

Stock Yards Bancorp, Inc.  
Form 10-K  
February 28, 2019

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**Form 10-K**

**Annual Report Pursuant to Section 13  
or 15(d) of the Securities Exchange Act of 1934**

**For the Fiscal Year Ended    Commission File Number  
December 31, 2018            1-13661**

**STOCK YARDS BANCORP, INC.**

**1040 East Main Street  
Louisville, Kentucky 40206  
(502) 582-2571**

**Incorporated in Kentucky    I.R.S. No. 61-1137529**

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

*Title of each class:*                      *Name of each exchange on which registered:*  
Common Stock, no par value    NASDAQ Global Select Market

**Securities registered pursuant to Section 12(g) of the Act:**

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None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes      No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes      No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer    Accelerated filer  
Non-accelerated filer    Smaller reporting company  
Emerging growth 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 Act).

Yes            No

The aggregate market value of registrant's voting stock held by non-affiliates of the registrant as of June 30, 2018 (the last business day of the registrant's most recently completed second fiscal quarter) was \$786,898,457.

The number of shares of the registrant's Common Stock, no par value, outstanding as of February 22, 2019, was 22,791,883.

**Documents Incorporated By Reference**

Portions of Registrant's definitive proxy statement related to Registrant's Annual Meeting of Shareholders to be held on April 25, 2019 (the "Proxy Statement"), to be filed with the Securities and Exchange Commission, are incorporated by reference into Part III of this Form 10-K.

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**Glossary of Acronyms and Terms**

The following listing provides a comprehensive reference of common acronyms and terms used throughout the document:

Allowance	Allowance for loan and lease losses
ASU	Accounting Standards Update
Bancorp	Stock Yards Bancorp, Inc.
Bank	Stock Yards Bank & Trust Company
BOLI	Bank Owned Life Insurance
BP	Basis Point = 1/100 <sup>th</sup> of one percent
CEO	Chief Executive Officer
COSO	Committee of Sponsoring Organizations
CRA	Community Reinvestment Act of 1977
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
EPS	Earnings Per Share
EVP	Executive Vice President
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHC	Financial Holding Company
FHLB	Federal Home Loan Bank
FHLMC	Federal Home Loan Mortgage Corporation
FNMA	Federal National Mortgage Association
GLB Act	Gramm-Leach-Bliley Act
GNMA	Government National Mortgage Association
KING	King Bancorp, Inc.
KSOP	Combined employee profit sharing and stock ownership plan
LIBOR	London Interbank Offered Rate
MSA	Metropolitan Statistical Area
MSR	Mortgage Servicing Right
OAEM	Other Assets Especially Mentioned
Oldham	THE BANCORP, Inc.
OREO	Other Real Estate Owned
OTTI	Other-Than-Temporary Impairment
Prime	Wall Street Journal Prime Rate
Provision	Provision for loan and lease losses
PSU	Performance Stock Unit
RSU	Restricted Stock Unit
SAR	Stock Appreciation Right
SEC	Securities and Exchange Commission
SVP	Senior Vice President
TDRs	Troubled Debt Restructurings
US GAAP	United States Generally Accepted Accounting Principles

WM&T Wealth Management and Trust

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**Part I**

**Item 1. Business**

Stock Yards Bancorp, Inc. (“Bancorp” or “Company”), headquartered in Louisville, Kentucky, is the holding company for Stock Yards Bank & Trust Company (“Bank”). Bancorp, which was incorporated in 1988 in Kentucky, is registered with, and subject to supervision, regulation and examination by, the Board of Governors of the Federal Reserve System. The Bank is wholly owned and is a state chartered bank. Because Bancorp has no significant operations of its own, its business and that of the Bank are essentially the same. The operations of the Bank are fully reflected in the consolidated financial statements of Bancorp. Accordingly, references to “Bancorp” in this document may encompass both the holding company and the Bank.

**Stock Yards Bank & Trust Company**

Stock Yards Bank & Trust Company is the banking and sole subsidiary of Bancorp and was chartered in 1904. The Bank is headquartered in Louisville, Kentucky and provides commercial and personal banking services in the Louisville, Kentucky, Indianapolis, Indiana and Cincinnati, Ohio metropolitan markets through 38 full service banking offices. The Bank is chartered under the laws of the Commonwealth of Kentucky. In addition to traditional commercial and personal banking activities, the Bank has a wealth management and trust department (“WM&T”) offering a wide range of investment management, trust, employee benefit plan, estate administration, and financial planning services. The Bank also originates and sells single-family residential mortgages. Additionally, the Bank offers securities brokerage services via its branch network through an arrangement with a third party broker-dealer.

At December 31, 2018, Stock Yards Bank & Trust Company had 591 full-time equivalent employees. Employees of Stock Yards Bank & Trust Company are entitled to participate in a variety of employee benefit programs including a combined employee profit sharing and stock ownership plan (“KSOP”). Management of Bancorp strives to be an employer of choice and considers the relationship with employees to be good.

**Supervision and Regulation**

Bank holding companies and commercial banks are extensively regulated under both federal and state laws. Changes in applicable laws or regulations may have a material effect on the business and prospects of Bancorp.



Bancorp, as a registered bank holding company, is subject to the supervision of and regulation by the Federal Reserve Board under the Bank Holding Company Act of 1956. In addition, Bancorp is subject to the provisions of Kentucky's banking laws regulating bank acquisitions and certain activities of controlling bank shareholders.

Kentucky and federal banking statutes delineate permissible activities for Kentucky state-chartered banks. Kentucky's statutes, however, contain a super parity provision for Kentucky chartered banks having one of the top two ratings in its most recent regulatory examination. This provision allows these state banks to engage in any banking activity in which a national bank, a state bank operating in any other state, or a federally chartered thrift could engage. The bank must first obtain a legal opinion specifying the statutory or regulatory provisions that permit the activity.

The Bank is subject to the supervision of the Kentucky Department of Financial Institutions and the Federal Deposit Insurance Corporation. The Federal Deposit Insurance Corporation ("FDIC") insures the deposits of the Bank to the current maximum of \$250,000 per depositor.

The Gramm-Leach-Bliley Act (the "GLB Act") allows for affiliations among banks, securities firms and insurance companies by means of a financial holding company ("FHC"). The GLB Act requires that, at the time of establishment of an FHC, all depository institutions within that corporate group must be "well managed" and "well capitalized" and must have received a rating of "satisfactory" or better under its most recent Community Reinvestment Act examination. Further, non-banking financial firms (for example an insurance company or securities firm) may establish a FHC and acquire a depository institution. While the distinction between banks and non-banking financial firms has been blurring over recent years, the GLB Act makes it less cumbersome for banks to offer services "financial in nature" but beyond traditional commercial banking activities. Likewise, non-banking financial firms may find it easier to offer services that had, heretofore, been provided primarily by depository institutions. In 2012, management of Bancorp elected to become and became a FHC.

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) was signed into law in 2010. Generally, the Dodd-Frank Act was effective the day after it was signed into law, but different effective dates apply to specific sections of the law. This extensive and complex legislation contained many provisions affecting the banking industry, including but not limited to:

Creation of a Bureau of Consumer Financial Protection overseeing banks with assets totaling \$10 billion or greater while writing and maintaining several regulations that apply to all banks,  
Determination of debit card interchange rates by the Federal Reserve Board,  
New regulation over derivative instruments,  
Phase outs of certain forms of trust preferred debt and hybrids previously included as bank capital, and  
Increases to FDIC deposit coverage, revised calculations for assessing bank premiums, and numerous other provisions affecting financial institution regulation, oversight of certain non-banking organizations, investor protection.

