VALIDUS HOLDINGS LTD
Form 10-Q
November 03, 2016
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2016

Commission file number 001-33606

VALIDUS HOLDINGS, LTD.
(Exact name of registrant as specified in its charter)

BERMUDA	98-0501001
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

29 Richmond Road, Pembroke, Bermuda HM 08
(Address of principal executive offices and zip code)
(441) 278-9000
(Registrant’s telephone number, including area code)

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

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 x No o

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. (Check one):

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x
As of November 1, 2016 there were 79,363,867 outstanding Common Shares, $0.175 par value per share, of the registrant.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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Validus Holdings, Ltd.
Consolidated Balance Sheets
As at September 30, 2016 (unaudited) and December 31, 2015
(Expressed in thousands of U.S. dollars, except share and per share information)

	September 30, 2016 (unaudited)	December 31, 2015 (audited)
Assets		
Fixed maturities trading, at fair value (amortized cost: 2016—$5,547,838; 2015—$5,556,900)	$5,576,341	$5,510,331
Short-term investments trading, at fair value (amortized cost: 2016—$2,481,573; 2015—$1,941,615)	2,481,406	1,941,635
Other investments, at fair value (cost: 2016—$371,668; 2015—$315,963)	394,695	336,856
Cash and cash equivalents	443,992	723,109
Restricted cash	113,048	73,270
Total investments, cash and cash equivalents	9,009,482	8,585,201
Investments in affiliates, equity method (cost: 2016—$86,305; 2015—$70,186)	99,731	88,065
Premiums receivable	939,127	658,682
Deferred acquisition costs	249,922	181,002
Prepaid reinsurance premiums	119,805	77,992
Securities lending collateral	10,629	4,863
Loss reserves recoverable	444,609	350,586
Paid losses recoverable	36,069	23,071
Income taxes recoverable	6,879	16,228
Deferred tax asset	26,015	21,661
Receivable for investments sold	21,854	39,766
Intangible assets	117,010	121,258
Goodwill	196,758	196,758
Accrued investment income	24,906	23,897
Other assets	183,357	126,782
Total assets	$11,486,153	$10,515,812
Liabilities		
Reserve for losses and loss expenses	$3,035,987	$2,996,567
Unearned premiums	1,359,438	966,210
Reinsurance balances payable	76,429	75,380
Securities lending payable	11,095	5,329
Deferred tax liability	3,278	3,847
Payable for investments purchased	49,435	77,475
Accounts payable and accrued expenses	144,086	627,331
Notes payable to AlphaCat investors	372,730	75,493
Senior notes payable	245,311	245,161
Debentures payable	538,168	537,668
Total liabilities	5,835,957	5,610,461
Commitments and contingent liabilities		
Redeemable noncontrolling interest	1,559,580	1,111,714
Shareholders' equity		
Preferred shares (Issued and Outstanding: 2016—6,000; 2015—nil)	150,000	—
Common shares (Issued: 2016—161,273,353; 2015—160,570,772; Outstanding: 2016—79,443,030; 2015—82,900,617)	28,223	28,100

Treasury shares (2016—81,830,323; 2015—77,670,155)	(14,320)	(13,592)
Additional paid-in capital	827,256	1,002,980
Accumulated other comprehensive loss	(21,092)	(12,569)
Retained earnings	2,897,553	2,634,056
Total shareholders’ equity available to Validus	3,867,620	3,638,975
Noncontrolling interest	222,996	154,662
Total shareholders’ equity	4,090,616	3,793,637
Total liabilities, noncontrolling interests and shareholders’ equity	$ 11,486,153	$ 10,515,812

The accompanying notes are an integral part of these Consolidated Financial Statements (unaudited).

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Validus Holdings, Ltd.
Consolidated Statements of Income and Comprehensive Income
For the Three and Nine Months Ended September 30, 2016 and 2015 (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(unaudited)		(unaudited)	
Revenues				
Gross premiums written	$372,418	$402,509	$2,309,251	$2,247,901
Reinsurance premiums ceded	(45,006)	(48,810)	(249,070)	(295,553)
Net premiums written	327,412	353,699	2,060,181	1,952,348
Change in unearned premiums	236,363	201,312	(351,415)	(248,759)
Net premiums earned	563,775	555,011	1,708,766	1,703,589
Net investment income	43,514	31,572	112,232	96,212
Net realized gains (losses) on investments	4,397	(1,187)	6,537	5,226
Change in net unrealized gains on investments	5,459	3,916	84,331	2,467
Income (loss) from investment affiliate	453	2,482	(4,249)	5,542
Other insurance related (loss) income and other income	(610)	1,526	1,627	2,566
Foreign exchange (losses) gains	(766)	(2,592)	11,765	(9,528)
Total revenues	616,222	590,728	1,921,009	1,806,074
Expenses				
Losses and loss expenses	258,394	256,010	789,971	763,085
Policy acquisition costs	113,434	105,039	328,593	307,773
General and administrative expenses	82,443	96,886	258,339	265,146
Share compensation expenses	10,501	9,983	32,465	28,279
Finance expenses	14,521	18,512	43,890	58,161
Total expenses	479,293	486,430	1,453,258	1,422,444
Income before taxes, loss from operating affiliates and income attributable to AlphaCat investors	136,929	104,298	467,751	383,630
Tax expense	(1,830)	(2,018)	(1,418)	(7,132)
Loss from operating affiliates	—	(7,963)	(23)	(2,241)
(Income) attributable to AlphaCat investors	(5,564)	(1,438)	(16,278)	(1,438)
Net income	$129,535	$92,879	$450,032	$372,819
Net (income) attributable to noncontrolling interests	(37,439)	(26,229)	(96,163)	(66,968)
Net income available to Validus	92,096	66,650	353,869	305,851
Dividends on preferred shares	(2,252)	—	(2,252)	—
Net income available to Validus common shareholders	$89,844	$66,650	$351,617	$305,851
Comprehensive income:				
Net income	$129,535	$92,879	$450,032	$372,819
Other comprehensive (loss) income				
Change in foreign currency translation adjustments	(1,370)	(1,850)	(6,685)	(2,106)
Change in minimum pension liability, net of tax	(1,101)	(28)	(705)	129
Change in fair value of cash flow hedge	(439)	75	(1,133)	(336)
Other comprehensive loss	(2,910)	(1,803)	(8,523)	(2,313)
Comprehensive income attributable to noncontrolling interests	(37,439)	(26,229)	(96,163)	(66,968)
Comprehensive income available to Validus	$89,186	$64,847	$345,346	$303,538

Earnings per share:				
Basic earnings per share available to Validus common shareholders	$1.12	$0.79	$4.31	$3.63
Earnings per diluted share available to Validus common shareholders	$1.11	$0.78	$4.24	$3.52
Cash dividends declared per common share	$0.35	$0.32	$1.05	$0.96
Weighted average number of common shares and common share equivalents outstanding:				
Basic	80,134,394	82,635,316	81,635,496	83,296,703
Diluted	81,244,556	85,629,494	82,938,624	86,841,927

The accompanying notes are an integral part of these Consolidated Financial Statements (unaudited).

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Validus Holdings, Ltd.
Consolidated Statements of Shareholders' Equity
For the Nine Months Ended September 30, 2016 and 2015 (unaudited)
(Expressed in thousands of U.S. dollars)

	Nine Months Ended September 30,	
	2016	2015
	(unaudited)	
Preferred shares		
Balance - beginning of period	$—	$—
Preferred shares issued	150,000	—
Balance - end of period	$150,000	$—
Common shares		
Balance - beginning of period	$28,100	$27,222
Common shares issued, net	123	504
Balance - end of period	$28,223	$27,726
Treasury shares		
Balance - beginning of period	$(13,592)	$(12,545)
Repurchase of common shares	(728)	(831)
Balance - end of period	$(14,320)	$(13,376)
Additional paid-in capital		
Balance - beginning of period	$1,002,980	$1,207,493
Offering expenses on preferred shares	(5,148)	—
Common shares (redeemed) issued, net	(7,754)	16,231
Repurchase of common shares	(195,287)	(203,086)
Share compensation expenses	32,465	28,279
Balance - end of period	$827,256	$1,048,917
Accumulated other comprehensive loss		
Balance - beginning of period	$(12,569)	$(8,556)
Other comprehensive loss	(8,523)	(2,313)
Balance - end of period	$(21,092)	$(10,869)
Retained earnings		
Balance - beginning of period	$2,634,056	$2,372,972
Net income	450,032	372,819
Net (income) attributable to noncontrolling interest	(96,163)	(66,968)
Dividends on preferred shares	(2,252)	—
Dividends on common shares	(88,120)	(86,256)
Balance - end of period	$2,897,553	$2,592,567
Total shareholders' equity available to Validus	$3,867,620	$3,644,965
Noncontrolling interest	$222,996	$159,116
Total shareholders' equity	$4,090,616	$3,804,081

The accompanying notes are an integral part of these Consolidated Financial Statements (unaudited).

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Validus Holdings, Ltd.
Consolidated Statements of Cash Flows
For the Nine Months Ended September 30, 2016 and 2015 (unaudited)
(Expressed in thousands of U.S. dollars)

	Nine Months Ended September 30,	
	2016	2015
	(unaudited)	
Cash flows provided by operating activities		
Net income	$450,032	$372,819
Adjustments to reconcile net income to cash provided by operating activities:		
Share compensation expenses	32,465	28,279
Amortization of discount on senior notes	81	81
Loss (income) from investment affiliate	4,249	(5,542)
Net realized gains on investments	(6,537)	(5,226)
Change in net unrealized gains on investments	(84,331)	(2,467)
Amortization of intangible assets	4,248	4,248
Loss from operating affiliates	23	2,241
Foreign exchange (gains) losses included in net income	(4,585)	16,549
Amortization of premium on fixed maturity investments	13,381	17,866
Change in:		
Premiums receivable	(288,048)	(356,734)
Deferred acquisition costs	(68,920)	(63,960)
Prepaid reinsurance premiums	(41,813)	(43,331)
Loss reserves recoverable	(97,742)	(9,111)
Paid losses recoverable	(13,165)	16,408
Income taxes recoverable	9,034	(16,088)
Deferred tax asset	(4,885)	1,390
Accrued investment income	(1,231)	1,059
Other assets	(83,068)	41,998
Reserve for losses and loss expenses	66,561	(61,691)
Unearned premiums	393,228	292,090
Reinsurance balances payable	2,726	(38,284)
Deferred tax liability	(593)	3,323
Accounts payable and accrued expenses	(26,514)	(49,057)
Net cash provided by operating activities	254,596	146,860
Cash flows used in investing activities		
Proceeds on sales of fixed maturity investments	2,047,496	2,888,919
Proceeds on maturities of fixed maturity investments	256,082	260,179
Purchases of fixed maturity investments	(2,317,674)	(3,169,834)
Purchases of short-term investments, net	(540,102)	(226,316)
Purchases of other investments, net	(53,627)	(6,065)
Increase in securities lending collateral	(5,766)	(5,991)
Redemption from operating affiliates	369	—
Investment in investment affiliates, net	(16,307)	(19,086)
(Increase) decrease in restricted cash	(39,778)	99,001
Net cash used in investing activities	(669,307)	(179,193)

