Bankwell Financial Group, Inc.
Form 10-K
March 04, 2019
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2018
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _________to________
Commission File Number: 001-36448
Bankwell Financial Group, Inc.
(Exact Name of Registrant as specified in its Charter)

Connecticut	20-8251355
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)

220 Elm Street
New Canaan, Connecticut 06840
(203) 652-0166
(Address, including zip code, and telephone number, including area code, of registrant’s principal executive offices)
Securities Registered Pursuant to Section 12(b) of the Act:
Common Stock, no par value per share
(Title of Class)
NASDAQ Global Market
(Name of exchange on which registered)

Securities Registered Pursuant to Section 12(g) of the Exchange Act:
None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ¨ Yes þ No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. ¨ Yes þ No
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. þ Yes ¨ No
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). þ Yes ¨ No
Indicate by check mark if disclosure of delinquent filers pursuant to item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K þ
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated

filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer ¨ Accelerated filer þ
Non-accelerated filer ¨ Smaller reporting company þ
Emerging growth company þ
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. þ
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No þ
Aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2018 based on the closing price of the common stock as reported on the NASDAQ Global Market: $196,751,216
As of February 25, 2019, there were 7,849,621 shares of the registrant's common stock outstanding.
DOCUMENTS INCORPORATED BY REFERENCE
Portions of the Registrant's definitive proxy statement for its Annual Meeting of Stockholders, expected to be filed pursuant to Regulation 14A within 120 days after the end of the 2018 fiscal year, are incorporated by reference into Part III of this report on form 10-K

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BANKWELL FINANCIAL GROUP, INC.
FORM 10-K

PART 1

Item 1. Business

Cautionary Note Regarding Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 or the Securities Act, and Section 21E of the Exchange Act. These statements are often, but not always, made with the words or phrases such as “may,” “should,” “believe,” “likely result in,” “expect,” “would,” “intend,” “could,” “predict,” “poter “continue,” “will,” “anticipate,” “seek,” “estimate,” “plan,” “projection,” and “outlook” or the negative version of those words similar words of a forward-looking nature. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about our industry, management’s beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. Accordingly, we caution you that any such forward-looking statements are not guarantees of future performance and are subject to risks, assumptions, uncertainties and other factors that could cause the actual results to differ materially from those contemplated by these forward-looking statements. Important factors that may cause actual results to differ from those contemplated by these forward-looking statements include, but are not limited to, those disclosed under “Risk Factors” in Part I Item 1A as well as the following factors:

- Local, regional and national business or economic conditions may differ from those expected;
- Credit risk and resulting losses in our loan portfolio;
- Our allowance for loan losses may not be adequate to absorb loan losses;
- Changes in real estate values could also increase our credit risk;
- Changes in our key management personnel;
- Inability to successfully execute our management team’s strategic initiatives;
- Our ability to successfully execute our growth initiatives such as branch openings and acquisitions;
- Volatility and direction of market interest rates;
- Increased competition within our market area which may limit our growth and profitability;
- Economic, market, operational, liquidity, credit and interest rate risks associated with our business;
- The effects of and changes in trade, monetary and fiscal policies and laws, including the Federal Reserve Board’s interest rate policies;
- Changes in accounting policies and practices, as may be adopted by regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;
- Changes in law and regulatory requirements (including those concerning taxes, banking, securities and insurance); and
- Further governmental intervention in the U.S. financial system.

The foregoing factors should not be construed as exhaustive. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from what we anticipate. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made, and we do not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise. New factors emerge from time to time, and it is not possible for us to predict which will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

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General

Bankwell Financial Group, Inc. is a bank holding company, headquartered in New Canaan, Connecticut and offers a broad range of financial services through its banking subsidiary, Bankwell Bank (collectively, we, our, us, the Company or the Bank), a Connecticut state chartered non-member bank founded in 2002. Our primary market is the New York metropolitan area, including Fairfield and New Haven Counties, Connecticut, which we serve from our main banking office located in New Canaan, Connecticut and eleven other branch offices located throughout the Fairfield and New Haven Counties area. As of December 31, 2018, on a consolidated basis, we had total assets of approximately $1.9 billion, net loans of approximately $1.6 billion, total deposits of approximately $1.5 billion, and shareholders' equity of approximately $174.2 million.

We are committed to being the premier "Hometown" bank in Fairfield and New Haven Counties and surrounding areas. We believe that our market exhibits attractive demographic attributes and presents competitive dynamics, thereby offering long-term opportunities for growth. We have a history of building long-term customer relationships and attracting new customers through what we believe is our superior customer service and our ability to deliver a diverse product offering. In addition, we believe that our strong capital position and extensive local ownership, coupled with a highly respected and experienced executive management team and board of directors, give us credibility with our customers and potential customers in our market. Our focus is on building a franchise with meaningful market share and consistent revenue growth complemented by operational efficiencies that we believe will produce attractive risk-adjusted returns for our shareholders.

Our History and Growth

Bankwell Bank was originally chartered as two separate banks, The Bank of New Canaan (including a separate division, Stamford First Bank) and The Bank of Fairfield, which were subsequently merged and rebranded as "Bankwell Bank." It was chartered with a commitment to building the premier community bank in the markets we serve. We began operations in April 2002 with an initial capitalization of $8.6 million. On November 5, 2013, we acquired The Wilton Bank, and it was merged into Bankwell Bank. On October 1, 2014, we acquired Quinnipiac Bank and Trust Company and it was merged into Bankwell Bank.

With the efforts of our strong management team, we continued our growth and maintained a strong track record of performance. From December 31, 2014 through December 31, 2018, our total assets grew from $1.1 billion to approximately $1.9 billion; our gross loans outstanding grew from $929.8 million to approximately $1.6 billion and our deposits grew from $835.4 million to approximately $1.5 billion. We believe this growth was driven by our ability to provide superior service to our customers and our financial stability. This loan growth was achieved while maintaining our focus on our strong underwriting standards.

Business Strategy

We are focused on being the "Hometown" bank and banking provider of choice in our highly attractive market areas through:

- Responsive, Customer-Centric Products and Services and a Community Focus. We offer a broad array of products and services which we customize to allow us to focus on building long-term relationships with our customers through high-quality, responsive and personal customer service. By focusing on the entire customer relationship, we build the trust of our customers which leads to long-term relationships and generates our organic growth. In addition, we are committed to meeting the needs of the communities that we serve. Our employees are involved in many civic and community organizations which we support through sponsorships. As a result, customers and potential customers within our market know about us and frequently interact with our employees which allows us to develop long-term customer relationships without extensive advertising.
- Strategic Acquisitions. To complement our organic growth, we focus on strategic acquisitions in or around our existing markets that further our objectives. We believe there are banking institutions that continue to face credit challenges, capital constraints and liquidity issues and that lack the scale and management expertise to manage the increasing regulatory burden and will likely need to partner with an institution like ours. As we evaluate potential acquisitions, we will continue to seek acquisitions that provide meaningful financial benefits, long-term organic growth opportunities and expense reductions, without compromising our risk profile.
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Utilization of Efficient and Scalable Infrastructure. We employ a systematic and calculated approach to increasing our profitability and improving our efficiencies. We continually upgrade our operating infrastructure, particularly in the areas of technology, data processing, compliance and personnel. We believe that our scalable infrastructure provides us with an efficient operating platform from which to grow in the near term, while continuing to deliver our high-quality, responsive customer service, which will enhance our ability to grow and increase our returns.

- Disciplined Focus on Risk Management. Effective risk management is a key component of our strong corporate culture. We use our strong risk management process to monitor our existing loan and investment securities portfolios, support operational decision-making and improve our ability to generate earning assets with strong credit quality. To maintain our strong credit quality, we use a comprehensive underwriting process and we seek to maintain a diversified loan portfolio and a conservative investment securities portfolio. Board-approved policies contain approval authorities, as appropriate,

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and are reviewed at least annually. We have a Risk Management Steering Committee comprised of executive officers who oversee new business initiatives and other activities that warrant oversight of risk and related mitigants. Internal review procedures are performed regarding anti-money laundering and consumer compliance requirements.

Our Competitive Strengths

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

- Our Market. Our current market is defined as the New York metropolitan area, including Fairfield and New Haven Counties, Connecticut. The Stamford market area includes numerous affluent suburban communities of professionals who work and commute into New York City, approximately 50 miles from our headquarters, and many small to mid-sized businesses which support these communities. Fairfield County is the wealthiest county in Connecticut based on median household income according to estimates from the United States Census Bureau. We believe that this market has economic and competitive dynamics that are favorable to executing our growth strategy.
- Experienced and Respected Management Team with a Proven and Successful Track Record. Our executive management team is comprised of seasoned professionals with significant banking experience, a history of high performance at local financial institutions and success in identifying, acquiring and integrating financial institutions. Our senior management team includes Christopher R. Gruseke, President and Chief Executive Officer (four years with us), Heidi S. DeWyngaert, Executive Vice President, Chief Lending Officer (fourteen years with us), Penko Ivanov, Executive Vice President, Chief Financial Officer (over two years with us), David Dineen, Executive Vice President, Head of Community Banking (three years with us), Christine A. Chivily, Executive Vice President, Chief Risk and Credit Officer (six years with us), and Laura Waitz, Executive Vice President, Chief of Staff (in her second year with us).
- Dedicated Board of Directors with Strong Community Involvement. Our Board of Directors is comprised of a group of local business leaders who understand the need for strong community banks that focus on serving the financial needs of their customers. The interests of our executive management team and directors are aligned with those of our shareholders through common stock ownership. By capitalizing on the close community ties and business relationships of our executive management team and directors, we are positioned to continue taking advantage of the market opportunity present in our primary market.
- Strong Capital Position. At December 31, 2018, we had a 9.16% tangible common equity ratio, and the Bank had a 10.14% tier 1 leverage ratio and an 11.56% tier 1 risk-based ratio. We believe that our ability to attract and generate capital has facilitated our growth and is an integral component to the execution of our business plan.
- Scalable Operating Platform. We provide banking technology, including remote deposit capture, internet banking and mobile banking, to offer our customers maximum flexibility and to create a scalable platform to accommodate our future growth aspirations. We believe that our advanced technology combined with responsive and personal service provides our customers with a superior banking experience.

Employees

At December 31, 2018, we had a total of 142 full-time employees, 2 part-time employees and no temporary employees. None of our employees are subject to a collective bargaining agreement.

Company Website and Availability of Securities and Exchange Commission Filings

Information regarding the Company is available through the Investor Relations link at www.mybankwell.com. The Company’s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge at www.sec.gov and at www.mybankwell.com under the Investor Relations link. Information on the website is not incorporated by reference and is not a part of this annual report on Form 10-K.

Competition

The financial services industry in our market and the surrounding area is highly competitive. We compete with commercial banks, savings banks, savings associations, money market funds, mortgage brokers, finance companies, credit unions, insurance companies, investment firms and private lenders in various segments of our business. Many of these competitors have more assets, capital and higher lending limits, and more resources than we do and may be able to conduct more intensive and broader-based promotional efforts to reach both commercial and individual customers. Competition for deposit products can depend heavily on pricing because of the ease with which customers can transfer deposits from one institution to another.

We focus our marketing efforts on small to medium-sized businesses and professionals. This focus includes retail, service, wholesale distribution and manufacturing businesses. We attract these customers based on relationships and contacts that our Management and our Board of Directors have within and beyond the market area. We do not expect to compete with large institutions

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for the primary banking relationships of large corporations. Many of our larger commercial bank competitors have greater name recognition and offer certain services that we do not; however, we believe that our presence in our primary market area and focus on providing superior service to professionals at small to medium sized businesses and individual employees of such businesses are instrumental to our success.

We emphasize personalized banking services and the advantage of local decision-making in our banking businesses, and this emphasis has been well received by the public in our market area. We derive a majority of our business from our local market area which includes our primary market area of the New York metropolitan area, including Fairfield and New Haven Counties, Connecticut.

Lending Activities

General. Our primary lending focus is to serve commercial and middle-market businesses, not-for-profit organizations and consumers with a variety of financial products and services, while maintaining strong and disciplined credit policies and procedures. We offer a wide array of commercial lending products to serve the needs of our customers. Commercial lending products include owner-occupied commercial real estate loans, commercial real estate investment loans, commercial loans (such as business term loans, equipment financing and lines of credit) to small and medium sized businesses and real estate construction and development loans. We focus our lending activities on loans that we originate to borrowers located in our market. We have established an informal, internal lending limit to one relationship of up to 40% of unimpaired capital and allowance for loan losses, if secured by commercial real estate. A relationship in this instance is defined as loans made to different entities but with a shared borrower principal(s). For individual loans, limits are set so as not to exceed the statutory maximum of 15% of unimpaired capital and allowance for loan losses.

We market our lending products and services to qualified borrowers through conveniently located banking offices, relationship networks and high touch personal service. We target our business development and marketing strategy primarily on small to medium sized businesses. Our relationship managers actively solicit the business of companies entering our market areas as well as long-standing businesses operating in the communities we serve. We seek to attract new lending customers through professional service, relationship networks, competitive pricing and innovative structure, including the utilization of federal and state tax incentives. We pride ourselves on smart, proficient underwriting and timely decision making for new loan requests due to our efficient approval structure and local decision-making. We believe this gives us a competitive advantage over larger institutions that are not as nimble.

Total loans before deferred loan fees and the allowance for loan losses were $1.6 billion at December 31, 2018. Since December 31, 2014, total loans have increased $675.0 million from $929.8 million, reflecting strong organic loan growth. The following table summarizes the composition of our loan portfolio for the dates indicated.

	At December 31,					
	2018		2017		2016	
	Amount	Percent of Loan Portfolio	Amount	Percent of Loan Portfolio	Amount	Percent of Loan Portfolio
	(In thousands)					
Real estate loans:						
Residential	$178,079	11.10 %	$193,524	12.54 %	$195,729	14.33 %
Commercial	1,094,066	68.18	987,242	63.98	845,322	61.89
Construction	73,191	4.56	101,636	6.59	107,441	7.86
	1,345,336	83.84	1,282,402	83.11	1,148,492	84.08
Commercial business	258,978	16.14	259,995	16.85	215,914	15.81
Consumer	412	0.02	619	0.04	1,533	0.11
Total loans	$1,604,726	100.00%	$1,543,016	100.00%	$1,365,939	100.00%

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	At December 31,			
	2015		2014	
	Amount	Percent of Loan Portfolio	Amount	Percent of Loan Portfolio
	(In thousands)			
Real estate loans:				
Residential	$193,110	16.83 %	$193,197	20.78 %
Commercial	697,542	60.79	521,181	56.06
Construction	82,273	7.17	63,229	6.80
	972,925	84.79	777,607	83.64
Commercial business	172,853	15.06	149,259	16.05
Consumer	1,735	0.15	2,896	0.31
Total loans	$1,147,513	100.00%	$929,762	100.00%

Commercial loans. We offer a wide range of commercial loans, including business term loans, equipment financing and lines of credit. Our target commercial loan market is small to medium sized businesses, including retail and professional establishments. The terms of these loans vary by purpose and by type of underlying collateral. The commercial loans primarily are underwritten on the basis of the borrower's ability to service the loan from cash flow. We make equipment loans with conservative margins generally for a term of ten years or less, supported by the useful life of the equipment, at fixed or variable rates, with the loan fully amortizing over the term. Loans to support working capital typically have terms not exceeding two years and usually are secured by accounts receivable, inventory and/or personal guarantees of the principals of the business and at times by the commercial real estate of the borrower. For loans secured by accounts receivable or inventory, principal typically is repaid as the assets securing the loan are converted into cash, and for loans secured with other types of collateral, principal is fully or partially amortized during the loan term with any balloon amount due at maturity. The quality of the commercial borrower's management and its ability both to properly evaluate changes in the supply and demand characteristics affecting its markets for products and services and to effectively respond to such changes are significant factors in a commercial borrower's creditworthiness. Risks associated with our commercial loan portfolio include those related to the strength of the borrower's business, which may be affected not only by local, regional and national market conditions, but also changes in the borrower's management and other factors beyond the borrower's control; those related to fluctuations in value of any collateral securing the loan; and those related to terms of the commercial loan, which may include balloon payments that must be refinanced or paid off at the end of the term of the loan. Our commercial loan portfolio presents a higher risk than our consumer real estate and consumer loan portfolios.

Commercial real estate loans. We offer real estate loans for owner-occupied commercial properties as well as commercial property owned by real estate investors. Commercial loans that are secured by owner-occupied commercial real estate and primarily collateralized by operating cash flows are also included in this category of loan throughout this document. Commercial real estate loan terms generally are limited to ten years or less, although payments may be structured on a longer amortization basis of twenty to thirty years. The interest rates on our commercial real estate loans may be fixed or adjustable, although rates typically are not fixed for a period exceeding five to ten years. We generally charge an origination fee for these loans. We often require personal guarantees from the principal owner of the business or real estate supported by a review of the principal owner's personal financial statements. Risks associated with commercial real estate loans include fluctuations in the value of real estate, the overall strength of the economy, new job creation trends, tenant vacancy rates, property use trends, business sector changes, environmental contamination, and the quality of the borrower's management. We make efforts to limit our risk by analyzing the borrower's cash flow and collateral value as well as all of the sponsors' investment activities. The real estate securing our existing commercial real estate loans includes a wide variety of property types, such as owner-occupied offices/warehouses/production facilities, office buildings, industrial, mixed-use residential/commercial, retail centers and multifamily properties. Our commercial real estate loan portfolio presents a higher risk than our consumer real estate and consumer loan portfolios.

Construction loans. Our construction portfolio includes loans to small and medium sized businesses to construct owner-used properties, loans to developers of commercial real estate investment properties and residential developments and, to a lesser extent, loans to individual clients for construction of single family homes in our market. Construction and development loans are generally made with a term of one to two years and interest is paid monthly. The ratio of the loan principal to the value of the collateral, as established by independent appraisal, typically will not exceed industry standards. Loan proceeds are disbursed based on the percentage of completion and only after the project has been inspected by an experienced construction lender or third-party inspector. Risks associated with construction loans include fluctuations in the value of real estate, project completion risk, leasing risk and change in market trends. We are also exposed to risk based on the ability of the construction loan borrower to refinance the debt or sell the property upon completion of the project, which may be affected by changes in market trends since the time that we funded the construction loan.