The Community Reinvestment Act of 1977 (“CRA”) requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low- and moderate-income individuals and communities. Depository institutions are periodically examined for compliance with the CRA, and banking regulators take into account CRA ratings when considering approval of certain applications. An unsatisfactory CRA rating could, among other things, result in the denial or delay of corporate applications filed by Bancorp or the Bank for proposed activities such as branch openings or relocations and applications to acquire, merge or consolidate with another banking institution or holding company.

The federal banking regulators have adopted rules limiting the ability of banks and other financial institutions to disclose non-public information about consumers to unaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to an unaffiliated third party. These regulations affect how consumer information is conveyed to outside vendors. The Bank is also subject to regulatory guidelines establishing standards for safeguarding customer information. These guidelines describe the federal banking agencies’ expectations for the creation, implementation and maintenance of an information security program, which would include administrative, technical and physical safeguards appropriate to the size and complexity of the institution and the nature and scope of its activities.

The Bank is subject to the Bank Secrecy Act and the USA Patriot Act. These statutes and related rules and regulations impose requirements and limitations on specified financial transactions and accounts and other relationships intended to guard against money laundering and terrorism financing. Financial institutions must take certain steps to assist government agencies in detecting and preventing money laundering and report certain types of suspicious transactions. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not

required.

In 2013, the Federal Reserve Board and the FDIC approved rules that substantially amended regulatory risk-based capital rules applicable to Bancorp and Bank. The rules implemented regulatory capital reforms of the Basel Committee on Banking Supervision reflected in “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems” (“Basel III”) and changes required by the Dodd-Frank Act. The Basel III regulatory capital reforms became effective for Bancorp and Bank on January 1, 2015, and included new minimum risk-based capital and leverage ratios. Minimum capital level requirements applicable to bank holding companies and banks subject to the rules are:

- a common equity Tier 1 capital ratio of 4.5%,
- a Tier 1 risk-based capital ratio of 6% (increased from 4%),
- a total risk-based capital ratio of 8% (unchanged from previous rules), and
- a Tier 1 leverage ratio of 4% for all institutions.

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The rules also established a “capital conservation buffer” of 2.5%, to be phased in over three years between 2016 and 2019, above the regulatory minimum risk-based capital ratios, and will result in the following minimum ratios once the capital conservation buffer is fully phased in:

a common equity Tier 1 risk-based capital ratio of 7.0%,  
a Tier 1 risk-based capital ratio of 8.5%, and  
a total risk-based capital ratio of 10.5%.

The capital conservation buffer requirement began being phased in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if capital levels fall below minimum levels plus the capital conservation buffer amounts. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

Under these rules, Tier 1 capital generally consists of common stock (plus related surplus) and retained earnings, limited amounts of minority interest in the form of additional Tier 1 capital instruments, and non-cumulative preferred stock and related surplus, subject to certain eligibility standards, less goodwill and other specified intangible assets and other regulatory deductions. The definition of Tier 2 capital is generally unchanged for most banking organizations, subject to certain new eligibility criteria.

Common equity Tier 1 capital generally consists of common stock, additional paid-in capital and retained earnings plus limited amounts of minority interest in the form of common stock, less goodwill and other specified intangible assets and other regulatory deductions.

The rules allowed banks and their holding companies with less than \$250 billion in assets a one-time opportunity to opt-out of a requirement to include unrealized gains and losses in accumulated other comprehensive income in their capital calculation. Bancorp elected to opt-out of this requirement.

As of December 31, 2018, Bancorp met the requirements to be considered well-capitalized and is not subject to limitations due to the capital conservation buffer.

**Available Information**

Bancorp files reports with the Securities and Exchange Commission (“SEC”) including the Annual Report on Form 10-K, quarterly reports on Form 10-Q, current event reports on Form 8-K, and proxy statements, as well as any amendments to those reports. The SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>. Bancorp’s Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to section 13(a) or 15(d) of the Exchange Act are also accessible at no cost on Bancorp’s web site at <http://www.syb.com> after they are electronically filed with the SEC.

## **Item 1A. Risk Factors**

Investment in Bancorp’s common stock involves risk, and Bancorp’s profitability and success may be affected by a number of factors including those discussed below.

### **Financial condition and profitability depend significantly on local and national economic conditions.**

The Company’s success depends on general economic conditions both locally and nationally. Most of Bancorp’s customers are in the Louisville, Indianapolis, and Cincinnati metropolitan areas. Compared to regional or national financial institutions, Bancorp is less able to spread risks of unfavorable local economic conditions across a large number of diversified economies. Some of Bancorp’s customers are directly impacted by the local economy while others have more national or global business dealings. Deterioration in the quality of the credit portfolio could have a material adverse effect on financial condition, results of operations, and ultimately capital.

### **Financial condition and profitability depend on real estate values in the Company’s market area.**

Bancorp offers a variety of secured loans, including commercial lines of credit, commercial term loans, real estate, construction, home equity, consumer and other loans. Bancorp’s loans are typically secured by real estate (both residential and commercial) primarily in Bancorp’s market areas. In instances where borrowers are unable to repay their loans and there has been deterioration in the value of loan collateral, Bancorp could experience higher loan losses which could have a material adverse effect on financial condition, and results of operations.

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**If actual loan losses are greater than Bancorp's assumption for loan losses, earnings could decrease.**

Bancorp's loan customers may not repay their loans according to the terms of these loans, collateral securing payment of these loans may be insufficient to ensure repayment and the wealth of guarantors providing guarantees to support these loans may be insufficient to aid in the repayment of these loans. Accordingly, Bancorp might experience significant credit losses which could have a material adverse effect on operating results. Bancorp makes various assumptions and judgments about collectability of the loan portfolio, including creditworthiness of borrowers and value of collateral for repayment of many loans. In determining the adequacy of the allowance for loan and lease losses ("allowance"), Bancorp considers, among other factors, an evaluation of economic conditions and Bancorp's loan loss experience. If Bancorp's assumptions prove to be incorrect or economic problems are worse than projected, the current allowance may be insufficient to cover loan losses and adjustments may be necessary to allow for different economic conditions or adverse developments in the loan portfolio. Such additions to the allowance, if necessary, could have a material adverse impact on financial results.

Federal and state regulators annually review Bancorp's allowance and may require an increase in the provision for loan losses or loan charge-offs. If regulatory agencies require any increase in the provision for loan losses or loan charge-offs for which Bancorp had not allocated, it would have a negative effect on financial results.

**Fluctuations in interest rates could reduce profitability.**

Bancorp's primary source of income is from net interest spread, the difference between interest earned on loans and investments and interest paid on deposits and borrowings. Bancorp expects to periodically experience gaps in interest rate sensitivities of Bancorp's assets and liabilities, meaning that either interest-bearing liabilities will be more sensitive to changes in market interest rates than interest-earning assets, or vice versa. In either event, if market interest rates should move contrary to Bancorp's position, this gap will work against Bancorp and earnings will be negatively affected.

