

OHIO VALLEY BANC CORP  
Form 10-Q  
November 09, 2018

United States  
Securities and Exchange Commission  
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-20914

OHIO VALLEY BANC CORP.  
(Exact name of registrant as specified in its charter)

Ohio 31-1359191  
(State of Incorporation) (I.R.S. Employer Identification No.)

420 Third Avenue  
Gallipolis, Ohio 45631  
(Address of principal executive offices) (ZIP Code)

(740) 446-2631  
(Issuer's telephone number, including area code)

\_\_\_\_\_

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

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. (Check one):

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

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.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes No

The number of common shares of the registrant outstanding as of November 9, 2018 was 4,733,120.

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OHIO VALLEY BANC CORP.

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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

OHIO VALLEY BANC CORP.  
CONSOLIDATED BALANCE SHEETS (UNAUDITED)  
(dollars in thousands, except share and per share data)

|  | September<br>30,<br>2018 | December<br>31,<br>2017 |
|--|--------------------------|-------------------------|
| <b>ASSETS</b>  |                          |                         |
| Cash and noninterest-bearing deposits with banks   | \$ 11,349                | \$ 12,664               |
| Interest-bearing deposits with banks   | 53,770                   | 61,909                  |
| Total cash and cash equivalents  | 65,119                   | 74,573                  |
| Certificates of deposit in financial institutions  | 2,310                    | 1,820                   |
| Securities available for sale  | 104,877                  | 101,125                 |
| Securities held to maturity (estimated fair value: 2018 - \$17,538; 2017 - \$18,079)   | 17,219                   | 17,581                  |
| Restricted investments in bank stocks  | 7,506                    | 7,506                   |
| Total loans  | 782,377                  | 769,319                 |
| Less: Allowance for loan losses  | (8,315 )                 | (7,499 )                |
| Net loans  | 774,062                  | 761,820                 |
| Premises and equipment, net  | 13,856                   | 13,281                  |
| Other real estate owned, net   | 1,332                    | 1,574                   |
| Accrued interest receivable  | 2,862                    | 2,503                   |
| Goodwill   | 7,371                    | 7,371                   |
| Other intangible assets, net   | 410                      | 514                     |
| Bank owned life insurance and annuity assets   | 29,198                   | 28,675                  |
| Other assets   | 7,394                    | 7,947                   |
| Total assets   | \$ 1,033,516             | \$ 1,026,290            |
| <b>LIABILITIES</b>   |                          |                         |
| Noninterest-bearing deposits   | \$ 232,575               | \$ 253,655              |
| Interest-bearing deposits  | 620,320                  | 603,069                 |
| Total deposits   | 852,895                  | 856,724                 |
| Other borrowed funds   | 40,514                   | 35,949                  |
| Subordinated debentures  | 8,500                    | 8,500                   |
| Accrued liabilities  | 17,768                   | 15,756                  |
| Total liabilities  | 919,677                  | 916,929                 |
| COMMITMENTS AND CONTINGENT LIABILITIES (See Note 5)  | ----                     | ----                    |
| <b>SHAREHOLDERS' EQUITY</b>  |                          |                         |
| Common stock (\$1.00 stated value per share, 10,000,000 shares authorized; 2018 - 5,392,859 shares issued; 2017 - 5,362,005 shares issued) | 5,393                    | 5,362                   |
| Additional paid-in capital   | 49,208                   | 47,895                  |

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|  |             |             |
|--|-------------|-------------|
| Retained earnings                          | 77,982      | 72,694      |
| Accumulated other comprehensive loss       | (3,032 )    | (878 )      |
| Treasury stock, at cost (659,739 shares)   | (15,712 )   | (15,712 )   |
| Total shareholders' equity                 | 113,839     | 109,361     |
| Total liabilities and shareholders' equity | \$1,033,516 | \$1,026,290 |

See accompanying notes to consolidated financial statements

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OHIO VALLEY BANC CORP.  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(dollars in thousands, except per share data)

|  | Three months<br>ended<br>September 30, |          | Nine months<br>ended<br>September 30, |          |
|--|--|----------|---------------------------------------|----------|
|  | 2018                                   | 2017     | 2018                                  | 2017     |
| Interest and dividend income:                            |  |          |                                       |          |
| Loans, including fees                                    | \$11,118                               | \$10,489 | \$33,134                              | \$31,410 |
| Securities   |  |          |                                       |          |
| Taxable  | 583                                    | 535      | 1,739                                 | 1,559    |
| Tax exempt   | 93                                     | 104      | 280                                   | 312      |
| Dividends  | 112                                    | 101      | 328                                   | 287      |
| Interest-bearing deposits with banks                     | 265                                    | 81       | 1,321                                 | 459      |
| Other Interest   | 10                                     | 7        | 26                                    | 17       |
|  | 12,181                                 | 11,317   | 36,828                                | 34,044   |
| Interest expense:  |  |          |                                       |          |
| Deposits   | 1,081                                  | 757      | 2,934                                 | 1,985    |
| Other borrowed funds                                     | 250                                    | 228      | 740                                   | 673      |
| Subordinated debentures                                  | 87                                     | 64       | 241                                   | 182      |
|  | 1,418                                  | 1,049    | 3,915                                 | 2,840    |
| Net interest income                                      | 10,763                                 | 10,268   | 32,913                                | 31,204   |
| Provision for loan losses                                | 962                                    | 1,601    | 1,695                                 | 1,921    |
| Net interest income after provision for loan losses      | 9,801                                  | 8,667    | 31,218                                | 29,283   |
| Noninterest income:                                      |  |          |                                       |          |
| Service charges on deposit accounts                      | 534                                    | 541      | 1,551                                 | 1,575    |
| Trust fees   | 69                                     | 64       | 197                                   | 177      |
| Income from bank owned life insurance and annuity assets | 173                                    | 577      | 522                                   | 981      |
| Mortgage banking income                                  | 93                                     | 59       | 225                                   | 164      |
| Electronic refund check / deposit fees                   | 33                                     | ----     | 1,566                                 | 1,667    |
| Debit / credit card interchange income                   | 943                                    | 863      | 2,736                                 | 2,506    |
| Gain (loss) on other real estate owned                   | (82 )                                  | (23 )    | 75                                    | (94 )    |
| Other  | 164                                    | 201      | 669                                   | 531      |
|  | 1,927                                  | 2,282    | 7,541                                 | 7,507    |
| Noninterest expense:                                     |  |          |                                       |          |
| Salaries and employee benefits                           | 5,537                                  | 5,019    | 16,780                                | 15,528   |
| Occupancy  | 469                                    | 449      | 1,336                                 | 1,331    |
| Furniture and equipment                                  | 263                                    | 269      | 775                                   | 787      |
| Professional fees  | 514                                    | 434      | 1,537                                 | 1,338    |
| Marketing expense  | 263                                    | 273      | 787                                   | 785      |
| FDIC insurance   | 110                                    | 99       | 368                                   | 366      |
| Data processing  | 759                                    | 564      | 2,180                                 | 1,652    |
| Software   | 398                                    | 365      | 1,160                                 | 1,102    |
| Foreclosed assets  | 54                                     | 158      | 164                                   | 425      |
| Amortization of intangibles                              | 33                                     | 38       | 105                                   | 120      |
| Other  | 1,361                                  | 1,554    | 4,051                                 | 5,039    |

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|                            |         |         |         |         |
|----------------------------|---------|---------|---------|---------|
|                            | 9,761   | 9,222   | 29,243  | 28,473  |
| Income before income taxes | 1,967   | 1,727   | 9,516   | 8,317   |
| Provision for income taxes | 221     | 74      | 1,428   | 1,706   |
| NET INCOME                 | \$1,746 | \$1,653 | \$8,088 | \$6,611 |
| Earnings per share         | \$.37   | \$.35   | \$1.71  | \$1.41  |
| Dividends per share        | \$ .21  | \$ .21  | \$.63   | \$.63   |

See accompanying notes to consolidated financial statements

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OHIO VALLEY BANC CORP.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)  
(dollars in thousands)

|  | Three months<br>ended<br>September 30,<br>2018 |         | Nine months<br>ended<br>September 30,<br>2018 |         |
|--|--|---------|---|---------|
|  | 2018   | 2017    | 2018  | 2017    |
| Net Income   | \$1,746  | \$1,653 | \$8,088                                       | \$6,611 |
| Other comprehensive income:                                |  |         |   |         |
| Change in unrealized loss on available for sale securities | (534 )   | 20      | (2,508)                                       | 1,485   |
| Related tax expense  | 112  | (7 )    | 527   | (505 )  |
| Total other comprehensive income (loss), net of tax        | (422 )   | 13      | (1,981)                                       | 980     |
| Total comprehensive income                                 | \$1,324  | \$1,666 | \$6,107                                       | \$7,591 |

See accompanying notes to consolidated financial statements

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OHIO VALLEY BANC CORP.  
 CONDENSED CONSOLIDATED STATEMENTS OF  
 CASH FLOWS (UNAUDITED)  
 (dollars in thousands)

|   | Nine months ended<br>September 30, |          |
|---|------------------------------------|----------|
|   | 2018                               | 2017     |
| Net cash provided by operating activities:                                    | \$13,239                           | \$5,926  |
| Investing activities:   |                                    |          |
| Proceeds from maturities of securities available for sale                     | 17,324                             | 16,358   |
| Purchases of securities available for sale                                    | (23,756)                           | (25,177) |
| Proceeds from maturities of securities held to maturity                       | 321                                | 846      |
| Purchases of securities held to maturity                                      | ----                               | (389 )   |
| Proceeds from maturities of certificates of deposit in financial institutions | ----                               | 245      |
| Purchases of certificates of deposit in financial institutions                | (490 )                             | (395 )   |
| Net change in loans   | (14,349)                           | (46,281) |
| Proceeds from sale of other real estate owned                                 | 810                                | 987      |
| Purchases of premises and equipment   | (1,437 )                           | (1,247 ) |
| Proceeds from bank owned life insurance                                       | ----                               | 3,754    |
| Net cash used in investing activities   | (21,577)                           | (51,299) |
| Financing activities:   |                                    |          |
| Change in deposits  | (3,758 )                           | 58,867   |
| Proceeds from common stock through dividend reinvestment                      | 1,049                              | ----     |
| Cash dividends  | (2,973 )                           | (2,947 ) |
| Proceeds from Federal Home Loan Bank borrowings                               | 8,000                              | 4,785    |
| Repayment of Federal Home Loan Bank borrowings                                | (2,487 )                           | (4,720 ) |
| Change in other long-term borrowings  | (862 )                             | (343 )   |
| Change in other short-term borrowings   | (85 )                              | (33 )    |
| Net cash provided by financing activities                                     | (1,116 )                           | 55,609   |
| Change in cash and cash equivalents   | (9,454 )                           | 10,236   |
| Cash and cash equivalents at beginning of period                              | 74,573                             | 40,166   |
| Cash and cash equivalents at end of period                                    | \$65,119                           | \$50,402 |
| Supplemental disclosure:  |                                    |          |
| Cash paid for interest  | \$3,580                            | \$2,665  |
| Cash paid for income taxes  | 1,750                              | 2,236    |
| Transfers from loans to other real estate owned                               | 494                                | 1,337    |
| Other real estate owned sales financed by The Ohio Valley Bank Company        | ----                               | 167      |

See accompanying notes to consolidated financial statements

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data)

NOTE 1- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**BASIS OF PRESENTATION:** The accompanying consolidated financial statements include the accounts of Ohio Valley Banc Corp. ("Ohio Valley") and its wholly-owned subsidiaries, The Ohio Valley Bank Company (the "Bank"), Loan Central, Inc. ("Loan Central"), a consumer finance company, Ohio Valley Financial Services Agency, LLC ("Ohio Valley Financial Services"), an insurance agency, and OVBC Captive, Inc. (the "Captive"), a limited purpose property and casualty insurance company. The Bank has one wholly-owned subsidiary, Ohio Valley REO, LLC ("Ohio Valley REO"), an Ohio limited liability company, to which the Bank transfers certain real estate acquired by the Bank through foreclosure for sale by Ohio Valley REO. Ohio Valley and its subsidiaries are collectively referred to as the "Company". All material intercompany accounts and transactions have been eliminated in consolidation. These interim financial statements are prepared by the Company without audit and reflect all adjustments of a normal recurring nature which, in the opinion of management, are necessary to present fairly the consolidated financial position of the Company at September 30, 2018, and its results of operations and cash flows for the periods presented. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the operating results to be anticipated for the full fiscal year ending December 31, 2018. The accompanying consolidated financial statements do not purport to contain all the necessary financial disclosures required by U.S. generally accepted accounting principles ("US GAAP") that might otherwise be necessary in the circumstances. The Annual Report of the Company for the year ended December 31, 2017 contains consolidated financial statements and related notes which should be read in conjunction with the accompanying consolidated financial statements. The consolidated financial statements for 2017 have been reclassified to conform to the presentation for 2018. These reclassifications had no effect on the net income or shareholders' equity.

**USE OF ESTIMATES IN THE PREPARATION OF FINANCIAL STATEMENTS:** The accounting and reporting policies followed by the Company conform to US GAAP established by the Financial Accounting Standards Board ("FASB"). The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

**INDUSTRY SEGMENT INFORMATION:** Internal financial information is primarily reported and aggregated in two lines of business, banking and consumer finance.

**EARNINGS PER SHARE:** Earnings per share are computed based on net income divided by the weighted average number of common shares outstanding during the period. The weighted average common shares outstanding were 4,730,624 and 4,688,284 for the three months ended September 30, 2018 and 2017, respectively. The weighted average common shares outstanding were 4,722,189 and 4,680,846 for the nine months ended September 30, 2018 and 2017, respectively. Ohio Valley had no dilutive effect and no potential common shares issuable under stock options or other agreements for any period presented.

**ADOPTION OF NEW ACCOUNTING STANDARD UPDATES ("ASU"):** In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, which was then adopted by the Company as of January 1, 2018 and all subsequent amendments to the ASU (collectively, "ASC 606"). ASC 606 (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as other real estate owned. The guidance establishes a five-step model which entities must follow to recognize revenue and removes inconsistencies and weaknesses in existing guidance. Additional disclosures providing information about contracts with customers are required. Adoption did not have a material impact on the Company's results of operations or financial position. The Company adopted ASC 606 using the modified retrospective transition method. As of December 31, 2017, the

Company had no uncompleted customer contracts and as a result, no cumulative transition adjustment was posted to the Company's accumulated deficit during 2018.

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## NOTE 1- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In January 2016, the FASB issued ASU No. 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities". The update provided updated accounting and reporting requirements for both public and non-public entities effective for interim and annual periods beginning after December 15, 2017, using a cumulative-effect adjustment to the balance sheet as of the beginning of the year of adoption. The most significant provisions that impacted the Company were: 1) measurement of equity securities at fair value, with the changes in fair value recognized in the income statement; 2) elimination of the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments at amortized cost on the balance sheet; 3) utilization of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and 4) requirement of separate presentation of both financial assets and liabilities by measurement category and form of financial asset on the balance sheet or accompanying notes to the financial statements. The Company adopted ASU No. 2016-01 effective January 1, 2018 and determined the impact to be not material to the Company's financial statements. The amendments did change the method utilized to disclose the fair value of the loan portfolio to reflect an exit price notion as opposed to an entry price. For additional information on fair value of assets and liabilities, see Note 2.

In August 2016, FASB issued an update (ASU 2016-15, "Statement of Cash Flows") (Topic 230), which addressed eight specific cash flow issues with the objective of reducing the existing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in this update applied to all entities, including business entities and not-for-profit entities that were required to present a statement of cash flows, and were effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company adopted ASU 2016-15 effective January 1, 2018, which had no impact to the consolidated financial statements and related disclosures.

In February 2018, the FASB issued ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income". The purpose of this Update is to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act that was enacted on December 22, 2017. The Update is effective for public business entities for annual periods beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company elected to early adopt this accounting guidance effective April 1, 2018. This resulted in the reclassification of \$173 in stranded tax effects from accumulated other comprehensive income to retained earnings within the June 30, 2018 Form 10-Q.