Cash flows provided by (used in) financing activities		
Net proceeds on issuance of notes payable to AlphaCat investors	296,527	75,607
Net proceeds on issuance of preferred shares	144,852	—
Issuance of common shares, net	(7,631)	16,735
Purchases of common shares under share repurchase program	(196,015)	(203,917)
Dividends paid on preferred shares	(2,252)	—
Dividends paid on common shares	(87,901)	(86,401)
Increase in securities lending payable	5,766	5,991
Third party investment in redeemable noncontrolling interest	381,950	497,700
Third party redemption of redeemable noncontrolling interest	(17,284)	(86,933)
Third party investment in noncontrolling interest	171,674	9,600
Third party distributions of noncontrolling interest	(127,103)	(158,175)
Third party subscriptions deployed on AlphaCat Funds and Sidecars	(412,736)	(161,900)
Net cash provided by (used in) financing activities	149,847	(91,693)
Effect of foreign currency rate changes on cash and cash equivalents	(14,253)	(13,901)
Net decrease in cash and cash equivalents	(279,117)	(137,927)
Cash and cash equivalents - beginning of period	723,109	550,401
Cash and cash equivalents - end of period	$443,992	$412,474
Supplemental disclosure of cash flow information:		
Taxes paid during the period	$5,914	$14,959
Interest paid during the period	$46,072	$46,847

The accompanying notes are an integral part of these Consolidated Financial Statements (unaudited).

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

1. Basis of preparation and consolidation
These unaudited Consolidated Financial Statements (the "Consolidated Financial Statements") have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 in Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In addition, the year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. This Quarterly Report on Form 10-Q should be read in conjunction with the financial statements and related notes included in Validus Holdings. Ltd.'s (the "Company") Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the U.S. Securities and Exchange Commission (the "SEC").
The Company consolidates in these Consolidated Financial Statements the results of operations and financial position of all voting interest entities ("VOE") in which the Company has a controlling financial interest and all variable interest entities ("VIE") in which the Company is considered to be the primary beneficiary. The consolidation assessment, including the determination as to whether an entity qualifies as a VIE or VOE, depends on the facts and circumstances surrounding each entity.
During the fourth quarter of 2015, the Company early adopted Accounting Standards Update ("ASU") 2015-02, “Consolidation (Topic 810) Amendments to the Consolidation Analysis” issued by the United States Financial Accounting Standards Board (“FASB”), which changed the method in which the Company determines whether entities are consolidated by the Company. The adoption of this amended accounting guidance was implemented utilizing a full retrospective application for all periods presented in the Company's Consolidated Financial Statements.
The amended guidance includes changes in the identification of the primary beneficiary of investment companies considered to be VIEs. These changes resulted in the Company concluding that it is considered to be the primary beneficiary of the AlphaCat sidecars, the AlphaCat ILS funds and the BetaCat ILS funds and therefore the Company is required to consolidate these entities. The adoption of the amended guidance also resulted in the Company concluding that it was no longer required to consolidate PaCRe Ltd. ("PaCRe") due to the change in the VIE definition of "kick-out" rights under the amended guidance. The cumulative effect of these changes on the Company's retained earnings through the nine months ended September 30, 2015 was a gain of $405.
The following tables present the impact of the application of the amended accounting guidance on the Company's Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2015 and Consolidated Statement of Cash Flows for the nine months ended September 30, 2015:

	Three Months Ended September 30, 2015		
	As previously reported	Adjustment for adoption of new consolidation guidance	Revised
Total revenues	$518,564	$ 72,164	$590,728
Total expenses	486,829	(399)	486,430
Net (loss) income	(5,013)	97,892	92,879
Net loss (income) attributable to noncontrolling interest	71,663	(97,892)	(26,229)
Net income available to Validus	66,650	—	66,650
Comprehensive income available to Validus	64,847	—	64,847

Basic earnings per share available to common shareholders	$0.79	$ —	$0.79
Earnings per diluted share available to common shareholders	$0.78	$ —	$0.78

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

	Nine Months Ended September 30, 2015		
	As previously reported	Adjustment for adoption of new consolidation guidance	Revised
Total revenues	$1,799,261	$ 6,813	$1,806,074
Total expenses	1,420,839	1,605	1,422,444
Net income	289,032	83,787	372,819
Net loss (income) attributable to noncontrolling interest	15,042	(82,010)	(66,968)
Net income available to Validus	304,074	1,777	305,851
Comprehensive income available to Validus	301,761	1,777	303,538
Basic earnings per share available to common shareholders	$3.61	$ 0.02	$3.63
Earnings per diluted share available to common shareholders	$3.50	$ 0.02	$3.52

	Nine Months Ended September 30, 2015		
	As previously reported	Adjustment for adoption of new consolidation guidance	Revised
Net cash provided by operating activities	$51,878	$ 94,982	$146,860
Net cash used in investing activities	(560,622)	381,429	(179,193)
Net cash provided by (used in) financing activities	367,421	(459,114)	(91,693)
Effect of foreign currency rate changes on cash and cash equivalents	(27,432)	13,531	(13,901)
Net decrease in cash	(168,755)	30,828	(137,927)
Cash and cash equivalents - beginning of period	577,240	(26,839)	550,401
Cash and cash equivalents - end of period	408,485	3,989	412,474

In the opinion of management, these Consolidated Financial Statements reflect all adjustments (including normal recurring adjustments) considered necessary for a fair statement of the Company's financial position and results of operations as at the end of and for the periods presented. All significant intercompany accounts and transactions have been eliminated. The results of operations for any interim period are not necessarily indicative of the results for a full year.

The preparation of these financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. While management believes that the amounts included in the Consolidated Financial Statements reflect its best estimates and assumptions, actual results could differ materially from those estimates. The Company’s principal estimates include:

•reserve for losses and loss expenses;
•premium estimates for business written on a line slip or proportional basis;
•the valuation of goodwill and intangible assets;

- reinsurance recoverable balances including the provision for uncollectible amounts; and
- investment valuation of financial assets.

The term “ASC” used in these notes refers to Accounting Standard Codification issued by the FASB.

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

2. Recent accounting pronouncements

Recently Issued Accounting Standards Not Yet Adopted

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" (ASU 2014-09). The guidance in this ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). 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. In March and April 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606) - Principal versus Agent Considerations (Reporting Revenue Gross versus Net)" and ASU 2016-10, "Revenue from Contracts with Customers (Topic 606) - Identifying Performance Obligations and Licensing". The amendments in these ASU's clarify the implementation guidance within ASU 2014-09 on principal versus agent considerations and the aspects of identifying performance obligations, respectively, while retaining the related principals in those areas. In May 2016, the FASB issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606) - Narrow-Scope Improvements and Practical Expedients". The amendments in this ASU do not change the core principle of the guidance in Topic 606. Rather, the amendments provide clarifying guidance in a few narrow areas and add practical expedients to reduce the potential for diversity in practice as well as the cost and complexity of applying the guidance. The original effective date for the amendments in ASU 2014-09 was for annual reporting periods beginning after December 15, 2016; however, in August 2015, the FASB delayed the effective date by one year through the issuance of ASU 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date". As such, the new effective date is for interim and annual reporting periods beginning after December 15, 2017. Entities may adopt the standard as of the original effective date; however, earlier adoption is not permitted. The Company is currently evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)". The amendments in this ASU increase the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and requiring the disclosure of key information about leasing arrangements. The amendments in this ASU are effective for interim and annual reporting periods beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-09, "Compensation-Stock Compensation (Topic 718) - Improvements to Employee Share-Based Payment Accounting". The amendments in this ASU simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. The amendments in this ASU are effective for interim and annual reporting periods beginning after December 15, 2016. Early adoption is permitted. The Company is currently evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)". The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination. This guidance is effective for annual periods beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted for annual periods beginning after December 15, 2018, and interim periods within those fiscal years. The Company is currently evaluating the impact of this guidance on the Company's Consolidated Financial Statements.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments". This ASU is directed at reducing diversity in practice and addresses eight specific issues in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The ASU is effective for fiscal periods beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. The Company is currently evaluating the impact of this guidance on the Company’s Consolidated Financial Statements.

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

In October 2016, the FASB issued ASU 2016-16, “Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory”. This ASU aims to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. Current U.S. GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. The ASU states that an entity should recognize the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. The ASU does not include new disclosure requirements; however, existing disclosure requirements might be applicable when accounting for the current and deferred income taxes for an intra-entity transfer of an asset other than inventory. The ASU is effective for fiscal periods beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements. The Company is currently evaluating the impact of this guidance on the Company’s Consolidated Financial Statements.

In October 2016, the FASB issued ASU 2016-17, “Consolidation (Topic 810) - Interests Held Through Related Parties That Are Under Common Control”. The amendments in this ASU does not change the characteristics of a primary beneficiary in current U.S. GAAP. The ASU requires that a reporting entity, in determining whether it satisfies the second characteristic of a primary beneficiary, include all of its direct variable interests in a VIE and, on a proportionate basis, its indirect variable interests in a VIE held through related parties, including related parties that are under common control with the reporting entity. The ASU is effective for public business entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. Entities that have not yet adopted ASU 2015-02 are required to adopt the amendments in this update at the same time and should apply the same transition method elected for the application of the ASU. Entities that already have adopted ASU 2015-02 are required to apply the amendments in this update retrospectively to all relevant prior periods beginning with the fiscal year in which ASU 2015-02 initially were applied. The Company is currently evaluating the impact of this guidance on the Company’s Consolidated Financial Statements.

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

3. Investments

During the fourth quarter of 2015, the Company enhanced disclosures with respect to the allocation of invested assets and the related returns between managed and non-managed investments. Managed investments represent assets governed by the Company's investment policy statement ("IPS"), whereas non-managed investments represent assets held in support of consolidated AlphaCat VIEs which are not governed by the Company's IPS. Refer to Note 5, "Variable interest entities," for further details. As such, prior period disclosures have been revised to conform to the current period presentation.

The Company classifies its fixed maturity and short-term investments as trading and accounts for its other investments in accordance with U.S. GAAP guidance for "Financial Instruments." As such, all investments are carried at fair value with interest and dividend income and realized and unrealized gains and losses included in net income for the period.