Many factors affect fluctuation of market interest rates, including, but not limited to the following:

- inflation or deflation
- recession
- a rise in unemployment
- tightening money supply
- international disorder and instability in foreign financial markets
- the Federal Reserve's actions to control interest rates

The Federal Reserve increased the overnight federal funds rate four times in 2018 which led to the Wall Street Journal Prime lending rate (“Prime”) increasing from 4.50% to 5.50%. Bancorp typically benefits from a rising interest rate environment, as the majority of the Company’s variable rate loans are tied to Prime with a lesser amount tied to the London Interbank Offering Rate (“LIBOR”). While variable rate loans have re-priced at higher rates Bancorp has also increased deposit rates in response to market pressure and funding needs. Deposit rates generally do not reprice as quickly as loans which positively affects earnings as rates rise in the short term. Market expectations are for the Federal Reserve to leave the federal funds rate at 5.50% for the duration of 2019. In addition, a flattening yield curve is widely anticipated, with the possibility of short term rates at some point exceeding longer term rates, resulting in an inverted yield curve. Deposit rates tend to be tied to the short end of the rate curve, while fixed-rate loans are largely priced based upon longer term rates, specifically five-year offerings. A flattening or inverted yield curve may increase Bancorp’s funding costs while limiting rates that can be earned on loans and investments, thereby decreasing net interest income and earnings. Migration of deposits out of Bancorp, as customers pursue higher rates, could impact liquidity and earnings as Bancorp competes for deposits. Changes in the mix of deposits could result in increased average rates paid on deposits, and lower earnings to Bancorp. Bancorp’s asset-liability management strategy, which is designed to mitigate risk from changes in market interest rates, may not be able to prevent changes in interest rates from having a material adverse effect on Bancorp’s results of operations and financial condition. Bancorp’s most recent earnings simulation model estimating the impact of changing interest rates on earnings for the next 12 months indicates net interest income will increase approximately 6% if interest rates immediately increase 200 basis points and decrease approximately 13% if rates immediately decrease 200 basis points. In 2019 Bancorp anticipates completing the purchase of King Bancorp, Inc., which will further add to funding pressure and could result in higher rates paid on deposits.

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**Bancorp is subject to funding risk.**

Funding risk represents dependence Bancorp has on large commercial deposit relationships. Approximately 40% of Bancorp's total deposits are centralized in accounts with balances \$500,000 or greater. Bancorp considers these deposits core funds as they represent long-standing, full-service relationships and are a testament to Bancorp's commitment to partner with business clients by providing exemplary service and competitive products. A sudden shift in customer behavior within these deposits resulting in balances being reduced or moved out of the Bank altogether could impact Bancorp's ability to capitalize on growth opportunities and meet current obligations. Bancorp has secondary sources of funding to draw upon as needed but the cost of those funds would be higher than typical deposit accounts which would negatively impact the financial condition and results of operation.

**Significant stock market volatility could negatively affect Bancorp's financial results.**

Income from WM&T constitutes approximately 47% of non-interest income. Trust assets under management are expressed in terms of market value, and a significant portion of fee income is based upon those values. A large majority of WM&T fees are based on market values which generally fluctuate with overall capital markets.

Capital and credit markets experience volatility and disruption from time to time. These conditions place downward pressure on credit availability, credit worthiness and customers' inclinations to borrow. Prolonged volatility or a significant disruption could negatively impact customers' ability to seek new loans or to repay existing loans. Personal wealth of many borrowers and guarantors has historically added a source of financial strength to certain loans and would be negatively impacted by severe market declines. Sustained reliance on personal assets to make loan payments would result in deterioration of their liquidity, and could result in loan defaults.

**Competition with other financial institutions could adversely affect profitability.**

Bancorp operates in a highly competitive industry that could become even more so as a result of earnings pressure of peer organizations, legislative, regulatory and technological changes and continued consolidation. Bancorp faces vigorous competition in price and structure of financial products from banks and other financial institutions. In recent years, credit unions have expanded their lending mix and now compete heavily with banks in the commercial real estate market. Non-traditional providers high risk tolerance for fixed rate, long-term loans has adversely affected Bancorp's net loan growth and results of operations. Bancorp also competes with other non-traditional providers of financial services, such as brokerage firms and insurance companies. As internet-based financial services continue to grow in acceptance, Bancorp must remain relevant as a place where consumers and businesses value personal service while other institutions offer these services without human interaction. The variety of sources of competition may reduce or limit margins on banking services, reduce market share and adversely affect results of operations and



financial condition.

**An extended disruption of vital infrastructure could negatively impact Bancorp's business, results of operations, and financial condition.**

Bancorp's operations depend upon, among other things, infrastructure, including equipment and facilities. Extended disruption of vital infrastructure by fire, power loss, natural disaster, telecommunications failure, information systems breaches, terrorist activity or the domestic and foreign response to such activity, or other events outside of Bancorp's control could have a material adverse impact on the financial services industry, the economy as a whole, and on Bancorp's business, results of operations and financial condition. Bancorp's business continuity plan may not work as intended or may not prevent significant interruption of operations. Occurrence of any failures or interruptions of information systems could damage Bancorp's reputation, result in loss of customer business, subject the Company to additional regulatory scrutiny, or expose Bancorp to civil litigation and possible financial liability, any of which could have an adverse effect on Bancorp's financial condition and results of operations.

**Security breaches or incidences of fraud could negatively impact Bancorp's business, results of operations, and financial condition.**

Bancorp's assets which are at risk for cyber-attacks include financial assets and non-public information belonging to customers. Cyber security risks include cyber espionage, blackmail, ransom, theft, and corporate account takeovers. Bancorp employs many preventive and detective controls to protect its assets, and provides mandatory recurring information security training to all employees. Bancorp has invested in multiple preventative tools in an attempt to protect customers from cyber threats and corporate account takeover. Bancorp regularly provides educational information regarding cyber threats to customers. Bancorp utilizes multiple third-party vendors who have access to the Company's assets via electronic media. While Bancorp requires third parties, many of whom are small companies, to have similar or superior controls in place, there is no guarantee that a breach of information could not occur. Activities of the Bank that subject Bancorp to risk of fraud by customers, employees, vendors, or members of the general public include ACH transactions, wire transactions, ATM transactions, checking transactions, and loan originations. Repeated incidences of fraud or a single large occurrence would adversely impact Bancorp's reputation and results of operations.

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**Bancorp’s credit metrics are currently at historically strong levels and this trend could normalize over time.**

During 2018, Bancorp’s asset quality metrics trended within a narrow range and exceeded benchmarks of the past several years to reach historically strong levels. Bancorp realizes that present asset quality metrics are exceptionally positive and, recognizing the cyclical nature of the lending business, the Company anticipates this trend will most likely normalize over time.

**Bancorp’s accounting policies and methods are critical to how Bancorp reports its financial condition and results of operations. They require management to make estimates about matters that are uncertain.**

Accounting policies and methods are fundamental to how Bancorp records and reports its financial condition and results of operations. Bancorp must exercise judgment in selecting and applying these accounting policies and methods so they comply with United States generally accepted accounting principles (“US GAAP”).

Bancorp has identified certain accounting policies as being critical because they require management’s judgment to ascertain the valuations of assets, liabilities, commitments and contingencies. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset, or reducing a liability. Bancorp has established detailed policies and control procedures intended to ensure these critical accounting estimates and judgments are well controlled and applied consistently.

Policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. Because of the uncertainty surrounding Bancorp’s judgments and estimates pertaining to these matters, there can be no assurances that actual results will not differ from those estimates. See the “Critical Accounting Policies” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” for more information.

**Bancorp operates in a highly regulated environment and may be adversely affected by changes to or lack of compliance with federal, state and local laws and regulations.**

Bancorp is subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or federal or state legislation could have a substantial impact on Bancorp and its operations. Additional legislation and regulations may be enacted or adopted in the future that could significantly affect Bancorp’s powers, authority and operations, which could have a material adverse effect on Bancorp’s financial condition and results of operations. If Bancorp’s policies, procedures and systems are deemed deficient, the Company would be subject to liability, including fines and regulatory actions, which may include restrictions on the ability to

pay dividends and the requirement to obtain regulatory approvals to proceed with certain aspects of Bancorp's business plan, including branching and acquisition plans.