#### Revenue Recognition

ASU No. 2014-09, "Revenue from Contracts with Customers" ASC 606 provides that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance enumerates five steps that entities should follow in achieving this core principle. Revenue generated from financial instruments, such as interest and dividends on loans and investment securities, are not included in the scope of ASC 606. The adoption of ASC 606 did not result in a change to the accounting for any of the Company's revenue streams that are within the scope of the amendments. The Company's services that fall within the scope of ASC 606 are recognized as revenue as the Company satisfies its obligation to the customer. All of the Company's revenue from contracts with customers within the scope of ASC 606 are presented in the Company's consolidated statements of income as components of non-interest income. The list below describes the specific revenue stream under ASC 606, which corresponds directly to the line item within the statement of income in which it is being included:

- Service charges on deposit accounts – these include general service fees charged for deposit account maintenance and activity and transaction-based fees charged for certain services, such as debit card, wire transfer, or overdraft

activities. Revenue is recognized when the performance obligation is completed, which is generally after a transaction is completed or monthly for account maintenance services.

· Trust fees - this includes periodic fees due from trust customers for managing the customers' financial assets. Fees are generally charged on a quarterly or annual basis and are recognized ratably throughout the period, as the services are provided on an ongoing basis.

NOTE 1- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

· Electronic refund check/deposit fees – A tax refund clearing agreement between the Bank and a tax refund product provider requires the Bank to process electronic refund checks and electronic refund deposits presented for payment on behalf of taxpayers through accounts containing taxpayer refunds. The Bank, in turn, receives a fee paid by the third-party tax software provider for each transaction that is processed. The amount of fees received are tiered based on the tax refund product selected. Since the Bank acts as a sub servicer in the tax process relationship, a portion of the fee collected is passed on to the tax refund product provider.

· Debit/credit card interchange income – includes interchange income from cardholder transactions conducted with merchants, throughout various interchange networks with which the Company participates. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, as transaction processing services are provided to the deposit customer. Gross fees from interchange are recorded in operating income separately from gross network costs, which are recorded in operating expense.

· Gain (loss) on other real estate owned – the Company records a gain or loss from the sale of other real estate owned ("OREO") when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

All of the Company's revenue from contracts with customers within the scope of ASC 606 listed above pertained to the banking segment, with no revenue impact recognized from the consumer finance segment during the periods presented.

ACCOUNTING GUIDANCE TO BE ADOPTED IN FUTURE PERIODS: In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses". ASU 2016-13 requires entities to report "expected" credit losses on financial instruments and other commitments to extend credit rather than the current "incurred loss" model. These expected credit losses for financial assets held at the reporting date are to be based on historical experience, current conditions, and reasonable and supportable forecasts. This ASU will also require enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an entity's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. This ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2019. Early adoption is permitted, for annual periods and interim periods within those annual periods, beginning after December 15, 2018. Management is currently in the developmental stages of implementing the ASU. A steering committee has been established, models are being evaluated, and available historical information is being collected, in order to assess the expected credit losses. However, the impact to the financial statements is still yet to be determined.

## NOTE 2 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

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

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

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

The following is a description of the Company's valuation methodologies used to measure and disclose the fair values of its financial assets and liabilities on a recurring or nonrecurring basis:

**Securities:** The fair values for securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

**Impaired Loans:** At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive specific allocations of the allowance for loan losses. For collateral dependent loans, fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

**Other Real Estate Owned:** Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of



management reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with management's own assumptions of fair value based on factors that include recent market data or industry-wide statistics. On an as-needed basis, the Company reviews the fair value of collateral, taking into consideration current market data, as well as all selling costs that typically approximate 10%.

## NOTE 2 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Interest Rate Swap Agreements: The fair value of interest rate swap agreements is determined using the market standard methodology of netting the discounted future fixed cash payments (or receipts) and the discounted expected variable cash receipts (or payments). The variable cash receipts (or payments) are based on the expectation of future interest rates (forward curves) derived from observed market interest rate curves (Level 2).

## Assets and Liabilities Measured on a Recurring Basis

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

|  | Fair Value Measurements at<br>September 30, 2018 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Significant<br>Identifiable<br>Assets<br>(Level 1) |           |      | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|---|-----------|------|--|--|
| <u>Assets:</u>                                 |   |           |      |  |  |
| U.S. Government sponsored entity securities    | ----  | \$ 16,452 | ---- |  |  |
| Agency mortgage-backed securities, residential | ----  | 88,425    | ---- |  |  |
| Interest rate swap derivatives                 | ----  | 159       | ---- |  |  |
| Interest rate swap derivatives                 | ----  | (159 )    | ---- |  |  |

|  | Fair Value Measurements at<br>December 31, 2017 Using<br>Quoted<br>Prices<br>in<br>Active<br>Markets<br>for Significant<br>Identifiable<br>Assets<br>(Level 1) |           |      | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|--|-----------|------|--|--|
| <u>Assets:</u>                                 |  |           |      |  |  |
| U.S. Government sponsored entity securities    | ----   | \$ 13,473 | ---- |  |  |
| Agency mortgage-backed securities, residential | ----   | 87,652    | ---- |  |  |
| Interest rate swap derivatives                 | ----   | 59        | ---- |  |  |
| Interest rate swap derivatives                 | ----   | (59 )     | ---- |  |  |

There were no transfers between Level 1 and Level 2 during 2018 or 2017.

## Assets and Liabilities Measured on a Nonrecurring Basis

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

Fair Value Measurements at  
September 30, 2018, Using  
Quoted  
Prices  
in  
Active  
Markets  
for Significant  
Identical  
Assets  
(Level 1)  
Other  
Observable  
Inputs  
(Level 2)  
Significant  
Unobservable  
Inputs  
(Level 3)

Assets:

Impaired loans:

|                         |      |      |        |
|-------------------------|------|------|--------|
| Residential real estate | ---- | ---- | \$ 332 |
|-------------------------|------|------|--------|

Other real estate owned:

Commercial real estate:

|              |      |      |     |
|--------------|------|------|-----|
| Construction | ---- | ---- | 822 |
|--------------|------|------|-----|

Fair Value Measurements at  
December 31, 2017, Using  
Quoted  
Prices  
in  
Active  
Markets  
for Significant  
Identical  
Assets  
(Level 1)  
Other  
Observable  
Inputs  
(Level 2)  
Significant  
Unobservable  
Inputs  
(Level 3)

Assets:

Impaired loans:

Commercial real estate:

|                   |      |      |        |
|-------------------|------|------|--------|
| Nonowner-occupied | ---- | ---- | \$ 216 |
|-------------------|------|------|--------|

|              |      |      |     |
|--------------|------|------|-----|
| Construction | ---- | ---- | 756 |
|--------------|------|------|-----|

Other real estate owned:

Commercial real estate:

|              |      |      |     |
|--------------|------|------|-----|
| Construction | ---- | ---- | 822 |
|--------------|------|------|-----|

## NOTE 2 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

At September 30, 2018, the Company's recorded investment of impaired loans measured for impairment using the fair value of collateral for collateral-dependent loans totaled \$741, with a corresponding valuation allowance of \$409. This resulted in an increase of \$409 to provision expense during the three and nine months ended September 30, 2018, with no additional charge-offs recognized. This is compared to a \$142 increase to provision expense during the three and nine months ended September 30, 2017, with no additional charge-offs recognized. At December 31, 2017, the recorded investment of impaired loans measured for impairment using the fair value of collateral for collateral-dependent loans totaled \$972, with no corresponding valuation allowance, resulting in no impact to provision expense and no charge-offs during the year ended December 31, 2017.

Other real estate owned that was measured at fair value less costs to sell at September 30, 2018 and December 31, 2017 had a net carrying amount of \$822, which is made up of the outstanding balance of \$2,217, net of a valuation allowance of \$1,395. There were no corresponding write downs during the three and nine months ended September 30, 2018 and 2017.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2018 and December 31, 2017:

| <u>September 30, 2018</u> | Fair Value | Valuation Technique(s) | Unobservable Input(s)     | Range       | (Weighted Average) |
|---------------------------|------------|------------------------|---------------------------|-------------|--------------------|
| Impaired loans:           |            |                        |                           |             |                    |
| Residential real estate   | \$ 332     | Sales approach         | Adjustment to comparables | 0% to 33%   | 12.4%              |
| Other real estate owned:  |            |                        |                           |             |                    |
| Commercial real estate:   |            |                        |                           |             |                    |
| Construction              | 822        | Sales approach         | Adjustment to comparables | 5% to 40%   | 18.1%              |
| <u>December 31, 2017</u>  | Fair Value | Valuation Technique(s) | Unobservable Input(s)     | Range       | (Weighted Average) |
| Impaired loans:           |            |                        |                           |             |                    |
| Commercial real estate:   |            |                        |                           |             |                    |
| Nonowner-occupied         | \$ 216     | Sales approach         | Adjustment to comparables | 1.6% to 50% | 26.7%              |
| Construction              | 756        | Sales approach         | Adjustment to comparables | 1.3% to 56% | 32.9%              |
| Other real estate owned:  |            |                        |                           |             |                    |
| Commercial real estate:   |            |                        |                           |             |                    |
| Construction              | 822        | Sales approach         | Adjustment to comparables | 5% to 40%   | 18.1%              |

The carrying amounts and estimated fair values of financial instruments at September 30, 2018 and December 31, 2017 are as follows:

|                   | Carrying Value | Fair Value Measurements at September 30, 2018 Using: |         |         |       |
|-------------------|----------------|--|---------|---------|-------|
|                   |                | Level 1  | Level 2 | Level 3 | Total |
| Financial Assets: |                |  |         |         |       |

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|   |          |          |         |         |          |
|---|----------|----------|---------|---------|----------|
| Cash and cash equivalents                         | \$65,119 | \$65,119 | \$----  | \$----  | \$65,119 |
| Certificates of deposit in financial institutions | 2,310    | ----     | 2,310   | ----    | 2,310    |
| Securities available for sale                     | 104,877  | ----     | 104,877 | ----    | 104,877  |
| Securities held to maturity                       | 17,219   | ----     | 8,697   | 8,841   | 17,538   |
| Restricted investments in bank stocks             | 7,506    | N/A      | N/A     | N/A     | N/A      |
| Loans, net  | 774,062  | ----     | ----    | 771,705 | 771,705  |
| Accrued interest receivable                       | 2,862    | ----     | 389     | 2,473   | 2,862    |
| Financial liabilities:                            |          |          |         |         |          |
| Deposits  | 852,895  | 232,575  | 618,608 | ----    | 851,183  |
| Other borrowed funds                              | 40,514   | ----     | 38,207  | ----    | 38,207   |
| Subordinated debentures                           | 8,500    | ----     | 6,606   | ----    | 6,606    |
| Accrued interest payable                          | 1,128    | 3        | 1,125   | ----    | 1,128    |

## NOTE 2 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

|   | Carrying<br>Value | Fair Value Measurements at December 31,<br>2017 Using: |         |         |          |
|---|-------------------|--|---------|---------|----------|
|   |                   | Level 1  | Level 2 | Level 3 | Total    |
| <b>Financial Assets:</b>                          |                   |  |         |         |          |
| Cash and cash equivalents                         | \$74,573          | \$74,573   | \$----  | \$----  | \$74,573 |
| Certificates of deposit in financial institutions | 1,820             | ----   | 1,820   | ----    | 1,820    |
| Securities available for sale                     | 101,125           | ----   | 101,125 | ----    | 101,125  |
| Securities held to maturity                       | 17,581            | ----   | 9,020   | 9,059   | 18,079   |
| Restricted investments in bank stocks             | 7,506             | N/A  | N/A     | N/A     | N/A      |
| Loans, net  | 761,820           | ----   | ----    | 760,746 | 760,746  |
| Accrued interest receivable                       | 2,503             | ----   | 268     | 2,235   | 2,503    |
| <b>Financial liabilities:</b>                     |                   |  |         |         |          |
| Deposits  | 856,724           | 253,655  | 602,268 | ----    | 855,923  |
| Other borrowed funds                              | 35,949            | ----   | 34,810  | ----    | 34,810   |
| Subordinated debentures                           | 8,500             | ----   | 6,678   | ----    | 6,678    |
| Accrued interest payable                          | 792               | 4  | 788     | ----    | 792      |

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

**Cash and Cash Equivalents:** The carrying amounts of cash and short-term instruments approximate fair values and are classified as Level 1.

**Certificates of Deposit in Financial Institutions:** The carrying amounts of certificates of deposit in financial institutions approximate fair values and are classified as Level 2.

**Securities Held to Maturity:** The fair values for securities held to maturity are determined in the same manner as securities held for sale and discussed earlier in this note. Level 3 securities consist of nonrated municipal bonds and tax credit ("QZAB") bonds.

**Restricted Investments in Bank Stocks:** It is not practical to determine the fair value of Federal Home Loan Bank, Federal Reserve Bank and United Bankers Bank stock due to restrictions placed on their transferability.

**Loans:** The estimated fair value of loans as of September 30, 2018 follows the guidance in ASU 2016-01, which prescribes an "exit price" approach in estimating and disclosing fair value of financial instruments. The fair value calculation at that date discounted estimated future cash flows using rates that incorporated discounts for credit, liquidity, and marketability factors. The fair value estimate shown as of December 31, 2017 used an "entry price" approach. The fair value calculation for that date discounted estimated future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Consequently, the fair value disclosures for September 30, 2018 and December 31, 2017 are not directly comparable.

**Deposits:** The fair values disclosed for noninterest-bearing deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date resulting in a Level 2 classification. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Other Borrowed Funds: The carrying values of the Company's short-term borrowings, generally maturing within ninety days, approximate their fair values resulting in a Level 2 classification. The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

Subordinated Debentures: The fair values of the Company's Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

## NOTE 2 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Accrued Interest Receivable and Payable: The carrying amount of accrued interest approximates fair value, resulting in a classification that is consistent with the earning assets and interest-bearing liabilities with which it is associated.