Consumer real estate loans.   In the fourth quarter of 2017, management made the strategic decision to no longer originate residential mortgage loans. Prior to this decision we offered first lien one-to-four family mortgage loans, as well as home equity lines of credit, in each case primarily on owner-occupied primary residences. We also originated for sale one-to-four family mortgage loans, which are classified as loans held for sale until sold to investors. Although our consumer real estate loan portfolio presents lower levels of risk than our commercial, commercial real estate and construction loan portfolios, we are exposed to risk based on fluctuations in the value of the real estate collateral securing the loan, as well as changes in the borrower’s financial condition, which could be affected by numerous factors, including divorce, job loss, illness or other personal hardship.

Consumer loans.   We may offer consumer loans as an accommodation to our existing customers, but do not market consumer loans to persons who do not have a pre-existing relationship with us. As of December 31, 2018, our consumer loans represented less than 1% of our total loan portfolio. While consumer loans may not remain below 1% of our portfolio, we do not expect our consumer loans to become a material component of our loan portfolio at any time in the foreseeable future. Although we do not engage in any material amount of consumer lending, our consumer loans, which are underwritten primarily based on the borrower’s financial condition and, in many cases, are unsecured credits, subject us to risk based on changes in the borrower’s financial condition, which could be affected by numerous factors, including those discussed above.

Credit Policy and Procedures

General.   We adhere to what we believe are disciplined underwriting standards, but also remain cognizant of the need to serve the credit needs of customers in our primary market areas by offering flexible loan solutions in a responsive and timely manner. We also seek to maintain a diversified loan portfolio across customer, product and industry types. However, our lending policies do not provide for any loans that are highly speculative, subprime, or that have high loan-to-value ratios. These components, together with active credit management, are the foundation of our credit culture, which we believe is critical to enhancing the long term value of our organization to our customers, employees, shareholders and communities.

We have a service-driven, relationship-based, business-focused credit culture, rather than a price-driven, transaction-based culture. Accordingly, substantially all of our loans are made to borrowers located or operating in our primary market with whom we have ongoing relationships across various product lines. The limited number of loans secured by properties located in out-of-market areas that we have made are generally to borrowers who are well-known to us. These borrowers typically have strong deposit relationships with the Bank.

Credit concentrations.   In connection with the management of our credit portfolio, we actively manage the composition of our loan portfolio, including credit concentrations. We monitor borrower and loan product concentrations on at least a quarterly basis. Loan product concentrations are reviewed annually in conjunction with the portfolio’s credit quality and the business plan for the coming year. All concentrations are monitored by our Chief Risk and Credit Officer and our Directors' Loan Committee. We have also established an informal, internal lending limit to one relationship of up to 40% of unimpaired capital and allowance for loan losses, if secured by commercial real estate. A relationship in this instance is defined as loans made to different entities but with a shared borrower principal(s). For individual loans, limits are set so as not to exceed the statutory maximum of 15% of unimpaired capital and allowance for loan losses. Our top 20 borrowing relationships range in exposure from $16.9 million to $84.9 million and are monitored on an on-going basis.

Loan approval process.   We seek to achieve an appropriate balance between prudent and disciplined underwriting on the one hand and flexibility in our decision-making and responsiveness to our customers on the other hand. Our credit approval policies have a tiered approval process, with larger exposures referred to the Bank’s Internal Loan Committee and the Directors’ Loan Committee, as appropriate, based on the size of the loan. Smaller exposures are approved under a three-signature system. Loans with policy exceptions require the next higher level of approval authority, the highest of which is the Directors’ Loan Committee, depending on dollar amount. These authorities are periodically reviewed and updated by our Board of Directors. We believe that our credit approval process provides for thorough underwriting and efficient decision making.

Credit risk management. Credit risk management involves a partnership between our relationship managers and our credit approval, credit administration, portfolio management and collections personnel. Portfolio monitoring and early problem recognition are an important aspect of maintaining our high credit quality standards. Past due reports are reviewed on an ongoing basis and insurance and tax payment monitoring is in place. Our evaluation and compensation program for our relationship managers includes significant goals that we believe motivate the relationship managers to focus on high quality credit consistent with our strategic focus on asset quality.

For 2018, it was our policy to review all non-amortizing commercial loans in excess of $50 thousand and amortizing commercial loans in excess of $750 thousand on an annual basis, or more frequently through the receipt of interim and annual financial statements and borrowing base certificates depending on loan structure and covenants. Our policies require rapid notification of delinquency and prompt initiation of collection actions. Relationship managers, portfolio managers, credit

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administration personnel and senior management proactively support collection activities in order to maximize accountability and efficiency.

As part of these annual review procedures, we analyze recent financial statements of the collateral property, business and/or borrower to determine the current level of occupancy, revenues and expenses and to investigate any deterioration in the value of the real estate collateral or in the borrower's or company's financial condition. Upon completion, we update, confirm or change the risk rating assigned to each loan. Relationship managers and portfolio managers are encouraged to bring potential credit issues to the attention of our Chief Risk and Credit Officer immediately upon any sign of deterioration in the performance of the borrower. We maintain a list of loans that receive additional attention if we believe there may be a potential credit risk via our Watch List report.

Loans that are upgraded or downgraded are reviewed by our Chief Risk and Credit Officer, while Watch List loans undergo a detailed quarterly analysis prepared by the relationship manager or portfolio manager and reviewed by management. This review includes an evaluation of the market conditions, the property's or company's trends, the borrower and guarantor status, the level of reserves required and loan accrual status. Additionally, we have an independent, third-party loan review performed semi-annually, which includes the accuracy of our loan grades and our credit administration functions. Finally, we perform an annual stress test of our commercial loan portfolio, in which we evaluate the impact on the portfolio of declining economic conditions, including lower values and decline in net operating income which may result from lower rental rates, lower occupancy rates and higher interest rates. Management reviews these reports and presents them to our loan committees. These asset review procedures provide management with additional information for assessing our asset quality.

Investment Activities

We manage our investment portfolio primarily for liquidity purposes. Our investment portfolio's primary purpose is to provide adequate liquidity necessary to meet any reasonable decline in deposits and any anticipated increase in the loan portfolio. The majority of these securities are classified as available for sale. The portfolio's secondary purpose is to generate adequate earnings to provide and contribute to stable income and to generate a profitable return while minimizing risk. Additionally, our investment portfolio may be used to provide adequate collateral for various regulatory or statutory requirements and to manage our interest rate risk. We invest in a variety of high-grade securities, including government agency securities, government guaranteed mortgage backed securities, highly rated corporate bonds and municipal securities. We regularly evaluate the composition of our portfolio as changes occur with respect to the interest rate yield curve. Although we may sell investment securities from time to time to take advantage of changes in interest rate spreads, it is our policy not to sell investment securities unless we can reinvest the proceeds at a similar or higher spread, so as not to take gains to the detriment of future income.

The investment policy is reviewed annually by our Board of Directors. Overall investment goals are established by our Board of Directors, Chief Financial Officer and our asset/liability management committee, or ALCO. Our Board of Directors has delegated the responsibility of monitoring our investment activities to ALCO. Day-to-day activities pertaining to the investment portfolio are conducted within our accounting department under the supervision of our Chief Financial Officer.

Deposits

Deposits are our primary source of funds to support our earning assets. We offer traditional depository products, including checking, savings, money market and certificates of deposit with a variety of rates. Deposits at the Bank are insured by the FDIC up to statutory limits. We have built a network of twelve deposit-taking branch offices and attracted significant transaction account business through our relationship-based approach.

Borrowed Funds

The Bank is a member of the Federal Home Loan Bank of Boston (FHLB), which is part of a twelve district Federal Home Loan Bank System. Members are required to own capital stock of the FHLB, and borrowings are collateralized by qualifying assets not otherwise pledged (principally single family residential mortgage loans and securities). The maximum amount of credit that the FHLB will extend varies from time to time, depending on its policies and the amount of qualifying collateral the member can pledge. We utilize advances from the FHLB as part of our overall funding strategy to meet short-term liquidity needs and, to a lesser degree, manage interest rate risk arising from the difference in asset and liability maturities.

On August 19, 2015, the Company completed a private placement of $25.5 million in aggregate principal amount of fixed rate subordinated notes (the “Notes”) to certain institutional investors. The Notes are non-callable for five years, have a stated maturity of August 15, 2025, and bear interest at a quarterly pay fixed rate of 5.75% per annum to the maturity date or the early redemption date (August 2020 and annually thereafter). The Notes have been structured to qualify for the Company as Tier 2 capital under regulatory guidelines. We used the net proceeds for general corporate purposes, which included maintaining liquidity at the holding company, providing equity capital to the Bank to fund balance sheet growth and our working capital needs.

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Enterprise Risk Management

We place significant emphasis on risk mitigation as an integral component of our organizational culture. We believe that our emphasis on risk management is manifested in our historically solid asset quality statistics. Risk management with respect to our lending philosophy focuses, among other things, on structuring credits to provide for multiple sources of repayment, coupled with strong underwriting by experienced relationship managers, lending and credit management. We perform quarterly reviews of criticized loans and criticized asset action plans for those borrowers who display deteriorating financial conditions in order to monitor those relationships and implement corrective measures on a timely basis to minimize losses. In addition, we perform an annual stress test of our commercial loan portfolio, in which we evaluate the impact on the portfolio of declining property values and lower net operating incomes as a result of economic conditions, including lower rental rates and lower occupancy rates. The stress test focuses only on the cash flow and valuation of the properties or businesses and ignores the liquidity, net worth and cash flow of any guarantors related to the credits.

We also focus on risk management in other areas throughout our organization. The Chief Risk and Credit Officer oversees the Risk Management function and chairs a Risk Management Steering Committee. We currently outsource our asset/liability calculations to a reputable third party, and on a quarterly basis, that third party runs the full interest rate risk model. Results of the model are reviewed and validated by our ALCO.

Supervision and Regulation

General

The Bank is subject to extensive regulation by the Connecticut Department of Banking, as its chartering agency, and by the FDIC, as its deposit insurer. The Bank’s deposits are insured up to applicable limits by the FDIC through the Deposit Insurance Fund. The Bank is required to file reports with, and is periodically examined by, the FDIC and the Connecticut Department of Banking concerning its activities and financial condition and must obtain regulatory approvals prior to entering into certain transactions, such as mergers with, or acquisitions of, other financial institutions.

The primary goals of the bank regulatory system are to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. This system is intended primarily for the protection of the Deposit Insurance Fund and bank depositors, rather than our shareholders and creditors. The banking agencies have broad enforcement power over bank holding companies and banks, including the authority, among other things, to enjoin “unsafe or unsound” practices, require affirmative action to correct any violation or practice, issue administrative orders that can be judicially enforced, direct increases in capital, direct the sale of subsidiaries or other assets, limit dividends and distributions, restrict growth, assess civil money penalties, remove officers and directors, and, with respect to banks, terminate deposit insurance or place the bank into conservatorship or receivership. In general, these enforcement actions may be initiated for violations of laws and regulations or unsafe or unsound practices.

The following discussion is a summary of the material laws, rules and regulations applicable to our operations, but does not purport to be a complete summary of all applicable laws, rules and regulations. These laws, rules and regulations may change from time to time and the regulatory agencies often have broad discretion in interpreting them. Any change in such laws, rules or regulations, whether by the Connecticut Department of Banking, the FDIC or the Federal Reserve Board could have a material adverse impact on the financial markets in general, and our operations and activities, financial condition, results of operations, growth plans and future prospects specifically.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act has significantly changed the current bank regulatory structure and continues to affect the lending and investment activities and general operations of depository institutions and their holding companies.

The current United States government administration has announced that it intends to slow down the adoption of new Dodd-Frank Act regulations and to consider proposing changes to the legislation. The following summary assumes no changes to the Dodd-Frank Act and regulations adopted to date, other than as noted below in our discussion of the Economic Growth, Regulatory Relief, and Consumer Protection Act.

The Dodd-Frank Act created the Consumer Financial Protection Bureau with extensive powers to implement and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rulemaking authority for a wide range of consumer protection laws that apply to all banks and savings associations including, among other things, the authority to prohibit “unfair, deceptive or abusive” acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings associations with more than $10 billion in assets. Banks and savings associations with $10 billion or less in assets will continue to be examined for compliance with federal consumer protection and fair lending laws by their applicable primary federal bank regulators. The Dodd-Frank Act also weakens the federal preemption available for national banks and federal savings associations and gives state attorneys general certain authority to enforce applicable federal consumer protection laws. The Dodd-Frank Act made many other changes to banking regulations including authorizing depository institutions, for the first time, to pay interest on business checking accounts, requiring originators of securitized loans to retain a percentage of the risk for transferred loans, establishing regulatory rate-setting for certain debit card interchange fees, establishing a number of reforms for mortgage originations, requiring bank holding companies and banks to be “well capitalized” and “well managed” in order to acquire banks located outside of their home state, requiring any bank holding company electing to be treated as a financial holding company to be “well capitalized” and “well managed” and authorizing national and state banks to establish de novo branches in any state that would permit a bank chartered in that state to open a branch at that location.

The Dodd-Frank Act also broadened the base for the FDIC insurance assessments. The FDIC was required to promulgate rules revising its assessment system so that insurance assessments are based on the average consolidated total assets less tangible equity capital of an insured depository institution instead of deposits. That rule took effect April 1, 2011. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008.

The Dodd-Frank Act increased shareholder influence over boards of directors by requiring companies to give shareholders a nonbinding vote on executive compensation and so-called “golden parachute” payments, and by authorizing the SEC to promulgate rules that would allow shareholders to nominate and solicit votes for their own candidates using a company’s proxy materials. It is challenging to predict the full impact the Dodd-Frank Act and its implementing regulations will have on community banks and their holding companies. The legislation and implementing regulations, particularly those provisions relating to the Consumer Financial Protection Bureau, has and is likely to continue to increase our operating and compliance costs.

Economic Growth, Regulatory Relief, and Consumer Protection Act

The Economic Growth, Regulatory Relief, and Consumer Protection Act (the EGRRCPA) became law on May 24, 2018. The EGRRCPA keeps in place fundamental aspects of the current bank regulatory structure, but provides community banks with relief from certain regulatory requirements, including some imposed by the Dodd-Frank Act. Among other things, the EGRRCPA requires the federal banking agencies to develop regulations establishing a “community bank leverage ratio” for banks and holding companies with less than $10 billion in consolidated assets and a qualifying risk profile. The EGRRCPA defines “community bank leverage ratio” (or CBLR) as the ratio of tangible equity capital to average total consolidated assets. The required regulations must specify a minimum CBLR of not less than 8% and not more than 10%. Qualifying banks that exceed the minimum CBLR will be deemed to be in compliance with generally applicable risk-based capital and leverage requirements and will be considered “well-capitalized” under Section 38 of the Federal Deposit Insurance Act (FDIA). On November 21, 2018, the federal banking agencies issued a notice of proposed rulemaking regarding these provisions of the EGRRCPA. The agencies proposed a minimum CBLR of 9%.

The EGRRCPA provides insured depository institutions and their affiliates with less than $10 billion in total consolidated assets and limited trading activities with an exemption from the Dodd-Frank Act’s “Volcker Rule” (which generally restricts certain banking entities such as the Company and the Bank from engaging in proprietary trading activities and entering into certain relationships with hedge funds and private-equity funds).

The EGRRCPA increased the consolidated assets limit for bank holding companies covered by the Federal Reserve Board’s “Small Bank Holding Company Policy Statement” (the Policy) from $1 billion to $3 billion. In addition to the consolidated assets limit, a covered bank holding company may not be engaged in significant non-banking and off-balance sheet activities and may not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the SEC. The Federal Reserve Board retains the authority to exclude any bank holding company from the Policy if such action is warranted for supervisory purposes. The Policy allows covered bank holding companies to operate with higher levels of debt than would normally be permitted. Under the Policy, a covered bank holding company is prohibited from paying dividends if its debt-to-equity ratio exceeds 1:1. In addition, the Federal Reserve Board expects that bank holding companies will retire all debt within 25 years of being incurred and reduce their debt to equity ratio to 30:1 or less within 12 years of incurring the debt. The Policy also directs that each depository institution subsidiary of a covered bank holding company remain well-capitalized. On August 28, 2018, the Federal Reserve Board issued an interim final rule regarding revisions to the Policy prompted by the EGRRCPA.

The EGRRCPA increased the consolidated assets threshold from $1 billion to $3 billion for insured depository institutions that qualify for an 18-month on-site exam cycle.
The EGRRCPA requires the federal banking agencies to promulgate regulations permitting insured depository institutions that have less than $5 billion in total consolidated assets (and satisfy other conditions) to use short-form reports of condition (i.e. call reports) for the first and third quarters of each year. On November 19, 2018, the federal banking agencies issued a notice of proposed rulemaking regarding these provisions of the EGRRCPA.
A number of the provisions included in the EGRRCPA require the federal banking agencies to issue regulations. It will likely take some time before all of these regulations are issued and fully implemented. The Company expects to continue to evaluate the potential impact of the EGRRCPA as it is further implemented by the regulators.

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Connecticut Banking Laws and Supervision

Connecticut Department of Banking. The Connecticut Department of Banking regulates the internal organization as well as the deposit, lending and investment activities of state-chartered banks, including the Bank. The approval of the Connecticut Department of Banking is required for, among other things, the establishment of branch offices and business combination transactions. The Connecticut Department of Banking conducts periodic examinations of Connecticut chartered banks. The FDIC also regulates many of the areas regulated by the Connecticut Department of Banking, and federal law may limit some of the authority provided to Connecticut chartered banks by Connecticut law.

