016 totaled \$208.5 million, or 18.3% 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 7,877 shares of the Company's common stock at a cost of \$99,000 during the first nine 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 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 September 30, 2016, SI Financial Group had cash and cash equivalents of \$2.3 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 September 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 September 30, 2016 and December 31, 2015 are as follows:

	September 30, 2016	December 31, 2015
	(In Thousands)	
Commitments to extend credit:		
Commitments to originate loans	\$ 14,946	\$ 7,531
Undisbursed construction loans	12,347	28,939
Undisbursed home equity lines of credit	51,400	46,819
Undisbursed commercial lines of credit	57,871	47,354
Overdraft protection lines	1,296	1,262
Standby letters of credit	133	173
Total commitments	\$ 137,993	\$ 132,078

Future loan commitments at September 30, 2016 and December 31, 2015 included fixed-rate loan commitments of \$7.7 million and \$5.3 million, respectively, at interest rates ranging from 2.63% to 5.85% and 2.88% to 5.75%, respectively.

The Bank is a limited partner in three small business investment corporations ("SBICs"). At September 30, 2016, the Bank's remaining off-balance sheet commitment for the capital investment in the SBICs was \$813,000.

For the nine months ended September 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 September 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 September 30, 2016.

	Percentage Change in Estimated Net Interest Income Over	
	12 Months	24 Months
100 basis point decrease in rates	(2.97)%	(4.22)%
200 basis point increase in rates	0.25	0.71
300 basis point increase in rates	(0.24)	0.08

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 or increased 300 basis points in the

12-month period. Conversely, net interest income would be positively impacted in the 12-month period if rates increased 200 basis points or in the 24-month period 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 September 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.

There are no material changes from the risk factors set forth under Part I, Item 1A. "Risk Factors" in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016 and the 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 Quarterly Report on Form 10-Q and 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.

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

The Company's repurchases of equity securities for the three months ended September 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
July 1 - 31, 2016	—	\$ —	—	—
August 1 - 31, 2016	—	—	—	—
September 1 - 30, 2016	4,647	13.21	—	—
Total	4,647	\$ 13.21	—	—

⁽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. ⁽¹⁾

3.2 Bylaws of SI Financial Group, Inc. ⁽²⁾

4 Specimen Stock Certificate of SI Financial Group, Inc. ⁽¹⁾

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 September 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.

⁽¹⁾ 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.

⁽²⁾ 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: November 9, 2016 /s/ Rheo A. Brouillard
Rheo A. Brouillard
President and Chief Executive Officer
(principal executive officer)

Date: November 9, 2016 /s/ Lauren L. Murphy
Lauren L. Murphy
Senior Vice President and Chief Financial Officer
(principal accounting and financial officer)