Off-balance Sheet Instruments: Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

## NOTE 3 – SECURITIES

The following table summarizes the amortized cost and fair value of securities available for sale and securities held to maturity at September 30, 2018 and December 31, 2017 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) and gross unrecognized gains and losses:

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| <u>Securities Available for Sale</u>             |                   |                              |                               |                            |
| <u>September 30, 2018</u>                        |                   |                              |                               |                            |
| U.S. Government sponsored entity securities      | \$ 16,835         | \$ ----                      | \$ (383 )                     | \$ 16,452                  |
| Agency mortgage-backed securities, residential   | 91,880            | 51                           | (3,506 )                      | 88,425                     |
| Total securities                                 | \$ 108,715        | \$ 51                        | \$ (3,889 )                   | \$ 104,877                 |
| <u>December 31, 2017</u>                         |                   |                              |                               |                            |
| U.S. Government sponsored entity securities      | \$ 13,622         | \$ ----                      | \$ (149 )                     | \$ 13,473                  |
| Agency mortgage-backed securities, residential   | 88,833            | 300                          | (1,481 )                      | 87,652                     |
| Total securities                                 | \$ 102,455        | \$ 300                       | \$ (1,630 )                   | \$ 101,125                 |
| <u>Securities Held to Maturity</u>               |                   |                              |                               |                            |
| <u>September 30, 2018</u>                        |                   |                              |                               |                            |
| Obligations of states and political subdivisions | \$ 17,216         | \$ 460                       | \$ (141 )                     | \$ 17,535                  |
| Agency mortgage-backed securities, residential   | 3                 | ----                         | ----                          | 3                          |
| Total securities                                 | \$ 17,219         | \$ 460                       | \$ (141 )                     | \$ 17,538                  |
| <u>December 31, 2017</u>                         |                   |                              |                               |                            |
| Obligations of states and political subdivisions | \$ 17,577         | \$ 533                       | \$ (35 )                      | \$ 18,075                  |
| Agency mortgage-backed securities, residential   | 4                 | ----                         | ----                          | 4                          |
| Total securities                                 | \$ 17,581         | \$ 533                       | \$ (35 )                      | \$ 18,079                  |





## NOTE 3 – SECURITIES (Continued)

The amortized cost and estimated fair value of debt securities at September 30, 2018, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because certain issuers may have the right to call or prepay the debt obligations prior to their contractual maturities. Securities not due at a single maturity are shown separately.

| Debt Securities:                               | Available for Sale |                      | Held to Maturity |                      |
|--|--------------------|----------------------|------------------|----------------------|
|  | Amortized Cost     | Estimated Fair Value | Amortized Cost   | Estimated Fair Value |
| Due in one year or less                        | \$----             | \$----               | \$2,416          | \$2,134              |
| Due in over one to five years                  | 16,835             | 16,452               | 5,448            | 5,877                |
| Due in over five to ten years                  | ----               | ----                 | 7,094            | 7,365                |
| Due after ten years                            | ----               | ----                 | 2,258            | 2,159                |
| Agency mortgage-backed securities, residential | 91,880             | 88,425               | 3                | 3                    |
| Total debt securities                          | \$108,715          | \$104,877            | \$17,219         | \$17,538             |

The following table summarizes securities with unrealized losses at September 30, 2018 and December 31, 2017, aggregated by major security type and length of time in a continuous unrealized loss position:

| September 30, 2018                               | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Loss   | Fair Value        | Unrealized Loss   | Fair Value | Unrealized Loss   |
| <u>Securities Available for Sale</u>             |                     |                   |                   |                   |            |                   |
| U.S. Government sponsored entity securities      | \$7,896             | \$ (42 )          | \$8,556           | \$ (341 )         | \$16,452   | \$ (383 )         |
| Agency mortgage-backed securities, residential   | 25,248              | (294 )            | 58,158            | (3,212 )          | 83,406     | (3,506 )          |
| Total available for sale                         | \$33,144            | \$ (336 )         | \$66,714          | \$ (3,553 )       | \$99,858   | \$ (3,889 )       |
|  |                     |                   |                   |                   |            |                   |
|  | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|  | Fair Value          | Unrecognized Loss | Fair Value        | Unrecognized Loss | Fair Value | Unrecognized Loss |
| <u>Securities Held to Maturity</u>               |                     |                   |                   |                   |            |                   |
| Obligations of states and political subdivisions | \$3,620             | \$ (20 )          | \$1,308           | \$ (121 )         | \$4,928    | \$ (141 )         |
| Total held to maturity                           | \$3,620             | \$ (20 )          | \$1,308           | \$ (121 )         | \$4,928    | \$ (141 )         |
|  |                     |                   |                   |                   |            |                   |
| December 31, 2017                                | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|  | Fair Value          | Unrealized Loss   | Fair Value        | Unrealized Loss   | Fair Value | Unrealized Loss   |
| <u>Securities Available for Sale</u>             |                     |                   |                   |                   |            |                   |
| U.S. Government sponsored entity securities      | \$6,910             | \$ (97 )          | \$6,563           | \$ (52 )          | \$13,473   | \$ (149 )         |
| Agency mortgage-backed                           |                     |                   |                   |                   |            |                   |

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|                          |          |         |   |          |           |   |          |           |   |
|--------------------------|----------|---------|---|----------|-----------|---|----------|-----------|---|
| securities, residential  | 37,421   | (434    | ) | 31,763   | (1,047    | ) | 69,184   | (1,481    | ) |
| Total available for sale | \$44,331 | \$ (531 | ) | \$38,326 | \$ (1,099 | ) | \$82,657 | \$ (1,630 | ) |

Less Than 12

| Months     |                   | 12 Months or More |                   | Total      |                   |
|------------|-------------------|-------------------|-------------------|------------|-------------------|
| Fair Value | Unrecognized Loss | Fair Value        | Unrecognized Loss | Fair Value | Unrecognized Loss |

Securities Held to Maturity

|  |       |       |   |         |        |   |         |        |   |
|--|-------|-------|---|---------|--------|---|---------|--------|---|
| Obligations of states and political subdivisions | \$362 | \$ (2 | ) | \$1,502 | \$ (33 | ) | \$1,864 | \$ (35 | ) |
| Total held to maturity                           | \$362 | \$ (2 | ) | \$1,502 | \$ (33 | ) | \$1,864 | \$ (35 | ) |

There were no sales of investment securities during the three and nine months ended September 30, 2018 and 2017. Unrealized losses on the Company's debt securities have not been recognized into income because the issuers' securities are of high credit quality as of September 30, 2018, and management does not intend to sell, and it is likely that management will not be required to sell, the securities prior to their anticipated recovery. Management does not believe any individual unrealized loss at September 30, 2018 and December 31, 2017 represents an other-than-temporary impairment.

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

|                                       | September<br>30,<br>2018 | December<br>31,<br>2017 |
|---------------------------------------|--------------------------|-------------------------|
| Loans are comprised of the following: |                          |                         |
| Residential real estate               | \$ 305,314               | \$ 309,163              |
| Commercial real estate:               |                          |                         |
| Owner-occupied                        | 64,236                   | 73,573                  |
| Nonowner-occupied                     | 115,107                  | 101,571                 |
| Construction                          | 39,202                   | 38,302                  |
| Commercial and industrial             | 116,489                  | 107,089                 |
| Consumer:                             |                          |                         |
| Automobile                            | 70,137                   | 68,626                  |
| Home equity                           | 22,419                   | 21,431                  |
| Other                                 | 49,473                   | 49,564                  |
|                                       | 782,377                  | 769,319                 |
| Less: Allowance for loan losses       | (8,315 )                 | (7,499 )                |
| Loans, net                            | \$ 774,062               | \$ 761,820              |

The following table presents the activity in the allowance for loan losses by portfolio segment for the three months ended September 30, 2018 and 2017:

|                                | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer | Total   |
|--------------------------------|----------------------------|---------------------------|---------------------------------|----------|---------|
| <u>September 30, 2018</u>      |                            |                           |                                 |          |         |
| Allowance for loan losses:     |                            |                           |                                 |          |         |
| Beginning balance              | \$ 1,886                   | \$ 2,392                  | \$ 1,242                        | \$ 2,119 | \$7,639 |
| Provision for loan losses      | 681                        | (378 )                    | 197                             | 462      | 962     |
| Loans charged off              | (184 )                     | ----                      | (136 )                          | (722 )   | (1,042) |
| Recoveries                     | 49                         | 431                       | 80                              | 196      | 756     |
| Total ending allowance balance | \$ 2,432                   | \$ 2,445                  | \$ 1,383                        | \$ 2,055 | \$8,315 |

|                                | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer | Total   |
|--------------------------------|----------------------------|---------------------------|---------------------------------|----------|---------|
| <u>September 30, 2017</u>      |                            |                           |                                 |          |         |
| Allowance for loan losses:     |                            |                           |                                 |          |         |
| Beginning balance              | \$ 1,300                   | \$ 2,813                  | \$ 932                          | \$ 1,907 | \$6,952 |
| Provision for loan losses      | 493                        | 540                       | 238                             | 330      | 1,601   |
| Loans charged-off              | (445 )                     | (434 )                    | (202 )                          | (420 )   | (1,501) |
| Recoveries                     | 83                         | 41                        | 4                               | 133      | 261     |
| Total ending allowance balance | \$ 1,431                   | \$ 2,960                  | \$ 972                          | \$ 1,950 | \$7,313 |

The following table presents the activity in the allowance for loan losses by portfolio segment for the nine months ended September 30, 2018 and 2017:

|                           | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer | Total |
|---------------------------|----------------------------|---------------------------|---------------------------------|----------|-------|
| <u>September 30, 2018</u> |                            |                           |                                 |          |       |

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Allowance for loan losses:

|                                |          |          |          |          |         |
|--------------------------------|----------|----------|----------|----------|---------|
| Beginning balance              | \$ 1,470 | \$ 2,978 | \$ 1,024 | \$ 2,027 | \$7,499 |
| Provision for loan losses      | 1,261    | (1,041 ) | 196      | 1,279    | 1,695   |
| Loans charged off              | (421 )   | (1 )     | (140 )   | (1,818 ) | (2,380) |
| Recoveries                     | 122      | 509      | 303      | 567      | 1,501   |
| Total ending allowance balance | \$ 2,432 | \$ 2,445 | \$ 1,383 | \$ 2,055 | \$8,315 |

Commercial

|                                | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer | Total   |
|--------------------------------|----------------------------|---------------------------|---------------------------------|----------|---------|
| <u>September 30, 2017</u>      |                            |                           |                                 |          |         |
| Allowance for loan losses:     |                            |                           |                                 |          |         |
| Beginning balance              | \$ 939                     | \$ 4,315                  | \$ 907                          | \$ 1,538 | \$7,699 |
| Provision for loan losses      | 870                        | (636 )                    | 588                             | 1,099    | 1,921   |
| Loans charged-off              | (591 )                     | (1,046 )                  | (605 )                          | (1,125 ) | (3,367) |
| Recoveries                     | 213                        | 327                       | 82                              | 438      | 1,060   |
| Total ending allowance balance | \$ 1,431                   | \$ 2,960                  | \$ 972                          | \$ 1,950 | \$7,313 |

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment of loans by portfolio segment and based on impairment method as of September 30, 2018 and December 31, 2017:

|   | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer   | Total      |
|---|----------------------------|---------------------------|---------------------------------|------------|------------|
| <u>September 30, 2018</u>                       |                            |                           |                                 |            |            |
| Allowance for loan losses:                      |                            |                           |                                 |            |            |
| Ending allowance balance attributable to loans: |                            |                           |                                 |            |            |
| Individually evaluated for impairment           | \$ 409                     | \$ 90                     | \$ ----                         | \$ ----    | \$ 499     |
| Collectively evaluated for impairment           | 2,023                      | 2,355                     | 1,383                           | 2,055      | 7,816      |
| Total ending allowance balance                  | \$ 2,432                   | \$ 2,445                  | \$ 1,383                        | \$ 2,055   | \$ 8,315   |
| Loans:  |                            |                           |                                 |            |            |
| Loans individually evaluated for impairment     | \$ 926                     | \$ 4,289                  | \$ 5,727                        | \$ ----    | \$ 10,942  |
| Loans collectively evaluated for impairment     | 304,388                    | 214,256                   | 110,762                         | 142,029    | 771,435    |
| Total ending loans balance                      | \$ 305,314                 | \$ 218,545                | \$ 116,489                      | \$ 142,029 | \$ 782,377 |
|   | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Consumer   | Total      |
| <u>December 31, 2017</u>                        |                            |                           |                                 |            |            |
| Allowance for loan losses:                      |                            |                           |                                 |            |            |
| Ending allowance balance attributable to loans: |                            |                           |                                 |            |            |
| Individually evaluated for impairment           | \$ ----                    | \$ 94                     | \$ ----                         | \$ ----    | \$ 94      |
| Collectively evaluated for impairment           | 1,470                      | 2,884                     | 1,024                           | 2,027      | 7,405      |
| Total ending allowance balance                  | \$ 1,470                   | \$ 2,978                  | \$ 1,024                        | \$ 2,027   | \$ 7,499   |
| Loans:  |                            |                           |                                 |            |            |
| Loans individually evaluated for impairment     | \$ 1,420                   | \$ 7,333                  | \$ 9,154                        | \$ 201     | \$ 18,108  |
| Loans collectively evaluated for impairment     | 307,743                    | 206,113                   | 97,935                          | 139,420    | 751,211    |
| Total ending loans balance                      | \$ 309,163                 | \$ 213,446                | \$ 107,089                      | \$ 139,621 | \$ 769,319 |

The following tables present information related to loans individually evaluated for impairment by class of loans as of September 30, 2018 and December 31, 2017:

|                                     | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for Loan<br>Losses<br>Allocated |
|-------------------------------------|--------------------------------|------------------------|--|
| <u>September 30, 2018</u>           |                                |                        |  |
| With an allowance recorded:         |                                |                        |  |
| Residential real estate             | \$ 715                         | \$ 707                 | \$ 409                                       |
| Commercial real estate:             |                                |                        |  |
| Nonowner-occupied                   | 363                            | 363                    | 90   |
| With no related allowance recorded: |                                |                        |  |
| Residential real estate             | 219                            | 219                    | ----   |
| Commercial real estate:             |                                |                        |  |
| Owner-occupied                      | 2,416                          | 2,416                  | ----   |
| Nonowner-occupied                   | 2,932                          | 1,510                  | ----   |

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|                                     |           |            |           |
|-------------------------------------|-----------|------------|-----------|
| Construction                        | 340       | ----       | ----      |
| Commercial and industrial           | 5,727     | 5,727      | ----      |
| Total                               | \$ 12,712 | \$ 10,942  | \$ 499    |
|                                     | Unpaid    |            | Allowance |
|                                     | Principal | Recorded   | for Loan  |
|                                     | Balance   | Investment | Losses    |
| <u>December 31, 2017</u>            |           |            | Allocated |
| With an allowance recorded:         |           |            |           |
| Commercial real estate:             |           |            |           |
| Nonowner-occupied                   | \$ 372    | \$ 372     | \$ 94     |
| With no related allowance recorded: |           |            |           |
| Residential real estate             | 1,420     | 1,420      | ----      |
| Commercial real estate:             |           |            |           |
| Owner-occupied                      | 3,427     | 3,427      | ----      |
| Nonowner-occupied                   | 4,989     | 3,534      | ----      |
| Construction                        | 352       | ----       | ----      |
| Commercial and industrial           | 9,154     | 9,154      | ----      |
| Consumer:                           |           |            | ----      |
| Home equity                         | 203       | 201        | ----      |
| Total                               | \$ 19,917 | \$ 18,108  | \$ 94     |

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables present information related to loans individually evaluated for impairment by class of loans for the three and nine months ended September 30, 2018 and 2017:

|                                     | Three months ended September 30, 2018 |                            |                                | Nine months ended September 30, 2018 |                            |                                |
|-------------------------------------|---------------------------------------|----------------------------|--------------------------------|--------------------------------------|----------------------------|--------------------------------|
|                                     | Average Impaired Loans                | Interest Income Recognized | Cash Basis Interest Recognized | Average Impaired Loans               | Interest Income Recognized | Cash Basis Interest Recognized |
| With an allowance recorded:         |                                       |                            |                                |                                      |                            |                                |
| Residential real estate             | \$707                                 | \$ ----                    | \$ ----                        | \$711                                | \$ ----                    | \$ ----                        |
| Commercial real estate:             |                                       |                            |                                |                                      |                            |                                |
| Nonowner-occupied                   | 365                                   | 3                          | 3                              | 368                                  | 12                         | 12                             |
| With no related allowance recorded: |                                       |                            |                                |                                      |                            |                                |
| Residential real estate             | 219                                   | 4                          | 4                              | 222                                  | 34                         | 34                             |
| Commercial real estate:             |                                       |                            |                                |                                      |                            |                                |
| Owner-occupied                      | 2,434                                 | 36                         | 36                             | 2,462                                | 105                        | 105                            |
| Nonowner-occupied                   | 1,786                                 | 11                         | 11                             | 2,154                                | 47                         | 47                             |
| Construction                        | ----                                  | 5                          | 5                              | ----                                 | 15                         | 15                             |
| Commercial and industrial           | 5,753                                 | 89                         | 89                             | 5,474                                | 321                        | 321                            |
| Total                               | \$11,264                              | \$ 148                     | \$ 148                         | \$11,391                             | \$ 534                     | \$ 534                         |

|                                     | Three months ended September 30, 2017 |                            |                                | Nine months ended September 30, 2017 |                            |                                |
|-------------------------------------|---------------------------------------|----------------------------|--------------------------------|--------------------------------------|----------------------------|--------------------------------|
|                                     | Average Impaired Loans                | Interest Income Recognized | Cash Basis Interest Recognized | Average Impaired Loans               | Interest Income Recognized | Cash Basis Interest Recognized |
| With an allowance recorded:         |                                       |                            |                                |                                      |                            |                                |
| Residential real estate             | \$221                                 | \$ 7                       | \$ 7                           | \$55                                 | \$ 7                       | \$ 7                           |
| Commercial real estate:             |                                       |                            |                                |                                      |                            |                                |
| Nonowner-occupied                   | 563                                   | 3                          | 3                              | 584                                  | 12                         | 12                             |
| Consumer:                           |                                       |                            |                                |                                      |                            |                                |
| Home equity                         | 208                                   | 1                          | 1                              | 210                                  | 5                          | 5                              |
| With no related allowance recorded: |                                       |                            |                                |                                      |                            |                                |
| Residential real estate             | 935                                   | 10                         | 10                             | 824                                  | 37                         | 37                             |
| Commercial real estate:             |                                       |                            |                                |                                      |                            |                                |
| Owner-occupied                      | 2,409                                 | 37                         | 37                             | 2,407                                | 112                        | 112                            |
| Nonowner-occupied                   | 3,552                                 | 19                         | 19                             | 3,518                                | 57                         | 57                             |
| Construction                        | 157                                   | 5                          | 5                              | 170                                  | 14                         | 14                             |
| Commercial and industrial           | 9,260                                 | 135                        | 135                            | 8,776                                | 358                        | 358                            |
| Total                               | \$17,305                              | \$ 217                     | \$ 217                         | \$16,544                             | \$ 602                     | \$ 602                         |

The recorded investment of a loan is its carrying value excluding accrued interest and deferred loan fees.