Lending Activities. Connecticut banking laws grant banks broad lending authority. With certain limited exceptions, loans to any one obligor under this statutory authority may not exceed 15% and fully secured loans may not exceed an additional 10% of a bank's equity capital and allowance for loan losses.

Dividends. The Bank may pay cash dividends out of its net profits. For purposes of this restriction, "net profits" represents the remainder of all earnings from current operations. Further, the total amount of all dividends declared by a bank in any year may not exceed the sum of a bank's net profits for the year in question combined with its retained net profits from the preceding two years. Federal law also prevents an institution from paying dividends or making other capital distributions that, if by doing so, would cause it to become "undercapitalized". Beginning January 1, 2016, the Basel III Capital Rules limit the amount of dividends the Bank can pay if its capital ratios are below the threshold levels of the capital conservation buffer established by the rules. The capital conservation buffer was phased in from January 1, 2016 to January 1, 2019, when the full capital conservation buffer of 2.5% (as a percentage of risk-weighted assets) became effective. The capital conservation buffer is in addition to the minimum risk-based capital requirement. The FDIC may further limit a bank's ability to pay dividends. Moreover, the federal agencies have issued policy statements that provide that insured banks should generally only pay dividends out of current operating earnings.

Powers. Connecticut law permits Connecticut banks to sell insurance and fixed and variable rate annuities if licensed to do so by the Connecticut Insurance Department. With the prior approval of the Connecticut Department of Banking, Connecticut banks are also authorized to engage in a broad range of activities related to the business of banking, or that are financial in nature or that are permitted under the Bank Holding Company Act or the Home Owners' Loan Act, both federal statutes, or the regulations promulgated as a result of these statutes. Connecticut banks are also authorized to engage in any activity permitted for a national bank or a federal savings association upon filing notice with the Connecticut Department of Banking unless the Connecticut Department of Banking disapproves the activity.

Assessments. Connecticut banks are required to pay annual assessments to the Connecticut Department of Banking to fund the Connecticut Department of Banking's operations. The general assessments are paid pro-rata based upon a bank's asset size.

Enforcement. Under Connecticut law, the Connecticut Department of Banking has extensive enforcement authority over Connecticut banks and, under certain circumstances, affiliated parties, insiders, and agents. The Connecticut Department of Banking's enforcement authority includes cease and desist orders, fines, receivership, conservatorship, removal of officers and directors, emergency closures, dissolution and liquidation.

Federal Bank Holding Company Regulation

General. As a bank holding company, we are subject to comprehensive regulation and regular examinations by the Federal Reserve Board. The Federal Reserve Board also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a bank holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices. Under Federal Reserve Board policy which has been codified by the Dodd-Frank Act, a bank holding company must serve as a source of strength for its subsidiary bank. Under this policy, the Federal Reserve Board may require, and has required in the past, a bank holding company to contribute additional capital to an undercapitalized subsidiary bank. A bank holding company must obtain Federal Reserve Board approval before: (1) acquiring, directly or indirectly, ownership or control of any voting securities of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such securities (unless it already owns or controls the majority of such securities); (2) acquiring all or substantially all of the assets of another bank or bank holding company; or (3) merging or consolidating with another bank holding company. Under Connecticut banking law, no person may acquire beneficial ownership of more than 10% of any class of voting securities of a Connecticut chartered bank, or any bank holding company of such a bank, without prior notification of, and lack of disapproval by, the Connecticut Department of Banking.

The Bank Holding Company Act also prohibits a bank holding company, with certain exceptions, from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute

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or by Federal Reserve Board regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the Federal Reserve Board includes, among other things: (1) operating a savings institution, mortgage company, finance company, credit card company or factoring company; (2) performing certain data processing operations; (3) providing certain investment and financial advice; (4) underwriting and acting as an insurance agent for certain types of credit-related insurance; (5) leasing property on a full-payout, non-operating basis; (6) selling money orders, travelers' checks and United States savings bonds; (7) real estate and personal property appraising; (8) providing tax planning and preparation services; (9) financing and investing in certain community development activities; and (10) subject to certain limitations, providing securities brokerage services for customers.

Dividends.   The Federal Reserve Board has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve Board's view that a bank holding company should pay cash dividends only to the extent that the Bank Holding Company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the Bank Holding Company's capital needs, asset quality and overall financial condition. The Federal Reserve Board also indicated that it would be inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. As discussed above, the Federal Reserve Board's Small Bank Holding Company Policy Statement includes provisions regulating the payment of dividends by companies subject to that policy statement.

Substantially all of our income is derived from, and the principal source of our liquidity is, dividends from the Bank. The ability of the Bank to pay dividends to us is also restricted by federal and state laws, regulations and policies. The Bank may pay cash dividends out of its net profits. For purposes of this restriction, "net profits" represents the remainder of all earnings from current operations. Further, the total amount of all dividends declared by a bank in any year may not exceed the sum of a bank's net profits for the past two fiscal years, plus the portion of the year in which the dividend is paid.

Under federal law, the Bank may not pay any dividend to us if the Bank is undercapitalized or the payment of the dividend would cause it to become undercapitalized. Beginning January 1, 2016, the Basel III Capital Rules limit the amount of dividends the Bank can pay to us if its capital ratios are below the threshold levels of the capital conservation buffer established by the rules. The capital conservation buffer was phased in from January 1, 2016 to January 1, 2019, when the full capital conservation buffer of 2.5% (as a percentage of risk-weighted assets) became effective. The capital conservation buffer is in addition to the minimum risk-based capital requirement. The FDIC may further restrict the payment of dividends by requiring the Bank to maintain a higher level of capital than would otherwise be required for it to be adequately capitalized for regulatory purposes. Moreover, if, in the opinion of the FDIC, the Bank is engaged in an unsafe or unsound practice (which could include the payment of dividends), the FDIC may require, generally after notice and hearing, it to cease such practice. The FDIC has indicated that paying dividends that deplete a depository institution's capital base to an inadequate level would be an unsafe banking practice. The FDIC has also issued policy statements providing that insured depository institutions generally should pay dividends only out of current operating earnings.

Redemption.   Bank holding companies are required to give the Federal Reserve Board prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the consolidated net worth of the Bank Holding Company. The Federal Reserve Board may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve Board order or any condition imposed by, or written agreement with, the Federal Reserve Board. This notification requirement does not apply to any bank holding company that (i) meets the well capitalized standard for commercial banks, (ii) is "well managed" within the meaning of the Federal Reserve Board regulations and (iii) is not subject to any unresolved supervisory issues. As discussed above, the Federal Reserve Board's Small Bank Holding Company Policy Statement includes provisions regulating stock redemptions by companies subject to that policy statement, including when such notice requirements apply.

Federal Bank Regulation

Safety and Soundness. The federal banking agencies, including the FDIC, have implemented rules and guidelines concerning standards for safety and soundness required pursuant to Section 39 of the Federal Deposit Insurance Corporation Improvement Act, or FDICIA. In general, the standards relate to (1) operational and managerial matters; (2) asset quality and earnings; and (3) compensation. The operational and managerial standards cover (a) internal controls and information systems, (b) internal audit systems, (c) loan documentation, (d) credit underwriting, (e) interest rate exposure, (f) asset growth, and (g) compensation, fees and benefits. Under the asset quality and earnings standards, the Bank is required to establish and maintain systems to (i) identify problem assets and prevent deterioration in those assets, and (ii) evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital reserves. Finally, the compensation standard states that compensation will be considered excessive if it is unreasonable or disproportionate to the services actually performed by the individual being compensated. If an insured state-chartered bank fails to meet any of the standards promulgated by regulation, then such institution will be required to submit a plan within 30 days to the FDIC specifying the steps it will take to correct the deficiency. In the event that an insured state-chartered bank fails to submit or fails in any material respect to implement a compliance plan within the time allowed by the federal banking agency, Section 39 of the FDICIA provides that the FDIC must order the institution to correct the deficiency

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and may (1) restrict asset growth; (2) require the bank to increase its ratio of tangible equity to assets; (3) restrict the rates of interest that the bank may pay; or (4) take any other action that would better carry out the purpose of prompt corrective action. We believe that the Bank has been and will continue to be in compliance with each of the standards as they have been adopted by the FDICIA.

Capital Requirements. The Federal Reserve Board monitors our capital adequacy, on a consolidated basis, and the FDIC and Connecticut Department of Banking monitor the capital adequacy of the Bank.

The Federal Reserve, the FDIC and the other federal and state bank regulatory agencies establish regulatory capital guidelines for U.S. banking organizations.

As of January 1, 2015, the Company and the Bank became subject to new capital rules set forth by the Federal Reserve, the FDIC and the other federal and state bank regulatory agencies. The new capital rules revise the banking agencies' leverage and risk-based capital requirements and the method for calculating risk weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act (the Basel III Capital Rules).

The Basel III Capital Rules establish a new minimum common equity Tier 1 capital requirement of 4.5% of risk-weighted assets; set the minimum leverage ratio at 4% of total assets; increased the minimum Tier 1 capital to risk-weighted assets requirement from 4% to 6%; and retained the minimum total capital to risk weighted assets requirement at 8.0%. A "well-capitalized" institution must generally maintain capital ratios 200 basis points higher than the minimum guidelines.

The Basel III Capital Rules also change the risk weights assigned to certain assets. The Basel III Capital Rules assigned a higher risk weight (150%) to loans that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The Basel III Capital Rules also alter the risk weighting for other assets, including marketable equity securities that are risk weighted generally at 300%. The Basel III Capital Rules require certain components of accumulated other comprehensive income (loss) to be included for purposes of calculating regulatory capital requirements unless a one-time opt-out is exercised. The Bank did exercise its opt-out option and will exclude the unrealized gain (loss) on investment securities component of accumulated other comprehensive income (loss) from regulatory capital.

The Basel III Capital Rules limit a banking organization's capital distributions and certain discretionary bonus payments to executive officers if the banking organization does not hold a "capital conservation buffer" of 2.5% in addition to the minimum risk based capital requirement. The "capital conservation buffer" was being phased in from January 1, 2016 to January 1, 2019, when the full capital conservation buffer became effective.

Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements.

As discussed above, the Economic Growth, Regulatory Relief, and Consumer Protection Act includes simplified capital rules for community banks with less than $10 billion in total consolidated assets and with limited trading activities.

Liquidity. We are required to maintain a sufficient amount of liquid assets to ensure our safe and sound operation. The final Basel III framework also requires banks and bank holding companies to measure their liquidity against specific liquidity tests. Although similar in some respects to liquidity measures historically applied by banks and banking agencies for management and supervisory purposes, the Basel III framework would require specific liquidity tests by rule.

Transactions with Affiliates. Under current federal law, transactions between depository institutions and their affiliates are governed by Sections 23A and 23B of the Federal Reserve Act, or FRA, and the Federal Reserve Board's Regulation W. In a holding company context, at a minimum, the parent holding company of a bank and any companies which are controlled by such parent holding company is an affiliate of the bank. Generally, Section 23A limits the extent to which the bank or its subsidiaries may engage in "covered transactions" with any one affiliate to 10% of such bank's capital stock and surplus, and contains an aggregate limit on all such transactions with all affiliates to 20% of capital stock and surplus. The term "covered transaction" includes, among other things, the making of loans or other extensions of credit to an affiliate and the purchase of assets from an affiliate. Section 23A also establishes specific collateral requirements for loans or extensions of credit to, or guarantees, acceptances on letters of credit issued on behalf of an affiliate. Section 23B requires that covered transactions and a broad list of other specified transactions be on terms substantially the same, or no less favorable, to the bank or its subsidiary as similar transactions with non-affiliates. The Dodd-Frank Act has expanded the definition of covered transactions and increased the timing and other aspects of the collateral requirements associated with covered transactions, including an expansion of the covered transactions to include credit exposures related to derivatives, repurchase agreements and securities lending arrangements and an increase in the amount of time for which collateral requirements regarding covered transactions must be satisfied.

Loans to Insiders. Further, Section 22(h) of the FRA restricts a depository institution with respect to loans to directors, executive officers, and principal shareholders (or insiders). Under Section 22(h), loans to insiders and their related interests may not exceed, together with all other outstanding loans to such persons and affiliated entities, the depository institution's total unimpaired capital and unimpaired surplus. Loans to insiders above specified amounts must receive the prior approval of the board of directors. Further, under Section 22(h), loans to directors, executive officers and principal shareholders must be made on terms substantially the same as offered in comparable transactions to other persons, except that such insiders may receive preferential loans made under a benefit or compensation program that is widely available to the depository institution's employees and does not give preference to the insider over the employees. Section 22(g) of the FRA places additional limitations on loans to executive officers. In addition to enhancing restrictions on insider transactions, the Dodd-Frank Act increases the types of transactions with insiders subject to restrictions, including certain asset sales with insiders.

Enforcement. The FDIC has extensive enforcement authority over insured banks, including the Bank. This enforcement authority includes, among other things, the ability to assess civil money penalties, issue cease and desist orders and remove directors and officers. In general, these enforcement actions may be initiated in response to violations of laws and regulations and unsafe or unsound practices.

The FDIC has authority under federal law to appoint a conservator or receiver for an insured bank under limited circumstances. The FDIC is required, with certain exceptions, to appoint a receiver or conservator for an insured state nonmember bank if that bank was "critically undercapitalized" on average during the calendar quarter beginning 270 days after the date on which the institution became "critically undercapitalized." The FDIC may also appoint itself as conservator or receiver for an insured state non-member institution under specific circumstances on the basis of the institution's financial condition or upon the occurrence of other events, including: (1) insolvency; (2) substantial dissipation of assets or earnings through violations of law or unsafe or unsound practices; (3) existence of an unsafe or unsound condition to transact business; and (4) insufficient capital, or the incurring of losses that will deplete substantially all of the institution's capital with no reasonable prospect of replenishment without federal assistance.

Insurance of Deposit Accounts. Deposit accounts at the Bank are insured by the Deposit Insurance Fund, generally up to a maximum of $250,000 per separately insured depositor, pursuant to changes made permanent by the Dodd-Frank Act. The FDIC assesses insured depository institutions to maintain the Deposit Insurance Fund. No institution may pay a dividend if in default of its deposit insurance assessment.

Under the FDIC's risk-based assessment system, insured depository institutions are assigned to a risk category based on supervisory evaluations, regulatory capital levels and other factors. A depository institution's assessment rate depends upon the category to which it is assigned and certain adjustments specified by the FDIC, with less risky institutions paying lower assessments.

On February 7, 2011, as required by the Dodd-Frank Act, the FDIC published a final rule to revise the deposit insurance assessment system. The rule, which took effect April 1, 2011, changed the assessment base used for calculating deposit insurance assessments from deposits to average consolidated total assets less average tangible equity capital. Since the new base is larger than the previous base, the FDIC also lowered assessment rates so that the rule would not significantly alter the total amount of revenue collected from the industry. The range of adjusted assessment rates is now 2.5 to 45 basis points of the new assessment base. The rule is expected to benefit smaller financial institutions, which typically rely more on deposits for funding, and shift more of the burden for supporting the Deposit Insurance Fund to larger financial institutions, which are thought to have greater access to nondeposit funding.

The Dodd-Frank Act increased the minimum target Deposit Insurance Fund ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The FDIC must seek to achieve the 1.35% ratio by September 30, 2020. In setting the assessments necessary to achieve the 1.35% ratio, the FDIC is supposed to offset the effect of the increased ratio on insured institutions with assets of less than $10 billion. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the FDIC. The FDIC has exercised that discretion by establishing a long range fund ratio of 2%.

A material increase in FDIC insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what FDIC insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that a depository institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We are not aware of any current practice, condition or violation that might lead to termination of the Bank's deposit insurance.

Deposit Operations. In addition to the regulations above, the Bank's deposit operations are subject to other federal laws applicable to depository accounts, such as the:

- Truth-In-Savings Act, requiring certain disclosures for consumer deposit accounts;
- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

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- Electronic Fund Transfer Act and Regulation E issued by the Consumer Financial Protection Bureau to implement that act, which govern electronic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services; and
- Rules and regulations of the various federal banking agencies charged with the responsibility of implementing these federal laws.

Federal Reserve System. The Federal Reserve Board regulations require depository institutions to maintain noninterest earning reserves against their transaction accounts (primarily NOW and regular checking accounts). The Federal Reserve Board regulations generally require that reserves be maintained against aggregate transaction accounts. The Bank is in compliance with these requirements.

Federal Home Loan Bank of Boston (FHLB). The Bank is a member of the FHLB, which is one of the regional Federal Home Loan Banks composing the Federal Home Loan Bank System. Each Federal Home Loan Bank serves as a central credit facility primarily for its member institutions. The Bank, as a member of the FHLB, is required to acquire and hold shares of capital stock in the FHLB.

Community Reinvestment Act (CRA). Under the CRA, as implemented by FDIC regulations, a bank has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community. The CRA does require the FDIC, in connection with its examination of a bank, to assess the bank's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by such bank, including applications to acquire branches and other financial institutions. The CRA requires the FDIC to provide a written evaluation of a bank's CRA performance utilizing a four-tiered descriptive rating system. In particular, the system focuses on three tests:

- A lending test, to evaluate the bank's record of making loans in its assessment areas;
- An investment test, to evaluate the bank's record of investing in community development projects, affordable housing, and programs benefiting low or moderate income individuals and businesses; and
- A service test, to evaluate the bank's delivery of services through its branches, ATMs, and other offices.

Connecticut has its own statutory counterpart to the CRA which is applicable to the Bank. The Connecticut version is generally similar to the CRA but utilizes a five-tiered descriptive rating system. Connecticut law requires the Connecticut Department of Banking to consider, but not be limited to, a bank's record of performance under Connecticut law in considering any application by the Bank to establish a branch or other deposit-taking facility, to relocate an office or to merge or consolidate with or acquire the assets and assume the liabilities of any other banking institution. In our most recent evaluation under Connecticut law the Bank received a CRA rating of "satisfactory".