The amortized cost (or cost), gross unrealized gains and (losses) and fair value of the Company's investments as at September 30, 2016 were as follows:

	Amortized Cost (or Cost)	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Managed investments:				
U.S. government and government agency	$ 833,897	$ 4,088	$ (439)	$ 837,546
Non-U.S. government and government agency	251,863	1,503	(4,976)	248,390
U.S. states, municipalities and political subdivisions	278,172	5,585	(396)	283,361
Agency residential mortgage-backed securities	644,403	13,980	(507)	657,876
Non-agency residential mortgage-backed securities	21,142	160	(687)	20,615
U.S. corporate	1,509,117	19,102	(1,542)	1,526,677
Non-U.S. corporate	434,621	3,611	(6,600)	431,632
Bank loans	598,847	1,635	(12,945)	587,537
Asset-backed securities	484,480	2,607	(1,568)	485,519
Commercial mortgage-backed securities	336,297	5,388	(888)	340,797
Total fixed maturities	5,392,839	57,659	(30,548)	5,419,950
Short-term investments	197,970	—	(167)	197,803
Other investments				
Fund of hedge funds	1,457	—	(498)	959
Hedge funds	12,073	5,983	—	18,056
Private equity investments	69,353	16,157	(1,840)	83,670
Fixed income investment funds	232,614	823	—	233,437
Overseas deposits	53,246	—	—	53,246
Mutual funds	2,925	2,402	—	5,327
Total other investments	371,668	25,365	(2,338)	394,695
Total managed investments	$ 5,962,477	$ 83,024	$ (33,053)	$ 6,012,448
Non-managed investments:				
Catastrophe bonds	$ 154,999	$ 2,890	$ (1,498)	$ 156,391
Short-term investments	2,283,603	—	—	2,283,603
Total non-managed investments	2,438,602	2,890	(1,498)	2,439,994
Total investments	$ 8,401,079	$ 85,914	$ (34,551)	$ 8,452,442

Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

The amortized cost (or cost), gross unrealized gains and (losses) and fair value of the Company's investments as at December 31, 2015 were as follows:

	Amortized Cost (or Cost)	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Managed investments:				
U.S. government and government agency	$ 940,428	$ 333	$ (3,559)	$ 937,202
Non-U.S. government and government agency	241,549	257	(3,838)	237,968
U.S. states, municipalities and political subdivisions	299,929	2,322	(962)	301,289
Agency residential mortgage-backed securities	606,676	6,361	(2,455)	610,582
Non-agency residential mortgage-backed securities	27,025	310	(415)	26,920
U.S. corporate	1,503,614	1,594	(15,257)	1,489,951
Non-U.S. corporate	453,178	797	(7,405)	446,570
Bank loans	592,981	275	(17,045)	576,211
Asset-backed securities	440,363	344	(3,583)	437,124
Commercial mortgage-backed securities	263,310	131	(3,306)	260,135
Total fixed maturities	5,369,053	12,724	(57,825)	5,323,952
Short-term investments	237,349	20	—	237,369
Other investments				
Fund of hedge funds	1,457	—	(40)	1,417
Hedge funds	14,018	6,962	—	20,980
Private equity investments	53,489	12,751	(2,469)	63,771
Fixed income investment funds	188,121	600	—	188,721
Overseas deposits	54,484	—	—	54,484
Mutual funds	4,394	3,089	—	7,483
Total other investments	315,963	23,402	(2,509)	336,856
Total managed investments	$ 5,922,365	$ 36,146	$ (60,334)	$ 5,898,177
Non-managed investments:				
Catastrophe bonds	$ 187,847	$ 635	$ (2,103)	$ 186,379
Short-term investments	1,704,266	—	—	1,704,266
Total non-managed investments	1,892,113	635	(2,103)	1,890,645
Total investments	$ 7,814,478	$ 36,781	$ (62,437)	$ 7,788,822

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

(a) Fixed maturity investments

The following table sets forth certain information regarding the investment ratings of the Company's fixed maturity investments as at September 30, 2016 and December 31, 2015.

	September 30, 2016			December 31, 2015		
	Fair Value	% of Total		Fair Value	% of Total	
Managed fixed maturities:						
Investment grade fixed maturities						
AAA	$2,417,068	43.3	%	$2,367,642	43.0	%
AA	526,729	9.5	%	569,386	10.3	%
A	1,084,128	19.4	%	1,031,326	18.7	%
BBB	736,400	13.2	%	691,538	12.6	%
Total investment grade managed fixed maturities	4,764,325	85.4	%	4,659,892	84.6	%
Non-investment grade fixed maturities						
BB	228,798	4.1	%	235,724	4.3	%
B	182,261	3.3	%	179,069	3.2	%
CCC	9,561	0.2	%	5,706	0.1	%
CC	—	0.0	%	1,015	0.0	%
NR	235,005	4.2	%	242,546	4.4	%
Total non-investment grade fixed maturities	655,625	11.8	%	664,060	12.0	%
Total managed fixed maturities	$5,419,950	97.2	%	$5,323,952	96.6	%
Non-managed fixed maturities:						
Investment grade catastrophe bonds						
BBB	$—	0.0	%	$1,911	0.0	%
Total investment grade catastrophe bonds	—	0.0	%	1,911	0.0	%
Non-investment grade catastrophe bonds						
BB	31,052	0.5	%	70,962	1.3	%
B	4,922	0.1	%	30,698	0.6	%
NR	120,417	2.2	%	82,808	1.5	%
Total non-investment grade catastrophe bonds	156,391	2.8	%	184,468	3.4	%
Total non-managed fixed maturities	156,391	2.8	%	186,379	3.4	%
Total fixed maturities	$5,576,341	100.0	%	$5,510,331	100.0	%

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except for percentages, share and per share information)

The amortized cost and fair value amounts for the Company's fixed maturity investments held at September 30, 2016 and December 31, 2015 are shown below by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	September 30, 2016		December 31, 2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Managed fixed maturities:				
Due in one year or less	$368,627	$366,437	$367,132	$366,019
Due after one year through five years	2,990,875	2,992,940	2,965,920	2,936,053
Due after five years through ten years	433,478	441,449	548,183	539,083
Due after ten years	113,537	114,317	150,444	148,036
	3,906,517	3,915,143	4,031,679	3,989,191
Asset-backed and mortgage-backed securities	1,486,322	1,504,807	1,337,374	1,334,761
Total managed fixed maturities	$5,392,839	$5,419,950	$5,369,053	$5,323,952
Non-managed catastrophe bonds:				
Due in one year or less	$40,231	—		

2,228

Unallocated
290

—

—

—

—

—

Total
$
7,828

$
29

$
7,509

$
1,089,422

$
8,004

$
1,081,418

December 31, 2017						
Commercial and industrial	$208	$—	$208	$54,759	$20	$54,739
Construction	336	—	336	42,484	—	42,484
Commercial real estate	5,185	28	5,157	551,445	4,763	546,682
Residential real estate	1,032	10	1,022	171,844	2,064	169,780
Consumer and other loans	26	—	26	1,130	—	1,130
Unallocated	548	—	—	—	—	—
Total	$7,335	$38	$6,749	$821,662	$6,847	$814,815

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An age analysis of loans receivable, which were past due as of March 31, 2018 and December 31, 2017, is as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 days Past Due	Greater Than 90 Days (a)	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
March 31, 2018							
Commercial and industrial	$1,988	$—	$—	$1,988	$55,053	$57,041	$ —
Construction	—	—	105	105	57,370	57,475	—
Commercial real estate	10,456	488	4,996	15,940	639,298	655,238	—
Residential real estate	593	42	3,995	4,630	312,810	317,440	—
Consumer and other	23	4	—	27	2,201	2,228	—
Total	$13,060	$534	$9,096	$22,690	$1,066,732	$1,089,422	$ —
December 31, 2017							
Commercial and industrial	$—	$—	$20	$20	$54,739	$54,759	$—
Construction	—	—	105	105	42,379	42,484	—
Commercial real estate	4,935	126	4,314	9,374	542,071	551,445	—
Residential real estate	1,304	122	1,581	3,007	168,837	171,844	—
Consumer and other	8	1	—	9	1,121	1,130	—
Total	$6,247	$249	$6,020	$12,515	$809,147	$821,662	$—

(a) includes loans greater than 90 days past due and still accruing and non-accrual loans.

Loans for which the accrual of interest has been discontinued, excluding PCI loans, at March 31, 2018 and December 31, 2017 were:

(Dollars in thousands)	March 31, 2018	December 31, 2017
Commercial and industrial	—	20
Construction	105	105
Commercial real estate	4,996	4,314
Residential real estate	3,995	1,581
Total	$ 9,096	$ 6,020

In determining the adequacy of the allowance for loan losses, we estimate losses based on the identification of specific problem loans through our credit review process and also estimate losses inherent in other loans on an aggregate basis by loan type. The credit review process includes the independent evaluation of the loan officer assigned risk ratings by the Chief Credit Officer and a third party loan review company. Such risk ratings are assigned loss component factors that reflect our loss estimate for each group of loans. It is management's and the Board of Directors' responsibility to oversee the lending process to ensure that all credit risks are properly identified, monitored, and controlled, and that loan pricing, terms and other safeguards against non-performance and default are commensurate with the level of risk undertaken and is rated as such based on a risk-rating system. Factors considered in assigning risk ratings and loss component factors include: borrower specific information related to expected future cash flows and operating results, collateral values, financial condition and payment status; levels of and trends in portfolio charge-offs and recoveries; levels in portfolio delinquencies; effects of changes in loan concentrations and observed trends in the economy and other qualitative measurements.

Our risk-rating system is consistent with the classification system used by regulatory agencies and with industry practices. Loan classifications of Substandard, Doubtful or Loss are consistent with the regulatory definitions of classified assets. The classification system is as follows:

- Pass: This category represents loans performing to contractual terms and conditions and the primary source of repayment is adequate to meet the obligation. We have five categories within the Pass classification depending on strength of repayment sources, collateral values and financial condition of the borrower.

- Special Mention: This category represents loans performing to contractual terms and conditions; however the primary source of repayment or the borrower is exhibiting some deterioration or weaknesses in financial condition that could potentially threaten the borrowers' future ability to repay our loan principal and interest or fees due.

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- Substandard: This category represents loans that the primary source of repayment has significantly deteriorated or weakened which has or could threaten the borrowers' ability to make scheduled payments. The weaknesses require close supervision by management and there is a distinct possibility that we could sustain some loss if the deficiencies are not corrected. Such weaknesses could jeopardize the timely and ultimate collection of our loan principal and interest or fees due. Loss may not be expected or evident, however, loan repayment is inadequately supported by current financial information or pledged collateral.

- Doubtful: Loans so classified have all the inherent weaknesses of a substandard loan with the added provision that collection or liquidation in full is highly questionable and not reasonably assured. The probability of at least partial loss is high, but extraneous factors might strengthen the asset to prevent loss. The validity of the extraneous factors must be continuously monitored. Once these factors are questionable the loan should be considered for full or partial charge-off.