Nonaccrual loans and loans past due 90 days or more and still accruing include both smaller balance homogenous loans that are collectively evaluated for impairment and individually classified as impaired loans.



The Company transfers loans to other real estate owned, at fair value less cost to sell, in the period the Company obtains physical possession of the property (through legal title or through a deed in lieu). As of September 30, 2018 and December 31, 2017, other real estate owned for residential real estate properties totaled \$379 and \$262, respectively. In addition, nonaccrual residential mortgage loans that are in the process of foreclosure had a recorded investment of \$2,399 and \$2,410 as of September 30, 2018 and December 31, 2017, respectively.

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents the recorded investment of nonaccrual loans and loans past due 90 days or more and still accruing by class of loans as of September 30, 2018 and December 31, 2017:

| <u>September 30, 2018</u> | Loans<br>Past Due<br>90 Days<br>And<br>Still<br>Accruing |  | Nonaccrual |
|---------------------------|--|--|------------|
|                           |  |  |            |
| Residential real estate   | \$ 167   |  | \$ 6,929   |
| Commercial real estate:   |  |  |            |
| Owner-occupied            | ----   |  | 494        |
| Nonowner-occupied         | ----   |  | 1,142      |
| Construction              | ----   |  | 389        |
| Commercial and industrial | 147  |  | 284        |
| Consumer:                 |  |  |            |
| Automobile                | 247  |  | 45         |
| Home equity               | 122  |  | 227        |
| Other                     | 373  |  | 67         |
| Total                     | \$ 1,056   |  | \$ 9,577   |

| <u>December 31, 2017</u>  | Loans<br>Past Due<br>90 Days<br>And<br>Still<br>Accruing |  | Nonaccrual |
|---------------------------|--|--|------------|
|                           |  |  |            |
| Residential real estate   | \$ 131   |  | \$ 5,906   |
| Commercial real estate:   |  |  |            |
| Owner-occupied            | ----   |  | 476        |
| Nonowner-occupied         | ----   |  | 2,454      |
| Construction              | ----   |  | 444        |
| Commercial and industrial | ----   |  | 337        |
| Consumer:                 |  |  |            |
| Automobile                | 127  |  | 86         |
| Home equity               | ----   |  | 283        |
| Other                     | 76   |  | 126        |
| Total                     | \$ 334   |  | \$ 10,112  |



## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents the aging of the recorded investment of past due loans by class of loans as of September 30, 2018 and December 31, 2017:

|                           | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90<br>Days<br>Or<br>More<br>Past<br>Due | Total<br>Past<br>Due | Loans<br>Not<br>Past Due | Total     |
|---------------------------|------------------------------|------------------------------|---|----------------------|--------------------------|-----------|
| <u>September 30, 2018</u> |                              |                              |   |                      |                          |           |
| Residential real estate   | \$3,924                      | \$910                        | \$1,848                                 | \$6,682              | \$298,632                | \$305,314 |
| Commercial real estate:   |                              |                              |   |                      |                          |           |
| Owner-occupied            | 113                          | 191                          | 129                                     | 433                  | 63,803                   | 64,236    |
| Nonowner-occupied         | 263                          | 363                          | 948                                     | 1,574                | 113,533                  | 115,107   |
| Construction              | 167                          | ----                         | 157                                     | 324                  | 38,878                   | 39,202    |
| Commercial and industrial | 2,737                        | 105                          | 276                                     | 3,118                | 113,371                  | 116,489   |
| Consumer:                 |                              |                              |   |                      |                          |           |
| Automobile                | 1,145                        | 266                          | 247                                     | 1,658                | 68,479                   | 70,137    |
| Home equity               | 251                          | 200                          | 334                                     | 785                  | 21,634                   | 22,419    |
| Other                     | 631                          | 112                          | 378                                     | 1,121                | 48,352                   | 49,473    |
| Total                     | \$9,231                      | \$2,147                      | \$4,317                                 | \$15,695             | \$766,682                | \$782,377 |
|                           |                              |                              |   |                      |                          |           |
|                           | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90<br>Days<br>Or<br>More<br>Past<br>Due | Total<br>Past<br>Due | Loans<br>Not<br>Past Due | Total     |
| <u>December 31, 2017</u>  |                              |                              |   |                      |                          |           |
| Residential real estate   | \$5,383                      | \$671                        | \$1,673                                 | \$7,727              | \$301,436                | \$309,163 |
| Commercial real estate:   |                              |                              |   |                      |                          |           |
| Owner-occupied            | 194                          | 161                          | 160                                     | 515                  | 73,058                   | 73,573    |
| Nonowner-occupied         | 140                          | ----                         | 2,238                                   | 2,378                | 99,193                   | 101,571   |
| Construction              | ----                         | ----                         | 169                                     | 169                  | 38,133                   | 38,302    |
| Commercial and industrial | 303                          | 243                          | 191                                     | 737                  | 106,352                  | 107,089   |
| Consumer:                 |                              |                              |   |                      |                          |           |
| Automobile                | 1,257                        | 346                          | 151                                     | 1,754                | 66,872                   | 68,626    |
| Home equity               | 90                           | 272                          | 27                                      | 389                  | 21,042                   | 21,431    |
| Other                     | 865                          | 218                          | 76                                      | 1,159                | 48,405                   | 49,564    |
| Total                     | \$8,232                      | \$1,911                      | \$4,685                                 | \$14,828             | \$754,491                | \$769,319 |

## Troubled Debt Restructurings:

A troubled debt restructuring ("TDR") occurs when the Company has agreed to a loan modification in the form of a concession for a borrower who is experiencing financial difficulty. All TDR's are considered to be impaired. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate

for new debt with similar risk; a reduction in the contractual principal and interest payments of the loan; or short-term interest-only payment terms.

The Company has allocated reserves for a portion of its TDR's to reflect the fair values of the underlying collateral or the present value of the concessionary terms granted to the customer.

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table presents the types of TDR loan modifications by class of loans as of September 30, 2018 and December 31, 2017:

|  | TDR's<br>Performing<br>to<br>Modified<br>Terms | TDR's Not<br>Performing<br>to<br>Modified<br>Terms | Total<br>TDR's |
|--|--|--|----------------|
| <u>September 30, 2018</u>                                |  |  |                |
| Residential real estate:                                 |  |  |                |
| Interest only payments                                   | \$ 218   | \$ ----  | \$218          |
| Commercial real estate:                                  |  |  |                |
| Owner-occupied   |  |  |                |
| Interest only payments                                   | 989  | ----   | 989            |
| Reduction of principal and interest payments             | 535  | ----   | 535            |
| Maturity extension at lower stated rate than market rate | 488  | ----   | 488            |
| Credit extension at lower stated rate than market rate   | 404  | ----   | 404            |
| Nonowner-occupied  |  |  |                |
| Interest only payments                                   | ----   | 948  | 948            |
| Rate reduction   | 363  | ----   | 363            |
| Credit extension at lower stated rate than market rate   | 563  | ----   | 563            |
| Commercial and industrial:                               |  |  |                |
| Interest only payments                                   | 5,427  | ----   | 5,427          |
| Total TDR's  | \$ 8,987                                       | \$ 948   | \$9,935        |

|  | TDR's<br>Performing<br>to<br>Modified<br>Terms | TDR's Not<br>Performing<br>to<br>Modified<br>Terms | Total<br>TDR's |
|--|--|--|----------------|
| <u>December 31, 2017</u>                                 |  |  |                |
| Residential real estate:                                 |  |  |                |
| Interest only payments                                   | \$ 697   | \$ ----  | \$697          |
| Commercial real estate:                                  |  |  |                |
| Owner-occupied   |  |  |                |
| Interest only payments                                   | 997  | ----   | 997            |
| Reduction of principal and interest payments             | 554  | ----   | 554            |
| Maturity extension at lower stated rate than market rate | 1,466  | ----   | 1,466          |
| Credit extension at lower stated rate than market rate   | 410  | ----   | 410            |
| Nonowner-occupied  |  |  |                |
| Interest only payments                                   | 560  | 1,961  | 2,521          |
| Rate reduction   | 372  | ----   | 372            |
| Credit extension at lower stated rate than market rate   | 570  | ----   | 570            |
| Commercial and industrial:                               |  |  |                |
| Interest only payments                                   | 9,154  | ----   | 9,154          |
| Consumer:  |  |  |                |
| Home equity  |  |  |                |

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|  |      |           |          |           |
|--|------|-----------|----------|-----------|
| Maturity extension at lower stated rate than market rate | ---- | 201       | 201      |           |
| Total TDR's  |      | \$ 14,780 | \$ 2,162 | \$ 16,942 |

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

At September 30, 2018, the balance in TDR loans decreased \$7,007, or 41.4%, from year-end 2017. The Company's specific allocations in reserves to customers whose loan terms have been modified in TDR's totaled \$90 at September 30, 2018, as compared to \$94 in reserves at December 31, 2017. At September 30, 2018, the Company had \$73 in commitments to lend additional amounts to customers with outstanding loans that are classified as TDR's, as compared to \$846 at December 31, 2017.

There were no TDR loan modifications that occurred during the three and nine months ended September 30, 2018. The following tables present the pre- and post-modification balances of TDR loan modifications by class of loans that occurred during the three and nine months ended September 30, 2017:

|  | Number of Loans | TDR's Performing to Modified Terms   |                                       | TDR's Not Performing to Modified Terms |                                       |
|--|-----------------|--------------------------------------|---------------------------------------|--|---------------------------------------|
|  |                 | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | Pre-Modification Recorded Investment   | Post-Modification Recorded Investment |
| <u>Three months ended September 30, 2017</u>             |                 |                                      |                                       |  |                                       |
| Commercial real estate:                                  |                 |                                      |                                       |  |                                       |
| Owner-occupied   |                 |                                      |                                       |  |                                       |
| Credit extension at lower stated rate than market rate   | 1               | \$ 412                               | \$ 412                                | \$ ----                                | \$ ----                               |
| Total TDR's  | 1               | \$ 412                               | \$ 412                                | \$ ----                                | \$ ----                               |
| <u>Nine months ended September 30, 2017</u>              |                 |                                      |                                       |  |                                       |
| Residential real estate                                  |                 |                                      |                                       |  |                                       |
| Maturity extension at lower stated rate than market rate | 1               | \$ 231                               | \$ 231                                | \$ ----                                | \$ ----                               |
| Commercial real estate:                                  |                 |                                      |                                       |  |                                       |
| Owner-occupied   |                 |                                      |                                       |  |                                       |
| Credit extension at lower stated rate than market rate   | 1               | 412                                  | 412                                   | ----                                   | ----                                  |
| Commercial and industrial                                |                 |                                      |                                       |  |                                       |
| Maturity extension at lower stated rate than market rate | 2               | 770                                  | 770                                   | ----                                   | ----                                  |
| Total TDR's  | 4               | \$ 1,413                             | \$ 1,413                              | \$ ----                                | \$ ----                               |

The troubled debt restructurings described above had no impact on the allowance for loan losses and resulted in no charge-offs during the three and nine months ended September 30, 2017.

The Company had no TDR's that, during the three and nine months ended September 30, 2018 and 2017, experienced any payment defaults within twelve months following their loan modification. A default is considered to have



occurred once the TDR is past due 90 days or more or it has been placed on nonaccrual. TDR loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt, such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. These risk categories are represented by a loan grading scale from 1 through 10. The Company analyzes loans individually with a higher credit risk rating and groups these loans into categories called "criticized" and "classified" assets. The Company considers its criticized assets to be loans that are graded 8 and its classified assets to be loans that are graded 9 through 11. The Company's risk categories are reviewed at least annually on loans that have aggregate borrowing amounts that meet or exceed \$500.

## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The Company uses the following definitions for its criticized loan risk ratings:

**Special Mention.** Loans classified as special mention indicate considerable risk due to deterioration of repayment (in the earliest stages) due to potential weak primary repayment source, or payment delinquency. These loans will be under constant supervision, are not classified and do not expose the institution to sufficient risks to warrant classification. These deficiencies should be correctable within the normal course of business, although significant changes in company structure or policy may be necessary to correct the deficiencies. These loans are considered bankable assets with no apparent loss of principal or interest envisioned. The perceived risk in continued lending is considered to have increased beyond the level where such loans would normally be granted. Credits that are defined as a troubled debt restructuring should be graded no higher than special mention until they have been reported as performing over one year after restructuring.

The Company uses the following definitions for its classified loan risk ratings:

**Substandard.** Loans classified as substandard represent very high risk, serious delinquency, nonaccrual, or unacceptable credit. Repayment through the primary source of repayment is in jeopardy due to the existence of one or more well defined weaknesses and the collateral pledged may inadequately protect collection of the loans. Loss of principal is not likely if weaknesses are corrected, although financial statements normally reveal significant weakness. Loans are still considered collectible, although loss of principal is more likely than with special mention loan grade 8 loans. Collateral liquidation is considered likely to satisfy debt.

**Doubtful.** Loans classified as doubtful display a high probability of loss, although the amount of actual loss at the time of classification is undetermined. This classification should be temporary until such time that actual loss can be identified, or improvements made to reduce the seriousness of the classification. These loans exhibit all substandard characteristics with the addition that weaknesses make collection or liquidation in full highly questionable and improbable. This classification consists of loans where the possibility of loss is high after collateral liquidation based upon existing facts, market conditions, and value. Loss is deferred until certain important and reasonable specific pending factors which may strengthen the credit can be more accurately determined. These factors may include proposed acquisitions, liquidation procedures, capital injection, receipt of additional collateral, mergers, or refinancing plans. A doubtful classification for an entire credit should be avoided when collection of a specific portion appears highly probable with the adequately secured portion graded substandard.

**Loss.** Loans classified as loss are considered uncollectible and are of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this asset yielding such a minimum value even though partial recovery may be affected in the future. Amounts classified as loss should be promptly charged off.