Consumer Protection and Fair Lending Regulations. We are subject to a variety of federal and Connecticut statutes and regulations that are intended to protect consumers and prohibit discrimination in the granting of credit. These statutes and regulations provide for a range of sanctions for non-compliance with their terms, including imposition of administrative fines and remedial orders, and referral to the Attorney General for prosecution of a civil action for actual and punitive damages and injunctive relief. Certain of these statutes authorize private individual and class action lawsuits and the award of actual, statutory and punitive damages and attorneys' fees for certain types of violations.

At the federal level, these laws include, among others, the following:

- Federal Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, color, religion or other prohibited factors in extending credit;
- Fair Credit Reporting Act of 1978, governing the use of consumer credit reports and the provision of information to credit reporting agencies;

- Fair Debt Collection Practices Act, governing the manner in which consumer debts may be collected by collection agencies;
- Real Estate Settlement Procedures Act, governing closing costs and settlement procedures and disclosures to consumers related thereto;

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- Service members Civil Relief Act of 2004, governing the repayment terms of, and property rights underlying, secured obligations of persons in military service; and
- Rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws.

Additional Considerations

Regulatory Enforcement Authority. Federal banking agencies have substantial enforcement authority over the financial institutions that they regulate including, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties, as defined. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities. Except under certain circumstances, federal law requires public disclosure of final enforcement actions by the federal banking agencies.

Incentive Compensation Guidance. The federal banking agencies have released comprehensive guidance on incentive compensation policies focused on ensuring that financial institutions' incentive compensation policies do not undermine the safety and soundness of those institutions by encouraging excessive risk taking. The incentive compensation guidance sets expectations for financial institutions concerning their incentive compensation arrangements and related risk management, control and governance processes. All employees that have the ability to materially affect the risk profile of a financial institution, either individually or as part of a group, are covered by the guidance. The guidance is based upon three core concepts: (1) balanced risk-taking incentives; (2) effective controls and risk management compatibility; and (3) strong corporate governance. Deficiencies in compensation practices that are identified may be incorporated into the institution's supervisory ratings, which can affect the organization's ability to take certain actions, including the ability to make acquisitions or take other actions. Enforcement actions by the institution's primary federal banking agency may be initiated if the institution's incentive compensation programs pose a risk to the safety and soundness of the organization. In addition, beginning January 1, 2016, the Basel III Capital Rules limit discretionary bonus payments to the Bank's executive officers if its capital ratios are below the threshold levels of the capital conservation buffer established by the rules. The capital conservation buffer was phased in from January 1, 2016 to January 1, 2019, when the full capital conservation buffer of 2.5% (as a percentage of risk-weighted assets) became effective. The capital conservation buffer is in addition to the minimum risk-based capital requirement.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 generally established a comprehensive framework to modernize and reform the oversight of public company auditing, improve the quality and transparency of financial reporting by those companies and strengthen the independence of auditors. Among other things, the legislation (1) created the Public Company Accounting Oversight Board, which is empowered to set auditing, quality control and ethics standards, to inspect registered public accounting firms, to conduct investigations and to take disciplinary actions, subject to SEC oversight and review; (2) strengthened auditor independence from corporate management by, among other things, limiting the scope of consulting services that auditors can offer their public company audit clients; (3) heightened the responsibility of public company directors and senior managers for the quality of the financial reporting and disclosure made by their companies; (4) adopted a number of provisions to deter wrongdoing by corporate management; (5) imposed a number of new corporate disclosure requirements; (6) adopted provisions which generally seek to limit and expose to public view possible conflicts of interest affecting securities analysts; and (7) imposed a range of new criminal penalties for fraud and other wrongful acts, as well as extended the period during which certain types of lawsuits can be brought against a company or its insiders. The Sarbanes-Oxley Act applies generally to all companies that file or are required to file periodic reports with the SEC under the Exchange Act.

Financial Modernization. The Gramm-Leach-Bliley Act, or the GLB Act, permits greater affiliation among banks, securities firms, insurance companies, and other companies under a type of financial services company known as a "financial holding company". A financial holding company essentially is a bank holding company with significantly expanded powers. Financial holding companies are authorized by statute to engage in a number of financial activities previously impermissible for bank holding companies, including securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; and merchant banking activities. The GLB Act also permits the Federal Reserve Board and the Treasury Department to authorize additional activities for financial holding companies if they are “financial in nature” or “incidental” to financial activities. A bank holding company may become a financial holding company if each of its subsidiary banks is well capitalized, well managed, and has at least a “satisfactory” CRA rating. A financial holding company must provide notice to the Federal Reserve Board within 30 days after commencing activities previously determined by statute or by the Federal Reserve Board and Department of the Treasury to be permissible. We have not submitted notice to the Federal Reserve Board of intent to be deemed a financial holding company. However, we are not precluded from submitting a notice in the future should we wish to engage in activities only permitted to financial holding companies.

Privacy Requirements. Under the GLB Act, all financial institutions are required to establish policies and procedures to restrict the sharing of non-public customer data with non-affiliated parties and to protect customer data from unauthorized access. In addition, the Fair Credit Reporting Act of 1970, or FCRA, includes many provisions concerning national credit reporting

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standards and permits consumers, including customers of the Bank, to opt out of information-sharing for marketing purposes among affiliated companies. The Fair and Accurate Credit Transactions Act of 2004 amended certain provisions of the FCRA and requires banks and other financial institutions to notify their customers if they report negative information about them to a credit bureau or if they are granted credit on terms less favorable than those generally available. The Bank currently has a privacy protection policy in place and believes such policy is in compliance with the regulations.

The Bank Secrecy Act and Related Anti-Money Laundering and Anti-Terrorist Financing Legislation. The Bank Secrecy Act, or the BSA, provides, in part, for the facilitation of information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering by enhancing anti-money laundering and financial transparency laws, as well as enhanced information collection tools and enforcement mechanics for the U.S. government, including: (1) requiring standards for verifying customer identification information at account opening; (2) rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering; (3) reports filed with the Treasury Department's Financial Crimes Enforcement Network of transactions exceeding $10,000 in currency; (4) filing suspicious activities reports by financial institutions regarding suspected customer money laundering, terrorism financing, or other violations of U.S. laws and regulations; and (5) requiring enhanced due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts or correspondent accounts for non-U.S. persons.

Title III of the USA PATRIOT Act of 2001 amended the BSA and incorporates anti-terrorist financing provisions into the requirements of the BSA and its implementing regulations. Among other things, the USA PATRIOT Act requires all financial institutions, including us, to institute and maintain a risk-based anti-money laundering compliance program that includes a customer identification program, provides for information sharing with law enforcement and between certain financial institutions by means of an exemption from the privacy provisions of the GLB Act, prohibits U.S. banks and broker-dealers from maintaining accounts with foreign "shell" banks, establishes due diligence and enhanced due diligence requirements for certain foreign correspondent banking and foreign private banking accounts and imposes additional record keeping requirements for certain correspondent banking arrangements. The USA PATRIOT Act also grants broad authority to the Secretary of the Treasury to take actions to combat money laundering, and federal bank regulators are required to evaluate the effectiveness of an applicant in combating money laundering in determining whether to approve any application submitted by a financial institution.

The Office of Foreign Assets Control, or OFAC, which is a division of the Treasury Department, is responsible for helping to ensure that U.S. entities do not engage in transactions with "enemies" of the United States, as defined by various Executive Orders and Acts of Congress. OFAC maintains lists of names of persons and organizations suspected of aiding, harboring or engaging in money laundering, terrorist acts, and other crimes. If the Bank finds a name on any transaction, account or wire transfer that is on an OFAC list, the Bank must freeze such account, file a suspicious activity report and notify OFAC. We have established policies and procedures to ensure compliance with the federal anti-laundering and combating terrorism provisions.

Proposed Legislation and Regulatory Action. New statutes, regulations and guidance are regularly proposed that contain wide-ranging potential changes to the statutes, regulations and competitive relationships of financial institutions operating and doing business in the United States. We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

Effect of Governmental Monetary Policies. Our earnings will be affected by domestic economic conditions and the monetary and fiscal policies of the U.S. government and its agencies. The Federal Reserve Board's monetary policies have had, and are likely to continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The monetary policies of the Federal Reserve Board affect the levels of bank loans, investments and deposits through its control over the issuance of U.S. government securities, its regulation of the discount rate applicable to member banks and its influence over reserve requirements to which member banks are subject. We cannot predict the nature or impact of future changes in monetary and fiscal policies.

Taxation

Federal Taxation

General: We are subject to federal income taxation in the same general manner as other corporations, with limited exceptions. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to us.

On December 22, 2017 the Tax Cuts and Jobs Act of 2017 was signed into law. As a result, the corporate tax rate was reduced from 35% to 21%. Companies are required to recognize the effect of tax law changes in the period of enactment in accordance with GAAP. As result of the tax law changes the Company recognized a write-down of its deferred tax asset position in the amount of $3.3 million for the year ended December 31, 2017.

Method of Accounting: For Federal income tax purposes, we report income and expenses on the accrual method of accounting and use tax year ending December 31 for filing federal income tax returns.

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Alternative Minimum Tax: The Internal Revenue Code of 1986, as amended (the “Code”), imposes an alternative minimum tax (“AMT”) at a rate of 20.0% on a base of regular taxable income plus certain tax preferences which we refer to as “alternative minimum taxable income.” The AMT is payable to the extent such alternative minimum taxable income is in excess of an exemption amount and the AMT exceeds the regular income tax. Net operating losses can offset no more than 90.0% of alternative minimum taxable income. Certain AMT payments may be used as credits against regular tax liabilities in future years. We have not been subject to the AMT and have no such amounts available as credits for carryover.

Net Operating Loss Carryovers: For the years ended 2018 and prior a corporation may carry back generated net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. For net operating losses arising in tax years after 2018, a corporation may not carryback the net operating loss but may carryforward such losses indefinitely, however the net operating loss deduction in a given year is limited to 80% of taxable income. At December 31, 2018, we had $2.5 million of net operating loss carryforwards for federal income tax purposes. The carryovers were transferred to the Company upon the merger with The Wilton Bank.

Corporate Dividends-Received Deduction: The Company may exclude from its income 100.0% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends received deduction is 80.0% in the case of dividends received from corporations with which a corporate recipient does not file a consolidated tax return, and corporations which own less than 20.0% of the stock of a corporation distributing a dividend may deduct only 70.0% of dividends received or accrued on their behalf.

The Company and the Bank are not currently under audit with respect to their federal tax returns.

State Taxation

We are subject to the Connecticut corporation business tax. The Connecticut corporation business tax is based on the federal taxable income before net operating loss and special deductions and makes certain modifications to federal taxable income to arrive at Connecticut taxable income. Connecticut taxable income is multiplied by the state tax rate (7.5% for the fiscal years ending December 31, 2018 and 2017) to arrive at Connecticut income tax. We are also subject to state income tax in other states as a result of loan originations made in other states.

In October, 2015, the Company created Bankwell Loan Servicing Group, Inc., a Passive Investment Company (“PIC”) organized for state income tax purposes. The PIC is a wholly-owned subsidiary of the Bank operating in accordance with Connecticut statutes. The PIC’s activities are limited in scope to holding and managing loans that are collateralized by real estate. Income earned by a PIC is determined in accordance with the statutory requirements for a passive investment company and the dividends paid by the PIC to the Bank are not taxable income for Connecticut income tax purposes. As a result of the formation of the PIC, the Bank no longer expects to be subject to Connecticut income taxes. State taxes are being recognized for income taxes on income earned in other states.

The Company and the Bank are not currently under audit with respect to their state tax returns.

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Item 1A. Risk Factors

Risks Relating to Our Business

As a business operating in the financial services industry, our business and operations may be adversely affected in numerous and complex ways by weak economic conditions.

Our businesses and operations, which primarily consist of lending money to customers in the form of loans, borrowing money from customers in the form of deposits and investing in securities, are sensitive to general business and economic conditions in the United States. If the U.S. economy weakens, our growth and profitability from our lending, deposit and investment operations could be constrained. Uncertainty about the federal fiscal policymaking process, the medium and long term fiscal outlook of the federal government, and future tax rates is a concern for businesses, consumers and investors in the United States. In addition, economic conditions in foreign countries, including uncertainty over the stability of the euro currency, could affect the stability of global financial markets, which could hinder U.S. economic growth. Weak economic conditions are characterized by deflation, fluctuations in debt and equity capital markets, a lack of liquidity and/or depressed prices in the secondary market for mortgage loans, increased delinquencies on mortgage, consumer and commercial loans, residential and commercial real estate price declines and lower home sales and commercial activity. The current economic environment is also characterized by interest rates at historically low levels, which impacts our ability to attract deposits and to generate attractive earnings through our investment portfolio. All of these factors are detrimental to our business, and the interplay between these factors can be complex and unpredictable. Our business is also significantly affected by monetary and related policies of the U.S. federal government and its agencies. Changes in any of these policies are influenced by macroeconomic conditions and other factors that are beyond our control. Adverse economic conditions and government policy responses to such conditions could have a material adverse effect on our business, financial condition, results of operations and prospects.

We may not be able to adequately measure and limit our credit risk, which could lead to unexpected losses.

The business of lending is inherently risky, including risks that the principal of or interest on any loan will not be repaid timely or at all or that the value of any collateral supporting the loan will be insufficient to cover our outstanding exposure. These risks may be affected by the strength of the borrower's business sector and local, regional and national market and economic conditions. Our risk management practices, such as monitoring the concentration of our loans within specific industries and our credit approval practices, may not adequately reduce credit risk, and our credit administration personnel, policies and procedures may not adequately adapt to changes in economic or any other conditions affecting customers and the quality of the loan portfolio. Finally, many of our loans are made to middle market businesses that may be less able to withstand competitive, economic and financial pressures than larger borrowers. A failure to effectively measure and limit the credit risk associated with our loan portfolio could have a material adverse effect on our business, financial condition, results of operations and future prospects.

Our allowance for loan losses may not be adequate to absorb losses inherent in our loan portfolio, which could have a material adverse effect on our financial condition and results of operations.

We maintain an allowance for loan losses to provide for losses inherent in our loan portfolio. Maintaining an adequate allowance for loan losses is critical to our financial results and condition. The level of our allowance for loan losses reflects management's continuing evaluation of general economic conditions, diversification and seasoning of the loan portfolio, historic loss experience, identified credit problems, delinquency levels and adequacy of collateral. The determination of the appropriate level of the allowance for loan losses is inherently highly subjective and requires us to make significant estimates of and assumptions regarding current credit risks and future trends, all of which may undergo material changes. Inaccurate management assumptions, continuing deterioration of economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses. In addition, our regulators, as an integral part of their examination process, review our loans and the adequacy of our allowance for loan losses and may direct us to make additions to our allowance for loan losses based on their judgments about information available to them at the time of their examination. Further, if actual charge-offs in future periods exceed the amounts allocated to our allowance for loan losses, we may need additional provision for loan losses to restore the adequacy of our allowance for loan losses. If we are required to materially increase our level of allowance for loan losses for any reason, such increase could have a material adverse effect on our business, financial condition, results of operations and future prospects.

Our concentration of large loans to certain borrowers may increase our credit risk.

Our growth over the last several years has been partially attributable to our ability to originate and retain loans. A good number of these loans have been made to a small number of borrowers, resulting in a high concentration of large loans to certain borrowers. We have established an informal, internal lending limit to one relationship of up to 40% of unimpaired capital and allowance for loan losses, if secured by commercial real estate. A relationship in this instance is defined as loans made to different entities but with a shared borrower principal(s). For individual loans, limits are set so as not to exceed the statutory maximum of 15% of unimpaired capital and allowance for loan losses. However, we may, under certain circumstances, consider going above our internal limit in situations where we are confident that (1) the loan to value ratio, other characteristics or the structure of the loan is such that it is a lower risk than standard, (2) we will be able to sell to another institution some portion of the relationship debt as either a whole loan or participation, (3) there is sufficient diversification in the ownership structure of the proposed borrowing entity that the involvement of one party to whom we have extended other debt will not significantly negatively impact the proposed loan's performance in a downturn or (4) the proposed loan is secured by particularly strong collateral, for example, a commercial real estate loan secured by real estate that has strong tenants with long-term leases, thereby reducing the reliance on the principals of the borrowing entity. As of December 31, 2018, our five largest relationships ranged from approximately $36.5 million to $84.9 million, and comprised in the aggregate, approximately 15% of our loan portfolio. In addition to other typical risks related to any loan, such as deterioration of the collateral securing the loans, this high concentration of borrowers presents a risk to our lending operations. If any one of these borrowers becomes unable to repay their loan obligations for any reason, our nonperforming loans and our allowance for loan losses could increase significantly, which could adversely and materially affect our business, financial condition and results of operations.

Our commercial real estate loan, commercial loan and construction loan portfolios expose us to risks that may be greater than the risks related to our other mortgage loans.

Our loan portfolio includes non-owner-occupied commercial real estate loans for individuals and businesses for various purposes, which are secured by commercial properties. These loans typically involve repayment dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service. Commercial real estate loans may be affected to a greater extent than residential loans by adverse conditions in real estate markets or the economy because commercial real estate borrowers' ability to repay their loans depends on successful leasing of their properties, in addition to the factors affecting residential real estate borrowers. These loans also involve greater risk because they generally are not fully amortizing over the loan period, but have a balloon payment due at maturity. A borrower's ability to make a balloon payment typically will depend on being able to either refinance the loan or sell the underlying property in a timely manner.

These loans expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be liquidated as easily as residential real estate. Non-owner-occupied commercial real estate loans generally involve relatively large balances to single borrowers or related groups of borrowers. Accordingly, charge-offs on non-owner occupied commercial real estate loans may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

Commercial loans are typically based on the borrowers' ability to repay the loans from the cash flow of their businesses. These loans may involve greater risk because the availability of funds to repay each loan depends substantially on the success of the business itself. In addition, the assets securing the loans have the following characteristics: (a) they depreciate over time, (b) they are difficult to appraise and liquidate, and (c) they fluctuate in value based on the success of the business.