- Loss: Loans so classified are considered uncollectible, and of such little value that their continuance as active assets is not warranted. Such loans are fully charged off.

The following tables illustrate our corporate credit risk profile by creditworthiness category as of March 31, 2018 and December 31, 2017:

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
March 31, 2018					
Commercial and industrial	$55,834	$478	$ 729	$ —	$57,041
Construction	57,230	140	105	—	57,475
Commercial real estate	630,560	11,033	13,645	—	655,238
Residential real estate	308,460	477	8,503	—	317,440
Consumer and other	1,992	—	236	—	2,228
	$1,054,076	$12,128	$ 23,218	$ —	$1,089,422
December 31, 2017					
Commercial and industrial	$54,405	$189	$165	$—	$54,759
Construction	42,379	105	—	—	42,484
Commercial real estate	537,636	3,508	10,301	—	551,445
Residential real estate	169,395	228	2,221	—	171,844
Consumer and other	1,130	—	—	—	1,130
	$804,945	$4,030	$12,687	$—	$821,662

The following table reflects information about our impaired loans, excluding PCI loans, by class as of March 31, 2018 and December 31, 2017:

	March 31, 2018			December 31, 2017		
(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial and industrial	$ —	$ 10	$ —	$ 20	$ 20	$ —
Construction	105	105	—	—	—	—
Commercial real estate	3,908	4,232	—	3,834	4,158	—
Residential real estate	3,061	3,105	—	1,844	1,877	—
With an allowance recorded:						
Commercial and industrial	—	—	—	—	—	—
Commercial real estate	930	1,393	29	929	1,392	28
Residential real estate	—	—	—	220	223	10
Total:						
Commercial and industrial	—	10	—	20	20	—
Construction	105	105	—	—	—	—
Commercial real estate	4,838	5,625	29	4,763	5,550	28
Residential real estate	3,061	3,105	—	2,064	2,100	10
	$8,004	$8,845	$29	$6,847	$7,670	$38

The following table presents the average recorded investment and income recognized for our impaired loans, excluding PCI loans, for the three months ended March 31, 2018 and 2017:

	For the Three Months Ended March 31, 2018		For the Three Months Ended March 31, 2017	
(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and industrial	$10	$ —	$19	$ —
Construction	53	—	—	—
Commercial real estate	3,871	12	2,308	—
Residential real estate	2,453	11	1,525	1
Total impaired loans without a related allowance	6,387	23	3,852	1
With an allowance recorded:				
Commercial real estate	930	—	2,142	8
Residential real estate	110	—	316	—
Total impaired loans with an allowance	1,040	—	2,465	8
Total impaired loans	$7,427	$ 23	$6,317	$ 9

We recognize interest income on performing impaired loans as payments are received. On non-performing impaired loans we do not recognize interest income as all payments are recorded as a reduction of principal on such loans.

Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, postponement or forgiveness of principal, forbearance or other actions intended to maximize collection. The concessions rarely

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result in the forgiveness of principal or accrued interest. In addition, we attempt to obtain additional collateral or guarantor support when modifying such loans. Non-accruing restructured loans may be returned to accrual status when there has been a sustained period of repayment performance (generally six consecutive months of payments) and both principal and interest are deemed collectible.

The following table presents the recorded investment in troubled debt restructured loans, based on payment performance status:

(Dollars in thousands)	Commercial Real Estate	Residential Real Estate	Total
March 31, 2018			
Performing	$ 656	$ 1,477	$2,133
Non-performing	2,522	373	2,895
Total	$ 3,178	$ 1,850	$5,028
December 31, 2017			
Performing	$449	$483	$932
Non-performing	1,594	242	1,836
Total	$2,043	$725	$2,768

Troubled debt restructured loans are considered impaired and are included in the previous impaired loans disclosures in this footnote. As of March 31, 2018, we have not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructuring.

There was no troubled debt restructuring that occurred during the three months ended March 31, 2018 and 2017. The increase in troubled debt restructured loans was due to loans acquired in the Community acquisition.

There was one troubled debt restructuring with an outstanding balance of $127 thousand for which there was a payment default within twelve months following the date of the restructuring for the three months ended March 31, 2018. There was no troubled debt restructuring for which there was a payment default within twelve months following the date of the restructuring for the three months ended March 31, 2017.

We may obtain physical possession of residential real estate collateralizing a consumer mortgage loan via foreclosure on an in-substance repossession. As of March 31, 2018, we had five foreclosed residential real estate properties with a carrying value of $1.3 million. As of December 31, 2017, we had one foreclosed residential real estate property with a carrying value of $179 thousand. In addition, as of March 31, 2018 and December 31, 2017, respectively, we had consumer loans with a carrying value of $1.2 million and $180 thousand collateralized by residential real estate property for which formal foreclosure proceedings were in process. The increases in amounts at March 31, 2018, compared to December 31, 2017, were due to loans acquired in the Community acquisition.

NOTE 6 – EARNINGS PER SHARE

Basic earnings per share are calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares (unvested restricted stock grants and stock options) had been issued, as well as any adjustment to income that would result from the assumed issuance of potential common shares that may be issued by us. Potential common shares related to stock options are determined using the treasury stock method.

(Dollars in thousands, except share and per share data)	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Shares Outstanding (weighted average)		7,740,685			4,685,553	
Shares held by Rabbi Trust		95,843			96,736	
Shares liability under deferred compensation agreement		(95,843)			(96,736)	
Basic earnings per share:						
Net earnings applicable to common stockholders	$1,308	7,740,685	$ 0.17	$2,011	4,685,553	$ 0.43
Effect of dilutive securities:						
Unvested stock awards	—	51,051		—	41,780	
Diluted earnings per share:						
Net income applicable to common stockholders and assumed conversions	$1,308	7,791,736	$ 0.17	$2,011	4,727,333	$ 0.43

There were 20,170 and 46,753 shares of unvested restricted stock awards and options outstanding during the three months ended March 31, 2018 and 2017, respectively, which were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive.

NOTE 7 – OTHER COMPREHENSIVE INCOME

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

The components of other comprehensive income, both before tax and net of tax, are as follows:

	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
(Dollars in thousands)						
Other comprehensive income (loss):						
Unrealized gains on available for sale securities	$(2,167)	$(588)	$(1,579)	$676	$270	$406
Fair value adjustments on derivatives	1,107	311	796	40	16	24
Reclassification adjustment for net losses (gains) on securities transactions included in net income	—	—	—	(107)	(42)	(65)
Total other comprehensive (loss) income	$(1,060)	$(277)	$(783)	$609	$244	$365

NOTE 8 – GOODWILL AND OTHER INTANGIBLES

The Company had goodwill of $24.8 million and $2.8 million for the periods ended March 31, 2018 and December 31, 2017, respectively. The increase was due to the merger with Community Bank with total goodwill amounting to $22.0 million. The Company reviews its goodwill and intangible assets annually, on September 30, or more frequently if conditions warrant, for impairment. In testing goodwill for impairment, the Company compares the estimated fair value of its reporting unit to its carrying amount, including goodwill.

The Company recorded a core deposit intangible of $1.3 million for the Community Bank acquisition. For the period ended March 31, 2018, the Company amortized $61 thousand in core deposit intangible. The estimated future amortization expense for the remainder of 2018 and for each of the succeeding five years ended December 31 is as follows (dollars in thousands):

For the Year Ended	Amortization Expense
2018	$ 182
2019	217
2020	194
2021	169
2022	145
2023	121

NOTE 9 – SEGMENT INFORMATION

Our insurance agency operations are managed separately from the traditional banking and related financial services that we also offer. The insurance agency operation provides commercial, individual, and group benefit plans and personal coverage.

	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Banking and Financial Services	Insurance Services	Total	Banking and Financial Services	Insurance Services	Total
(Dollars in thousands)						
Net interest income from external sources	$10,768	$ —	$ 10,768	$6,749	$ —	$ 6,749
Other income from external sources	925	1,932	2,857	730	1,747	2,477
Depreciation and amortization	448	6	454	266	6	272
Income before income taxes	614	909	1,523	2,022	820	2,842
Income tax expense (1)	(149)	364	215	503	328	831
Total assets	1,371,795	4,689	1,376,484	865,832	6,450	872,282

(1) Insurance Services calculated at statutory tax rate of 28.1% .

NOTE 10 – STOCK-BASED COMPENSATION

We currently have stock-based compensation plans in place for our directors, officers, employees, consultants and advisors. Under the terms of these plans we may grant restricted shares and stock options for the purchase of our common stock. The stock-based compensation is granted under terms determined by our Compensation

Committee. Our standard stock option grants have a maximum term of 10 years, generally vest over periods ranging between one and five years, and are granted with an exercise price equal to the fair market value of the common stock on the date of grant. Restricted stock is valued at the market value of the common stock on the date of grant and generally vests over periods of three to five years. All dividends paid on restricted stock, whether vested or unvested, are paid to the shareholder.

Information regarding our stock option plans for the six months ended March 31, 2018 is as follows:

	Number of Shares	Weighted Average Exercise Price per Share	Weighted Average Contractual Term	Aggregate Intrinsic Value
Options outstanding, beginning of year	69,123	$ 11.10		
Options outstanding, end of quarter	69,123	$ 11.10	7.1	$1,334,151
Options exercisable, end of quarter	36,229	$ 10.85	7.0	$708,336
Option price range at end of quarter	$9.97 to $12.83			
Option price of exercisable shares	$9.97 to $12.83			

During the three months ended March 31, 2018 and 2017, we expensed $12 thousand and $12 thousand, respectively, in stock-based compensation under stock option awards.

There were no options granted during the three months ended March 31, 2018 and 2017. Expected future expense relating to the unvested options outstanding as of March 31, 2018 is $104 thousand over a weighted average period of 2.1 years. Upon exercise of vested options, management expects to draw on treasury stock as the source of the shares.

The summary of changes in unvested restricted stock awards for the three months ended March 31, 2018, is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested restricted stock, beginning of year	85,761	$ 18.34
Granted	20,169	29.15
Forfeited	(4,148)	17.66
Vested	(29,145)	16.15
Unvested restricted stock, end of period	72,637	$ 22.25

During the three months ended March 31, 2018 and 2017, we expensed $153 thousand and $153 thousand, respectively, in stock-based compensation under restricted stock awards.

At March 31, 2018, unrecognized compensation expense for unvested restricted stock was $1.4 million, which is expected to be recognized over an average period of 2.5 years.

NOTE 11 – GUARANTEES

We do not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Standby letters of credit are conditional commitments issued by us to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Generally, we hold collateral and/or personal guarantees supporting these commitments. As of March 31, 2018, we had $1.7 million of outstanding letters of credit. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2018, for guarantees under standby letters of credit issued is not material.