Criticized and classified loans will mostly consist of commercial and industrial and commercial real estate loans. The Company considers its loans that do not meet the criteria for a criticized and classified asset rating as pass rated loans, which will include loans graded from 1 (Prime) to 7 (Watch). All commercial loans are categorized into a risk category either at the time of origination or reevaluation date. As of September 30, 2018 and December 31, 2017, and based on the most recent analysis performed, the risk category of commercial loans by class of loans was as follows:

| <u>September 30, 2018</u> | Pass     | Criticized | Classified | Total    |
|---------------------------|----------|------------|------------|----------|
| Commercial real estate:   |          |            |            |          |
| Owner-occupied            | \$54,380 | \$ 2,476   | \$ 7,380   | \$64,236 |
| Nonowner-occupied         | 111,921  | 847        | 2,339      | 115,107  |

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|                           |           |           |           |           |
|---------------------------|-----------|-----------|-----------|-----------|
| Construction              | 38,898    | 133       | 171       | 39,202    |
| Commercial and industrial | 97,204    | 9,494     | 9,791     | 116,489   |
| Total                     | \$302,403 | \$ 12,950 | \$ 19,681 | \$335,034 |

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## NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

| <u>December 31, 2017</u>  | Pass      | Criticized | Classified | Total     |
|---------------------------|-----------|------------|------------|-----------|
| Commercial real estate:   |           |            |            |           |
| Owner-occupied            | \$64,993  | \$ 934     | \$ 7,646   | \$73,573  |
| Nonowner-occupied         | 93,197    | 3,776      | 4,598      | 101,571   |
| Construction              | 37,735    | 156        | 411        | 38,302    |
| Commercial and industrial | 91,097    | 6,058      | 9,934      | 107,089   |
| Total                     | \$287,022 | \$ 10,924  | \$ 22,589  | \$320,535 |

The Company also obtains the credit scores of its borrowers upon origination (if available by the credit bureau), but the scores are not updated. The Company focuses mostly on the performance and repayment ability of the borrower as an indicator of credit risk and does not consider a borrower's credit score to be a significant influence in the determination of a loan's credit risk grading.

For residential and consumer loan classes, the Company evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment of residential and consumer loans by class of loans based on repayment activity as of September 30, 2018 and December 31, 2017:

| <u>September 30, 2018</u> | Consumer   |             |          |                         | Total     |
|---------------------------|------------|-------------|----------|-------------------------|-----------|
|                           | Automobile | Home Equity | Other    | Residential Real Estate |           |
| Performing                | \$69,845   | \$22,070    | \$49,033 | \$ 298,218              | \$439,166 |
| Nonperforming             | 292        | 349         | 440      | 7,096                   | 8,177     |
| Total                     | \$70,137   | \$22,419    | \$49,473 | \$ 305,314              | \$447,343 |

| <u>December 31, 2017</u> | Consumer   |             |          |                         | Total     |
|--------------------------|------------|-------------|----------|-------------------------|-----------|
|                          | Automobile | Home Equity | Other    | Residential Real Estate |           |
| Performing               | \$68,413   | \$21,148    | \$49,362 | \$ 303,126              | \$442,049 |
| Nonperforming            | 213        | 283         | 202      | 6,037                   | 6,735     |
| Total                    | \$68,626   | \$21,431    | \$49,564 | \$ 309,163              | \$448,784 |

The Company, through its subsidiaries, originates residential, consumer, and commercial loans to customers located primarily in the southeastern areas of Ohio as well as the western counties of West Virginia. Approximately 4.84% of total loans were unsecured at September 30, 2018, down from 4.86% at December 31, 2017.

## NOTE 5 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, and financial guarantees written, is represented by the contractual amount of those instruments. The contract amounts of these instruments are not included in the consolidated financial statements. At September 30, 2018, the contract amounts of these instruments totaled approximately \$72,042, compared to \$68,859 at December 31, 2017. The Bank uses the same

credit policies in making commitments and conditional obligations as it does for instruments recorded on the balance sheet. Since many of these instruments are expected to expire without being drawn upon, the total contract amounts do not necessarily represent future cash requirements.

## NOTE 6 - OTHER BORROWED FUNDS

Other borrowed funds at September 30, 2018 and December 31, 2017 are comprised of advances from the Federal Home Loan Bank ("FHLB") of Cincinnati and promissory notes. At December 31, 2017, FHLB Borrowings included \$29 in capitalized lease obligations.

|                    | FHLB<br>Borrowings | Promissory<br>Notes | Totals   |
|--------------------|--------------------|---------------------|----------|
| September 30, 2018 | \$ 34,109          | \$ 6,405            | \$40,514 |
| December 31, 2017  | \$ 28,625          | \$ 7,324            | \$35,949 |

Pursuant to collateral agreements with the FHLB, advances were secured by \$296,332 in qualifying mortgage loans, \$70,705 in commercial loans and \$5,365 in FHLB stock at September 30, 2018. Fixed-rate FHLB advances of \$34,109 mature through 2042 and have interest rates ranging from 1.53% to 3.31% and a year-to-date weighted average cost of 2.36%. There were no variable-rate FHLB borrowings at September 30, 2018.

At September 30, 2018, the Company had a cash management line of credit enabling it to borrow up to \$80,000 from the FHLB. All cash management advances have an original maturity of 90 days. The line of credit must be renewed on an annual basis. There was \$80,000 available on this line of credit at September 30, 2018.

Based on the Company's current FHLB stock ownership, total assets and pledgeable loans, the Company had the ability to obtain borrowings from the FHLB up to a maximum of \$238,871 at September 30, 2018. Of this maximum borrowing capacity, the Company had \$151,462 available to use as additional borrowings, of which \$80,000 could be used for short-term, cash management advances, as mentioned above.

Promissory notes, issued primarily by Ohio Valley, are due at various dates through a final maturity date of August 1, 2026, and have fixed rates ranging from 1.50% to 4.09% through August 1, 2021 and a year-to-date weighted average cost of 2.83% at September 30, 2018, as compared to 2.77% at December 31, 2017. Promissory notes payable by Ohio Valley to related parties totaled \$360 at September 30, 2018, and December 31, 2017. Promissory notes payable to other banks totaled \$2,578 at September 30, 2018, as compared to \$3,440 at December 31, 2017.

Letters of credit issued on the Bank's behalf by the FHLB to collateralize certain public unit deposits as required by law totaled \$53,300 at September 30, 2018 and \$60,000 at December 31, 2017.

Scheduled principal payments as of September 30, 2018:

|            | FHLB<br>Borrowings | Promissory<br>Notes | Totals   |
|------------|--------------------|---------------------|----------|
| 2018       | \$ 1,042           | \$ 657              | \$1,699  |
| 2019       | 3,651              | 3,290               | 6,941    |
| 2020       | 3,380              | 1,068               | 4,448    |
| 2021       | 3,000              | 565                 | 3,565    |
| 2022       | 2,841              | 588                 | 3,429    |
| Thereafter | 20,195             | 237                 | 20,432   |
|            | \$ 34,109          | \$ 6,405            | \$40,514 |

## NOTE 7 – SEGMENT INFORMATION

The reportable segments are determined by the products and services offered, primarily distinguished between banking and consumer finance. They are also distinguished by the level of information provided to the chief operating decision maker, who uses such information to review performance of various components of the business, which are then aggregated if operating performance, products/services, and customers are similar. Loans, investments, and deposits provide the majority of the net revenues from the banking operation, while loans provide the majority of the net revenues for the consumer finance segment. All Company segments are domestic.

Total revenues from the banking segment, which accounted for the majority of the Company's total revenues, totaled 92.6% and 92.2% of total consolidated revenues for the quarters end September 30, 2018 and 2017, respectively.

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## NOTE 7 – SEGMENT INFORMATION (Continued)

The accounting policies used for the Company's reportable segments are the same as those described in Note 1 - Summary of Significant Accounting Policies. Income taxes are allocated based on income before tax expense.

Information for the Company's reportable segments is as follows:

Three Months Ended September 30,  
2018

|                     | Banking   | Consumer<br>Finance | Total<br>Company |
|---------------------|-----------|---------------------|------------------|
| Net interest income | \$10,168  | \$ 595              | \$10,763         |
| Provision expense   | 950       | 12                  | 962              |
| Noninterest income  | 1,875     | 52                  | 1,927            |
| Noninterest expense | 9,107     | 654                 | 9,761            |
| Tax expense         | 226       | (5 )                | 221              |
| Net income          | 1,760     | (14 )               | 1,746            |
| Assets              | 1,021,730 | 11,786              | 1,033,516        |

Three Months Ended September 30,  
2017

|                     | Banking   | Consumer<br>Finance | Total<br>Company |
|---------------------|-----------|---------------------|------------------|
| Net interest income | \$9,681   | \$ 587              | \$10,268         |
| Provision expense   | 1,615     | (14 )               | 1,601            |
| Noninterest income  | 2,224     | 58                  | 2,282            |
| Noninterest expense | 8,579     | 643                 | 9,222            |
| Tax expense         | 69        | 5                   | 74               |
| Net income          | 1,642     | 11                  | 1,653            |
| Assets              | 1,008,078 | 11,536              | 1,019,614        |

Nine Months Ended September 30,  
2018

|                     | Banking   | Consumer<br>Finance | Total<br>Company |
|---------------------|-----------|---------------------|------------------|
| Net interest income | \$30,289  | \$ 2,624            | \$32,913         |
| Provision expense   | 1,550     | 145                 | 1,695            |
| Noninterest income  | 6,916     | 625                 | 7,541            |
| Noninterest expense | 27,236    | 2,007               | 29,243           |
| Tax expense         | 1,199     | 229                 | 1,428            |
| Net income          | 7,220     | 868                 | 8,088            |
| Assets              | 1,021,730 | 11,786              | 1,033,516        |

Nine Months Ended September 30,  
2017

| Banking | Consumer<br>Finance |
|---------|---------------------|
|---------|---------------------|



|                     |           |          | Total<br>Company |
|---------------------|-----------|----------|------------------|
| Net interest income | \$28,558  | \$ 2,646 | \$31,204         |
| Provision expense   | 1,815     | 106      | 1,921            |
| Noninterest income  | 6,965     | 542      | 7,507            |
| Noninterest expense | 26,477    | 1,996    | 28,473           |
| Tax expense         | 1,338     | 368      | 1,706            |
| Net income          | 5,893     | 718      | 6,611            |
| Assets              | 1,008,078 | 11,536   | 1,019,614        |

ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF  
2. OPERATIONS

(dollars in thousands, except share and per share data)

Forward Looking Statements

Except for the historical statements and discussions contained herein, statements contained in this report constitute "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Act of 1934 and as defined in the Private Securities Litigation Reform Act of 1995. Such statements are often, but not always, identified by the use of such words as "believes," "anticipates," "expects," and similar expressions. Such statements involve various important assumptions, risks, uncertainties, and other factors, many of which are beyond our control and which could cause actual results to differ materially from those expressed in such forward looking statements. These factors include, but are not limited to: changes in political, economic or other factors, such as inflation rates, recessionary or expansive trends, taxes, the effects of implementation of legislation and the continuing economic uncertainty in various parts of the world; competitive pressures; fluctuations in interest rates; the level of defaults and prepayment on loans made by the Company; unanticipated litigation, claims, or assessments; fluctuations in the cost of obtaining funds to make loans; and regulatory changes. Additional detailed information concerning a number of important factors which could cause actual results to differ materially from the forward-looking statements contained in management's discussion and analysis is available in the Company's filings with the Securities and Exchange Commission, under the Securities Exchange Act of 1934, including the disclosure under the heading "Item 1A. Risk Factors" of Part 1 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017 and in "Item 1A. Risk Factors" of this report. Readers are cautioned not to place undue reliance on such forward looking statements, which speak only as of the date hereof. The Company undertakes no obligation and disclaims any intention to republish revised or updated forward looking statements, whether as a result of new information, unanticipated future events or otherwise.

Financial Overview

The Company is primarily engaged in commercial and retail banking, offering a blend of commercial and consumer banking services within southeastern Ohio as well as western West Virginia. The banking services offered by the Bank include the acceptance of deposits in checking, savings, time and money market accounts; the making and servicing of personal, commercial, floor plan and student loans; the making of construction and real estate loans; and credit card services. The Bank also offers individual retirement accounts, safe deposit boxes, wire transfers and other standard banking products and services. In addition, the Bank has facilitated the payment of tax refunds through a third-party tax refund product provider through electronic refund check/deposit ("ERC/ERD") transactions. ERC/ERD transactions involve the payment of a tax refund to the taxpayer after the Bank has received the refund from the federal/state government. ERC/ERD transactions occur primarily during the tax refund season, typically during the first quarter of each year. The Bank's relationship with the third-party provider will not continue in 2019, but the Bank intends to consider alternative similar relationships for future years. Loan Central also provides refund anticipation loans ("RALs") to its customers. RALs are short-term cash advances against a customer's anticipated income tax refund.

Net income totaled \$1,746 during the third quarter of 2018, an increase of \$93, or 5.6%, compared to \$1,653 during the third quarter of 2017. Earnings per share for the third quarter of 2018 finished at \$.37 per share, compared to \$.35 per share during the third quarter of 2017. The Company's net income during the nine months ended September 30, 2018 totaled \$8,088, an increase of \$1,477, or 22.3%, compared to \$6,611 during the nine months ended September 30, 2017. Earnings per share during the first nine months of 2018 finished at \$1.71 per share, compared to \$1.41 per share during the first nine months of 2017. Higher earnings during both the quarterly and year-to-date periods were impacted primarily by higher interest revenues from loans and interest-bearing deposits with banks, as well as lower provision expense. Improved earnings were also impacted by a lower tax rate applied to operating income during 2018.

The improvement to net earnings also had a direct impact to the Company's annualized net income to average asset ratio, or return on assets ("ROA"), which increased to 1.01% at September 30, 2018, compared to 0.87% at September 30, 2017. The Company's net income to average equity ratio, or return on equity ("ROE"), also increased to 9.67% at September 30, 2018, compared to 8.24% at September 30, 2017.

Net interest income for the three and nine months ended September 30, 2018 showed positive growth over the same periods in 2017, increasing 4.8% and 5.5%, respectively. The increase came primarily from interest revenues associated with year-to-date average earning asset growth of \$63,893. The growth in average earning assets came mostly from interest-bearing deposits with banks and loans. The Company's average interest-bearing Federal Reserve clearing account grew \$36,647, or 53.2%, during the first nine months of 2018 over the same period in 2017, as a result of growth in average deposits exceeding the growth in loans, as well as growth from seasonal tax refund processing activity. Furthermore, the Federal Reserve's action to increase short-term interest rates by 100 basis points from September 2017 to September 2018 contributed to interest revenue growth. The Company's average loans during the third quarter and year-to-date periods ended September 30, 2018 increased 2.8% and 3.6% over the same periods in 2017, respectively, led by growth within the commercial loan segment.

During the three months ended September 30, 2018, the Company's provision expense decreased \$639, which contributed to a decrease of \$226 during the nine months ended September 30, 2018, compared to the same periods in 2017. The effect of lower provision expense was primarily the result of lower net charge-offs, which decreased 76.9% and 61.9% during the three and nine months ended September 30, 2018, as compared to the same periods in 2017, respectively.

During the three months ended September 30, 2018, the Company's noninterest income decreased \$355, or 15.6%, as compared to the same period in 2017. This decrease led to limited growth in noninterest income of \$34, or 0.5%, during the nine months ended September 30, 2018, as compared to the same period in 2017. The change in noninterest income was impacted primarily by bank owned life insurance and annuity assets, which decreased over \$400 during both the quarterly and year-to-date periods. This decrease was largely the result of tax-free bank owned life insurance proceeds collected in the third quarter of 2017. Further impacting noninterest income was revenue from other real estate owned ("OREO"). Although OREO income decreased by \$59 during the third quarter of 2018, it was higher than the prior year amount, increasing \$169 during the year-to-date period ended September 30, 2018, as compared to the same period in 2017. This increase can be attributed to a lower amount of write-downs to OREO assets combined with higher gains on the sale of specific OREO assets during 2018. Debit and credit card interchange income also had a positive impact on noninterest revenue, increasing \$80 during the third quarter of 2018 and \$230 during the first nine months of 2018, as compared to the same periods in 2017. The remaining noninterest income categories increased \$28, or 3.2%, during the third quarter of 2018 and increased \$94, or 2.3%, during the first nine months of 2018, as compared to the same periods in 2017.