Risk of loss on a construction loan depends largely upon whether our initial estimate of the property's value at completion of construction equals or exceeds the cost of the property construction (including interest), the availability of permanent takeout financing, the completion of the project and/or the builder's ability to ultimately lease or sell the property. During the construction phase, a number of factors can result in delays and cost overruns. If estimates of value are inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan or by sale of collateral.

Our underwriting, review and monitoring cannot eliminate all of the risks related to these loans. Unexpected deterioration in the credit quality of our commercial real estate loan, commercial loan or construction loan portfolios would require us to increase our provision for loan losses, which would reduce our profitability and could have a material adverse effect on our business, financial condition, results of operations and future prospects.

Lack of seasoning of our loan portfolio could increase risk of credit defaults in the future.

As a result of our growth over the past recent years, a large portion of loans in our loan portfolio and of our lending relationships are of relatively recent origin. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process referred to as "seasoning." As a result, a portfolio of older loans will usually behave more predictably than a newer portfolio. Because a large portion of our portfolio is relatively new, the current level of delinquencies and defaults may not represent the level that may prevail as the portfolio becomes more seasoned and may not serve as a reliable basis for predicting the health and nature of our loan portfolio, including net charge-offs and the ratio of nonperforming assets in the future. Our limited experience with these loans does not provide us with a significant payment history pattern with which to judge future collectability. As a result, it may be difficult to predict the future performance of our loan portfolio. If defaults increase, we could experience an increase in delinquencies and charge-offs and we may be required to increase our allowance for loan losses, which could have a material adverse effect on our business, financial condition, results of operations and prospects.

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A prolonged downturn in the real estate market could result in losses and adversely affect our profitability.
As of December 31, 2018, the majority of our loan portfolio was composed of commercial and consumer real estate loans. The sale of real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. A decline in real estate values could impair the value of our collateral and our ability to sell the collateral upon any foreclosure, which would likely require us to increase our provision for loan losses. In the event of a default with respect to any of these loans, the amounts we receive upon sale of the collateral may be insufficient to recover the outstanding principal and interest on the loan. If we are required to re-value the collateral securing a loan to satisfy the debt during a period of reduced real estate values or to increase our allowance for loan losses, our profitability could be adversely affected, which could have a material adverse effect on our business, financial condition, results of operations and prospects.
We are subject to interest rate risk that could negatively impact our profitability.
Our profitability, like that of most financial institutions, depends to a large extent on our net interest income, which is the difference between our interest income on interest earning assets, such as loans and investment securities, and our interest expense on interest-bearing liabilities, such as deposits and borrowings.
Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the U.S. Federal Reserve Board, or the Federal Reserve, or the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the interest we pay on deposits and borrowings, but such changes could also affect our ability to originate loans and obtain deposits, the fair value of our financial assets and liabilities, and the average duration of our assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore net income, could be adversely affected. A continuation of the current levels of interest rates could cause the spread between our loan yields and our deposit rates paid to compress our net interest margin and our net income could be adversely affected. Further, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our business, financial condition, results of operations and future prospects.
In addition, an increase in interest rates could also have a negative impact on our results of operations by reducing the ability of borrowers to repay their current loan obligations. These circumstances could not only result in increased loan defaults, foreclosures and charge-offs, but also necessitate further increases to our allowance for loan losses, each of which could have a material adverse effect on our business, results of operations, financial condition and future prospects.
Our business is concentrated in Fairfield and New Haven Counties, Connecticut and the surrounding areas, and we are more sensitive than our more geographically diversified competitors to adverse changes in the local economy.
We conduct a majority of our operations in the New York metropolitan area, including Fairfield and New Haven Counties, Connecticut. A majority of the real estate loans in our loan portfolio are secured by properties located in the New York metropolitan area, including Fairfield and New Haven Counties. In addition, as of December 31, 2018, the majority of the loans in our loan portfolio (measured by dollar amount) were made to borrowers who live or conduct business in the New York metropolitan area. We compete against a number of financial institutions who maintain significant operations located outside of the New York metropolitan area and outside the State of Connecticut. Accordingly, any regional or local economic downturn, or natural or man-made disaster, that affects Connecticut or the New York metropolitan area or existing or prospective property or borrowers in Connecticut or the New York metropolitan area may affect us and our profitability more significantly and more adversely than our more geographically diversified competitors, which could cause a material adverse effect on our business, financial condition, results of operations and prospects.
Strong competition within our market area could reduce our profits and slow growth.
Competition in the financial services industry in our market and the surrounding area is strong. Numerous commercial banks, savings banks and savings associations maintain offices or are headquartered in or near our primary market area. Commercial banks, savings banks, savings associations, money market funds, mortgage brokers, finance companies, credit unions, insurance companies, investment firms and private lenders compete with us for various

segments of our business. These competitors often have far greater resources than we do and are able to conduct more intensive and broader based promotional efforts to reach both commercial and individual customers.
Our ability to compete successfully will depend on a number of factors, including, among other things:

- Our ability to build and maintain long-term customer relationships while ensuring high ethical standards and safe and sound banking practices;
- The scope, relevance and pricing of products and services that we offer;
- Customer satisfaction with our products and personalized services;

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- Industry and general economic trends; and
- Our ability to keep pace with technological advances and to invest in new technology.

Increased competition could require us to increase the rates we pay on deposits or lower the rates we offer on loans, which could reduce our profitability. We derive a majority of our business from our primary market area, the New York metropolitan area, including Fairfield and New Haven Counties, Connecticut. Our failure to compete effectively in our primary market could cause us to lose market share and could have a material adverse effect on our business, financial condition, results of operations and future prospects.

We are a community bank and our ability to maintain our reputation is critical to the success of our business.

We are a community bank, and our reputation is one of the most valuable components of our business. We strive to conduct our business in a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values of being an integral part of the communities we serve, delivering superior service to our customers and caring about our customers and associates. If our reputation is negatively affected, by the actions of our employees or otherwise, our business and, therefore, our operating results may be materially adversely affected.

We may not be able to execute our management team’s growth strategy.

As part of our management team’s growth strategy, we pursue a business plan focused on the development and growth of our franchise in our existing market and surrounding areas. In addition to pursuing organic growth, another element of our management team’s strategy will be to acquire other branches, whole financial institutions or related lines of business. We intend to actively seek potential acquisition opportunities. There are numerous risks that may make it difficult for us to execute this growth strategy and we cannot assure you that we will be successful in executing any part of our management team’s strategy or that we will be able to maintain our historical rate of growth. Challenges we will face include obtaining regulatory approvals with respect to acquisitions, assuring that we will not become subject to regulatory actions in the future that could restrict our growth, identifying appropriate targets for acquisitions, negotiating acquisitions on terms that are acceptable to us, and encountering competition for acquisitions from financial institutions and other entities with similar business strategies that have greater financial resources, relevant experience and more personnel than us. Accordingly, there can be no assurance that we will be successful in completing future acquisitions at all or on terms that are acceptable to us. Our ability to grow will be limited if we are unable to successfully make acquisitions in the future.

Some institutions we may acquire may have distressed assets and there can be no assurance that we would be able to realize the value we predict from these assets or that we would make sufficient provision for future losses in the value of, or accurately estimate the future write downs taken in respect of, these assets.

Declines in home prices and/or weak general economic conditions may result in increases in delinquencies and losses in the loan portfolios and other assets of financial institutions that we may acquire in amounts that exceed our initial forecasts developed during the due diligence investigation prior to acquiring those institutions. In addition, the loss reserves of institutions we may acquire may prove inadequate or be negatively affected, and asset values may be impaired, in the future due to factors we cannot predict, including significant deterioration in economic conditions and further declines in collateral values and credit quality indicators. Any of these events could adversely affect the financial condition, liquidity, capital position and value of any institutions that we acquire and of the Bank as a whole.

We may not be able to overcome the integration and other risks associated with acquisitions, which could adversely affect our growth and profitability.

We may from time to time consider acquisition opportunities that we believe complement our activities and have the ability to enhance our profitability. Acquisition activities could be material to our business and involve a number of risks, including the following:

- Incurring time and expense associated with identifying and evaluating potential acquisitions and negotiating potential transactions, resulting in our attention being diverted from the operation of our existing business;
- Using inaccurate estimates and judgments to evaluate credit, operations, management and market risks with respect to the target institution or assets;
- Intense competition from other banking organizations and other inquirers for acquisitions;
-

- Potential exposure to unknown or contingent liabilities of banks and businesses we acquire;
- The time and expense required to integrate the operations and personnel of the combined businesses;
- Experiencing higher operating expenses relative to operating income from the new operations;
- Creating an adverse short-term effect on our results of operations;

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- Losing key employees and customers as a result of an acquisition that is poorly received;
- Significant problems relating to the conversion of the financial and customer data of the entity;
- Inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with clients, customers, depositors and employees or to achieve the anticipated benefits of the acquisition; or
- Risks of impairment to goodwill or other than temporary impairment.

Depending on the condition of any institution or assets or liabilities that we may acquire, that acquisition may, at least in the near term, adversely affect our capital and earnings and, if not successfully integrated with our organization, may continue to have such effects over a longer period. We may not be successful in overcoming these risks or any other problems encountered in connection with pending or potential acquisitions, and any acquisition we may consider will be subject to prior regulatory approval. Our inability to overcome these risks could have an adverse effect on our profitability, return on equity and return on assets, our ability to implement our business strategy and enhance shareholder value, which, in turn, could have a material adverse effect on our business, financial condition, results of operations and prospects. Further, if we experience difficulties with the integration process, the anticipated benefits of the investment or acquisition transaction may not be realized fully or at all or may take longer to realize than expected. As a result of an investment or acquisition transaction, we may be required to take write-downs or write-offs, restructuring and impairment or other charges that could have a significant negative effect on our financial condition and results of operations, which could cause you to lose some or all of your investment.

We must conduct due diligence investigations of target institutions we intend to acquire. Intensive due diligence is time consuming and expensive due to the operations, accounting, finance and legal professionals who must be involved in the due diligence process. Even if we conduct extensive due diligence on a target institution with which we combine, this diligence may not reveal all material issues that may affect a particular target institution, and factors outside the control of the target institution and outside of our control may later arise. If, during our diligence process, we fail to identify issues specific to a target institution or the environment in which the target institution operates, we may be forced to later write down or write off assets, restructure our operations, or incur impairment or other charges that could result in our reporting losses. These charges may also occur if we are not successful in integrating and managing the operations of the target institution with which we combine. In addition, charges of this nature may cause us to violate net worth or other covenants to which we may be subject as a result of assuming preexisting debt held by a target institution or by virtue of our obtaining debt financing.

Resources could be expended in considering or evaluating potential acquisitions that are not consummated, which could materially and adversely affect subsequent attempts to locate and acquire or merge with another business.

We anticipate that the process of identifying and investigating institutions for potential acquisitions and the negotiation, drafting and execution of relevant agreements, disclosure documents and other instruments will require substantial management time and attention and substantial costs for accountants, attorneys and others. If a decision is made not to complete a specific acquisition transaction, the costs incurred up to that point for the proposed transaction likely would not be recoverable. Furthermore, even if an agreement is reached relating to a specific target institution, we may fail to consummate the transaction for any number of reasons, including those beyond our control. Any such event will result in a loss to us of the related costs incurred, which could materially and adversely affect subsequent attempts to locate and acquire or merge with another institution.

Our lending limit may restrict our growth and prevent us from effectively implementing our business strategy.

We are limited in the amount we can loan to a single borrower by the amount of our capital. Under Connecticut banking law, the total direct or indirect liabilities of any one obligor that are not fully secured, however incurred, to any Connecticut bank, exclusive of such bank’s investment in the investment securities of such obligor, shall not exceed at the time incurred 15% of the equity capital and allowance for loan losses of such bank. The total direct or indirect liabilities of any one obligor that are fully secured, however incurred, to any Connecticut bank, exclusive of such bank’s investment in the investment securities of such obligor, shall not exceed at the time incurred 10% of the equity capital and allowance for loan losses of such bank, provided this limitation shall be separate from and in addition to the limitation on liabilities that are not fully secured. We have also established an informal, internal lending limit to one relationship of up to 40% of unimpaired capital and allowance for loan losses, if secured by commercial real estate. A relationship in this instance is defined as loans made to different entities but with a shared borrower principal(s). For individual loans, limits are set so as not to exceed the statutory maximum of 15% of unimpaired capital and allowance for loan losses. Based upon our current capital levels and our informal, internal limit on loans, the amount we may lend both in the aggregate and to any one borrower is significantly less than that of many of our competitors and may discourage potential borrowers who have credit needs in excess of our lending limit from doing business with us. We accommodate larger loans by selling participations in those loans to other financial institutions, but this strategy may not always be available. If we are unable to compete effectively for loans from our target customers, we may not be able to effectively implement our business strategy, which could have a material adverse effect on our business, financial condition, results of operations and future prospects.

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We are dependent on our executive management team and other key employees and we could be adversely affected by the unexpected loss of their services.

We are led by an experienced core management team with substantial experience in the market that we serve, and our operating strategy focuses on providing products and services through long-term relationship managers. Accordingly, our success depends in large part on the performance of our key personnel, as well as on our ability to attract, motivate and retain highly qualified senior and middle management. Competition for employees is intense, and the process of locating key personnel with the combination of skills and attributes required to execute our business plan may be lengthy. We believe that retaining the services and skills of our management team is important to our success. The unexpected loss of services of any of our key personnel could have an adverse impact on us because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel. If the services of any of our key personnel should become unavailable for any reason, we may not be able to identify and hire qualified persons on terms acceptable to us, which could cause a material adverse effect on our business, financial condition, results of operations and prospects.

The fair value of our investment securities can fluctuate due to factors outside of our control.

Factors beyond our control can significantly influence the fair value of securities in our portfolio and can cause potential adverse changes to the fair value of these securities. These factors include, but are not limited to, rating agency actions with respect to individual securities, defaults by the issuer or with respect to the underlying securities, and changes in market interest rates and continued instability in the capital markets. Any of these factors, among others, could cause other-than-temporary impairments and realized and/or unrealized losses in future periods and declines in other comprehensive income, which could materially and adversely affect our business, results of operations, financial condition and prospects. The process for determining whether impairment of a security is other-than-temporary usually requires complex, subjective judgments about the future financial performance and liquidity of the issuer and any collateral underlying the security in order to assess the probability of receiving all contractual principal and interest payments on the security.

We may be required to repurchase mortgage loans or indemnify buyers against losses in some circumstances, which could harm liquidity, results of operations and financial condition.

When mortgage loans are sold, whether as whole loans or pursuant to a securitization, we are required to make customary representations and warranties to purchasers, guarantors and insurers, including government-sponsored entities, about the mortgage loans and the manner in which they were originated. Whole loan sale agreements require us to repurchase or substitute mortgage loans, or indemnify buyers against losses, in the event we breach these representations or warranties. In addition, we may be required to repurchase mortgage loans as a result of early payment default of the borrower on a mortgage loan. If repurchase and indemnity demands increase and such demands are valid claims and are in excess of our provision for potential losses, our liquidity, results of operations and financial condition may be adversely affected.

Our financial results depend on management’s selection of accounting methods and certain assumptions and estimates.

Our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with Accounting Principles Generally Accepted in the United States, or GAAP, and with general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of certain assets and liabilities, disclosure of contingent assets and liabilities and the reported amount of related revenues and expenses. Certain accounting policies inherently are based to a greater extent on estimates, assumptions and judgments of management and, as such, have a greater possibility of producing results that could be materially different than originally reported. They require management to make subjective or complex judgments, estimates or assumptions, and changes in those estimates or assumptions could have a significant impact on our consolidated financial statements. These critical accounting policies include the fair value of acquired assets, the allowance for loan losses, stock-based compensation and derivative instrument valuation. Because of the uncertainty of estimates involved in these matters, we may be required to significantly increase the allowance for loan losses or sustain loan losses that are significantly higher than the reserve provided or otherwise incur charges that could have a material adverse effect on our business, financial condition, results of operations and future prospects.

We may be adversely affected by the soundness of other financial institutions.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services companies are interrelated as a result of trading, clearing, counterparty, and other relationships. We have exposure to different industries and counterparties, and through transactions with counterparties in the financial services industry, including broker-dealers, commercial banks, investment banks, and other financial intermediaries. Further, our private banking channel relies on relationships with a number of other financial institutions for referrals. As a result, declines in the financial condition of, or even rumors or questions about, one or more financial institutions, financial service companies or the financial services industry generally, may lead to market-wide liquidity, asset quality or other problems and

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could lead to losses or defaults by us or by other institutions. These problems, losses or defaults could have a material adverse effect on our business, financial condition, results of operations and future prospects.

We rely on third parties to provide key components of our business infrastructure, and failure of these parties to perform for any reason could disrupt our operations.

Our business depends on the successful and uninterrupted functioning of our information technology and telecommunications systems and third-party servicers. The failure of these systems, or the termination of a third-party software license or service agreement on which any of these systems is based, could interrupt our operations. Because our information technology and telecommunications systems interface with and depend on third-party systems, we could experience service denials if demand for such services exceeds capacity or such third-party systems fail or experience interruptions. If significant, sustained or repeated, a system failure or service denial could compromise our ability to operate effectively, damage our reputation, result in a loss of customer business, and subject us to additional regulatory scrutiny and possible financial liability, any of which could have a material adverse effect on our business, financial condition, results of operations and prospects.

We face various technological risks that could adversely affect our business.

We rely on communication and information systems to conduct business. Potential failures, interruptions or breaches in system security could result in disruptions or failures in our key systems, such as general ledger, deposit or loan systems. The risk of electronic fraudulent activity within the financial services industry, especially in the commercial banking sector due to cyber criminals targeting bank accounts and other customer information is on the rise. We have developed policies and procedures aimed at preventing and limiting the effect of failure, interruption or security breaches, including cyber-attacks of information systems; however, there can be no assurance that these incidences will not occur, or if they do occur, that they will be appropriately addressed. The occurrence of any failures, interruptions or security breaches, including cyber-attacks of our information systems could damage our reputation, result in the loss of business, subject us to increased regulatory scrutiny or subject us to civil litigation and possible financial liability, any of which could have an adverse effect on our results of operation and financial condition.