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses its best judgment in estimating the fair value of our financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts we could have realized in a sale transaction on the dates indicated. The fair value amounts have been measured as of their respective period ends, and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

In accordance with U.S. GAAP, we use a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by the hierarchy are as follows:

- Level I - Quoted prices are available in active markets for identical assets or liabilities as of the reported date.
- Level II - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these asset and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.
- Level III - Assets and liabilities that have little to no pricing observability as of reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following table summarizes the fair value of our financial assets measured on a recurring basis by the above pricing observability levels as of March 31, 2018 and December 31, 2017:

(Dollars in thousands)	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
March 31, 2018				
U.S. government agencies	$ 29,902	$ —	$ 29,902	$ —
U.S. government-sponsored enterprises	15,982	—	15,982	—
State and political subdivisions	60,948	—	60,948	—
Mortgage-backed securities -				
U.S. government-sponsored enterprises	65,221	—	65,221	—
Corporate debt	2,048	—	2,048	—
Derivative instruments				
Interest rate swaps	2,558	—	2,558	—
December 31, 2017				
U.S. government agencies	$18,861	$—	$18,861	$—
U.S. government-sponsored enterprises	6,061	—	6,061	—
State and political subdivisions	41,234	—	41,234	—
Mortgage-backed securities -				
U.S. government-sponsored enterprises	30,544	—	30,544	—
Corporate debt	2,030	—	2,030	—
Derivative instruments				
Interest rate swaps	1,451	—	1,451	—

Our available for sale and held to maturity securities portfolios contain investments, which were all rated within our investment policy guidelines at time of purchase, and upon review of the entire portfolio all securities are marketable and have observable pricing inputs.

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at March 31, 2018 and December 31, 2017 are as follows:

(Dollars in thousands)	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
March 31, 2018				
Impaired loans	$ 111	$ —	$ —	$ 111
Foreclosed real estate	546	—	—	546
December 31, 2017				
Impaired loans	$1,794	$ —	$ —	$1,794
Foreclosed real estate	568	—	—	568

The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis and for which Level III inputs were used to determine fair value:

	Qualitative Information about Level III Fair Value Measurements			
(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
March 31, 2018				
Impaired loans	$ 111	Appraisal of collateral	Appraisal adjustments (1)	0% to (-100.0%) (-7.32%)
Foreclosed real estate	546	Appraisal of collateral	Selling expenses (1)	-7.0%(-7.0%)
December 31, 2017				
Impaired loans	$1,794	Appraisal of collateral	Appraisal adjustments (1)	0% to (-100.0%) (-0.22%)
Foreclosed real estate	568	Appraisal of collateral	Selling expenses (1)	-7.0% (-7.0%)

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated selling expenses. The range and weighted average of selling expenses and other appraisal adjustments are presented as a percentage of the appraisal.

The following information should not be interpreted as an estimate of the fair value of the entire company since a fair value calculation is only provided for a limited portion of our assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between our disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair value of our financial instruments at March 31, 2018 and December 31, 2017:

Cash and Cash Equivalents (Carried at Cost): The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair value.

Deposits (Carried at Cost): Fair value for fixed-rate time certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits. We generally purchase amounts below the insured limit, limiting the amount of credit risk on these time deposits.

Securities: The fair value of securities, available for sale (carried at fair value) and securities held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level I), or matrix pricing

(Level II), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level III). In the absence of such evidence, management's best estimate is used.

Federal Home Loan Bank Stock (Carried at Cost): The carrying amount of restricted investment in bank stock approximates fair value and considers the limited marketability of such securities.

Loans Receivable (Carried at Cost): The Company has adopted ASU 2016-01, and therefore is measuring the fair value of loans receivable under the exit price notion rather than the previous method of entry price notion. Under the entry price notion, the fair value estimate of loans receivable was based on discounted cash flow. At March 31, 2018, the exit price notion used to estimate the fair value of loans receivable was based on similar techniques, with the addition of current origination spreads, liquidity premiums, or credit adjustments.

Impaired Loans (Carried at Lower of Cost or Fair Value): Fair value of impaired loans is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included in Level III fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value of impaired loans totaled $111 thousand and $1.8 million at March 31, 2018 and December 31, 2017, respectively. These balances consist of loans that were written down or required additional reserves during the periods ended March 31, 2018 and December 31, 2017, respectively.

Deposit Liabilities (Carried at Cost): The fair values disclosed for demand, savings and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings (Carried at Cost): Fair values of Federal Home Loan Bank ("FHLB") advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Derivatives (Carried at Fair Value): The Company also uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges, and which satisfy hedge accounting requirements, involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without the exchange of the underlying notional amount. These derivatives were used to hedge the variable cash outflows associated with FHLB borrowings along with our junior subordinated debenture at U.S. Capital Trust. The effective portion of changes in the fair value of these derivatives are recorded in accumulated other comprehensive income, and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of these derivatives is recognized directly in earnings.

The fair value of the Company`s derivatives are determined using discounted cash flow analysis using observable market-based inputs, which are considered Level 2 inputs.

Subordinated Debentures (Carried at Cost): Fair values of subordinated debt are estimated using discounted cash flow analysis, based on market rates currently offered on such debt with similar credit risk characteristics, terms and remaining maturity.

Accrued Interest Receivable and Accrued Interest Payable (Carried at Cost): The carrying amounts of accrued interest receivable and payable approximate its fair value.

Off-Balance Sheet Instruments (Disclosed at Cost): Fair values for our off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The fair values of our financial instruments at March 31, 2018 and December 31, 2017, were as follows:

	March 31, 2018				
(Dollars in thousands)	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
Financial assets:					
Cash and cash equivalents	$ 15,080	$ 15,080	$ 15,080	$ —	$ —
Time deposits with other banks	200	200	—	200	—
Securities available for sale	174,101	174,101	—	174,101	—
Securities held to maturity	5,534	5,629	—	5,629	—
Federal Home Loan Bank stock	8,358	8,358	—	8,358	—
Loans receivable, net of allowance	1,080,601	1,039,947	—	—	1,039,947
Accrued interest receivable	5,085	5,085	—	5,085	—
Interest rate swaps	2,558	2,558	—	2,558	—
Financial liabilities:					
Non-maturity deposits	781,565	781,565	—	781,565	—
Time deposits	261,766	239,533	—	239,533	—
Short-term borrowings	125,025	125,033	125,033	—	—
Long-term borrowings	30,000	28,935	—	28,935	—
Subordinated debentures	27,851	25,399	—	25,399	—
Accrued interest payable	533	533	—	533	—

(Dollars in thousands)	December 31, 2017 Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level I)	Significant Other Observable Inputs (Level II)	Significant Unobservable Inputs (Level III)
Financial assets:					
Cash and cash equivalents	$11,646	$11,646	$11,646	$ —	$ —
Time deposits with other banks	100	100	—	100	—
Securities available for sale	98,730	98,730	—	98,730	—
Securities held to maturity	5,304	5,430	—	5,430	—
Federal Home Loan Bank stock	4,925	4,925	—	4,925	—
Loans receivable, net of allowance	813,365	788,119	—	—	788,119
Accrued interest receivable	2,472	2,472	—	2,472	—
Interest rate swaps	1,451	1,451	—	1,451	—
Financial liabilities:					
Non-maturity deposits	563,694	563,694	—	563,694	—
Time deposits	198,797	197,549	—	197,549	—
Short-term borrowings	55,350	55,335	55,335	—	—
Long-term borrowings	35,000	34,761	—	34,761	—
Subordinated debentures	27,848	25,259	—	25,259	—
Accrued interest payable	470	470	—	470	—

NOTE 13 – DERIVATIVES

The Company’s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges are recorded in accumulated other comprehensive income and are subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the three months ended March 31, 2018 such derivatives were used to hedge the variable cash outflows associated with four FHLB borrowings totaling $26.0 million. The Company entered into an interest rate swap agreement to hedge its $12.5 million variable rate (3 Mo Libor +1.44%) junior subordinated debt issued by Sussex Capital Trust II, a non-consolidated wholly-owned subsidiary of the Company, for 10 years at a fixed rate of 3.10%. The ineffective portion of the change in fair value of the derivatives are recognized directly in earnings. The Company implemented this program during the quarter ended March 31, 2016.

During the three months ended March 31, 2018 and 2017, the Company did not record any hedge ineffectiveness.

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Statements of Financial Condition at March 31, 2018 and December 31, 2017:

	March 31, 2018			
	Notional/ Contract Amount	Fair Value	Balance Sheet Location	Expiration Date
(Dollars in thousands)				
Derivatives designated as hedging instruments				
Interest rate swaps by effective date:				
March 15, 2016	$12,500	$935	Other Assets	March 15, 2026
December 15, 2016	5,000	303	Other Assets	December 15, 2026
June 15, 2017	6,000	349	Other Assets	June 15, 2027
December 15, 2017	10,000	659	Other Assets	December 15, 2027
December 15, 2017	5,000	312	Other Assets	December 15, 2027
Total	$38,500	$2,558		

	December 31, 2017			
	Notional/ Contract Amount	Fair Value	Balance Sheet Location	Expiration Date
(Dollars in thousands)				
Derivatives designated as hedging instruments				
Interest rate swaps by effective date:				
March 15, 2016	$12,500	$610	Other Assets	March 15, 2026
December 15, 2016	5,000	161	Other Assets	December 15, 2026
June 15, 2017	6,000	170	Other Assets	June 15, 2027
December 15, 2017	10,000	352	Other Assets	December 15, 2027
December 15, 2017	5,000	158	Other Assets	December 15, 2027
Total	$38,500	$1,451		

The table below presents the Company's derivative financial instruments that are designated as cash flow hedgers of interest rate risk and their effect on the Company's Consolidated Statements of Financial Conditions during the three months ended March 31, 2018 and 2017:

	Three Months Ended March 31, 2018		
	Amount of Gain Recognized in OCI on Derivatives, net of Tax (Effective Portion)	Location of Gain (Loss) Recognized in Income of Derivatives (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income of Derivatives (Ineffective Portion)
(Dollars in thousands)			
Derivatives in cash flow hedges			
Interest rate swaps by effective date:			
March 15, 2016	$234	Not applicable	$ —
December 15, 2016	103	Not applicable	—
June 15, 2017	129	Not applicable	—
December 15, 2017	220	Not applicable	—
December 15, 2017	111	Not applicable	—
Total	$797		$ —

	Three Months Ended March 31, 2017		
	Amount of Gain Recognized in OCI on Derivatives, net of Tax (Effective Portion)	Location of Gain (Loss) Recognized in Income of Derivatives (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income of Derivatives (Ineffective Portion)
(Dollars in thousands)			
Derivatives in cash flow hedges			
Interest rate swaps by effective date:			

March 15, 2016	$13	Not applicable	$	—
December 15, 2016	8	Not applicable	—	
June 15, 2017	1	Not applicable	—	
December 15, 2017	1	Not applicable	—	
December 15, 2017	1	Not applicable	—	
Total	$24		$	—

The Company has master netting arrangements with its counterparty. All master netting arrangements include rights to offset associated with the Company's recognized derivative assets, derivative liabilities, and cash collateral received and pledged.