Total noninterest expense increased \$539, or 5.8%, for the third quarter of 2018, and increased \$770, or 2.7%, for the nine months ended September 30, 2018, as compared to the same periods in 2017. Both the quarterly and year-to-date periods have been impacted by higher salaries and employee benefit costs and data processing expenses, which have collectively increased 10.3% and 8.1%, respectively, as compared to 2017. The increases were largely from annual merit increases and higher health insurance expense. Further impacting noninterest expense was data processing expense, which increased over 30% during both the three and nine months ended September 30, 2018, as compared the same periods in 2017. Partially offsetting noninterest expense growth was costs from foreclosed assets, which decreased over 60% during both the three and nine months ended September 30, 2018, as compared the same periods in 2017. Further reducing overhead costs for the year was fraud-related expense, which decreased \$855 during the nine months ended September 30, 2018, as compared to the same period in 2017. This decrease in expense was related to four fraudulent wire transfers with a single account relationship totaling \$933 that were discovered during the second quarter of 2017. Prior to the end of 2017's second quarter, the Company was able to recover \$103, resulting in net expense of \$830 at June 30, 2017. The Company recovered the remainder of the expense from insurance in the fourth quarter of 2017. The remaining noninterest expense categories decreased \$58, or 1.7%, during the third quarter of 2018 and increased \$106, or 1.1%, during the first nine months of 2018, as compared to the same periods in 2017, largely from professional fees and third-party consulting expenses.

The Company's provision for income taxes increased \$147 during the third quarter of 2018, but decreased \$278 during the first nine months of 2018, as compared to the same periods in 2017. The year-to-date decline was related to the reduction of the federal income tax rate from 34% to 21% as part of the Tax Cuts and Jobs Act ("TCJA") enacted on December 22, 2017. The increase in tax expense for the third quarter was largely due to a higher level of taxable income combined with tax expense benefits recognized on tax-free BOLI proceeds and related post-retirement liability adjustments recorded in the third quarter of 2017. These factors completely offset the effects of the federal income tax rate reduction.

At September 30, 2018, total assets were \$1,033,516, compared to \$1,026,290 at year-end 2017. Higher assets were impacted mostly by growth in the Company's loan portfolio, finishing at \$782,377 at September 30, 2018, compared to \$769,319 at year-end 2017. The commercial lending segment experienced a 4.5% increase from year-end 2017,

which added to a 1.7% increase in consumer loans, and completely offset a 1.2% decrease in residential real estate loans from year-end 2017. Total investment securities also increased \$3,390 from year-end 2017, due mostly to new purchases of U.S. Government sponsored entity and Agency mortgage-backed securities. Asset increases were partially offset by lower interest-bearing deposits with banks, which decreased \$8,139 from year-end 2017, driven by loan and investment security growth.

Total liabilities were \$919,677 at September 30, 2018, up \$2,748 from December 31, 2017. Interest-bearing deposits accounted for \$17,251 of the increase, mostly from an increasing demand for time deposits, as well as growth in public fund and statement savings account balances. Additional liability growth came from a \$4,565 increase in other borrowed funds resulting from three new long-term advances with the Federal Home Loan Bank totaling \$8 million that were used to fund specific earning asset purchases during the first quarter of 2018. Partially offsetting the increases to interest-bearing deposits and borrowings was a \$21,080 decrease in noninterest-bearing deposits. The change in noninterest-bearing deposits came mostly from lower business checking account balances within the Mason County, West Virginia market area.

At September 30, 2018, total shareholders' equity was \$113,839, up \$4,478 since December 31, 2017. Regulatory capital ratios of the Company remained higher than the "well capitalized" minimums.

#### Comparison of Financial Condition at September 30, 2018 and December 31, 2017

The following discussion focuses, in more detail, on the consolidated financial condition of the Company at September 30, 2018 compared to December 31, 2017. This discussion should be read in conjunction with the interim consolidated financial statements and the footnotes included in this Form 10 Q.

#### Cash and Cash Equivalents

At September 30, 2018, cash and cash equivalents were \$65,119, a decrease of \$9,454 from \$74,573 at December 31, 2017. The decrease in cash and cash equivalents came mostly from the Company's interest-bearing Federal Reserve Bank clearing account, impacted by the funding need associated with growth in loans and investment securities from year-end 2017. The Company utilizes its interest-bearing Federal Reserve Bank clearing account to maintain seasonal tax refund deposits, as well as to fund earning asset growth and maturities of retail certificates of deposit ("CD's"). The interest rate paid on both the required and excess reserve balances is based on the targeted federal funds rate established by the Federal Open Market Committee. Short-term rate increases of 25 basis points during each of December 2017, March 2018, June 2018 and September 2018 caused the federal funds rate to finish at 2.25% at September 30, 2018. The interest rate increases had a corresponding effect on the interest revenue growth experienced during the first nine months of 2018 on Federal Reserve Bank clearing account balances. The 2.25% interest rate is higher than the rate the Company would have received from its investments in federal funds sold. Furthermore, Federal Reserve Bank balances are 100% secured.

As liquidity levels vary continuously based on consumer activities, amounts of cash and cash equivalents can vary widely at any given point in time. The Company's focus will be to invest excess funds in longer-term, higher-yielding assets, primarily loans, when the opportunities arise.

The Company has been informed by its third-party tax refund product provider that the provider intends to cease utilizing the services of the Bank by the end of 2018, before the current contract expiration date of December 31, 2019. Until the Bank replaces that agreement with an agreement with another tax refund product provider, the Company's liquidity levels likely will be materially affected and the Bank will need to use other sources of funding for earning asset growth. The Bank has determined that it will be unable to replace that agreement for the 2019 tax season but will consider alternatives for future years. The Bank is also pursuing payment from its current provider for breach of contract.

#### Certificates of deposit

At September 30, 2018, the Company had \$2,310 in certificates of deposit owned by the Captive, an increase of \$490, or 26.9%, from year-end 2017. The deposits on hand at September 30, 2018 consist of ten certificates with remaining

maturity terms ranging from less than 1 month up to 36 months.

Securities

The balance of total securities increased \$3,390, or 2.9%, compared to year-end 2017. The Company's investment securities portfolio is made up mostly of U.S. Government agency ("Agency") mortgage-backed securities, which increased \$772, or 0.9%, from year-end 2017 and represented 72.4% of total investments at September 30, 2018. During the first nine months of 2018, the Company invested \$15,826 in new Agency mortgage-backed securities, while receiving principal repayments of \$12,615. The monthly repayment of principal has been the primary advantage of Agency mortgage-backed securities as compared to other types of investment securities, which deliver proceeds upon maturity or call date. The Company also experienced a \$2,979, or 22.1%, increase in U.S. Government sponsored entity securities, primarily from new purchases during 2018.

In addition, increasing market rates during the first nine months of 2018 led to a \$2,508 increase in the net unrealized loss position associated with the Company's available for sale securities, which lowered the fair value of securities at September 30, 2018. The fair value of an investment security moves inversely to interest rates, so as rates increased, the unrealized loss in the portfolio was further affected. These changes in rates are typical and do not impact earnings of the Company as long as the securities are held to full maturity.

### Loans

The loan portfolio represents the Company's largest asset category and is its most significant source of interest income. Gross loan balances totaled \$782,377 at September 30, 2018, representing an increase of \$13,058, or 1.7%, as compared to \$769,319 at December 31, 2017. Positive loan growth from the commercial and consumer loan portfolios was partially offset by balance decreases in the residential real estate loan portfolio.

The majority of the Company's successful loan growth resides in the commercial lending portfolio, which increased \$14,499, or 4.5%, from year-end 2017. This increase came mostly from the commercial and industrial segment, which increased \$9,400, or 8.8%, from year-end 2017. The increase was mostly impacted by a \$7,961 state and municipal loan origination from the West Virginia market area during the first quarter of 2018. Commercial and industrial loans consist of loans to corporate borrowers primarily in small to mid-sized industrial and commercial companies that include service, retail and wholesale merchants. Collateral securing these loans includes equipment, inventory, and stock.

Commercial loan growth was also impacted by the commercial real estate loan segment, which increased \$5,099, or 2.4%, from year-end 2017. The commercial real estate segment comprised the largest portion of the Company's total commercial loan portfolio at September 30, 2018, representing 65.2%. The Company experienced an increase in nonowner-occupied loan originations, causing balances to grow by \$13,536, or 13.3%, from year-end 2017. Nonowner-occupied loan originations during the first nine months of 2018 came mostly from the Waverly and Athens, Ohio markets. Loan increases also came from construction loans, which increased \$900, or 2.4%, from year-end 2017. Partially offsetting these increases within the commercial real estate loan segment were larger payoffs from the owner-occupied loan segment, which decreased \$9,337, or 12.7%, from year-end 2017. While management believes lending opportunities exist in the Company's markets, future commercial lending activities will depend upon economic and related conditions, such as general demand for loans in the Company's primary markets, interest rates offered by the Company, the effects of competitive pressure and normal underwriting considerations. Management will continue to place emphasis on its commercial lending, which generally yields a higher return on investment as compared to other types of loans.

Consumer loan balances at September 30, 2018 increased \$2,408, or 1.7%, from year-end 2017, finishing at \$142,029. This growth was driven by higher automobile and home equity loan balances from year-end 2017. Automobile loans represent the Company's largest consumer loan segment at 49.4% of total consumer loans. The Company will continue to attempt to increase its auto lending segment while maintaining strict loan underwriting processes to limit future loss exposure.

The residential real estate loan segment comprises the largest portion of the Company's overall loan portfolio at 39.0% and consists primarily of one- to four-family residential mortgages and carries many of the same customer and industry risks as the commercial loan portfolio. Residential real estate loan balances during the first nine months of 2018 decreased \$3,849 or 1.2%, from year-end 2017. This decrease was largely the result of increasing short-term adjustable-rate mortgages, which were up \$359, being completely offset by decreasing long-term fixed-rate mortgages, which decreased \$6,745, from year-end 2017. As part of management's interest rate risk strategy, the Company continues to sell most of its long-term fixed-rate residential mortgages to the Federal Home Loan Mortgage Corporation, while maintaining the servicing rights for those mortgages. A customer that does not qualify for a long-term, secondary market loan may choose from one of the Company's other adjustable-rate mortgage products,



which has contributed to higher balances of adjustable-rate mortgages from year-end 2017.

### Allowance for Loan Losses

The Company established an \$8,315 allowance for loan losses at September 30, 2018, which was up from the \$7,499 allowance at year-end 2017. The allowance was impacted by an increase of \$411 in general allocations from year-end 2017. As part of the Company's quarterly analysis of the allowance for loan losses, management reviewed various factors that directly impact the general allocation needs of the allowance, which include: historical loan losses, loan delinquency levels, local economic conditions and unemployment rates, criticized/classified asset coverage levels and loan loss recoveries. From year-end 2017, both the historical loss and economic risk factors increased by 1 basis point, which contributed to the higher general allocation of the allowance for loan losses at September 30, 2018. However, the Company's improved delinquency levels at September 30, 2018 served to partially offset these risk factor effects. Nonperforming loans to total loans finished at 1.36% for both September 30, 2018 and December 31, 2017. Nonperforming assets to total assets dropped from 1.17% at year-end 2017 to 1.16% at September 30, 2018. General risks in the portfolio were positively impacted by lower impaired loans at September 30, 2018, which decreased \$7,166, or 39.6%, from year-end 2017, while criticized and classified loans from the commercial loan segment were collectively down \$882, or 2.6%, from year-end 2017.

Further additions to the allowance for loan losses came from an increase in the Company's specific allocations from \$94 at year-end 2017 to \$499 at September 30, 2018. Specific allocations of the allowance for loan losses identify loan impairment by measuring fair value of the underlying collateral and the present value of estimated future cash flows. The specific allocations at September 30, 2018 were primarily related to one residential real estate loan relationship that was determined to have a collateral value deficiency during the third quarter of 2018.

The Company's allowance for loan losses to total loans ratio finished at 1.06% at September 30, 2018 and 0.97% at year-end 2017. Management believes that the allowance for loan losses at September 30, 2018 was adequate and reflected probable incurred losses in the loan portfolio. There can be no assurance, however, that adjustments to the allowance for loan losses will not be required in the future. Changes in the circumstances of particular borrowers, as well as adverse developments in the economy, are factors that could change, and management will make adjustments to the allowance for loan losses as necessary. Asset quality will continue to remain a key focus, as management continues to stress not just loan growth, but quality in loan underwriting as well.

### Deposits

Deposits continue to be the most significant source of funds used by the Company to meet obligations for depositor withdrawals, to fund the borrowing needs of loan customers, and to fund ongoing operations. Total deposits at September 30, 2018 decreased \$3,829, or 0.4%, from year-end 2017. This change in deposits came primarily from noninterest-bearing deposit balances, which were down by \$21,080, or 8.3%, from year-end 2017. During the first nine months of 2018, the Company experienced a \$15 million decrease in its business checking account balances in relation to one commercial depositor relationship.

Partially offsetting the decline in noninterest-bearing balances were increases in interest-bearing deposits, which were collectively up \$17,251, or 2.9%, from year-end 2017. The increase came mostly from higher interest-bearing NOW account balances from year-end 2017, which increased \$11,119, or 15.3%. This increase was largely driven by higher municipal NOW product balances. Growth in interest-bearing deposits was further impacted by a \$6,409, or 6.4%, increase in statement savings account balances from year-end 2017. Conversely, the Company saw its money market account balances decrease \$10,636, or 8.0%, from year-end 2017, primarily from its Market Watch tiered account. Since the first half of 2017, the Company has experienced a deposit shift into more interest-bearing time deposits. At September 30, 2018, time deposits grew \$5,828, or 2.9%, from year-end 2017. The increase has come mostly from retail time deposits, which increased \$9,769, or 5.8% from year-end 2017. The growth in retail time deposits was affected by a short-term promotional CD offering by the Bank during the fourth quarter of 2017 that carried a competitive rate to attract additional retail funding. With market investment rates increasing, management has adjusted its CD rates upward, which have generated more of a consumer preference to invest in a CD as compared to a tiered money market product. The Company's brokered CD issuances decreased \$3,941, or 11.0%, as more interest-bearing deposit assets were used to fund earning asset growth.

While facing increased competition for deposits in its market areas, the Company will continue to emphasize growth and retention in its core deposit relationships during the remainder of 2018, reflecting the Company's efforts to reduce its reliance on higher cost funding and improving net interest income.

### Other Borrowed Funds

Other borrowed funds were \$40,514 at September 30, 2018, an increase of \$4,565, or 12.7%, from year-end 2017. The increase was related to management's decision to fund specific fixed-rate loans with like-term FHLB advances during the first quarter of 2018. While deposits continue to be the primary source of funding for growth in earning assets, management will continue to utilize Federal Home Loan Bank advances and promissory notes to help manage interest rate sensitivity and liquidity.

### Shareholders' Equity

Regulations of the Board of Governors of the Federal Reserve System (the "FRB") require a state-chartered bank that is a member of a Federal Reserve Bank to maintain certain amounts and types of capital and generally also require bank holding companies to meet such requirements on a consolidated basis. The FRB generally requires bank holding companies that have chosen to become financial holding companies to be "well capitalized," as defined by FRB regulations, in order to continue engaging in activities permissible only to bank holding companies that are registered as financial holding companies. If, however, a bank holding company, whether or not also a financial holding company, satisfies the requirements of the Federal Reserve's Small Bank Holding Company Policy (the "SBHCP"), the holding company is not required to meet the consolidated capital requirements. As amended effective in September, the SBHCP requires that the holding company have assets of less than \$3 billion, that it meet certain qualitative requirements, and that all of the holding company's bank subsidiaries meet all bank capital requirements. As of September 30, 2018, the Company was deemed to meet the SBHCP requirements and so was not required to meet consolidated capital requirements at the holding company level.

Total shareholders' equity at September 30, 2018 of \$113,839 increased \$4,478, or 4.1%, as compared to \$109,361 at December 31, 2017. Capital growth during 2018 came primarily from year-to-date net income of \$8,088, less dividends paid of \$2,973. In addition, net unrealized losses on available for sale securities increased \$2,154 from year-end 2017, as increasing interest rates during the first nine months of 2018 caused a reduction in the fair value of the Company's investment portfolio.

### Comparison of Results of Operations For the Three and Nine Months Ended September 30, 2018 and 2017

The following discussion focuses, in more detail, on the consolidated results of operations of the Company for the three and nine months ended September 30, 2018 compared to the same period in 2017. This discussion should be read in conjunction with the interim consolidated financial statements and the footnotes included in this Form 10 Q.