**Bancorp's ability to stay current on technological changes in order to compete and meet customer demands is constantly being challenged.**

The financial services industry is constantly undergoing rapid technological changes, with frequent introductions of new technology-driven products and services. Future success of Bancorp will depend, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as to create additional operational efficiencies and greater privacy and security protection for customers and their personal information. Many of Bancorp's competitors have substantially greater resources to invest in technological improvements. Bancorp may not be able to effectively implement new technology-driven products and services as quickly as competitors or be successful in marketing these products and services to its customers. Bancorp relies on third party providers for many of its technology-driven banking products and services. Some of these companies may be slow to respond with upgrades or enhancements to their products to keep pace with improvements in technology or the introduction of competing products. Failure to successfully keep pace with technological change affecting the financial services industry could impair Bancorp's ability to effectively compete to retain or acquire new business and could have an adverse impact on its business, financial position, results of operations and liquidity.

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**Bancorp is dependent upon outside third parties for processing and handling of the Company's records and data.**

Bancorp relies on software developed by third-party vendors to process various transactions. In some cases, Bancorp has contracted with third parties to run their proprietary software on the Company's behalf. While Bancorp performs a review of controls instituted by applicable vendors over these programs in accordance with industry standards and performs testing of user controls, the Company relies on continued maintenance of controls by these third-party vendors, including safeguards over security of client data. Bancorp may incur a temporary disruption in the Company's ability to conduct business or process transactions, or incur reputational damage, if a third-party vendor fails to adequately maintain internal controls or institute necessary changes to systems. Such a disruption or breach of security could have a material adverse effect on Bancorp's business. Further, if these third-party service providers experience difficulties, or should terminate their services, and the Company is unable to replace them on a timely basis, Bancorp's business operations could be interrupted. If an interruption were to continue for a significant period of time, or if the Company incurred excessive costs involved with replacing third-party service provider, the Company's business, financial condition and results of operations could be adversely affected.

**Bancorp may not be able to attract and retain skilled people.**

Bancorp's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in the industry and markets in which Bancorp engages can be intense, and the Company may not be able to retain or hire the people wanted or needed. To attract and retain qualified employees, Bancorp must compensate them at market levels. If Bancorp is unable to continue to attract and retain qualified employees, or do so at rates necessary to maintain the Company's competitive position, Bancorp's performance, including the Company's competitive position, could suffer, and, in turn, adversely affect Bancorp's business, financial condition or results of operations.

**Bancorp invests in partnerships that generate federal income tax savings and these may not continue.**

Bancorp invests in certain partnerships that yield federal income tax credits resulting in higher net income for Bancorp. These transactions may also include lending to developers, further enhancing profitability of the transaction. These transactions typically involve a very limited number of counterparties. Availability and suitability of these transactions are not particularly predictable and may not continue to be favorable to Bancorp. Recently enacted income tax reform could result in fewer transactions and the extent to which federal income tax credits favorably affect Bancorp's net income. Therefore the positive effect on Bancorp's net income may not continue at levels previously experienced.

**Changes in customer use of banks could adversely affect Bancorp's financial condition and results of operations.**

Rapid evolution of non-bank alternatives for initiation and completion of financial transactions puts Bancorp at risk of losing sources of revenue and funding. The ability of customers to pay bills, transfer funds, and purchase assets without utilizing the banking system could result in loss of fee income, deposits, and loans. If Bancorp is unable to continue timely development of competitive new products and services, its business, financial condition and results of operations could be adversely affected.

**The Current Expected Credit Loss ("CECL") accounting standard will result in a significant change in how Bancorp recognizes credit losses and may have a material impact on the Company's financial condition or results of operations.**

In June 2016, the Financial Accounting Standards Board issued an accounting standard update, "Financial Instruments-Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments," which replaces the current "incurred loss" model for recognizing credit losses with an "expected loss" model. Whereas the incurred loss model delays recognition of loss on financial instruments until it is probable a loss has occurred, the expected loss model will recognize a loss at the time the loan is first added to the balance sheet. As result of this differing methodology, Bancorp expects adoption of the CECL model will materially affect the determination of the allowance and could require a significant increase to the allowance. Any material increase to the required level of loan loss allowance could adversely affect Bancorp's business, financial condition, and results of operations.

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The CECL standard will become effective for Bancorp for fiscal years beginning after December 15, 2019 and for interim periods beginning with the first quarter of 2020. While the impact of implementing the CECL model cannot be quantified at this time, Bancorp expects to recognize a one-time cumulative-effect adjustment to the allowance and stockholders' equity in the first quarter of 2020. Interagency guidance issued in December 2018 allows for a three year phase-in of the cumulative-effect adjustment for regulatory capital reporting.

**Company acquisitions could adversely affect Bancorp's financial condition and results of operations.**

An institution that the Company acquires may have asset quality issues or contingent liabilities that the Company did not discover or fully recognize in the due diligence process, thereby resulting in unanticipated losses. Acquisitions of other institutions also typically require integration of different corporate cultures, loan and deposit products, pricing strategies, data processing systems and other technologies, accounting, internal audit and financial reporting systems, operating systems and internal controls, marketing programs and personnel of the acquired institution. The integration process is complicated and time consuming and could divert the Company's attention from other business concerns and may be disruptive to its clients and clients of the acquired institution. The Company's failure to successfully integrate an acquired institution could result in loss of key clients and employees, and prevent the Company from achieving expected synergies and cost savings.

**Bancorp must transition from using LIBOR as a benchmark for loan pricing and swap transactions.**

LIBOR will cease to exist as a published rate after 2021. As of December 31, 2018, Bancorp has approximately \$400 million in variable rate loans with interest rates tied to LIBOR, of which approximately \$200 million have maturity dates beyond December 31, 2021. Bancorp's derivative activities based upon LIBOR include interest rate swap transactions with maturities beyond 2021 with notional amounts totaling approximately \$56 million. The Federal Reserve through the Alternative Reference Rate Committee has recommended a replacement benchmark rate, the Secured Overnight Financing Rate. All loan and swap contracts extending beyond 2021 will need to be managed effectively to ensure appropriate benchmark rate replacements are provided for and adopted. Failure to identify a replacement benchmark rate and/or update data processing systems could result in future interest rate changes not being correctly captured, which could result in interest rate risk not being mitigated as intended, or interest earned being miscalculated, which could adversely impact Bancorp's business, financial condition, and results of operations.

**Item 1B. Unresolved Staff Comments**

Bancorp has no unresolved SEC staff comments.

**Item 2. Properties**

The principal offices of Bancorp are located at 1040 East Main Street, Louisville, Kentucky. Bancorp's operations center is at a separate location. In addition to the main office complex and the operations center, Bancorp owned 21 branch properties at December 31, 2018, two of which are located on leased land. At that date, Bancorp also leased 17 branch facilities as well as its WM&T facility. Of the 38 banking locations, 28 are located in the Louisville Metropolitan Statistical Area ("MSA"), five are located in the Indianapolis MSA and five are located in the Cincinnati MSA. See Notes 6 and 19 to Bancorp's consolidated financial statements for the year ended December 31, 2018, for additional information relating to amounts invested in premises and equipment and lease commitments.

**Item 3. Legal Proceedings**

See Note 19 to Bancorp's consolidated financial statements for the year ended December 31, 2018, for information relating to legal proceedings.

**Item 4. Mine Safety Disclosures**

Not applicable.

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**Executive Officers of the Registrant**

The following table lists the names and ages as of December 31, 2018 of all current executive officers of Bancorp and the Bank. Each executive officer is appointed by Bancorp’s Board of Directors to serve at the discretion of the Board.

There is no arrangement or understanding between any executive officer of Bancorp or the Bank and any other person(s) pursuant to which he/she was or is to be selected as an officer.