As required under the master netting arrangement with its derivatives counterparty, the Company received financial collateral from its counterparty totaling $2.8 million at March 31, 2018 that was not included as an offsetting amount.

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

MANAGEMENT STRATEGY

We are a community-oriented financial institution serving northern New Jersey, northeastern Pennsylvania, New York City, New York and Queens County, New York. While offering traditional community bank loan and deposit products and services, we obtain non-interest income through our insurance brokerage operations and the sale of non-deposit products.

We continue to focus on strengthening our core operating performance by improving our net interest income and margin by closely monitoring our yield on earning assets and adjusting the rates offered on deposit products. We have been focused on building for the future and strengthening our core operating results within our risk management framework.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with U.S. GAAP and practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in our consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Actual results could differ from those estimates.

Critical accounting estimates are necessary in the application of certain accounting policies and procedures, and are particularly susceptible to significant change. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. There have been no material changes to our critical accounting policies during the three months ended March 31, 2018. For additional information on our critical accounting policies, please refer to Note 1 of the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2017.

COMPARISION OF OPERATING RESULTS FOR THREE MONTHS ENDED MARCH 31, 2018 AND 2017

Overview – For the quarter ended March 31, 2018, the Company reported net income of $1.3 million, or $0.17 per basic and diluted share, as compared to net income of $2.0 million, or $0.43 per basic and diluted share, for the same period last year. The decrease in net income was mainly attributable to merger-related costs associated with the merger of Community Bank of Bergen County ("Community Bank"), NJ with and into the Bank, partially offset by an increase in net income due to the addition of Community Bank's operations following the merger. As of January 4, 2018, Community Bank had total assets, loans and deposits of $343.8 million, $236.1 million and $301.2 million, respectively. The first quarter of 2018 included the independent operations and expenses of both, the Company and Community Bank, until March 26, 2018 when the Company completed all systems integrations and are now operating under one company platform.

The Company's net income, adjusted for tax effected merger-related expenses of $2.4 million, increased $1.7 million, or 82.8%, to $3.7 million, or $0.47 per basic and diluted share, for the quarter ended March 31, 2018, as compared to the same period last year. The Company's return on average assets, adjusted for tax effected merger-related expenses of $2.4 million, for the quarter ended March 31, 2018, was 1.10%, an increase from 0.94% for the quarter ended March 31, 2017.

Comparative Average Balances and Average Interest Rates – The following table presents, on a fully tax equivalent basis, a summary of our interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for the three month periods ended March 31, 2018 and 2017:

	Three Months Ended March 31,					
(Dollars in thousands)	2018			2017		
Earning Assets:	Average Balance	Interest	Average Rate (2)	Average Balance	Interest	Average Rate (2)
Securities:						
Tax exempt (3)	$54,987	$575	4.24 %	$47,443	$470	4.02 %
Taxable	120,776	736	2.47 %	62,767	341	2.20 %
Total securities	175,763	1,311	3.03 %	110,210	811	2.98 %
Total loans receivable (1) (4)	1,063,727	11,900	4.54 %	701,862	7,598	4.39 %
Other interest-earning assets	12,397	30	0.98 %	12,940	16	0.50 %
Total earning assets	$1,251,887	$13,241	4.29 %	$825,012	$8,425	4.14 %
Non-interest earning assets	96,249			41,062		
Allowance for loan losses	(7,505)			(6,723)		
Total Assets	$1,340,631			$859,351		
Sources of Funds:						
Interest bearing deposits:						
NOW	$259,677	$398	0.62 %	$177,107	$119	0.27 %
Money market	96,463	248	1.04 %	73,935	124	0.68 %
Savings	221,946	77	0.14 %	137,742	71	0.21 %
Time	265,139	735	1.12 %	166,670	403	0.98 %
Total interest bearing deposits	843,225	1,458	0.70 %	555,454	717	0.52 %
Borrowed funds	111,886	506	1.83 %	85,919	481	2.27 %
Junior subordinated debentures	27,849	315	4.59 %	27,840	321	4.68 %
Total interest bearing liabilities	$982,960	$2,279	0.94 %	$669,213	$1,519	0.92 %

Non-interest bearing liabilities:						
Demand deposits	208,694			124,991		
Other liabilities	5,112			3,591		
Total non-interest bearing liabilities	213,806			128,582		
Stockholders' equity	143,865			61,556		
Total Liabilities and Stockholders' Equity	$1,340,631			$859,351		
Net Interest Income and Margin(5)		10,962	3.55 %		6,906	3.39 %
Tax-equivalent basis adjustment		(194)			(157)	
Net Interest Income		$10,768			$6,749	

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(1) Includes loan fee income.
(2) Average rates on securities are calculated on amortized costs.
(3) Full tax equivalent basis, using a 21% effective tax rate and adjusted for TEFRA (Tax and Equity Fiscal Responsibility Act) interest expense disallowance.
(4) Loans outstanding include non-accrual loans.
(5) Represents the difference between interest earned and interest paid, divided by average total interest-earning assets.

Net Interest Income – Net interest income is the difference between interest and deferred fees earned on loans and other interest-earning assets and interest paid on interest-bearing liabilities. Net interest income is directly affected by changes in volume and mix of interest-earning assets and interest-bearing liabilities that support those assets, as well as changing interest rates when differences exist in repricing dates of assets and liabilities.

Net interest income on a fully tax equivalent basis increased $4.1 million, or 58.7%, to $11.0 million for the first quarter of 2018, as compared to $6.9 million for the same period in 2017. The increase in net interest income was largely due to a $426.9 million, or 51.7%, increase in average interest earning assets, principally loans receivable, which increased $361.9 million, or 51.6%. The net interest margin increased by sixteen basis points to 3.55% for the first quarter of 2018, as compared to the same period in 2017. These increases were largely attributable to the merger with Community.

Interest Income – Our total interest income, on a fully tax equivalent basis, increased $4.8 million, or 57.2%, to $13.2 million for the quarter ended March 31, 2018, as compared to the same period last year. The increase was primarily due to higher average earning assets, which increased $426.9 million for the quarter ended March 31, 2018, as compared to the same period in 2017. The average yield increased fifteen basis points to 4.29% for the quarter ended March 31, 2018, as compared to 4.14% for the same period last year.

Our total interest income earned on loans receivable increased $4.3 million, or 56.6%, to $11.9 million for the first quarter of 2018, as compared to the same period in 2017. The increase was primarily driven by an increase in average balance of loans receivable of $361.9 million, or 51.6%, for the three months ended March 31, 2018, as compared to the same period last year. The average yield increased fifteen basis points to 4.54% for the quarter ended March 31, 2018, as compared to 4.39% for the same period last year. The increases in average yield was largely driven by purchase accounting accretion resulting from the merger with Community.

Our total interest income earned on securities, on a fully tax equivalent basis, increased $500 thousand, to $1.3 million for the quarter ended March 31, 2018 from $811 thousand for the same period in 2017. The increase in interest income earned on securities was mainly due to a 59.5% increase on the average balance. The average yield for the quarter ended March 31, 2018 increased five basis points to 3.03% as compared to the same period in 2017.

Other interest-earning assets include federal funds sold and interest bearing deposits in other banks. Our interest earned on total other interest-earning assets increased $14 thousand to $30 thousand for the first quarter of 2018 as compared to the same period last year. The average balances in other interest-earning assets decreased $543 thousand to $12.4 million in the first quarter of 2018 from $12.9 million during the first quarter a year earlier. Despite the decline in average balance, interest income increased to $30 thousand for the first quarter of 2018 due to a 48 basis point increase in the average yield to 0.98% as compared to 0.50% in the same period in 2017 which was mainly driven by the deposits held at the Federal Reserve Bank and Wilmington Trust.

Interest Expense – Our interest expense for the three months ended March 31, 2018 increased $760 thousand, or 50.0%, to $2.3 million from $1.5 million for the same period in 2017. The increase was principally due to higher average balances in interest-bearing liabilities, which increased $313.7 million, or 46.9%, to $983.0 million for the first quarter of 2018 from $669.2 million for the same period in 2017. The average rate for the quarter ended March 31, 2018 increased two basis points to 0.94% as compared to 0.92% for the same period last year.

Our interest expense on deposits increased $741 thousand, or 103.3%, for the quarter ended March 31, 2018, as compared to the same period last year. The increase was largely attributed to the increase in the average balance of total interest bearing deposits, which increased $287.8 million during the first quarter of 2018, as compared to the same period in 2017. The average rate increased eighteen basis points to 0.70% for the quarter ended March 31, 2018, as compared to 0.52% for the same period last year.

Our interest expense on borrowed funds increased $25 thousand, or 5.2%, for the quarter ended March 31, 2018, as compared to the same period last year. The increase was largely attributed to a $26.0 million increase in the average balance of borrowed funds during the first quarter of 2018, as compared to the same period in 2017. The increase was partially offset by a 44 basis point decrease in the average rate to 1.83% as compared to 2.27% in the same period in 2017.

Our interest expense on all of the Company`s subordinated debt decreased $6 thousand, or 1.9%, for the quarter ended March 31, 2018, as compared to the same period last year. The decrease was mainly attributed to a nine basis points decrease in average rate to 4.59% for the quarter ended March 31, 2018, as compared to 4.68% for the same period last year.

Provision for Loan Losses – Provision for loan losses increased $101 thousand to $508 thousand for the first quarter of 2018, as compared to $407 thousand for the same period in 2017. The provision for loan losses reflects management's judgment concerning the risks inherent in our existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the activity in the allowance during the periods. Management reviews the adequacy of its allowance on an ongoing basis and will provide additional provisions, as management may deem necessary.

Non-Interest Income – Our non-interest income increased $380 thousand, or 15.3%, to $2.9 million for the first quarter of 2018, as compared to the same period last year. The increase was principally due to growth of $148 thousand in insurance commissions and fees relating to SB One Insurance Agency, an increase of $133 thousand in other income and an increase of $79 thousand in bank owned life insurance. The aforementioned was partly offset by a reduction in gain on sales of securities of approximately $107 thousand.

Non-Interest Expense – Our non-interest expenses increased $5.6 million, or 94.0%, to $11.6 million for the first quarter of 2018, as compared to the same period last year. The increase was largely due to merger-related expenses of $3.3 million related to the acquisition of Community and increases in salaries and employee benefits of $1.5 million as a result of the merger with Community.