We are subject to losses due to fraudulent and negligent acts on the part of loan applicants, our borrowers, other vendors and our employees.

When we originate loans, we rely heavily upon information supplied by third parties, including the information contained in the loan application, property appraisal, title information and employment and income documentation. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant, the borrower, another third party or one of our employees, we generally bear the risk of loss associated with the misrepresentation. A loan subject to a material misrepresentation is typically unsaleable or subject to repurchase if it is sold prior to detection of the misrepresentation, and the persons and entities involved are often difficult to locate and it is often difficult to collect any monetary losses that we have suffered from them. We have controls and processes designed to help us identify misrepresented information in our loan origination operations. We cannot assure you, however, that we have detected or will detect all misrepresented information in our loan originations.

Unauthorized access, cyber-crime and other threats to data security may require significant resources, harm our reputation, and adversely affect our business.

We necessarily collect, use and hold personal and financial information concerning individuals and businesses with which we have a banking relationship. Threats to data security, including unauthorized access and cyber-attacks rapidly emerge and change, exposing us to additional costs for protection or remediation and competing time constraints to secure our data in accordance with customer expectations, statutory and regulatory privacy and other requirements. It is difficult or impossible to defend against every risk being posed by changing technologies, as well as criminal intent on committing cyber-crime. Increasing sophistication of cyber-criminals and terrorists make keeping up with new threats difficult and could result in a breach. Controls employed by our information technology department and our other employees and vendors could prove inadequate. We could also experience a breach due to intentional or negligent conduct on the part of employees or other internal sources, software bugs or other technical malfunctions, or other causes. As a result of any of these threats, our customer accounts may become vulnerable to account takeover schemes or cyber-fraud. Our systems and those of our third-party vendors may also become vulnerable to damage or disruption due to circumstances beyond our or their control, such as from catastrophic events, power anomalies or outages, natural disasters, network failures, and viruses and malware.

A breach of our security that results in unauthorized access to our data could expose us to a disruption or challenges relating to our daily operations as well as to data loss, litigation, damages, fines and penalties, significant increases in compliance costs, and reputational damage, any of which could have a material adverse effect on our business, results of operations, financial condition and future prospects.

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We are subject to environmental liability risk associated with our lending activities.

In the course of our business, we may purchase real estate, or we may foreclose on and take title to real estate. As a result, we could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. Any significant environmental liabilities could cause a material adverse effect on our business, financial condition, results of operations and future prospects.

We may incur impairment to goodwill.

We test our goodwill for impairment at least annually. Significant negative industry or economic trends, reduced estimates of future cash flows or disruptions to our business, could indicate that goodwill might be impaired. Our valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and to rely on projections of future operating performance. Projections of future operating results and cash flows may vary significantly from actual results. Additionally, if our analysis results in impairment to our goodwill, we would be required to record a non-cash charge to earnings in our financial statements during the period in which such impairment is determined to exist. Any such charge could have a material adverse effect on our results of operations.

Uncertainty about the future of LIBOR may adversely affect our business.

LIBOR is used extensively in the United States as a benchmark for various commercial and financial contracts, including adjustable rate mortgages, corporate debt, interest rate swaps and other derivatives. LIBOR is set based on interest rate information reported by certain banks, which may stop reporting such information after 2021. It is uncertain at this time whether LIBOR will change or cease to exist or the extent to which those entering into financial contracts will transition to any other particular benchmark. Other benchmarks may perform differently than LIBOR or alternative benchmarks have performed in the past or have other consequences that cannot currently be anticipated. It is also uncertain what will happen with instruments that rely on LIBOR for future interest rate adjustments and which remain outstanding if LIBOR ceases to exist.

We have derivative contracts and limited loan exposure tied to LIBOR. Although we are not yet able to assess what the ultimate impact of the transition from LIBOR will be, failure to adequately manage the transition could have a material adverse effect on our business, financial condition and results of operations.

Risks Applicable to the Regulation of our Industry

We operate in a highly regulated environment, which could have a material and adverse impact on our operations and activities, financial condition, results of operations, growth plans and future prospects.

Banking is highly regulated under federal and state law. We are subject to extensive regulation and supervision that governs almost all aspects of our operations. As a registered bank holding company, we are subject to supervision, regulation and examination by the Federal Reserve. As a commercial bank chartered under the laws of Connecticut, the Bank is subject to supervision, regulation and examination by the State of Connecticut Department of Banking and the FDIC.

The primary goals of the bank regulatory system are to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. This system is intended primarily for the protection of the FDIC's Deposit Insurance Fund and bank depositors, rather than our shareholders and creditors. The banking agencies have broad enforcement power over bank holding companies and banks, including the authority, among other things, to enjoin "unsafe or unsound" practices, require affirmative action to correct any violation or practice, issue administrative orders that can be judicially enforced, direct increases in capital, direct the sale of subsidiaries or other assets, limit dividends and distributions, restrict growth, assess civil monetary penalties, remove officers and directors, and, with respect to banks, terminate our charter, terminate our deposit insurance or place the Bank into conservatorship or receivership. In general, these enforcement actions may be initiated for violations of laws and regulations or unsafe or unsound practices.

Compliance with the myriad of laws and regulations applicable to our organization can be difficult and costly. In addition, these laws, regulations and policies are subject to continual review by governmental authorities, and changes to these laws, regulations and policies, including changes in interpretation or implementation of these laws, regulations and policies, could affect us in substantial and unpredictable ways and often impose additional compliance costs. Further, any new laws, rules and regulations, such as the Dodd-Frank Act, could make compliance more difficult or expensive. All of these laws and regulations, and the supervisory framework applicable to our industry, could have a material adverse impact on our operations and activities, financial condition, results of operations, growth plans and future prospects.

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Federal and state regulators periodically examine our business and we may be required to remediate adverse examination findings.

The Federal Reserve, the FDIC and the Connecticut Department of Banking periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, a regulatory agency were to determine that our financial condition, capital resources, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, it may take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance and place us into receivership or conservatorship. Any regulatory action against us could have a material adverse effect on our business, results of operations, financial condition and future prospects.

The Bank’s FDIC deposit insurance premiums and assessments may increase.

The deposits of the Bank are insured by the FDIC up to legal limits and, consequently, subject it to the payment of FDIC deposit insurance assessments. The Bank’s regular assessments are determined by its risk classification, which is based on its regulatory capital levels and the level of supervisory concern that it poses. Any future special assessments, increases in assessment rates or required prepayments in FDIC insurance premiums could reduce our profitability or limit our ability to pursue certain business opportunities, which could materially and adversely affect our business, financial condition, results of operations and prospects.

The Bank is subject to further reporting requirements under FDIC regulations.

We are subject to further reporting requirements under the rules of the FDIC for the year ended December 31, 2018 as the Bank’s total assets exceed $1.0 billion, including a requirement for management to prepare a report that contains an assessment by management of the Bank’s effectiveness of internal control structure and procedures for financial reporting as of the end of such fiscal year. In addition, we are required to obtain an independent public accountant’s attestation report concerning our internal control structure over financial reporting. The rules for management to assess the Bank’s internal controls over financial reporting are complex, and require significant documentation, testing and possible remediation. The effort to comply with regulatory requirements relating to internal controls cause us to incur increased expenses and a diversion of management’s time and other internal resources. If the Bank cannot favorably assess the effectiveness of its internal controls over financial reporting, or if its independent registered public accounting firm is unable to provide an unqualified attestation report on the Bank’s internal controls, the price of our common stock as well as investor confidence could be adversely affected and we may be subject to additional regulatory scrutiny.

We are subject to numerous laws designed to protect consumers, including the Community Reinvestment Act, or CRA, and fair lending laws, and failure to comply with these laws could lead to a wide variety of sanctions.

Various laws impose nondiscriminatory lending requirements on financial institutions, including the CRA, the Equal Credit Opportunity Act and the Fair Housing Act. A successful regulatory challenge to an institution’s performance under the CRA or fair lending laws and regulations could result in a wide variety of sanctions, including damages and civil money penalties, injunctive relief, restrictions on mergers and acquisitions activity, restrictions on expansion, and restrictions on entering new business lines. Private parties may also have the ability to challenge an institution’s performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our business, financial condition, results of operations and prospects.

We face a risk of noncompliance and enforcement action with the Bank Secrecy Act and other anti-money laundering statutes and regulations.

Financial institutions are required to institute and maintain an effective anti-money laundering program and file suspicious activity and currency transaction reports as appropriate under The Bank Secrecy Act, The USA PATRIOT ACT of 2001 and certain other laws and regulations. Significant civil penalties can be assessed by a variety of regulators and governmental agencies for violations of these laws and regulations. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could materially and adversely affect our business, financial condition, results of operations and prospects.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

The Bank's main office is located at 208 Elm Street in New Canaan, Connecticut. The property is leased by us until 2021, with two remaining five-year renewal options. In July 2012, we initially leased additional space adjacent to 208 Elm Street at 220 Elm Street primarily for our executive management offices. The property located at 220 Elm Street was purchased by the Bank in December of 2016.

We also lease office space for each of our branch offices in New Canaan, Stamford, Norwalk, Fairfield and North Haven Connecticut. The leases for our facilities have terms expiring at dates ranging from 2019 to 2030, although certain of the leases contain options to extend beyond these dates. We own the Wilton and Hamden branch offices.

We believe that our current facilities are adequate for our current level of operations. Each lease is at market rate based on similar properties in the applicable market area. We believe that we have the necessary infrastructure in place to support our projected growth.

During the second quarter of 2018, the Company opened three additional branch locations, located in Darien, Westport, and Stamford, Connecticut.

Our branch offices are located as follows:

Branch	Address	Owned or Leased
Elm Street	208 Elm Street New Canaan, CT 06840	Lease (expires 2021)
Cherry Street	156 Cherry Street New Canaan, CT 06840	Lease (expires 2021)
Bedford	612 Bedford Street Stamford, CT 06901	Lease (expires 2020)
High Ridge	1095 High Ridge Road, Stamford, CT 06905	Lease (expires 2028)
Black Rock	2220 Black Rock Turnpike Fairfield, CT 06825	Lease (expires 2024)
Sasco Hill	One Sasco Hill Road Fairfield, CT 06824	Lease (expires 2024)
Wilton	47 Old Ridgefield Road Wilton, CT 06897	Own
Norwalk	370 Westport Avenue Norwalk, CT 06851	Lease (expires 2030)
Hamden	2704 Dixwell Avenue Hamden, CT 06518	Own
North Haven	24 Washington Avenue North Haven, CT 06473	Lease (expires 2019)
Westport	100 Post Road East, Westport, CT 06880	Lease (expires 2028)
Darien	1065 Post Road, Darien, CT 06820	Lease (expires 2028)

Item 3. Legal Proceedings

From time to time we are a party to various litigation matters incidental to the conduct of our business. We are not presently party to any legal proceedings the resolution of which we believe would have a material adverse effect on our business, future prospects, financial condition, liquidity, results of operation, cash flows or capital levels.

Item 4. Mine Safety Disclosures

Not applicable.

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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's Common Stock has traded on the NASDAQ Global Market under the Symbol "BWFG" since the completion of its initial public offering on May 15, 2014.

There were approximately 280 shareholders of record of BWFG Common Stock as of December 31, 2018. This number does not reflect the number of persons or entities holding stock in nominee name through banks, brokerage firms or other nominees.

The Company's shareholders are entitled to dividends when and if declared by the Board of Directors, out of funds legally available. The ability of the Company to pay dividends depends, in part, on the ability of the Bank to pay dividends to the Company. In accordance with Connecticut statutes, regulatory approval is required for the Bank to pay dividends in excess of the Bank's profits retained in the current year plus retained profits from the previous two years. The Bank is also prohibited from paying dividends that would reduce its capital ratios below minimum regulatory requirements.

Issuer Purchases of Equity Securities

On December 19, 2018, the Company's Board of Directors authorized a share repurchase program of up to 400,000 shares of the Company's Common Stock. The Company intends to accomplish the share repurchases through open market transactions, though the Company could accomplish repurchases through other means, such as privately negotiated transactions. The timing, price and volume of repurchases will be based on market conditions, relevant securities laws and other factors. The share repurchase plan does not obligate the Company to acquire any particular amount of Common Stock, and it may be modified or suspended at any time at the Company's discretion. The Company did not repurchase any of its common stock during 2018 or 2017.

Common Stock Performance Graph

The performance graph below compares the Company's cumulative shareholder return on its common stock since May 15, 2014, the IPO date to the cumulative return of the NASDAQ Composite Index and the NASDAQ Bank Index. Cumulative return assumes the reinvestment of dividends, and is expressed in dollars based on an assumed investment of $100.

There can be no assurance that our stock performance in the future will continue with the same or similar trend depicted in the graph below. We will not make or endorse any predictions as to future stock performance.

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Index	5/15/2014	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Bankwell Financial Group, Inc.	100.00	116.67	110.28	180.56	190.78	159.50
Nasdaq Composite Index	100.00	116.39	123.05	132.29	169.65	163.06
Nasdaq Bank Index	100.00	109.89	117.17	158.21	163.76	134.44

In accordance with the rules of the SEC, this section captioned “Common Stock Performance Graph”, shall not be incorporated by reference into any of our future filings made under the Securities Exchange Act of 1934 or the Securities Act of 1933. The Common Stock Performance Graph, including its accompanying table and footnotes, is not deemed to be soliciting material or to be filed under the Exchange Act or the Securities Act.

Item 6. Selected Financial Data

The following table sets forth selected consolidated financial data as of the dates and for the periods presented. The selected consolidated statement of financial condition data as of December 31, 2018 and 2017 and the selected consolidated statement of income data for the years ended December 31, 2018, 2017 and 2016 have been derived mainly from our audited consolidated financial statements and related notes that we have included elsewhere in this Annual Report. The selected consolidated statement of financial condition data as of December 31, 2016, 2015 and 2014 and the selected consolidated statement of income data for the years ended December 31, 2015 and 2014 have been derived mainly from audited consolidated financial statements that are not presented in this Annual Report.

The selected historical consolidated financial data as of any date and for any period are not necessarily indicative of the results that may be achieved as of any future date or for any future period. You should read the following selected statistical and financial data in conjunction with the more detailed information contained in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and the related notes that we have presented elsewhere in this Annual Report.

Net income for the year ended December 31, 2017 was negatively impacted by the Tax Cuts and Jobs Act of 2017 as it relates to legislation that required a re-measurement of our deferred tax asset, which required a $3.3 million write-off recognized as a direct increase to income tax expense. As a result, the performance metrics presented below have been adversely impacted due to the decline in net income driven by this write-off.

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Selected Financial Data

	At or For the Years Ended December 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands, except per share data)				
Statements of Income:					
Interest income	$80,064	$71,201	$60,990	$50,754	$35,589
Interest expense	23,738	16,837	11,898	7,966	3,929
Net interest income	56,326	54,364	49,092	42,788	31,660
Provision for loan losses	3,440	1,341	3,914	3,230	2,152
Net interest income after provision for loan losses	52,886	53,023	45,178	39,558	29,508
Noninterest income	3,900	4,629	2,676	3,484	3,041
Noninterest expense	35,633	32,523	29,544	29,171	25,812
Income before income tax	21,153	25,129	18,310	13,871	6,737
Income tax expense	3,720	11,299	5,960	4,841	2,169
Net income	17,433	13,830	12,350	9,030	4,568
Net income attributable to common shareholders	$17,433	$13,830	$12,350	$8,905	$4,458
Per Share Data:					
Basic earnings per share	$2.23	$1.80	$1.64	$1.23	$0.78
Diluted earnings per share	$2.21	$1.78	$1.62	$1.21	$0.78
Book value per share (end of period)[a]	22.43	20.98	19.39	17.87	16.84
Tangible book value per share (end of period)[a][b]	22.06	20.59	18.98	17.43	16.35
Dividend payout ratio[f]	21.56 %	15.54 %	13.45 %	4.16 %	— %
Shares outstanding (end of period)[a]	7,764,647	7,676,238	7,524,069	7,372,968	7,019,620
Weighted average shares outstanding–basic	7,722,175	7,572,409	7,396,019	7,071,550	5,577,942
Weighted average shares outstanding–diluted	7,775,480	7,670,413	7,491,052	7,140,558	5,605,512
Performance Ratios:					
Return on average assets[c]	0.94 %	0.80 %	0.85 %	0.75 %	0.52 %
Return on average common shareholders' equity	10.19 %	8.93 %	8.94 %	6.67 %	5.13 %
Return on average shareholders' equity[c]	10.19 %	8.93 %	8.94 %	6.76 %	4.66 %
Average shareholders' equity to average assets	9.24 %	8.97 %	9.47 %	11.08 %	11.14 %
Net interest margin	3.18 %	3.30 %	3.54 %	3.77 %	3.84 %
Efficiency ratio[b]	59.2 %	54.9 %	56.5 %	62.3 %	68.7 %
Asset Quality Ratios:					
Total past due loans to total loans[d]	0.78 %	1.67 %	0.47 %	0.51 %	0.86 %
Nonperforming loans to total loans[d]	0.88 %	0.36 %	0.22 %	0.33 %	0.36 %
Nonperforming assets to total assets[e]	0.75 %	0.31 %	0.20 %	0.38 %	0.39 %
Allowance for loan losses to nonperforming loans	109.80 %	344.90 %	612.26 %	373.76 %	323.02 %
Allowance for loan losses to total loans[d]	0.96 %	1.23 %	1.32 %	1.23 %	1.17 %
Net charge-offs (recoveries) to average loans[d]	0.44 %	0.03 %	0.01 %	(0.01)%	(0.05)%
Statements of Financial Condition:					

Total assets	$1,873,665	$1,796,607	$1,628,919	$1,330,372	$1,099,531
Gross portfolio loans[d]	1,604,726	1,543,016	1,365,939	1,147,513	929,762
Investment securities	116,584	113,767	104,610	50,807	76,463
Deposits	1,502,244	1,398,405	1,289,037	1,046,942	835,439
FHLB borrowings	160,000	199,000	160,000	120,000	129,000
Subordinated debt	25,155	25,103	25,051	25,000	—
Total equity	174,196	161,027	145,895	131,769	129,210
Capital Ratios:					
Tier 1 capital to average assets					
Bankwell Bank	10.14 %	9.61 %	10.10 %	10.84 %	11.12 %
Tier 1 capital to risk-weighted assets					
Bankwell Bank	11.56 %	10.99 %	11.59 %	12.18 %	12.47 %
Total capital to risk-weighted assets					
Bankwell Bank	12.50 %	12.19 %	12.85 %	13.39 %	13.55 %
Total shareholders' equity to total assets	9.30 %	8.96 %	8.96 %	9.90 %	11.75 %
Tangible common equity ratio[b]	9.16 %	8.81 %	8.78 %	9.68 %	10.47 %

(a) Excludes preferred stock and unvested restricted stock awards.