<b>Name and Age of Executive Officer</b>	<b>Position and Offices with Bancorp and/or the Bank</b>
James A. Hillebrand Age 50	Chief Executive Officer and Director of Bancorp and the Bank
Philip S. Poindexter Age 52	President of Bancorp and the Bank
Kathy C. Thompson Age 57	Senior Executive Vice President and Director of Bancorp and the Bank
Nancy B. Davis Age 63	Executive Vice President, Treasurer and Chief Financial Officer of Bancorp and the Bank
William M. Dishman III Age 55	Executive Vice President and Chief Risk Officer of the Bank
T. Clay Stinnett Age 45	Executive Vice President and Chief Strategic Officer of Bancorp and the Bank
Michael J. Croce Age 49	Executive Vice President and Director of Retail Banking of the Bank
Michael V. Rehm Age 54	Executive Vice President, Chief Lending Officer

Mr. Hillebrand was appointed CEO of Bancorp and the Bank in October 2018. Prior thereto, he served as President of Bancorp and the Bank since July 2008. Prior thereto, he served as Executive Vice President (“EVP”) and Director of Private Banking of the Bank since 2005. From 2000 to 2004, he served as SVP (“SVP”) of Private Banking. Mr. Hillebrand joined the Bank in 1996.



Mr. Poindexter was appointed President of Bancorp and the Bank in October 2018. Prior thereto, he served as Chief Lending Officer of the Bank since July 2008. Prior thereto, he served as EVP of the Bank and Director of Commercial Banking. Mr. Poindexter joined the Bank in 2004.

Ms. Thompson was appointed Senior EVP of Bancorp and the Bank in January 2006. Prior thereto, she served as EVP of Bancorp and the Bank. She joined the Bank in 1992 and is Manager of the Wealth Management and Trust Department.

Ms. Davis was appointed EVP of Bancorp and the Bank in 1999 and Chief Financial Officer in 1993. She joined the Bank in 1991.

Mr. Dishman joined the Bank as EVP and Chief Risk Officer in February 2009.

Mr. Stinnett was appointed EVP and Chief Strategic Officer of Bancorp and the Bank in February 2011. Prior thereto, he served as SVP and Chief Strategic Officer of the Bank since 2005. Mr. Stinnett joined the Bank in 2000.

Mr. Croce was appointed EVP of the Bank and Director of Retail Banking in July 2014. Prior thereto, he served as SVP of the Bank and Division Manager of Business Banking. Mr. Croce joined the Bank in 2004.

Mr. Rehm was appointed EVP and Chief Lending Officer of the Bank in October 2018. Prior thereto, he served as SVP of the Bank and Division Manager of Commercial Lending. Mr. Rehm joined the Bank in 2006.

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## Part II

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

Bancorp’s common stock is traded on the NASDAQ Global Select Market under the ticker symbol SYBT. On December 31, 2018, Bancorp had approximately 1,600 shareholders of record, and approximately 5,800 beneficial owners holding shares in nominee or “street” name.

The following table shows information relating to the repurchase of shares of common stock by Bancorp during the three months ended December 31, 2018.

	<b>Total number of shares purchased</b>	<b>Average price paid per share</b>	<b>Total number of shares purchased as part of publicly announced plan</b>	<b>Maximum number of shares that may yet be purchased under the plan</b>
October 1 - October 31	1,103	\$ 31.15	–	–
November 1 - November 30	290	31.73	–	–
December 1 - December 31	190	32.80	–	–
<b>Total</b>	1,583	\$ 31.45	–	–

Activity represents shares of stock withheld to satisfy employee tax obligations due upon the exercise of stock appreciation rights, on lapsed shares of restricted stock and on performance stock unit awards. Bancorp does not have an active stock repurchase program.

The following performance graphs and data shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed soliciting material or subject to Regulation 14A of the Exchange Act or incorporated by reference in any filing under the Exchange Act or the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.

The first graph below compares performance of Bancorp Common Stock to the Russell 2000 index, the SNL Midwest Bank index, and the SNL Bank NASDAQ index for Bancorp's last five fiscal years. The graph assumes the value of the investment in Bancorp Common Stock and in each index was \$100 at December 31, 2013 and that all dividends were reinvested.

In addition to the five-year period required by the SEC, the ten-year period is presented because it provides additional perspective, and Bancorp management believes that longer-term performance is of greater interest. The ten-year graph assumes the value of the investment in Bancorp Common Stock and in each index was \$100 at December 31, 2008 and that all dividends were reinvested.

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<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/13</b>	<b>12/31/14</b>	<b>12/31/15</b>	<b>12/31/16</b>	<b>12/31/17</b>	<b>12/31/18</b>
Stock Yards Bancorp, Inc.	\$ 100.00	\$ 107.50	\$ 125.12	\$ 238.53	\$ 195.67	\$ 174.95
Russell 2000 Index	100.00	104.89	100.26	121.63	139.44	124.09
SNL Midwest Bank Index	100.00	108.71	110.36	147.46	158.46	135.31
SNL Bank NASDAQ Index	100.00	103.57	111.80	155.02	163.20	137.56

<i>Index</i>	<i>Period Ending</i>										
	<b>12/31/08</b>	<b>12/31/09</b>	<b>12/31/10</b>	<b>12/31/11</b>	<b>12/31/12</b>	<b>12/31/13</b>	<b>12/31/14</b>	<b>12/31/15</b>	<b>12/31/16</b>	<b>12/31/17</b>	<b>12/31/18</b>
Stock Yards Bancorp, Inc.	\$ 100.00	\$ 80.02	\$ 94.70	\$ 81.85	\$ 92.48	\$ 135.83	\$ 146.01	\$ 169.94	\$ 323.99	\$ 264.33	\$ 236.33
Russell 2000 Index	100.00	127.17	161.32	154.59	179.86	249.69	261.91	250.35	303.69	348.17	309.83
SNL Midwest Bank Index	100.00	84.75	105.24	99.40	119.64	163.80	178.07	180.78	241.54	259.56	221.64
SNL Bank NASDAQ Index	100.00	81.12	95.71	84.92	101.22	145.48	150.67	162.65	225.52	237.43	200.12

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(In thousands except per share data and ratios)	<b>Years ended December 31</b>									
	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>					
<b>Income statement data</b>										
Interest income	\$ 129,773	\$ 110,899	\$ 102,207	\$ 93,235	\$ 89,112					
Interest expense	15,357	7,246	4,918	4,852	5,330					
Net interest income	114,416	103,653	97,289	88,383	83,782					
Provision for loan and lease losses	2,705	2,550	3,000	750	(400)					
Non-interest income	45,346	44,499	42,920	39,315	38,563					
Non-interest expenses	89,509	90,420	80,938	72,828	72,642					
Income before income tax expense	67,548	55,182	56,271	54,120	50,103					
Income tax expense	12,031	17,139	15,244	16,933	15,281					
Net income	\$ 55,517	\$ 38,043	\$ 41,027	\$ 37,187	\$ 34,822					
<b>Per share data</b>										
Net income, basic	\$ 2.45	\$ 1.69	\$ 1.84	\$ 1.68	\$ 1.59					
Net income, diluted	2.42	1.66	1.80	1.65	1.57					
Cash dividends declared	0.96	0.80	0.72	0.64	0.59					
Book value	16.11	14.71	13.88	12.80	11.75					
Market value	32.80	37.70	46.95	25.19	22.23					
Weighted average common and common equivalent shares - diluted	22,944	22,983	22,792	22,459	22,144					
<b>Balance sheet data</b>										
Total assets	\$ 3,302,924	\$ 3,239,646	\$ 3,039,481	\$ 2,816,801	\$ 2,563,868					
Loans	2,548,171	2,409,570	2,305,375	2,033,007	1,868,550					
Allowance	25,534	24,885	24,007	22,441	24,920					
Available for sale securities	436,995	574,524	570,074	565,876	513,056					
Deposits	2,794,356	2,578,295	2,520,548	2,371,702	2,123,627					
Federal funds purchased	10,247	161,352	47,374	22,477	47,390					
Federal Home Loan Bank advances	48,177	49,458	51,075	43,468	36,832					
Stockholders' equity	366,500	333,644	313,872	286,519	259,895					
<b>Average balances</b>										
Stockholders' equity	347,041	327,798	304,151	274,451	245,425					
Total Assets	3,159,726	3,037,581	2,886,396	2,573,901	2,398,430					
Federal Home Loan Bank advances	48,766	50,300	45,455	41,041	35,709					
<b>Selected ratios</b>										
Return on average assets	1.76	%	1.25	%	1.42	%	1.44	%	1.45	%
Return on average equity	16.00		11.61		13.49		13.55		14.19	
Average stockholders' equity to average assets	10.98		10.79		10.54		10.66		10.23	
Net interest rate spread	3.60		3.52		3.51		3.59		3.67	
Net interest rate margin, fully tax-equivalent	3.83		3.64		3.59		3.67		3.75	
Efficiency ratio, fully tax-equivalent	55.92		60.61		57.39		56.62		58.91	