Income Taxes – Our income tax expense, which includes both federal and state tax expenses, decreased $616 thousand, or 74.1% to $215 thousand for the first quarter of 2018, as compared to the same period last year. The Company's effective tax rate for the first quarter of 2018 was 14.1%, as compared to 29.2% for the first quarter of 2017. The decrease in the Company's tax rate was largely due to the Tax Cuts and Jobs Act enacted in December 2017 which reduced the federal corporate income tax rate to 21% and the merger with Community which resulted in the Company's tax free income becoming a larger percentage of its overall income.

COMPARISION OF FINANCIAL CONDITION AT MARCH 31, 2018 TO DECEMBER 31, 2017

Total Assets – At March 31, 2018, our total assets were $1.4 billion, an increase of $397.1 million, or 40.6%, as compared to total assets of $979.4 million at December 31, 2017. The increase was largely attributable to the merger with Community.

Cash and Cash Equivalents – Our cash and cash equivalents increased by $3.4 million to $15.1 million at March 31, 2018, or 1.1% of total assets, from $11.6 million, or 1.2% of total assets, at December 31, 2017

Securities Portfolio – At March 31, 2018, the securities portfolio, which includes available for sale and held to maturity securities, was $179.6 million, compared to $104.0 million at December 31, 2017. Available for sale securities were $174.1 million at March 31, 2018, compared to $98.7 million at December 31, 2017. The available for sale securities are held primarily for liquidity, interest rate risk management and profitability. Accordingly, our investment policy is to invest in securities with low credit risk, such as U.S. government agency obligations, state and political obligations and mortgage-backed securities. Held to maturity securities were $5.5 million at March 31, 2018 and $5.3 million at December 31, 2017.

Net unrealized losses in the available for sale securities portfolio were $1.7 million for March 31, 2018 as compared to a net unrealized gain of $449 thousand at December 31, 2017.

We conduct a regular assessment of our investment securities to determine whether any securities are OTTI. Further detail of the composition of the securities portfolio and discussion of the results of the most recent OTTI assessment are in Note 3 – Securities to our unaudited consolidated financial statements.

The unrealized losses in our securities portfolio are mostly driven by changes in spreads and market interest rates. All of our securities in an unrealized loss position have been evaluated for other-than-temporary impairment as of March 31, 2018 and we do not consider any security OTTI. We evaluated the prospects of the issuers in relation to the severity and the duration of the unrealized losses. In addition, we do not intend to sell, and it is more likely than not that we will not have to sell, any of our securities before recovery of their cost basis.

Other investments, which consisted primarily of FHLB stock, increased $3.4 million to $8.4 million at March 31, 2018 as compared to $4.9 million at December 31, 2017. We also held $200 thousand in time deposits with other financial institutions at March 31, 2018, as compared to $100 thousand at December 31, 2017.

Loans – The loan portfolio comprises our largest class of earning assets. Total loans receivable, net of unearned income, increased $267.7 million, or 32.6%, to $1.1 billion at March 31, 2018, as compared to $820.7 million at December 31, 2017. The merger with Community resulted in an increase in total loans of $236.1 million. During the three months ended March 31, 2018, the Company also had $33.1 million of commercial loan production, which was partly offset by $12.6 million in commercial loan payoffs.

The following table summarizes the composition of our gross loan portfolio by type:

(Dollars in thousands)	March 31, 2018	December 31, 2017
Commercial and industrial loans	$57,041	$54,759
Construction	57,475	42,484
Commercial real estate	655,238	551,445
Residential real estate	317,440	171,844
Consumer and other	2,228	1,130
Total gross loans	$1,089,422	$821,662

Loan and Asset Quality – The ratio of non-performing assets ("NPAs"), which include non-accrual loans, loans 90 days past due and still accruing, troubled debt restructured loans currently performing in accordance with renegotiated terms and foreclosed real estate, to total assets increased to 1.07% at March 31, 2018 from 0.94% December 31, 2017. NPAs exclude $3.7 million of purchased credit-impaired ("PCI") loans acquired through the merger with Community. NPAs increased $5.5 million, or 60.1%, to $14.8 million at March 31, 2018, as compared to $9.2 million at December 31, 2017. Non-accrual loans, excluding $3.7 million of PCI loans, increased $3.1 million, or 51.1%, to $9.1 million at March 31, 2018, as compared to $6.0 million at December 31, 2017. Loans past due 30 to 89 days totaled $13.6 million at March 31, 2018, representing an increase of $7.1 million, or 109.3%, as compared to $6.5 million at December 31, 2017.

We continue to actively market our foreclosed real estate properties, which increased $1.3 million to $3.5 million at March 31, 2018 as compared to $2.3 million at December 31, 2017. At March 31, 2018, the Company's foreclosed real estate properties had an average carrying value of approximately $253 thousand per property.

The allowance for loan losses increased $493 thousand, or 6.7%, to $7.8 million, or 0.72% of total loans, at March 31, 2018, compared to $7.3 million, or 0.89% of total loans, at December 31, 2017. The decline in allowance coverage was primarily driven by the addition of Community acquired loans with no allowance for loan losses; such loans were recorded at fair value at the acquisition date. The Company recorded $508 thousand in provision for loan losses for the three months ended March 31, 2018 as compared to $407 thousand for the three months ended March 31, 2017. Additionally, the Company recorded net charge-offs of $15 thousand for the three months ended March 31, 2018, as compared to $306 thousand in net charge-offs for the three months ended March 31, 2017. The allowance for loan losses as a percentage of non-accrual loans decreased to 86.1% at March 31, 2018 from 121.8% at December 31, 2017.

Management continues to monitor our asset quality and believes that the NPAs are adequately collateralized and anticipated material losses have been adequately reserved for in the allowance for loan losses. However, given the uncertainty of the current real estate market, additional provisions for losses may be deemed necessary in future periods. The following table provides information regarding risk elements in the loan portfolio at each of the periods presented:

(Dollars in thousands)	March 31, 2018		December 31, 2017	
Non-accrual loans	$9,096		$6,020	
Non-accrual loans to total loans	0.84	%	0.73	%
NPAs	$14,755		$9,227	
NPAs to total assets	1.07	%	0.94	%
Allowance for loan losses as a % of non-accrual loans	86.06	%	121.84	%
Allowance for loan losses to total loans	0.72	%	0.89	%

A loan is considered impaired, in accordance with the impairment accounting guidance, when based on current information and events, it is probable that we will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Total impaired loans were $8.0 million and $6.8 million at March 31. 2018 and December 31, 2017, respectively. The Company also had PCI loans from the merger with Community with a carrying value of $5.8 million at March, 31 2018. Impaired loans include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. Not all impaired loans and restructured loans are on non-accrual, and therefore not all are considered non-performing loans. Restructured loans still accruing totaled $2.1 million and $932 thousand at March 31, 2018 and December 31, 2017, respectively.

We also continue to monitor our portfolio for potential problem loans. Potential problem loans are defined as loans which cause management to have serious concerns as to the ability of such borrowers to comply with the present loan repayment terms and which may cause the loan to be placed on non-accrual status. As of March 31, 2018, we had two loan relationship comprised of three loans totaling $9.1 million that we deemed potential problem loans. Management is actively monitoring these loans.

Further detail of the credit quality of the loan portfolio is included in Note 5 – Allowance for Loan Losses and Credit Quality of Financing Receivables to our unaudited consolidated financial statements.

Allowance for Loan Losses – The allowance for loan losses consists of general, allocated and unallocated components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical charge-off experience and expected losses derived from our internal risk rating process. The unallocated component covers the potential for other adjustments that may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

Management regularly assesses the appropriateness and adequacy of the loan loss reserve in relation to credit exposure associated with individual borrowers, overall trends in the loan portfolio and other relevant factors, and believes the reserve is reasonable and adequate for each of the periods presented.

At March 31, 2018, the total allowance for loan losses increased $493 thousand, or 6.7%, to $7.8 million, or 0.72% of total loans, compared to $7.3 million, or 0.89% of total loans, at December 31, 2017. The decline in allowance coverage was primarily driven by the addition of Community acquired loans with no allowance for loan losses; such loans were recorded at fair value at the acquisition date. The Company recorded $508 thousand in provision for loan losses for the three months ended March 31, 2018 as compared to $407 thousand for the three months ended March 31, 2017. Additionally, the Company recorded net charge-offs of $15 thousand for the three months ended March 31, 2018, as compared to $306 thousand in net charge-offs for the three months ended March 31, 2017. The allowance for loan losses as a percentage of non-accrual loans decreased to 86.1% at March 31, 2018 from 121.8% at December 31, 2017.

The table below presents information regarding our provision and allowance for loan losses for the three months ended March 31, 2018 and 2017:

(Dollars in thousands)	March 31, 2018	March 31, 2017

Balance, beginning of period	$7,335	$6,696
Provision	508	407
Charge-offs	(34)	(318)
Recoveries	19	12
Balance, end of period	$7,828	$6,797

The table below presents details concerning the allocation of the allowance for loan losses to the various categories for each of the periods presented. The allocation is made for analytical purposes and it is not necessarily indicative of the categories in which future credit losses may occur. The total allowance is available to absorb losses from any category of loans.

(Dollars in thousands)	March 31, 2018 Amount	Percentage of Loans In Each Category To Gross Loans		December 31, 2017 Amount	Percentage of Loans In Each Category To Gross Loans	
Commercial and industrial	$389	5.2	%	$208	6.7	%
Construction	345	5.3	%	336	5.2	%
Commercial real estate	5,801	60.2	%	5,185	67.1	%
Residential real estate	972	29.1	%	1,032	20.9	%
Consumer and other loans	31	0.2	%	26	0.1	%
Unallocated	290	—	%	548	—	%
Total	$7,828	100.0	%	$7,335	100.0	%

Bank-Owned Life Insurance (“BOLI”) – Our BOLI carrying value amounted to $30.2 million at March 31, 2018 and $22.1 million at December 31, 2017. The increase of $8.1 million is largely due to the merger with Community.

Goodwill and Other Intangibles – Goodwill represents the excess of the purchase price over the fair market value of net assets acquired. At March 31, 2018 we had recorded goodwill totaling $24.8 million as compared to $2.8 million at December 31, 2017. The increase in our goodwill primarily resulted from the merger with Community in the recorded amount of $22.0 million. Additionally, our recorded goodwill includes the acquisition of Tri-State in 2001 and the 2006 acquisition of deposits. In accordance with U.S. GAAP, goodwill is not amortized, but evaluated at least annually for impairment. Any impairment of goodwill results in a charge to income. We periodically assess whether events and changes in circumstances indicate that the carrying amounts of goodwill and intangible assets may be impaired. The estimated fair value of the reporting segment exceeded its book value; therefore, no write-down of goodwill was required. The goodwill related to the insurance agency is not deductible for tax purposes.