### Net Interest Income

The most significant portion of the Company's revenue, net interest income, results from properly managing the spread between interest income on earning assets and interest expense incurred on interest-bearing liabilities. During the third quarter of 2018, net interest income increased \$495, or 4.8%, as compared to the third quarter of 2017. During the nine months ended September 30, 2018, net interest income increased \$1,709, or 5.5%, as compared to the nine months ended September 30, 2017. The improvement came primarily from an average balance growth in loans and interest-bearing deposits with banks, as well as short-term rate increases from a year ago.

Total interest and fee income recognized on the Company's earning assets increased \$864, or 7.6%, during the third quarter of 2018, as compared to the same period in 2017. During the nine months ended September 30, 2018, interest and fee income on earning assets increased \$2,784, or 8.2%, as compared to the same period in 2017. Growth was led by interest and fees on loans, which increased \$629, or 6.0%, and \$1,724, or 5.5%, during the three and nine months ended September 30, 2018, as compared to the same periods in 2017, respectively. Average loans for the quarter ended September 30, 2018 compared to the quarter ended September 30, 2017 grew by 2.8%, or \$21,135. Average loans for the nine months ended September 30, 2018 increased \$26,882, or 3.6%, as compared to the nine months ended September 30, 2017. Throughout most of 2017, the Company experienced a growing trend of loan origination improvement that has had a positive impact to loan earnings in 2018. Furthermore, loan originations continued to improve during the third quarter of 2018, increasing average loans by \$8,077 when compared to the linked quarter ended June 30, 2018. The West Virginia market areas have been successful in generating over \$12.5 million in average loan balances, mostly from commercial lending, when comparing the nine months ended September 30, 2018

to 2017. During the same periods, the Athens, Ohio loan production office has also been successful in generating over \$12.5 million in average commercial and residential real estate loans. Average loan growth from a year ago was also impacted by growth within the automobile segment, as well as the commercial and industrial loan segment, impacted by loan participations and loans to states and political subdivisions.

During the three months ended September 30, 2018, interest income from interest-bearing deposits with banks increased \$184, or 227.2%, which contributed to an increase of \$862, or 187.8%, during the nine months ended September 30, 2018, when compared to the same periods in 2017. The increase was primarily due to higher interest revenue recorded from the Company's interest-bearing Federal Reserve Bank clearing account. The Company continues to utilize its Federal Reserve clearing account to manage seasonal tax refund deposits and fund earning asset growth. Average Federal Reserve Bank clearing account balances grew 94.4% and 53.2% during the three and nine months ended September 30, 2018, as compared to the same periods in 2017, which contributed to higher interest income. Furthermore, this interest-bearing account carried an interest rate of 1.25% at September 30, 2017. In December 2017, the Federal Reserve increased short-term rates by 25 basis points, and then again in March, June and September 2018 by another 25 basis points each to reach 2.25% at September 30, 2018. The timing of the December 2017 and March 2018 rate adjustments benefited the Company, as it entered into the first quarter of 2018 experiencing significant levels of excess funds impacted by the large volume of ERC/ERD transactions that was maintained within the Federal Reserve clearing account. Since the first quarter of 2018, these excess funds have been decreasing as a result of exiting the tax season.

The Company has been informed by its third-party tax refund product provider that the provider intends to cease utilizing the services of the Bank at December 31, 2018, before the current contract expiration date of December 31, 2019. Until the Bank replaces that agreement with an agreement with another tax refund product provider, the Company's deposits with the Federal Reserve Bank will be reduced, resulting in a decrease in the Company's interest income. The Bank has determined that it will be unable to replace that agreement for the 2019 tax season but will consider alternatives for future years. The Bank is also pursuing payment from its current provider for breach of contract. During the first nine months of 2018, when almost all of the tax refund processing has been completed and temporary deposits have been disbursed by the Bank, the Company earned approximately \$894 in interest from tax refunds held in the Bank's Federal Reserve Bank clearing account.

The Company also believes that it may experience a reduction in interest income as a result of a new state law, signed into law on July 30, 2018, which places numerous restrictions on short-term and small loans extended by certain non-bank lenders in Ohio. The new law, which will not apply to loans made before April 27, 2019, will apply to much of the lending of Loan Central. The Company is still attempting to determine the effect of the law on Loan Central and the Company, including the loans that would no longer be offered, increased expenses of loans offered and whether Loan Central might qualify for an exemption from the law, possibly after a potential amendment to the law or by making Loan Central a subsidiary of the Bank. The Company believes at this time, however, that the effect will not be material to the Company on a consolidated basis.

Total interest expense incurred on the Company's interest-bearing liabilities during the third quarter of 2018 increased \$369, or 35.2%, as compared to the same period in 2017. This increase contributed to a \$1,075, or 37.9%, increase in interest expense during the nine months ended September 30, 2018 when compared to the same period in 2017. The increase was primarily from interest expense on deposits, particularly time deposits. With loan demand up and average loan balances growing successfully during 2018 and most of 2017, the Company utilized more CD balances as a funding source to help keep pace with earning assets. The Company was successful in marketing a short-term CD special during the fourth quarter of 2017 that helped generate additional retail funds. The Company also utilized more brokered CD deposits as an additional funding source during the second half of 2017 that has impacted 2018 interest costs. As a result, average time deposits through September 30, 2018 have grown over \$23 million when compared to average time deposits through September 30, 2017. The Company's use of higher-costing time deposits caused the Company's total weighted average costs on interest-bearing deposits to increase by 19 basis points from 0.46% at September 30, 2017 to 0.65% at September 30, 2018. The higher average cost associated with time deposits, combined with higher average balances in 2018, contributed to over 80% of the interest expense increase during the three and nine months ended September 30, 2018, as compared to the same periods in 2017.

The Company's net interest margin is defined as fully tax-equivalent net interest income as a percentage of average earning assets. During 2018, the Company's third quarter net interest margin finished at 4.49%, compared to 2017's

third quarter net interest margin of 4.52%. The year-to-date net interest margin at September 30, 2018 finished at 4.41%, compared to 4.50% at September 30, 2017. This margin compression was related to higher average balances maintained at the Federal Reserve, which diluted the net interest margin due to the yield on those balances being less than other earning assets, such as loans and securities. Further impacting a lower margin is the continued rise in average costs on deposits, particularly time deposits. The Company's primary focus is to invest its funds into higher yielding assets, particularly loans, as opportunities arise. However, if loan balances do not continue to expand and remain a larger component of overall earning assets, the Company will face pressure within its net interest income and margin improvement.

### Provision for Loan Losses

During the third quarter of 2018, the Company's provision expense decreased \$639, or 39.9%, as compared to the same period in 2017. Lower provision expense was largely impacted by a \$954 decrease in quarterly net charge-offs, primarily from the commercial real estate segment. The positive impact of lower net charge-offs was partially offset by higher specific allocations of the allowance for loan losses. At September 30, 2018, specific reserves totaled \$499 compared to \$94 at year-end 2017. The increase was related to the collateral impairment of one residential real estate loan relationship that generated provision expense of \$409 during the third quarter of 2018.

During the first nine months of 2018, provision expense decreased \$226, or 11.8%, as compared to the same period in 2017. Lower year-to-date provision expense was primarily impacted by net charge-offs. Net charge-offs during the first nine months of 2018 totaled \$879, which represented a decrease of \$1,428 from the net charge-offs experienced during the same period in 2017, mostly from the commercial loan portfolio. The net charge-offs during the first nine months of 2017 included \$1,011 in charge-offs of specific reserves for which allocations had already been made prior to 2017.

Future provisions to the allowance for loan losses will continue to be based on management's quarterly in-depth evaluation that is discussed in further detail under the caption "Critical Accounting Policies - Allowance for Loan Losses" within this Management's Discussion and Analysis.

### Noninterest Income

Noninterest income for the three months ended September 30, 2018 decreased \$355, or 15.6%, when compared to the three months ended September 30, 2017. The quarter-to-date drop in revenue contributed to a limited growth in noninterest income of \$34, or 0.5%, during the nine months ended September 30, 2018, when compared to the nine months ended September 30, 2017. Lower quarterly noninterest revenue was largely impacted by BOLI and annuity income, which decreased \$404, or 70.0%, during the three months ended September 30, 2018, when compared to the same period in 2017. BOLI and annuity income was also down \$459, or 46.8%, during the year-to-date period ended September 30, 2018, as compared to 2017. BOLI investments are maintained by the Company in association with various benefit plans, including deferred compensation plans, director retirement plans and supplemental retirement plans. During the third quarter of 2017, the Company recorded \$3,530 in anticipated cash proceeds related to four BOLI policies, which yielded net BOLI proceeds of \$399 that was recorded to income. This large spike in earnings during the third quarter of 2017 caused the reduced effect in the third quarter of 2018, and also reduced the pace of growth in noninterest income on a year-to-date basis.

Noninterest income during 2018 was positively impacted by higher gains on OREO properties. In June of 2018, the Company recorded a \$104 net gain on the sale of one commercial property that contributed to the \$75 in total OREO revenue recorded during the nine months ended September 30, 2018. Further impacting OREO income were lower losses incurred on OREO properties. In January 2017, the Company recorded a fair value write-down of \$42 on one commercial property that contributed to the \$94 in total OREO losses recorded during the first nine months of 2017. With the Company minimizing its fair value write-downs during 2018, this generated a reverse effect (benefit) in the OREO income presented during the nine months ended September 30, 2018, when compared to the same period in 2017. As a result, OREO income increased \$169 during the nine months ended September 30, 2018, as compared to the same period in 2017. During the three months ended September 30, 2018 the Company experienced higher net OREO losses of \$82, as compared to \$23 in net OREO losses during the previous year's third quarter.

The Company also continues to benefit from increases in debit and credit card interchange income, as the transaction volume associated with its debit and credit card products continues to grow. Card transactions came mostly from restaurant, gasoline and retail store purchases. The Company has also been successful in promoting the use of both debit and credit cards by offering incentives that permit their users to redeem accumulated points for merchandise, as well as cash incentives paid. As a result, debit and credit card interchange income increased \$80, or 9.3%, during the



third quarter of 2018, and \$230, or 9.2%, during the first nine months of 2018, as compared to the same periods in 2017.

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The remaining noninterest income categories increased \$28, or 3.2%, during the third quarter of 2018 and increased \$94, or 2.3%, during the first nine months of 2018, as compared to the same periods in 2017. This was largely impacted by increases in swap rate agreement revenue and mortgage banking income, being partially offset by lower seasonal ERC/ERD fees.

While ERC/ERD fees were down, this activity has generated close to 21% of the Company's noninterest income so far in 2018. During the first nine months of 2018, the Company earned \$1,566 in ERC/ERD fees, constituting almost all of the ERC/ERD fees expected for 2018. Because the Bank has been informed that its third-party tax refund product provider intends to cease utilizing the services of the Bank by the end of 2018, the Company's ERC/ERD fees and non-interest income will be negatively affected.

#### Noninterest Expense

Noninterest expense during the third quarter of 2018 increased \$539, or 5.8%, as compared to the same period in 2017. Noninterest expense during the first nine months of 2018 increased \$770, or 2.7%, as compared to the same period in 2017. The key contributor to both overhead expense period increases came from expenses associated with salaries and employee benefits. Salary and employee benefit costs were up \$518, or 10.3%, during the third quarter of 2018, and up \$1,252, or 8.1%, during the year-to-date period ended September 30, 2018, as compared to the same periods in 2017. Higher employee compensation costs continue to be impacted by annual merit increases and higher insurance costs.

The Company also experienced growth in data processing expense, which increased \$195, or 34.6%, during the third quarter of 2018, and \$528, or 32.0%, during the nine months ended September 30, 2018, as compared to the same periods in 2017. The Company's total data processing expense is largely impacted by the transaction volume associated with debit and credit cards. However, the increase from 2017 to 2018 came mostly from costs associated with improving operating system efficiencies that could potentially lead to higher noninterest revenue opportunities. The expense is subject to the actual results of noninterest revenue improvement and will be monitored during the remainder of 2018.

Partially offsetting these effects of higher overhead expense were lower fraud-related and foreclosure asset expense. Fraud-related expense decreased \$12, or 33.3%, and \$855, or 93.5%, during the three and nine months ended September 30, 2018, as compared to the same periods in 2017, respectively. During the second quarter of 2017, the Company was made aware that four wire transfers associated with a single account relationship in May 2017 totaling \$933 were fraudulently initiated. The Company was able to recover \$103 of the money that was wired, which resulted in a net loss exposure of \$830 at September 30, 2017. Although the Company would eventually recover the net expense in the fourth quarter of 2017 from existing insurance policies, the fraudulent transaction contributed to higher noninterest expense at September 30, 2017.

Also down was foreclosure expense, which decreased \$104, or 65.8%, and \$261, or 61.4%, during the three and nine months ended September 30, 2018, as compared to the same periods in 2017, respectively. Costs associated with foreclosed assets include the costs of maintaining various commercial real estate properties, such as taxes, management fees and general maintenance.

The remaining noninterest expense categories decreased \$58, or 1.7%, during the third quarter of 2018, as compared to the same period in 2017. This decrease between periods was impacted mostly from higher third-party consulting expenses incurred during the third quarter of 2017. The remaining noninterest expense categories increased \$106, or 1.1%, during the first nine months of 2018, as compared to the same period in 2017. This change was largely from professional fees. Professional fees were impacted by legal expense associated with the recovery efforts on loan deficiency balances. Also within this line item were higher examination fees, which were impacted by the reinstatement of annual assessments on Ohio-chartered banks during the fourth quarter of 2017. Due to the timing of reinstatement, the annual assessment by the Ohio Division of Financial Institutions will cover all of 2018, as compared to just the second half of 2017.

Efficiency

The Company's efficiency ratio is defined as noninterest expense as a percentage of fully tax-equivalent net interest income plus noninterest income. The effects from provision expense are excluded from the efficiency ratio. Management continues to place emphasis on managing its balance sheet mix and interest rate sensitivity as well as developing more innovative ways to generate noninterest revenue. During the quarterly and year-to-date periods ended September 30, 2018, the Company was successful in generating more net interest income primarily due to higher average earning assets. However, noninterest revenue decreased 15.6% during the third quarter of 2018, which, when combined with net interest income, contributed to a limited net revenue growth pace that was outweighed by a higher pace of growth in quarterly overhead expense. As a result, the Company's efficiency number during the quarter-to-date period ended September 30, 2018 increased (regressed) from 72.33% to 76.23%. On a year-to-date basis, the successful growth in net interest income helped offset the limited growth in noninterest income and outpace the growth in overhead expense. As a result, the Company's efficiency numbers during the year-to-date period ended September 30, 2018 improved from 72.5% to 71.7%.

### Provision for income taxes

The Company recorded an income tax provision of \$1,428 during the first nine months of 2018 and had an effective tax rate for the year of 15.0% on pre-tax income of \$9,516. During the same period in 2017, the Company recorded an income tax provision of \$1,706 and had an effective tax rate of 20.5% on pre-tax income of \$8,317. The decline in the effective tax rate reflects the changes made by the TCJA, which was enacted on December 22, 2017. The TCJA provided for a reduction in the corporate federal income tax rate from 34% to 21% effective January 1, 2018, as well as the introduction of business-related exclusions, deductions and credits. Conversely, during the third quarter of 2018, the Company's income tax provision finished at \$221 compared to \$74 during the same period in 2017. The increase in quarterly tax expense was largely due to a higher level of taxable income combined with tax expense benefits recognized on tax-free BOLI proceeds and related post-retirement liability adjustments recorded in the third quarter of 2017. These factors completely offset the effects of the federal income tax rate reduction.