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Non-performing loans to total loans	0.13	0.31	0.29	0.44	0.64
Non-performing assets to total assets	0.13	0.31	0.39	0.48	0.70
Net charge offs to average loans	0.08	0.07	0.07	0.17	0.18
Allowance to total loans	1.00	1.03	1.04	1.10	1.33

Share and per share information has been adjusted to reflect the 3 for 2 stock-split in April 2016 effected in the form of a 50% stock dividend.

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

**Financial Section Summary**

The financial section of this Form 10-K includes management’s discussion and analysis, consolidated financial statements, and the notes to those financial statements. Bancorp has prepared the following summary to assist in your review of the financial section. It is designed to give the reader an overview of Stock Yards Bancorp, Inc. and summarize some of the more important activities and events that occurred during 2018. Share and per share information has been adjusted to reflect the April 2016 3 for 2 stock-split which was effected in the form of a 50% stock dividend.

The financial section includes the following:

“Management’s discussion and analysis (“MD&A”) provides information regarding the consolidated financial condition and results of operations of Bancorp. It contains management’s view about industry trends, risks, uncertainties, accounting policies that Bancorp views as critical in light of its business and results of operations. The discussion includes key performance drivers, financial position, cash flows, commitments and contingencies, important events, transactions that have occurred over the last three years, and forward-looking information, as appropriate.

Financial statements include Consolidated Balance Sheets as of the end of the last two years, and Consolidated Statements of Income, Comprehensive Income, Changes in Stockholders’ Equity, and Cash Flows, for each of the last three years. Bancorp’s financial statements are prepared in accordance with US GAAP.

Notes to the financial statements provide insight into, and are an integral part of, the financial statements. These notes contain explanations of significant accounting policies, details about certain captions on the financial statements, information about significant events or transactions that have occurred, discussions about legal proceedings, commitments and contingencies, and selected financial information relating to business segments. Notes to the financial statements also are prepared in accordance with US GAAP.

Reports related to the financial statements and internal controls over financial reporting include the following:

- A report from BKD, LLP, an independent registered public accounting firm, which includes their opinion on the presentation of Bancorp’s consolidated financial statements in conformity with US GAAP based on their audits;
- A report from management indicating Bancorp’s responsibility for financial reporting and the financial statements;

A report from management indicating Bancorp's responsibility for the system of internal control over financial reporting, including an assessment of the effectiveness of those controls;  
A report from BKD, LLP, which includes their opinion on the effectiveness of Bancorp's internal control over financial reporting; and  
A report from KPMG, LLP, an independent registered public accounting firm, which includes their opinion on the presentation of Bancorp's consolidated financial statements in conformity with US GAAP based on their prior period audits.

## **Our Business**

Stock Yards Bancorp, Inc. was incorporated in 1988, and its business is substantially the same as that of its wholly owned subsidiary, Stock Yards Bank & Trust Company. The Bank has operated continuously since it opened in 1904. The Bank conducted business at one location for 85 years and began branching in 1989. At December 31, 2018, the Bank had 28 full service banking locations in the Louisville MSA, 5 full service banking locations in the Indianapolis MSA, and 5 full service banking locations in the Cincinnati MSA. Bancorp's focus on flexible, attentive customer service has been key to its growth and profitability. The wide range of services provided by WM&T, investment product sales, and mortgage origination help support the corporate philosophy of capitalizing on full service customer relationships.



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**Forward-Looking Statements**

This report contains forward-looking statements under the Private Securities Litigation Reform Act that involve risks and uncertainties. These forward-looking statements may be identified by the use of words such as “expect”, “anticipate”, “plan”, “foresee”, “believe” or other words with similar meaning. Although Bancorp believes assumptions underlying forward-looking statements contained herein are reasonable, any of these assumptions could be inaccurate. Factors that could cause actual results to differ from results discussed in forward-looking statements include, but are not limited to: economic conditions both generally and more specifically in markets in which Bancorp and its subsidiary operate; competition for Bancorp’s customers from other providers of financial services; government legislation and regulation which change from time to time and over which Bancorp has no control; changes in interest rates; material unforeseen changes in liquidity, deterioration in the real estate market, results of operations or financial condition of Bancorp’s customers; or other risks detailed in Bancorp’s filings with the Securities and Exchange Commission and Item 1A of this Form 10-K, all of which are difficult to predict and many of which are beyond the control of Bancorp. Additionally, these forward-looking statements include, but are not limited to, statements relating to the expected timing and benefits of the proposed acquisition of King Bancorp, Inc., including future financial and operating results, cost savings, enhanced revenues, and accretion/dilution to reported earnings that may be realized from the acquisition, as well as other statements of expectations regarding the acquisition and other statements of goals, intentions and expectations; statements regarding its business plan and growth strategies; statements regarding the asset quality of King Bancorp’s loan and investment portfolios; and estimates of King Bancorp’s risks and future costs and benefits, whether with respect to the acquisition or otherwise.

**Critical Accounting Policies**

Bancorp has prepared consolidated financial information in this report in accordance with US GAAP. In preparing the consolidated financial statements, Bancorp makes estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurances that actual results will not differ from those estimates.

Management has identified the accounting policy related to the allowance and provision for loan and lease losses (“provision”) as critical to the understanding of Bancorp’s results of operations and discussed this conclusion with the Audit Committee of the Board of Directors. Since application of this policy requires significant management assumptions and estimates, it could result in materially different amounts to be reported if conditions or underlying circumstances were to change. The provision reflects an allowance methodology driven by risk ratings, historical losses, specific loss allocations, and qualitative factors. Assumptions include many factors such as changes in borrowers’ financial condition which can change quickly or historical loss ratios related to certain loan portfolios which may or may not be indicative of future losses. In the first quarter of 2018, Bancorp extended the historical period used to capture Bancorp’s historical loss ratios from 28 quarters to 32 quarters. This extension of the historical period was applied to all classes and segments of the loan portfolio. The expansion of the look-back period for the quantitative historical loss rate caused Bancorp to review the overall methodology for the qualitative factors to ensure

the Company was appropriately capturing the risk not addressed in the quantitative historical loss rate. Management believes the extension of the look-back period is appropriate to capture the impact of a full economic cycle and more accurately represents the current level of risk inherent in the loan portfolio.