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(b) This measure is not a measure recognized under GAAP and is therefore considered to be a non-GAAP financial measure. See “Non-GAAP Financial Measures” for a description of this measure and a reconciliation of this measure to its most directly comparable GAAP measure.
(c) Calculated based on net income before preferred stock dividend.
(d) Calculated using the principal amounts outstanding on loans.
(e) Nonperforming assets consist of nonperforming loans and other real estate owned.
(f) The Company paid its first quarterly dividend to shareholders in the fourth quarter of 2015.

NON-GAAP FINANCIAL MEASURES

We identify “efficiency ratio”, “tangible common equity ratio”, “tangible book value per share”, “total revenue” and “return on average common shareholders’ equity” as “non-GAAP financial measures.” In accordance with the SEC’s rules, we classify a financial measure as being a non-GAAP financial measure if that financial measure excludes or includes amounts, or is subject to adjustments that have the effect of excluding or including amounts, that are included or excluded, as the case may be, in the most directly comparable measure calculated and presented in accordance with generally accepted accounting principles as in effect from time to time in the United States in our statements of income, balance sheet or statements of cash flows. Non-GAAP financial measures do not include operating and other statistical measures or ratios or statistical measures calculated using exclusively either financial measures calculated in accordance with GAAP, operating measures or other measures that are not non-GAAP financial measures or both.

The non-GAAP financial measures that we discuss in this annual report should not be considered in isolation or as a substitute for the most directly comparable or other financial measures calculated in accordance with GAAP. Moreover, the manner in which we calculate the non-GAAP financial measures that we discuss in this annual report may differ from that of other companies reporting measures with similar names. You should understand how such other banking organizations calculate their financial measures similar or with names similar to the non-GAAP financial measures we have discussed in this annual report when comparing such non-GAAP financial measures.

Efficiency ratio is defined as non-interest expenses, less merger and acquisition related expenses, other real estate owned expenses and amortization of intangible assets, divided by our operating revenue, which is equal to net interest income plus non-interest income excluding gains and losses on sales of securities, gains and losses on other real estate owned and gain on bargain purchase. In our judgment, the adjustments made to operating revenue allow investors and analysts to better assess our operating expenses in relation to our core operating revenue by removing the volatility that is associated with certain one-time items and other discrete items that are unrelated to our core business.

Tangible common equity is defined as total shareholders’ equity, excluding preferred stock, less goodwill and other intangible assets. We believe that this measure is important to many investors in the marketplace who are interested in changes from period to period in common shareholders’ equity exclusive of changes in intangible assets. Goodwill, an intangible asset that is recorded in a purchase business combination, has the effect of increasing both common equity and assets while not increasing our tangible common equity or tangible assets.

Tangible common equity ratio is defined as the ratio of tangible common equity divided by total assets less goodwill and other intangible assets. We believe that this measure is important to many investors in the marketplace who are interested in relative changes from period to period in common equity and total assets, each exclusive of changes in intangible assets. We believe that the most directly comparable GAAP financial measure is total shareholders’ equity to total assets.

Tangible book value per share is defined as book value, excluding the impact of goodwill and other intangible assets, if any, divided by shares of our common stock outstanding.

Total revenue is defined as the sum of net interest income before provision of loan losses and noninterest income.

Return on average common shareholders’ equity is defined as net income attributable to common shareholders divided by total average shareholders’ equity less average preferred stock, if any.

The information provided below presents a reconciliation of each of our non-GAAP financial measures to the most directly comparable GAAP financial measure.

	Years Ended December 31,				
	2018	2017	2016	2015	2014
Efficiency Ratio					
Noninterest expense	$35,633	$32,523	$29,544	$29,171	$25,812
Less: foreclosed real estate expenses	—	70	157	168	36
Less: Amortization of Intangibles	92	118	151	196	133
Less: merger and acquisition expenses	—	—	—	2	1,801
Adjusted noninterest expense (numerator)	$35,541	$32,335	$29,236	$28,805	$23,842
Net interest income	$56,326	$54,364	$49,092	$42,788	$31,660
Noninterest income	3,900	4,629	2,676	3,484	3,041
Adjustments for: gains/(losses) on sales of securities	222	165	(115)	—	—
Adjustments for: (losses) gains on sale of foreclosed real estate	—	(78)	128	—	—
Adjusted operating revenue (denominator)	$60,004	$58,906	$51,755	$46,272	$34,701
Efficiency ratio	59.2%	54.9%	56.5%	62.3%	68.7%
Tangible Common Equity and Tangible Common Equity/Tangible Assets					
Total shareholders’ equity	$174,196	$161,027	$145,895	$131,769	$129,210
Less: preferred stock	—	—	—	—	10,980
Common shareholders’ equity	174,196	161,027	145,895	131,769	118,230
Less: Intangible assets	2,879	2,971	3,090	3,241	3,437
Tangible Common shareholders’ equity	$171,317	$158,056	$142,805	$128,528	$114,793
Total assets	$1,873,665	$1,796,607	$1,628,919	$1,330,372	$1,099,531
Less: Intangible assets	2,879	2,971	3,090	3,241	3,437
Tangible assets	$1,870,786	$1,793,636	$1,625,829	$1,327,131	$1,096,094
Tangible common shareholders’ equity to tangible assets	9.16%	8.81%	8.78%	9.68%	10.47%
Tangible Book Value per Share					
Total shareholders’ equity	$174,196	$161,027	$145,895	$131,769	$129,210
Less: preferred stock	—	—	—	—	10,980
Common shareholders’ equity	174,196	161,027	145,895	131,769	118,230
Less: Intangible assets	2,879	2,971	3,090	3,241	3,437
Tangible common shareholders’ equity	$171,317	$158,056	$142,805	$128,528	$114,793
Common shares issued	7,842,271	7,751,424	7,620,663	7,516,291	7,185,482
Less: shares of unvested restricted stock	77,624	75,186	96,594	143,323	165,862
Common shares outstanding	7,764,647	7,676,238	7,524,069	7,372,968	7,019,620
Book value per share	$22.43	$20.98	$19.39	$17.87	$16.84
Less: effects of intangible assets	0.37	0.39	0.41	0.44	0.49
Tangible Book Value per Common Share	$22.06	$20.59	$18.98	$17.43	$16.35
Total Revenue					
Net Interest income	$56,326	$54,364	$49,092	$42,788	$31,660
Add: noninterest income	3,900	4,629	2,676	3,484	3,041
Total Revenue	$60,226	$58,993	$51,768	$46,272	$34,701
Noninterest income as a percentage of total revenue	6.48%	7.85%	5.17%	7.53%	8.76%
Return on Average Common Shareholders’ Equity					
	$17,433	$13,830	$12,350	$8,905	$4,458

Net Income Attributable to Common Shareholders					
Total average shareholders' equity	$171,024	$154,929	$138,131	$133,553	$97,921
Less: average preferred stock	—	—	—	—	10,980
Average Common Shareholders' Equity	171,024	154,929	138,131	133,553	86,941
Return on Average Common Shareholders' Equity	10.19 %	8.93 %	8.94 %	6.67 %	5.13 %

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This section presents management's perspective on our financial condition and results of operations. The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes contained elsewhere in this annual report. To the extent that this discussion describes prior performance, the descriptions relate only to the periods listed, which may not be indicative of future financial outcomes. In addition to historical information, this discussion contains forward looking statements that involve risks, uncertainties and assumptions that could cause results to differ materially from management's expectations. Factors that could cause such differences are discussed in the sections titled "Cautionary Note Regarding Forward-Looking Statements" and "Risk Factors". We assume no obligation to update any of these forward-looking statements.

General

Bankwell Financial Group, Inc. is a bank holding company headquartered in New Canaan, Connecticut. Through our wholly owned subsidiary, Bankwell Bank, we serve small and medium-sized businesses and retail customers in the New York metropolitan area and throughout Connecticut with the majority of our loans in Fairfield and New Haven Counties, Connecticut. We have a history of building long-term customer relationships and attracting new customers through what we believe is our strong customer service and our ability to deliver a diverse product offering.

The following discussion and analysis presents our results of operations and financial condition on a consolidated basis. However, because we conduct all of our material business operations through the Bank, the discussion and analysis relates to activities primarily conducted at the Bank.

We generate most of our revenue from interest on loans and investments and fee-based revenues. Our primary source of funding for our loans is deposits. Our largest expenses are interest on these deposits and salaries and related employee benefits. We measure our performance primarily through our net interest margin, efficiency ratio, ratio of allowance for loan losses to total loans, return on average assets and return on average equity, among other metrics, while maintaining appropriate regulatory leverage and risk-based capital ratios.

Executive Overview

We are focused on being the "Hometown" bank and the banking provider of choice in our attractive market area, and to serve as a locally based alternative to our larger competitors. We aim to do this through:

- Responsive, customer-centric products and services and a community focus;
- Strategic acquisitions;
- Utilization of efficient and scalable infrastructure; and
- Disciplined focus on risk management.

On August 19, 2015, the Company completed a private placement of $25.5 million in aggregate principal amount of fixed rate subordinated notes (the "Notes") to certain institutional investors. The Notes are non-callable for five years, have a stated maturity of August 15, 2025, and bear interest at a quarterly pay fixed rate of 5.75% per annum to the maturity date or the early redemption date, August 2020 and annually thereafter.

On November 20, 2015, the Company redeemed $10.98 million (10,980 shares) of preferred stock issued pursuant to the United States Department of Treasury ("Treasury") under the Small Business Lending Fund Program (the "SBLF"). The shares were redeemed at their liquidation value of $1,000 per share plus accrued dividends through November 20, 2015. The redemption was approved by the Company's primary federal regulator and was funded with the Company's surplus capital. With this redemption, the Company has redeemed all of its outstanding SBLF stock.

On January 31, 2018, the Company's Board of Directors declared a $0.12 per share cash dividend, payable March 8, 2018 to shareholders of record on February 26, 2018. On April 25, 2018 the Company's Board of Directors declared a $0.12 per share cash dividend, payable May 25, 2018 to shareholders of record on May 15, 2018. On July 26, 2018 the Company's Board of Directors declared a $0.12 per share cash dividend, payable August 27, 2018 to shareholders of record on August 17, 2018. On October 30, 2018 the Company's Board of Directors declared a $0.12 per share cash dividend, payable November 26, 2018 to shareholders of record on November 16, 2018.

On June 9, 2018, we opened three de novo branches located in Darien, Westport, and Stamford, Connecticut, increasing our total number of branches to twelve.

The primary measures we use to evaluate and manage our financial results are set forth in the table below. Although we believe these measures are meaningful in evaluating our results and financial condition, they may not be directly comparable to similar measures used by other financial services companies and may not provide an appropriate basis to compare our results or

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financial condition to the results or financial condition of our competitors. The following table sets forth the key financial measures we use to evaluate the success of our business and our financial position and operating performance.

Net income for the year ended December 31, 2017 was negatively impacted by the Tax Cuts and Jobs Act of 2017 as it relates to legislation that required a re-measurement of our deferred tax asset, which required a $3.3 million write-off recognized as a direct increase to income tax expense. As a result, the performance metrics presented below have been adversely impacted due to the decline in net income driven by this write-off.

Key Financial Measures

	Key Financial Measures[a] At or For the Years Ended December 31,		
	2018	2017	2016
	(Dollars in thousands, except per share data)		
Selected balance sheet measures:			
Total assets	$1,873,665	$1,796,607	$1,628,919
Gross portfolio loans	1,604,726	1,543,016	1,365,939
Deposits	1,502,244	1,398,405	1,289,037
FHLB borrowings	160,000	199,000	160,000
Subordinated debt	25,155	25,103	25,051
Total equity	174,196	161,027	145,895
Selected statement of income measures:			
Total revenue[c]	60,226	58,993	51,768
Net interest income before provision for loan losses	56,326	54,364	49,092
Income before income tax expense	21,153	25,129	18,310
Net income	17,433	13,830	12,350
Basic earnings per share	$2.23	$1.80	$1.64
Diluted earnings per share	$2.21	$1.78	$1.62

	Key Financial Measures[a] At or For the Years Ended December 31,		
	2018	2017	2016
Other financial measures and ratios:			
Return on average assets	0.94 %	0.80 %	0.85 %
Return on average common shareholders’ equity[c]	10.19 %	8.93 %	8.94 %
Net interest margin	3.18 %	3.30 %	3.54 %
Efficiency ratio[c]	59.2 %	54.9 %	56.5 %
Tangible book value per share (end of period)[c][d]	$22.06	$20.59	$18.98
Net charge-offs to average loans[b]	0.44 %	0.03 %	0.01 %
Nonperforming assets to total assets[e]	0.75 %	0.31 %	0.20 %
Allowance for loan losses to nonperforming loans	109.80 %	344.90 %	612.26 %
Allowance for loan losses to total loans[b]	0.96 %	1.23 %	1.32 %

(a) We have derived the selected balance sheet measures as of December 31, 2018 and 2017 and the selected statement of income measures for the years ended December 31, 2018, 2017 and 2016 from our audited consolidated financial statements included elsewhere in this annual report. Average balances have been computed using daily averages. Our historical results may not be indicative of our results for any future period.

(b) Calculated using the principal amounts outstanding on loans.

(c)

This measure is not a measure recognized under GAAP and is therefore considered to be a non-GAAP financial measure. See “Non-GAAP Financial Measures” for a description of this measure and a reconciliation of this measure to its most directly comparable GAAP measure.

(d) Excludes unvested restricted stock awards.

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(e) Nonperforming assets consist of nonperforming loans and other real estate owned.

Critical Accounting Policies and Estimates

The discussion and analysis of our results of operations and financial condition are based on our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires us to make significant estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from our current estimates, as a result of changing conditions and future events.

We believe that accounting estimates related to the initial measurement of the allowance for loan losses, stock-based compensation, derivative instrument valuation, investment securities valuation, evaluation of investment securities for other than temporary impairment and deferred income taxes valuation are particularly critical and susceptible to significant near-term change.

Allowance for Loan Losses

Determining an appropriate level of allowance for loan losses involves a high degree of judgment. We use a methodology to systematically measure the amount of estimated loan loss exposure inherent in the loan portfolio for purposes of establishing a sufficient allowance for loan losses. The methodology includes elements for specific reserves on impaired loans and loss allocations for non-impaired loans.

Loss allocations are identified for individual loans deemed to be impaired in accordance with GAAP. Impaired loans are loans for which it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreements, including non-accrual loans and all loans restructured in a troubled debt restructuring. Impaired loans do not include large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, which consist of most residential mortgage loans, commercial real estate, commercial loans and consumer loans. Impairment is measured on a discounted cash flow method based upon the loan's contractual effective interest rate, or at the loan's observable market price, or if the loan is collateral dependent, at the fair value of the collateral less costs to sell. For collateral dependent loans, management may adjust appraised values to reflect estimated market value declines or apply other discounts to appraised values for unobservable factors resulting from its knowledge of circumstances associated with the property.

Loss allocations for non-impaired loans are determined by portfolio segment and are based on the Bank's and peer banks' historical loss experiences over an economic cycle adjusted for qualitative factors. Qualitative factors include, but are not limited to, lending policies and procedures, nature and volume of the portfolio, concentrations of credit, lending management and staff, volume and severity of problem loans, quality of review and rating systems, value of underlying collateral, current economic conditions, and competitive and regulatory issues. We analyze historical loss experience over periods deemed to be relevant to the inherent risk of loss in loan portfolios as of the balance sheet date. During 2017, we updated our allowance methodology and underlying loan loss assumptions, incorporating recent industry and product loss trends. This resulted in a non-recurring pretax $1.3 million reduction in the allowance and increase in earnings.

Loss allocations for non-impaired loans are based on an internal rating system and the application of loss allocation factors. The loan rating system is described under the caption "Credit quality indicators" in Note 5 of the Notes to Consolidated Financial Statements. The loan rating system and the related loss allocation factors take into consideration parameters including the borrower's financial condition, the borrower's performance with respect to loan terms, and the adequacy of collateral. The loss allocation factors also take into account general and regional economic statistics, trends, and portfolio characteristics such as age of portfolio and the Bank's experience with a particular loan product. We periodically reassess and adjust the loss allocation factors used in the assignment of loss factors that we believe are not adequately presented in historical loss experience including trends in real estate values, changes in unemployment levels and increases in delinquency levels to appropriately reflect our analysis of migratory loss experience.

Because the methodology is partly based upon peer bank data and trends, current economic data as well as management's judgment, factors may arise that result in different estimations. Adversely different conditions or assumptions could lead to increases in the allowance. In addition, various regulatory agencies periodically review the allowance for loans losses. Such agencies may require additions to the allowance based on their judgments about information available to them at the time of their examination. As of December 31, 2018, management believes that the allowance is adequate and consistent with asset quality and delinquency indicators.