### Capital Resources

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company and the Bank on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Minimum requirements increased for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity tier 1 capital to risk-weighted assets ratio of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets. The capital conservation buffer began to phase in on January 1, 2016 at 0.625%, and as of January 1, 2018, was 1.875%. The buffer will be phased in over a four-year period, increasing by the same amount on each subsequent January 1, until fully phased-in on January 1, 2019. Further, Basel III rules increased the minimum ratio of tier 1 capital to risk-weighted assets from 4.0% to 6.0%, and all banks are now subject to a 4.0% minimum leverage ratio. The required total risk-based capital ratio was unchanged. Failure to maintain the required common equity tier 1 capital conservation buffer will result in potential restrictions on a bank's ability to pay dividends, repurchase stock and/or pay discretionary compensation to its employees.

Prompt corrective action regulations applicable to insured depository institutions provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At September 30, 2018 and year-end 2017, the Bank met the capital requirements to be deemed well capitalized under the regulatory framework for prompt corrective action. Regulations of the Board of Governors of the Federal Reserve System (the "FRB") require a state-chartered bank that is a member of a Federal Reserve Bank to maintain certain amounts and types of capital and generally also require bank holding companies to meet such requirements on a consolidated basis. The FRB generally requires bank holding companies that have chosen to become financial holding companies to be "well capitalized," as defined by FRB regulations, in order to continue engaging in activities permissible only to bank holding companies that are registered as financial holding companies. If, however, a bank holding company, whether or not also a financial holding company, satisfies the requirements of the Federal Reserve's Small Bank Holding Company Policy (the "SBHCP"), the holding company is not required to meet the consolidated capital requirements. As amended effective in September, the SBHCP requires that the holding company have assets of less than \$3 billion, that it meet certain qualitative requirements, and that all of the holding company's bank subsidiaries meet all bank capital requirements. As of September 30, 2018, the Company was deemed to meet the SBHCP requirements and so was not required to meet consolidated capital requirements at the holding company level.



The following table summarizes the capital ratios (excluding the capital conservation buffer) of the Company and the Bank. The minimums for the Company are those that would have been required if the Company was not a small bank holding company under the SBHCP.

|   | 9/30/18 | 12/31/17 | Minimum<br>Regulatory<br>Capital<br>Ratio | Minimum<br>To Be Well<br>Capitalized<br>(1) |
|---|---------|----------|---|---|
| Total risk-based capital ratio                |         |          |   |   |
| Company                                       | 17.3%   | 16.6%    | 8.0%                                      | 10.0%                                       |
| Bank  | 15.8%   | 15.3%    | 8.0%                                      | 10.0%                                       |
| Common equity tier 1 risk-based capital ratio |         |          |   |   |
| Company                                       | 15.0%   | 14.3%    | 4.5%                                      | N/A   |
| Bank  | 14.7%   | 14.3%    | 4.5%                                      | 6.5%  |
| Tier 1 risk-based capital ratio               |         |          |   |   |
| Company                                       | 16.1%   | 15.5%    | 6.0%                                      | 6.0%  |
| Bank  | 14.7%   | 14.3%    | 6.0%                                      | 8.0%  |
| Leverage ratio                                |         |          |   |   |
| Company                                       | 11.5%   | 11.0%    | 4.0%                                      | N/A   |
| Bank  | 10.5%   | 10.1%    | 4.0%                                      | 5.0%  |

(1) For the Company, these amounts are required to engage in activities permissible only for a bank holding company that meets the financial holding company requirements. For the Bank, these are the amounts required for the Bank to be deemed well capitalized under the prompt corrective action regulations.

Cash dividends paid by the Company were \$2,973 during the first nine months of 2018. The year-to-date dividends paid totaled \$0.63 per share for 2018.

### Liquidity

Liquidity relates to the Company's ability to meet the cash demands and credit needs of its customers and is provided by the ability to readily convert assets to cash and raise funds in the marketplace. Total cash and cash equivalents, held to maturity securities maturing within one year and available for sale securities, totaling \$172,412, represented 16.7% of total assets at September 30, 2018. In addition, the FHLB offers advances to the Bank, which further enhances the Bank's ability to meet liquidity demands. At September 30, 2018, the Bank could borrow an additional \$151,462 from the FHLB, of which \$80,000 could be used for short-term, cash management advances. Furthermore, the Bank has established a borrowing line with the Federal Reserve. At September 30, 2018, this line had total availability of \$57,725. Lastly, the Bank also has the ability to purchase federal funds from a correspondent bank.

### Off-Balance Sheet Arrangements

As discussed in Note 5 – Financial Instruments with Off-Balance Sheet Risk, the Company engages in certain off-balance sheet credit-related activities, including commitments to extend credit and standby letters of credit, which could require the Company to make cash payments in the event that specified future events occur. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of

a fee. Standby letters of credit are conditional commitments to guarantee the performance of a customer to a third party. While these commitments are necessary to meet the financing needs of the Company's customers, many of these commitments are expected to expire without being drawn upon. Therefore, the total amount of commitments does not necessarily represent future cash requirements.

Critical Accounting Policies

The most significant accounting policies followed by the Company are presented in Note A to the financial statements in the Company's 2017 Annual Report to Shareholders. These policies, along with the disclosures presented in the other financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions, and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management currently views the adequacy of the allowance for loan losses and business combinations to be critical accounting policies.

### Allowance for loan losses

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

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans generally consist of loans with balances of \$200 or more on nonaccrual status or nonperforming in nature. Loans for which the terms have been modified, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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

Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Smaller balance homogeneous loans, such as consumer and most residential real estate, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosure. Troubled debt restructurings are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Company determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and impaired loans that are not individually reviewed for impairment and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent 3 years for the consumer and real estate portfolio segment and 5 years for the commercial portfolio segment. The total loan portfolio's actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: Commercial Real Estate, Commercial and Industrial, Residential Real Estate, and Consumer.

Commercial and industrial loans consist of borrowings for commercial purposes by individuals, corporations, partnerships, sole proprietorships, and other business enterprises. Commercial and industrial loans are generally secured by business assets such as equipment, accounts receivable, inventory, or any other asset excluding real estate and generally made to finance capital expenditures or operations. The Company's risk exposure is related to deterioration in the value of collateral securing the loan should foreclosure become necessary. Generally, business



assets used or produced in operations do not maintain their value upon foreclosure, which may require the Company to write down the value significantly to sell.

Commercial real estate consists of nonfarm, nonresidential loans secured by owner-occupied and nonowner-occupied commercial real estate as well as commercial construction loans. An owner-occupied loan relates to a borrower purchased building or space for which the repayment of principal is dependent upon cash flows from the ongoing business operations conducted by the party, or an affiliate of the party, who owns the property. Owner-occupied loans that are dependent on cash flows from operations can be adversely affected by current market conditions for their product or service. A nonowner-occupied loan is a property loan for which the repayment of principal is dependent upon rental income associated with the property or the subsequent sale of the property. Nonowner-occupied loans that are dependent upon rental income are primarily impacted by local economic conditions which dictate occupancy rates and the amount of rent charged. Commercial construction loans consist of borrowings to purchase and develop raw land into one- to four-family residential properties. Construction loans are extended to individuals as well as corporations for the construction of an individual or multiple properties and are secured by raw land and the subsequent improvements. Repayment of the loans to real estate developers is dependent upon the sale of properties to third parties in a timely fashion upon completion. Should there be delays in construction or a downturn in the market for those properties, there may be significant erosion in value which may be absorbed by the Company.

Residential real estate loans consist of loans to individuals for the purchase of one- to four-family primary residences with repayment primarily through wage or other income sources of the individual borrower. The Company's loss exposure to these loans is dependent on local market conditions for residential properties as loan amounts are determined, in part, by the fair value of the property at origination.

Consumer loans are comprised of loans to individuals secured by automobiles, open-end home equity loans and other loans to individuals for household, family, and other personal expenditures, both secured and unsecured. These loans typically have maturities of 6 years or less with repayment dependent on individual wages and income. The risk of loss on consumer loans is elevated as the collateral securing these loans, if any, rapidly depreciate in value or may be worthless and/or difficult to locate if repossession is necessary. During the last several years, one of the most significant portions of the Company's net loan charge-offs have been from consumer loans. Nevertheless, the Company has allocated the highest percentage of its allowance for loan losses as a percentage of loans to the other identified loan portfolio segments due to the larger dollar balances and inherent risk associated with such portfolios.

#### Business combinations

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred and the amount of any noncontrolling interest in the acquiree. Acquisition related transaction costs are expensed and included in other operational result. When a business is acquired, the Company assesses the financial assets and liabilities assumed for appropriate classification and designation in accordance with the contractual terms, economic circumstances and pertinent conditions as at the acquisition date. We are required to record the assets acquired, including identified intangible assets, and the liabilities assumed at their fair value. These often involve estimates based on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analyses or other valuation techniques that may include estimates of attrition, inflation, asset growth rates, or other relevant factors. In addition, the determination of the useful lives over which an intangible asset will be amortized is subjective. Under FASB ASC 350 (SFAS No. 142 Goodwill and Other Intangible Assets), goodwill and indefinite-lived assets recorded must be reviewed for impairment on an annual basis, as well as on an interim basis if events or changes indicate that the asset might be impaired. An impairment loss must be recognized for any excess of carrying value over fair value of the goodwill or the indefinite-lived intangible asset.

#### Concentration of Credit Risk

The Company maintains a diversified credit portfolio, with residential real estate loans currently comprising the most significant portion. Credit risk is primarily subject to loans made to businesses and individuals in southeastern Ohio and western West Virginia. Management believes this risk to be general in nature, as there are no material concentrations of loans to any industry or consumer group. To the extent possible, the Company diversifies its loan portfolio to limit credit risk by avoiding industry concentrations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

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## ITEM 4. CONTROLS AND PROCEDURES

### Evaluation of Disclosure Controls and Procedures

With the participation of the Chief Executive Officer and President (the principal executive officer) and the Senior Vice President and Chief Financial Officer (the principal financial officer) of Ohio Valley, Ohio Valley's management has evaluated the effectiveness of Ohio Valley's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the quarterly period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, Ohio Valley's Chief Executive Officer and Senior Vice President and Chief Financial Officer have concluded that Ohio Valley's disclosure controls and procedures are effective as of the end of the quarterly period covered by this Quarterly Report on Form 10-Q to ensure that information required to be disclosed by Ohio Valley in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by Ohio Valley in the reports that it files or submits under the Exchange Act is accumulated and communicated to Ohio Valley's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

### Changes in Internal Control over Financial Reporting

There was no change in Ohio Valley's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during Ohio Valley's fiscal quarter ended September 30, 2018, that has materially affected, or is reasonably likely to materially affect, Ohio Valley's internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

Not applicable.

### ITEM 1A. RISK FACTORS

#### The expected discontinuance of the Bank's tax refund services under a contract with a third-party tax refund product provider may have an adverse effect on our net income and liquidity.

Through our relationship with a single tax refund product provider, the Bank offers products to facilitate the payment of tax refunds for customers who electronically file their tax returns. Under this program, the taxpayer may receive an electronic refund check or electronic refund deposit ("ERC/ERD"). In return, the Bank charges a fee for the service. For the 2018 tax season, the Company recorded ERC/ERD fee income of \$1,566. In addition, the Bank recorded interest income of \$894 on the temporary maintenance of tax refunds in the Bank's Federal Reserve Bank clearing account pending disbursement of the refunds.

The Bank has been informed by its third-party tax refund product provider that it intends to cease utilizing the services of the Bank by the end of 2018. The termination of this relationship, unless and until replaced, will adversely affect the Company's liquidity and net income. The Bank will be unable to replace the relationship for the 2019 tax season but will consider alternatives for future years.

A new Ohio law applicable to certain non-bank lenders may result in a reduction of income from Loan Central's operations, thus reducing the Company's net income.

The Company also believes that it may experience a reduction in interest income as a result of a new state law, signed into law on July 30, 2018, which places numerous restrictions on short-term and small loans extended by certain non-bank lenders in Ohio. The new law, which will apply to loans made on and after April 27, 2019, will apply to much of the lending of Loan Central. The Company is still attempting to determine the effect of the law on Loan Central and the Company, including the loans that would no longer be offered, increased expenses of loans offered, and whether Loan Central might qualify for an exemption from the law, possibly after a potential amendment to the law or by making Loan Central a subsidiary of the Bank.

In addition to the risk factors described above, you should carefully consider the risk factors disclosed in Part I, Item 1.A. "Risk Factors" in Ohio Valley's Annual Report on Form 10-K for the fiscal year ended December 31, 2017, as filed with the Securities and Exchange Commission. These risk factors could materially affect the Company's business, financial condition or future results. The risk factors described in the Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that management currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results. Moreover, the Company undertakes no obligation and disclaims any intention to publish revised information or updates to forward looking statements contained in such risk factors or in any other statement made at any time by any director, officer, employee or other representative of the Company unless and until any such revisions or updates are expressly required to be disclosed by applicable securities laws or regulations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Ohio Valley did not sell any unregistered equity securities during the three months ended September 30, 2018.

Ohio Valley did not purchase any of its shares during the three months ended September 30, 2018.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

(a) Exhibits:

| Exhibit<br>Number | Exhibit Description   |
|-------------------|---|
| 2(a)              | Agreement and Plan of Merger between Ohio Valley Banc Corp. and Milton Bancorp, Inc. dated January 7, 2016: Incorporated herein by reference to Exhibit 2.1 to Ohio Valley's Current Report on Form 8-K filed on January 7, 2016 (SEC File No. 0-20914).  |
| 2(b)              | Amendment to Agreement and Plan of Merger by and between Ohio Valley Banc Corp. and Milton Bancorp, Inc., dated April 20, 2016: Incorporated herein by reference to Exhibit 2.1 to Ohio Valley's Current Report on Form 8-K filed on April 21, 2016 (SEC File No. 0-20914).   |
| 3(a)              | Amended Articles of Incorporation of Ohio Valley (reflects amendments through April 7, 1999) [for SEC reporting compliance only - - not filed with the Ohio Secretary of State]. Incorporated herein by reference to Exhibit 3(a) to Ohio Valley's Annual Report on Form 10-K for fiscal year ended December 31, 2007 (SEC File No. 0-20914). |
| 3(b)              | Code of Regulations of Ohio Valley (as amended by the shareholders on May 12, 2010): Incorporated herein by reference to Exhibit 3(b) to Ohio Valley's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2010 (SEC File No. 0-20914).   |
| 4                 | <u>Agreement to furnish instruments and agreements defining rights of holders of long-term debt: Filed herewith.</u>  |
| 31.1              | <u>Rule 13a-14(a)/15d-14(a) Certification (Principal Executive Officer): Filed herewith.</u>  |
| 31.2              | <u>Rule 13a-14(a)/15d-14(a) Certification (Principal Financial Officer): Filed herewith.</u>  |
| 32                | <u>Section 1350 Certifications (Principal Executive Officer and Principal Accounting Officer): Filed herewith.</u>  |
| 101.INS #         | XBRL Instance Document: Filed herewith. #   |
| 101.SCH #         | XBRL Taxonomy Extension Schema: Filed herewith. #   |
| 101.CAL #         | XBRL Taxonomy Extension Calculation Linkbase: Filed herewith. #   |
| 101.DEF #         | XBRL Taxonomy Extension Definition Linkbase: Filed herewith. #  |
| 101.LAB #         | XBRL Taxonomy Extension Label Linkbase: Filed herewith. #   |
| 101.PRE #         | XBRL Taxonomy Extension Presentation Linkbase: Filed herewith. #  |

# Attached as Exhibit 101 are the following documents formatted in XBRL (eXtensive Business Reporting Language): (i) Unaudited Consolidated Balance Sheets; (ii) Unaudited Condensed Consolidated Statements of Income; (iii) Unaudited Consolidated Statements of Comprehensive Income; (iv) Unaudited Condensed Consolidated Statements of Cash Flows; and (v) Notes to the Consolidated Financial Statements.



SIGNATURES

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

OHIO VALLEY BANC CORP.

Date: November 9, 2018 By: /s/Thomas E. Wiseman  
Thomas E. Wiseman  
President and Chief Executive Officer

Date: November 9, 2018 By: /s/Scott W. Shockey  
Scott W. Shockey  
Senior Vice President and Chief Financial Officer