The quarterly allowance calculation has both quantitative and qualitative factors which support the total balance of the allowance at period end. By extending the look-back period to 32 quarters to capture historical loss data for a full economic cycle, the allowance level increased approximately \$1.3 million compared with a 28 quarter look-back period as of March 31, 2018. The change in methodology was consistent with management's judgment regarding risk in the loan portfolio and consistent with internal analysis showing continued strong asset quality related not only in the Company's loan portfolio, but the Bank's peer group as well, validating continuation of the current economic cycle and thus the reasoning to extend the look-back period. Management will continue to evaluate appropriateness of the look-back period based on the status of the economic cycle. To the extent that management's assumptions prove incorrect, results from operations could be materially affected by a higher or lower provision for loan losses. The accounting policy related to the allowance is applicable to the commercial banking segment of Bancorp. The impact and any associated risks related to this policy on Bancorp's business operations are discussed in the "allowance for loan and lease losses" section below.

The allowance is management's estimate of probable losses inherent in the loan portfolio as of the balance sheet date. 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.

Bancorp's allowance calculation includes allocations to loan portfolio segments at December 31, 2018 for qualitative factors including, among other factors, local economic and business conditions in each of our primary markets, quality and experience of lending staff and management, exceptions to lending policies, levels of and trends in past due loans and loan classifications, concentrations of credit such as collateral type, trends in portfolio growth, trends in value of underlying collateral for collateral-dependent loans, effect of other external factors such as the national economic and business trends, quality and depth of the loan review function, and management's judgement of current trends and potential risks. Bancorp utilizes the sum of all allowance amounts derived as described above as the appropriate level of allowance. Changes in criteria used in this evaluation or availability of new information could cause the allowance to be increased or decreased in future periods. In addition, bank regulatory agencies, as part of their examination process, may require adjustments to the allowance based on their judgments and estimates.

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**Overview of 2018**

The following discussion should be read in conjunction with Bancorp's consolidated financial statements and accompanying notes and other schedules presented elsewhere in this report.

In 2018, Bancorp completed a record year of revenue growth, supported by solid asset and deposit growth. Total revenue, comprising fully tax equivalent net interest income and non-interest income, increased 8% to \$160.1 million in 2018 from \$148.9 million in 2017. Net income for the year ended December 31, 2018, was \$55.5 million or \$2.42 per diluted share compared with \$38.0 million or \$1.66 per diluted share for 2017.

Key aspects of the Company's performance for the year included:

The loan portfolio increased 6% year-over-year, helping drive interest income 17% higher in 2018, as compared with 2017;

Net interest margin rose 19 basis points in 2018, as compared with 2017, reflecting loan growth over the past year, higher yields on loans, and an increase in non-interest bearing deposits;

Credit quality metrics, which have remained at historically solid levels, improved further in 2018;

The Wealth Management and Trust Group revenue continued to grow, although that growth moderated in the fourth quarter due to the decline in the stock market; and

The effective tax rate declined consistent with federal income tax reform legislation enacted on December 22, 2017; net income for the fourth quarter of 2017 also reflected a non-cash charge of \$5.9 million or \$0.25 per diluted share to revalue the Company's net deferred tax asset.

As is the case with most banks, the primary source of Bancorp's revenue is net interest income and fees from various financial services provided to customers. Net interest income is the difference between interest income earned on loans, investment securities and other interest earning assets less interest expense on deposit accounts and other interest bearing liabilities. Loan growth and interest rates earned on loans are critical to overall profitability. Similarly, deposit growth is crucial to funding loans, and rates paid on deposits directly impact profitability. New business volume is influenced by economic factors including market interest rates, business spending, consumer confidence and competitive conditions within the marketplace.

As a result of record loan production, Bancorp increased the loan portfolio \$139 million, or 6%, to \$2.5 billion as of December 31, 2018. Increasing average yields on interest earning assets, along with the impact of increased volumes of loans contributed to higher interest income for 2018, as interest income increased \$18.9 million, or 17%, over the same period in 2017. Higher funding costs on deposits and borrowings, and deposit growth during 2018 resulted in increased interest expense of \$8.1 million or 112%, year over year. Bancorp benefited in recent years from historically low costs of funding, so that even modest increases in interest expense result in a significant percentage change over

prior periods. Net interest margin in 2018 increased to 3.83%, as compared with 3.64% in 2017 despite continuing pressure of a highly competitive lending environment and increasing rates paid on deposits.

Total non-interest income increased \$847 thousand, or 2% in 2018, as compared with 2017, and represented 28% of total revenues, down slightly from 30% in 2017. WM&T income, debit and credit card fees, treasury management fees, and investment products fees all increased in 2018 over 2017, with the greatest dollar increase from WM&T. WM&T represents an important part of the relationship focused philosophy of the Company and, accordingly, income from the department represents approximately 47% of total non-interest income for Bancorp. The magnitude of WM&T revenue distinguishes Bancorp from most other community banks of similar asset size and the 2018 increase reflected a rising stock market for most of the year and a strong year in terms of new WM&T clients added.

A decrease in amortization/impairment of investments in tax credit partnerships due to reduced investment opportunities resulted in lower non-interest expenses for 2018. Increases in other expenses, particularly personnel and technology costs associated with growth and operational support offset much of that decrease. Reflecting these variances, Bancorp's efficiency ratio for 2018 of 55.9% was down from 60.6% in 2017.

For the year ended December 31, 2018, Bancorp recorded a \$2.7 million provision, compared with \$2.6 million for the same period in 2017. The provision represents a charge to earnings necessary to maintain an allowance that, in management's evaluation, is adequate to provide coverage for inherent losses on outstanding loans. The provision was a reflection of continued historically strong credit quality metrics. Bancorp's allowance was 1.00% of total loans at December 31, 2018, compared with 1.03% of total loans at December 31, 2017.

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Bancorp's effective income tax rate decreased to 17.8% in 2018 from 31.1% in 2017. The decrease was largely a result of the reduction of the marginal federal tax rate from 35% to 21% effective January 1, 2018, due to the Tax Cuts and Jobs Act enacted on December 22, 2017. The tax reform also resulted in higher taxes in 2017 from a one-time \$5.9 million charge to remeasure Bancorp's net deferred tax asset. The 2017 effective tax rate included significantly more tax savings from stock-based compensation deductions and federal income tax credits. Bancorp anticipates an overall effective tax rate of approximately 18% in 2019. Bancorp invests in certain partnerships that yield federal income tax credits. The tax benefit of these investments exceeds the impairment charge associated with them, resulting in a positive impact on net income. The timing of these transactions is not predictable, and the magnitude can vary widely.

In 2017 Bancorp adopted ASU 2016-09 "Compensation – Stock Compensation Improvements to Employee Share-Based Payment Accounting". The standard requires the Company to recognize all excess tax benefits and deficiencies through the income statement as income tax expense or benefit. Under previous GAAP, any excess tax benefits were recognized in additional paid-in capital to offset current period and subsequent period tax deficiencies. Bancorp recorded benefits of \$549 thousand and \$1.5 million for such tax benefits against the provision for income tax expense in 2018, and 2017, respectively.

As of December 31, 2018, the Company's total stockholders' equity to total assets was 11.10% compared with 10.30% at December 31, 2017. The Company's ratio of tangible common equity to total tangible assets was 11.05% as of December 31, 2018, compared with 10.25% at December 31, 2017. Tangible common equity (TCE), a non-GAAP measure, is a measure of a company's capital which is useful in evaluating the quality and adequacy of capital. It consists of a company's common equity less any preferred equity, less intangible assets. Tangible common equity is divided by tangible assets, which equals total assets less intangible assets. See the Non-GAAP Financial Measures section for details on reconciliation to US GAAP measures.

Challenges for 2019 will include achieving continued loan growth, managing net interest margin, managing credit quality, integrating an acquisition into the organization, and adapting to technology changes and evolving customer behavior.