Stock-based Compensation

The Company measures and recognizes compensation cost relating to share-based payment transactions based on the grant-date fair value of the equity instruments issued. The fair value of time-based restricted stock is recorded based on the grant date fair value of the Company's common stock. The fair value of market-based restricted stock is based on values derived using a Monte Carlo based pricing model. The fair value of stock options is determined using the Black-Scholes Option Pricing model. Stock-based compensation costs are recognized over the requisite service period for the awards. Compensation expense reflects the number of awards expected to vest and is adjusted based on awards that ultimately vest.

Derivative Instrument Valuation

The Company enters into interest rate swap agreements as part of the Company's interest rate risk management strategy. Management applies the hedge accounting provisions of Accounting Standards Codification ("ASC") Topic 815, and formally documents at inception all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking the various hedges. Additionally, the Company assesses whether the derivative used in its hedging transaction is expected to be and has been highly effective in offsetting changes in the fair value or cash flows of the hedged item. The Company discontinues hedge accounting when it is determined that a derivative is not expected to be or has ceased to be highly effective as a hedge, and then reflects changes in fair value of the derivative in earnings after termination of the hedge relationship.

The Company has characterized all of its interest rate swaps that qualify under ASC Topic 815 hedge accounting as cash flow hedges. Cash flow hedges are used to minimize the variability in cash flows of assets or liabilities, or forecasted transactions caused by interest rate fluctuations, and are recorded at fair value in other assets within the consolidated balance sheet. Changes in the fair value of these cash flow hedges are initially recorded in accumulated other comprehensive income and subsequently reclassified into earnings when the forecasted transaction affects earnings.

Investment Securities Valuation

Fair values of the Company's investment securities are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The Company's private placement municipal housing authority bonds, classified as held to maturity, have no available quoted market price. The fair value for these securities is estimated using a discounted cash flow model. Due to the judgments and uncertainties involved in the estimation process, the estimates could result in materially different results under different assumptions and conditions.

Evaluation of Investment Securities for Other Than Temporary Impairment

The Company evaluates investment securities within the Company's available for sale and held to maturity portfolios for other-than-temporary impairment ("OTTI"), at least quarterly. If the fair value of a debt security is below the amortized cost basis of the security, OTTI is required to be recognized if any of the following are met: (1) the Company intends to sell the security; (2) it is "more likely than not" that the Company will be required to sell the security before recovery of its amortized cost basis; or (3) for debt securities, the present value of expected cash flows is not sufficient to recover the entire amortized cost basis. For all impaired debt securities that are intended for sale, or more likely than not will be required to sell, the full amount of the loss is recognized as OTTI through earnings. Credit related OTTI for all other impaired debt securities is recognized through earnings. Non-credit related OTTI for such debt securities is recognized in other comprehensive income, net of applicable taxes. Should actual factors and conditions differ materially from those expected by management, the actual realization of gains or losses on investment securities could differ materially from the amounts recorded in the financial statements.

Deferred Income Taxes

In accordance with ASC Topic 740, "Income Taxes," certain aspects of accounting for income taxes require significant management judgment, including assessing the realizability of Deferred Tax Assets (DTAs). Such judgments are subjective and involve estimates and assumptions about matters that are inherently uncertain. Should actual factors and conditions differ materially from those used by management, the actual realization of DTAs could differ materially from the amounts recorded in the Consolidated Financial Statements and the accompanying Notes thereto.

DTAs generally represent items for which a benefit has been recognized for financial accounting purposes that cannot be realized for tax purposes until a future period. The realization of DTAs depends upon future sources of taxable income. Valuation allowances are established for those DTAs determined not likely to be realized based on management's judgment.

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Emerging Growth Company

The JOBS Act permits us, as an “emerging growth company”, to take advantage of an extended transition period to comply with new or revised accounting standards and not commence complying with new or revised accounting standards until private companies must do so. Under the JOBS Act, we may make an irrevocable election to “opt out” of that extended transition period and comply with new or revised accounting standards when public companies that are not emerging growth companies must commence complying with those standards. We have elected to “opt out” of the extended transition period.

Earnings Overview

2018 Earnings Overview

Our net income for the year ended December 31, 2018 was $17.4 million, an increase of $3.6 million, or 26.1%, compared to the year ended December 31, 2017. Net income available to common shareholders for the year ended December 31, 2018 was $17.4 million, or $2.21 per diluted share, compared to net income available to common shareholders of $13.8 million, or $1.78 per diluted share for the year ended December 31, 2017. Our returns on average shareholders' equity and average assets for the year ended December 31, 2018, were 10.19% and 0.94%, respectively, compared to 8.93% and 0.80%, respectively for the year ended December 31, 2017.

The increase in net income for 2018 compared to 2017 was primarily a result of higher net interest income and income tax expense savings resulting from the tax law change enacted in 2017. Net interest income for the year ended December 31, 2018 was $56.3 million, an increase of $2.0 million compared to the year ended December 31, 2017. Our net interest margin decreased 12 basis points to 3.18% for the year ended December 31, 2018 compared to the year ended December 31, 2017 reflecting higher rates on interest bearing deposits driven by rate increases in our competitive marketplace.

Our efficiency ratio was 59.2% for the year ended December 31, 2018 compared to 54.9% for the year ended December 31, 2017. The increase in the efficiency ratio was driven by slower growth in net interest income and an increase in noninterest expense associated with the opening of three new branches during the second quarter of 2018, as well as a number of non-recurring expenses recognized in the first quarter of 2018 that caused our efficiency ratio to temporarily jump to 62.0%.

2017 Earnings Overview

Our net income for the year ended December 31, 2017 was $13.8 million, an increase of $1.5 million, or 12.0%, compared to the year ended December 31, 2016. Net income available to common shareholders for the year ended December 31, 2017, was $13.8 million, or $1.78 per diluted share, compared to net income available to common shareholders of $12.4 million, or $1.62 per diluted share, for the year ended December 31, 2016. Our returns on average shareholders' equity and average assets for the year ended December 31, 2017, were 8.93% and 0.80%, respectively, compared to 8.94% and 0.85%, respectively for the year ended December 31, 2016. The decrease in returns was entirely attributable to the write-off of the deferred tax asset at year-end 2017 due to the Tax Cuts and Jobs Act of 2017.

The increase in net income for 2017 compared to 2016 was primarily due to an increase of interest and fees on loans as a result of strong organic loan growth. This increase was partially offset by the $3.3 million write-off of the deferred tax asset as a result of the legislation enacted as part of the Tax Cuts and Jobs Act of 2017. Net interest income for the year ended December 31, 2017 was $54.4 million, an increase of $5.3 million compared to the year ended December 31, 2016. Our net interest margin decreased 24 basis points to 3.30% for the year ended December 31, 2017 compared to the year ended December 31, 2016 reflecting an increase in rates on interest bearing deposits driven by promotional rate increases to remain competitive in the market place and to attract additional deposits.

Our efficiency ratio was 54.9% for the year ended December 31, 2017 compared to 56.5% for the year ended December 31, 2016. The improvement in our efficiency ratio was attributable to our focus on expense control and achieving economies of scale.

Results of Operations

Net Interest Income

Net interest income is the difference between interest earned on loans and securities and interest paid on deposits and other borrowings, and is the primary source of our operating income. Net interest income is affected by the level of interest rates, changes in interest rates and changes in the amount and composition of interest-earning assets and interest-bearing liabilities. Included in interest income are certain loan fees, such as deferred origination fees and late charges. We convert tax-exempt income to a FTE basis using the statutory federal income tax rate adjusted for applicable state income taxes net of the related federal tax benefit. The average balances are principally daily averages. Interest income on loans includes the effect of deferred loan fees and costs accounted for as yield adjustments. Premium amortization and discount accretion are included in the respective interest income and interest expense amounts.

Year ended December 31, 2018 compared to year ended December 31, 2017

FTE net interest income for the years ended December 31, 2018 and 2017 was $56.6 million and $55.0 million, respectively. Net interest income increased due to higher yields and an increase in earning assets offset by higher rates and volume on interest bearing deposits.

FTE basis interest income for the year ended December 31, 2018 increased by $8.5 million to $80.3 million, or 12%, compared to FTE basis interest income for the year ended December 31, 2017 due primarily to growth in higher yielding interest earning assets, specifically, loan growth and yield increases in our commercial real estate and commercial business portfolios. Average interest earning assets were $1.8 billion for the year ended December 31, 2018, increasing by $115.5 million, or 7%, from the year ended December 31, 2017. The average balance of total loans increased $112.6 million, or 8%, contributing $7.9 million to the increase in interest income. The total average balance of securities for the year ended December 31, 2018 increased by $9.5 million, or 9%, from the year ended December 31, 2017. The total yield in earnings assets increased to 4.45% at December 31, 2018, compared to 4.25% at December 31, 2017. The increase in yield was primarily driven by an increase in rates on loans and an increase in income earned resulting from loan prepayments.

Interest expense for the year ended December 31, 2018, increased by $6.9 million, or 41%, compared to interest expense for 2017 due to an increase in volume and increases in rates on interest bearing deposits driven by rate increases in our competitive marketplace. The weighted average cost of deposits increased 41 basis points to 1.47% due to an increase in market rates and our desire to attract additional deposits. The weighted average cost of borrowed money increased by 11 basis points to 2.21%. Average interest bearing liabilities for the year ended December 31, 2018 increased by $106.9 million, or 8%, from the year ended December 31, 2017, primarily due to higher average balances in money market and savings accounts.

Year ended December 31, 2017 compared to year ended December 31, 2016

FTE net interest income for the years ended December 31, 2017 and 2016 was $55.0 million and $49.7 million, respectively. Net interest income increased due to increases in earning assets offset by higher rates and volume on interest bearing deposits driven by our continued earning asset growth.

FTE basis interest income for the year ended December 31, 2017 increased by $10.2 million to $71.8 million, or 17%, compared to FTE basis interest income for the year ended December 31, 2016 due primarily to growth in interest earning assets, specifically, loan growth in our commercial real estate and commercial business portfolios. Average interest earning assets were $1.7 billion for the year ended December 31, 2017 up by $263.2 million, or 19%, from the year ended December 31, 2016. The average balance of total loans increased $209.8 million, or 17%, contributing $8.8 million to the increase in interest income. The total average balance of securities for the year ended December 31, 2017 increased by $8.9 million, or 9%, from the year ended December 31, 2016. The total yield in earnings assets decreased to 4.25% at December 31, 2017 compared to 4.31% at December 31, 2016. The decrease in yield was primarily driven by a decrease in yields on commercial real estate loans and commercial business loans.

Interest expense for the year ended December 31, 2017 increased by $4.9 million, or 42%, compared to interest expense for 2016 due to an increase in volume and increases in rates on interest bearing deposits driven by promotional rate increases to remain competitive in the market place. The weighted average cost of deposits increased 20 basis points to 1.06% due to an increase in market rates and our desire to attract additional deposits. The weighted average cost of borrowed money decreased by 9 basis points to 2.10%. Average interest bearing liabilities for the year ended December 31, 2017 increased by $258.8 million, or 23%, from the year ended December 31, 2016, primarily due to higher average balances in time deposits, money market accounts and borrowed money.

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Distribution of Assets, Liabilities and Stockholders’ Equity; Interest Rates and Interest Differential

The following table below presents the average balances and yields earned on interest-earning assets and average balances and weighted average rates paid on our funding liabilities for the years ended December 31, 2018, 2017 and 2016.

	Years Ended December 31,								
	2018			2017			2016		
	Average Balance	Interest	Yield/ Rate(5)	Average Balance	Interest	Yield/ Rate(5)	Average Balance	Interest	Yield/ Rate(5)
	(Dollars in thousands)								
Assets:									
Cash and fed funds sold	$77,923	$1,428	1.84 %	$85,308	$790	0.93 %	$41,838	$173	0.41 %
Securities(1)	118,311	3,686	3.12	108,775	3,830	3.52	99,905	3,046	3.05
Loans:									
Commercial real estate	1,014,255	47,967	4.66	907,223	41,638	4.53	772,890	36,572	4.65
Residential real estate	189,121	7,016	3.71	194,344	6,983	3.51	194,047	7,031	3.62
Construction(2)	90,773	4,667	5.07	107,752	5,195	4.75	100,611	4,602	4.50
Commercial business	282,425	15,037	5.25	253,868	12,981	5.04	185,523	9,791	5.19
Consumer	481	28	5.88	1,227	44	3.62	1,560	81	5.17
Total loans	1,577,055	74,715	4.67	1,464,414	66,841	4.50	1,254,631	58,077	4.55
Federal Home Loan Bank stock	9,177	517	5.63	8,486	337	3.97	7,366	255	3.46
Total earning assets	1,782,466	$80,346	4.45 %	1,666,983	$71,798	4.25 %	1,403,740	$61,551	4.31 %
Other assets	68,002			60,904			54,580		
Total assets	$1,850,468			$1,727,887			$1,458,320		
Liabilities and shareholders’ equity:									
Interest -bearing liabilities:									
NOW	$60,410	$157	0.26 %	$57,712	$93	0.16 %	$56,123	$109	0.19 %
Money market	482,886	6,431	1.33	404,848	3,427	0.85	317,210	1,836	0.58
Savings	124,214	1,649	1.33	102,915	763	0.74	72,800	315	0.43
Time	619,448	10,714	1.73	633,260	8,411	1.33	524,237	6,040	1.15
Total interest-bearing deposits	1,286,958	18,951	1.47	1,198,735	12,694	1.06	970,370	8,300	0.86
Borrowed money	213,546	4,787	2.21	194,875	4,143	2.10	164,450	3,598	2.19
Total interest-bearing liabilities	1,500,504	$23,738	1.58 %	1,393,610	$16,837	1.21 %	1,134,820	$11,898	1.05 %
Noninterest-bearing deposits	166,566			169,250			172,098		
Other liabilities	12,374			10,098			13,271		
Total liabilities	1,679,444			1,572,958			1,320,189		
Shareholders’ equity	171,024			154,929			138,131		
Total liabilities and shareholders’ equity	$1,850,468			$1,727,887			$1,458,320		
Net interest income(3)		$56,608			$54,961			$49,653	
Interest rate spread			2.87 %			3.04 %			3.26 %
Net interest margin(4)			3.18 %			3.30 %			3.54 %

(1) Average balances and yields for securities are based on amortized cost.

(2) Includes commercial and residential real estate construction loans.

(3) The adjustment for securities and loans taxable equivalency was $282 thousand, $597 thousand and $561 thousand, respectively, for the years ended December 31, 2018, 2017 and 2016. Tax exempt income was converted to a fully

taxable equivalent basis at a 20 percent tax rate for 2018 and a 30 percent tax rate for 2017 and 2016.
(4) Net interest income as a percentage of total earning assets.
(5) Yields are calculated using the contractual day count convention for each respective product type.

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Effect of changes in interest rates and volume of average earning assets and average interest-bearing liabilities

The following table shows the extent to which changes in interest rates and changes in the volume of average earning assets and average interest-bearing liabilities have affected net interest income. For each category of earning assets and interest-bearing liabilities, information is provided relating to: changes in volume (changes in average balances multiplied by the prior year's average interest rates); changes in rates (changes in average interest rates multiplied by the prior year's average balances); and the total change. Changes attributable to both volume and rate have been allocated proportionately based on the relationship of the absolute dollar amount of change in each.

	Year Ended December 31, 2018 vs 2017 Increase (Decrease)			Year Ended December 31, 2017 vs 2016 Increase (Decrease)		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest and dividend income:						
Cash and fed funds sold	$(74)	$712	$638	$281	$336	$617
Securities	319	(463)	(144)	286	498	784
Loans:						
Commercial real estate	5,031	1,298	6,329	6,206	(1,140)	5,066
Residential real estate	(190)	223	33	4	(52)	(48)
Construction	(857)	329	(528)	337	256	593
Commercial business	1,504	552	2,056	3,513	(323)	3,190
Consumer	(35)	19	(16)	(15)	(22)	(37)
Total loans	5,453	2,421	7,874	10,045	(1,281)	8,764
Federal Home Loan Bank stock	29	151	180	42	40	82
Total change in interest and dividend income	$5,727	$2,821	$8,548	$10,654	$(407)	$10,247
Interest expense:						
Deposits:						
NOW	$5	$59	$64	$3	$(19)	$(16)
Money market	756	2,248	3,004	594	997	1,591
Savings	184	702	886	164	284	448
Time	(187)	2,490	2,303	1,366	1,005	2,371
Total deposits	758	5,499	6,257	2,127	2,267	4,394
Borrowed money	411	233	644	654	(109)	545
Total change in interest expense	1,169	5,732	6,901	2,781	2,158	4,939
Change in net interest income	$4,558	$(2,911)	$1,647	$7,873	$(2,565)	$5,308

Provision for Loan Losses

The provision for loan losses is based on management's periodic assessment of the adequacy of our allowance for loan losses which, in turn, is based on such interrelated factors as the composition of our loan portfolio and its inherent risk characteristics, the level of nonperforming loans and net charge-offs, both current and historic, local economic and credit conditions, the direction of real estate values, and regulatory guidelines. The provision for loan losses is charged against earnings in order to maintain our allowance for loan losses and reflects management's best estimate of probable losses inherent in our loan portfolio at the balance sheet date.

The provision for loan losses for the year ended December 31, 2018 was $3.4 million compared to a $1.3 million provision for loan losses for the year ended December 31, 2017. The increase in the provision for loan losses is attributable to a $6.2 million charge-off related to one lending relationship recognized in the fourth quarter of 2018, offset by a reduction in reserve rates driven by improving historical loss trends.

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Noninterest Income

Noninterest income is a component of our revenue and is comprised primarily of fees generated from loan and deposit relationships with our customers, fees generated from sales and referrals of loans, income earned on bank-owned life insurance and gains on sales of investment securities. The following table compares noninterest income for the years ended December 31, 2018, 2017 and 2016.

	Years Ended December 31,			2018/2017 Change			2017/2016 Change		
	2018	2017	2016	$	%		$	%	
	(Dollars in thousands)								
Service charges and fees	$1,090	$1,007	$963	$83	8	%	$44	5	%
Bank owned life insurance	1,057	1,170	693	(113)	(10)		477	69	
Gains and fees from sales of loans	984	1,427	466						