Deposits – Our total deposits increased $280.8 million, or 36.8%, to $1.0 billion at March 31, 2018, from $762.5 million at December 31, 2017, primarily driven by the merger with Community. The growth in deposits was mostly due to an increase in interest bearing deposits of $208.6 million, or 33.8%, and non-interest bearing deposits of $72.3 million, or 49.4%, at March 31, 2018, as compared to December 31, 2017, respectively.

Borrowings – Our borrowings consist of short-term and long-term advances from the FHLB. The advances are secured under terms of a blanket collateral agreement by a pledge of qualifying mortgage loans. We had $155.0 million and $90.4 million in borrowings at FHLB, at a weighted average interest rate of 1.95% and 1.61% at March 31, 2018 and December 31, 2017, respectively. The long-term borrowings at March 31, 2018 consisted of $25.0 million of fixed rate advances and $5.0 million of advances with quarterly convertible puts that allow us to put the advance back to the FHLB quarterly after one year from issuance. During the quarter ended March 31, 2016, the Company entered into forward starting interest rate swap agreements related to four of its FHLB borrowings. Please refer to Liquidity and Capital Resources – Off-Balance Sheet Arrangements.

Subordinated Debentures – On June 28, 2007, Sussex Capital Trust II (the “Trust”), a Delaware statutory business trust and our non-consolidated wholly owned subsidiary, issued $12.5 million of variable rate capital trust pass-through securities to investors. The Trust purchased $12.9 million of variable rate junior subordinated deferrable interest debentures from us. The debentures are the sole asset of the Trust. The terms of the junior subordinated debentures are the same as the terms of the capital securities. We have also fully and unconditionally guaranteed the obligations of the Trust under the capital securities. The interest rate is based on the three-month LIBOR plus 144 basis points and adjusts quarterly. The rate at March 31, 2018 was 3.56%. During the quarter ended March 31, 2016, the Company entered into an interest rate swap agreement related to the junior subordinated debentures where the Company pays a fixed rate of 3.10% and receives the three-month LIBOR plus 144 basis points. Please refer to Liquidity and Capital Resources – Off-Balance Sheet Arrangements. The capital securities are currently redeemable by us at par in whole or in part. The capital securities must be redeemed upon final maturity of the subordinated debentures on September 15, 2037. The proceeds of these trust preferred securities, which have been contributed to the Bank, are included in the Bank’s capital ratio calculations and treated as Tier I capital. During the quarter ended December 31, 2016, the Company completed the private placement of the subordinated notes. The subordinated notes have a maturity date of December 22, 2026 and bear interest at the rate of 5.75% per annum, payable quarterly, for the first five years of the term, and then at a variable rate that will reset quarterly to a level equal to the then current 3-month LIBOR plus 350 basis points over the remainder of the term.

In accordance with FASB ASC 810, Consolidations, our wholly owned subsidiary, the Trust, is not included in our consolidated financial statements.

Equity – Stockholders' equity, inclusive of accumulated other comprehensive income, net of income taxes, was $146.3 million, an increase of $52.1 million when compared to December 31, 2017, largely due to the merger with Community. The Company completed the merger on January 4, 2018 which was the primary driver in an increase in book value per common share of 18.2% from $15.59 at December 31, 2017 to $18.43 at March 31, 2018. At March 31, 2018, the leverage, Tier I risk-based capital, total risk-based capital and common equity Tier I capital ratios for the Bank were 10.90%, 13.58%, 14.33% and 13.58%, respectively, all in excess of the ratios required to be deemed "well-capitalized."

LIQUIDITY AND CAPITAL RESOURCES

A fundamental component of our business strategy is to manage liquidity to ensure the availability of sufficient resources to meet all financial obligations and to finance prospective business opportunities. Liquidity management is critical to our stability. Our liquidity position over any given period of time is a product of our operating, financing and investing activities. The extent of such activities is often shaped by such external factors as competition for deposits and loan demand.

Traditionally, financing for our loans and investments is derived primarily from deposits, along with interest and principal payments on loans and investments. At March 31, 2018, total deposits amounted to $1.0 billion, an increase of $280.8 million, or 36.8%, from December 31, 2017. At March 31, 2018 and December 31, 2017, borrowings from FHLB and subordinated debentures totaled $182.9 million and $118.2 million, respectively, and represented 13.3% and 12.1% of total assets, respectively.

Loan production continued to be our principal investing activity. Total loans receivable, net of unearned income, at March 31, 2018, amounted to $1.1 billion, an increase of $267.7 million, or 32.6%, compared to December 31, 2017.

Our most liquid assets are cash and due from banks and federal funds sold. At March 31, 2018, the total of such assets amounted to $15.1 million, or 1.1%, of total assets, compared to $11.6 million, or 1.2% of total assets at December 31, 2017. Another significant liquidity source is our available for sale securities portfolio. At March 31, 2018, available for sale securities amounted to $174.1 million, compared to $98.7 million at December 31, 2017.

In addition to the aforementioned sources of liquidity, we have available various other sources of liquidity, including federal funds purchased from other banks and the FRB discount window. The Bank also has the capacity to borrow an additional $119.8 million through its membership in the FHLB and $10.0 million at ACBB at March 31, 2018. Management believes that our sources of funds are sufficient to meet our present funding requirements.

In July 2013, the FRB, the Office of the Comptroller of the Currency (the "OCC") and the FDIC approved final rules (the "Capital Rules") that established a new capital framework for U.S. banking organizations. The Capital Rules generally implement the Basel Committee on Banking Supervision's (the "Basel Committee") December 2010 final capital framework referred to as "Basel III" for strengthening international capital standards. In addition, the Capital Rules implement certain provisions of the Dodd-Frank Act, including the requirements of Section 939A to remove references to credit ratings from the federal banking agencies' rules.

At March 31, 2018, the Bank's Tier I, Total and Common Equity Tier I ("CET1") capital ratios were 13.60%, 14.35% and 13.60%, respectively. In addition to the risk-based guidelines, the Bank's regulators require that banks which meet the regulators' highest performance and operational standards maintain a minimum leverage ratio (Tier I capital as a percentage of tangible assets) of 4.0%. As of March 31, 2018, the Bank had a leverage ratio of 10.90%. The Bank's risk based and leverage ratios are in excess of those required to be considered "well-capitalized" under FDIC regulations.

The Capital Rules also requires a "capital conservation buffer," composed entirely of CET1, on top of these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity and other capital instrument repurchases and compensation based on the amount of the shortfall. Beginning January 1, 2016, the capital standards applicable to the Company will include an additional capital conservation buffer of 0.625%, increasing 0.625% each year thereafter. When fully phased-in on January 1, 2019, the Company will include an additional capital conservation buffer of 2.5% of CET1, effectively resulting in minimum ratios inclusive of the capital conservation buffer of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and (iii) total capital to risk-weighted assets of at least 10.5%. As of March 31, 2018, the Bank had a capital conservation buffer of 6.35%.

The Capital Rules substantially revised the risk-based capital requirements applicable to bank holding companies and their depository institution subsidiaries. The risk-based capital guidelines are designed to make regulatory capital requirements sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposures and to minimize disincentives for holding liquid, low-risk assets. The capital guidelines apply on a consolidated basis to bank holding companies

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with consolidated assets of $1 billion or more, and to certain bank holding companies with less than $1 billion in assets if they are engaged in substantial non-banking activity or meet certain other criteria.

We have no investment or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity or the availability of capital resources, except for the trust preferred securities of the Trust. We are not aware of any known trends or any known demands, commitments, events or uncertainties, which would result in any material increase or decrease in liquidity. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

Off-Balance Sheet Arrangements – Our consolidated financial statements do not reflect off-balance sheet arrangements that are made in the normal course of business. These off-balance sheet arrangements consist of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. At March 31, 2018, these unused commitments totaled $213.8 million and consisted of $109.1 million in commitments to grant commercial real estate, construction and land development loans, $38.9 million in home equity lines of credit, $64.1 million in other unused commitments and $1.7 million in letters of credit. These instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to us. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

During the first quarter of 2016, the Company entered into interest rate swap agreements with notional amounts totaling $38.5 million, of which all are designated as cash flow hedges. The Company entered into $26.0 million in forward starting interest rate swap agreements coinciding with the maturity of five FHLB Advances over the next 21 months that had an average rate of 4.03%. The forward interest rate swaps have a term of 10 years at an average fixed rate of 1.97% and will hedge short term wholesale funding. Additionally, the Company entered into a $12.5 million interest rate swap agreement to coincide with a junior subordinated debt issued by Sussex Capital Trust II, for a term of 10 years at a fixed rate of 3.10%.

Item 3 - Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4 - Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely discussion regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during our last fiscal quarter that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1 - Legal Proceedings

We are not involved in any legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Management believes that such proceedings are, in the aggregate, immaterial to our financial condition and results of operations.

Item 1A - Risk Factors

For a summary of risk factors relevant to our operations, see Part 1, Item 1A, “Risk Factors” in our 2017 Annual Report on Form 10-K.

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

There were no sales by us of unregistered securities during the three months ended March 31, 2018.

Item 3 - Defaults Upon Senior Securities

Not applicable.

Item 4 - Mine Safety Disclosures

Not applicable.

Item 5 - Other Information

Not applicable.

Item 6 - Exhibits

The exhibits required to be filed as part of this Quarterly Report on Form 10-Q are listed below.

EXHIBIT INDEX

Exhibit Number	Description
2.1	Agreement and Plan of Merger, dated as of April 10, 2017, by and between Sussex Bancorp, Sussex Bank and Community Bank of Bergen County, NJ (incorporated by reference to Exhibit 2.1 of the Form 8-K filed with the SEC on April 11, 2017).
3.1	Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Quarterly Report on 10-Q filed with the SEC on August 15, 2011).
3.2	Amendment to Restate Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Currency Report on Form 8-K filed with the SEC on May 4, 2018).
3.3	Second Amended and Restated By-laws (incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed with the SEC on May 4, 2018).
4.1	Specimen common stock certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the Registration Statement on Form S-1 filed with the SEC on June 3, 2013).
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.
32.1*	Section 1350 Certifications of the Chief Executive Officer and Chief Financial Officer.
101	Financial statements from the Quarterly Report on Form 10-Q of SB One Bancorp for the quarter ended March 31, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income and Comprehensive Income; (iii) the Consolidated Statements of Stockholders' Equity; (iv) the Consolidated Statements of Cash Flows and (v) Notes to Unaudited Consolidated Financial Statements.

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* Furnished herewith and not deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 10, 2018 SB ONE BANCORP

By: /s/ Steven M. Fusco
Steven M. Fusco
Chief Financial Officer and Senior Executive Vice President
(Principal Financial and Accounting Officer)

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