Bancorp's goals for 2019 include net loan growth at a pace similar to that experienced in 2018. This will be impacted by competition, prevailing economic conditions, line of credit utilization and prepayments in the loan portfolio.

Bancorp believes there is continued opportunity for loan growth in all three of its markets, and Bancorp's ability to deliver attractive loan growth over the long-term is linked to Bancorp's success.

Bancorp expects to maintain net interest margin at a level commensurate with 2018. While Bancorp does not expect the Federal Open Market Committee to adjust rates in 2019, the yield-curve is expected to flatten and possibly invert. Management expects converting liquidity on hand in the form of cash and securities into higher earning assets to offset anticipated deposit rate increases resulting from competitive market pressure.

Bancorp has been successful at gathering sufficient deposits to fund loan growth. While deposits in all market areas have grown, the most significant increases arose in the Louisville market, particularly in time deposits. Bancorp will need to continue to increase deposits while managing deposit mix to support loan growth in all markets.

Bancorp derives significant non-interest income from WM&T services. Most of these fees are based upon the market value of assets under management (AUM). To continue growth of this income source Bancorp must attract new customers and retain existing customers. Bancorp believes there is opportunity for growth in its three markets. Growth in market values of AUM and fees is dependent upon positive returns in the overall capital markets. Bancorp has no control over market volatility.

Bancorp expects to complete the merger of King Bancorp, Inc. in 2019. Acquisitions require integration of different corporate cultures, loan and deposit products, pricing strategies, data processing systems and other technologies, accounting, internal audit and financial reporting systems, operating systems and internal controls, and marketing programs and personnel. Bancorp will need to manage the transition effectively so as to maximize retention of King's customers, integrate personnel and systems efficiently, and maximize anticipated economic benefits.

Technological advances are consistently providing opportunities for Bancorp to consider potential new products and delivery channels. Bancorp's customers' demand for innovative and relevant products and services is expected to trend along with changing technology. Bancorp will need to continue to make prudent investments in technology while managing associated risks so as to remain competitive with other financial service providers.

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The following sections provide more details on subjects presented in this overview.

**Results of Operations**

Net income was \$55.5 million or \$2.42 per share on a diluted basis for 2018 compared with \$38.0 million or \$1.66 per share for 2017 and \$41.0 million or \$1.80 per share for 2016.

Net income for 2018 was positively impacted by:

- a \$10.8 million, or 10% increase in net interest income,
- a \$1.0 million, or 5% increase in WM&T income, and
- a \$5.1 million, or 30% decrease in income tax.

Net income for 2018 was negatively impacted by:

- a \$3.5 million, or 8% increase in compensation expense, and
- a \$940 thousand, or 12% increase in technology and communication expense.

The following paragraphs provide a more detailed analysis of significant factors affecting operating results.

**Net Interest Income**

Net interest income, the most significant component of Bancorp's earnings, represents total interest income less total interest expense. Net interest spread is the difference between the taxable equivalent rate earned on average interest earning assets and the rate expensed on average interest bearing liabilities. Net interest margin represents net interest income on a taxable equivalent basis as a percentage of average earning assets. Net interest margin is affected by both interest rate spread and the level of non-interest bearing sources of funds. The level of net interest income is determined by mix and volume of interest earning assets, interest bearing deposits and interest bearing liabilities and by changes in interest rates. The discussion that follows is based on tax-equivalent interest data.

Comparative information regarding net interest income follows:

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(Dollars in thousands)	2018	2017	2016	2018/2017 Change	2017/2016 Change		
Net interest income, tax- equivalent basis	\$114,723	\$104,446	\$98,123	9.8	%	6.4	%
Net interest spread	3.60	% 3.52	% 3.51	% 8	bp	1	bp
Net interest margin	3.83	% 3.64	% 3.59	% 19	bp	5	bp
Average earning assets	\$2,998,526	\$2,872,717	\$2,730,949	4.4	%	5.2	%
Five year Treasury note rate at year end	2.51	% 2.20	% 1.93	% 31	bp	27	bp
Average five year							
Treasury note rate	2.75	% 1.91	% 1.33	% 84	bp	58	bp
Prime rate at year end	5.50	% 4.50	% 3.75	% 100	bp	75	bp
Average prime rate	4.90	% 4.10	% 3.51	% 80	bp	59	bp
One month LIBOR at year end	2.52	% 1.56	% 0.77	% 96	bp	79	bp
Average one month LIBOR	2.02	% 1.11	% 0.50	% 91	bp	61	bp

bp = basis point = 1/100th of a percent

References above to net interest margin and net interest spread exclude the sold portion of certain participation loans from calculations. Such loans remain on Bancorp's balance sheet as required by US GAAP because Bancorp retains some form of effective control; however, Bancorp receives no interest income on the sold portion of these loans.

These participation loans sold are excluded from calculation of margins, because Bancorp believes it provides a more accurate depiction of the performance of its loan portfolio.



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Prime rate, the five year Treasury note rate and the one month LIBOR are included above to provide a general indication of the interest rate environment in which Bancorp operated. Approximately \$1 billion, or 40%, of Bancorp's loans are variable rate, of which 99% are indexed to either the Prime rate or one month LIBOR and generally reprice as those rates change. At inception, most of Bancorp's fixed rate loans are priced in relation to the five year Treasury note.

Average loan balances increased \$214 million or 9% in 2018. The Federal Reserve increased the target federal funds rate four times during the year, and rising interest rates allowed for an increase in loan yields of 36 basis points despite a competitive lending environment. Bancorp grew average interest bearing deposits \$67 million or 4%. Average interest costs on interest bearing deposits increased 38 basis points as management increased rates on certain deposit accounts during 2018. Average Federal Home Loan Bank ("FHLB") advances decreased by \$1.5 million or 3.1%, with average cost decreasing by one basis point to 1.89%.

Management anticipates net interest margins in 2019 will be similar to levels achieved in 2018 due the expected lack of rate increases from the Federal Open Market Committee, and a potential flattening or inverting yield curve. However, competitive pressures on rates for new loans could result in pressure on the net interest margin for 2019. Approximately 40% of the Company's loan portfolio is priced at variable rates, so any future rate increases will benefit this part of the portfolio. The remainder of the portfolio is priced at fixed rates. As fixed-rate loans renew and new fixed-rate loans originate, pricing could be higher, but pricing will be subject to competitive conditions, prevailing interest rates, and a flattening or possibly inverted yield curve. The margin could be affected negatively if competitive conditions for loan pricing within Bancorp's markets prevents the realization of higher fixed rates. Similarly, increased competition for deposits could result in higher rates paid on deposits, which would negatively affect net interest margin. Bancorp recognizes that higher rates paid on alternative investments available to customers will eventually force deposit interest rates to increase more quickly and severely than what has been experienced to date.

## **Asset/Liability Management and Interest Rate Risk**

Managing interest rate risk is critical to Bancorp. The primary objective of interest rate risk management is to neutralize effects of interest rate changes on net income. By considering both on and off-balance sheet financial instruments, management evaluates interest rate sensitivity while attempting to optimize net interest income within the constraints of prudent capital adequacy, liquidity needs, market opportunities and customer requirements.

## **Interest Rate Simulation Sensitivity Analysis**

Bancorp uses an earnings simulation model to estimate and evaluate the impact of an immediate change in interest rates on earnings in a one year forecast. The simulation model is designed to reflect dynamics of interest earning

assets and interest bearing liabilities. By estimating effects of interest rate increases and decreases, the model can reveal approximate interest rate risk exposure. This simulation model is used by management to gauge approximate results given a specific change in interest rates at a given point in time. The model is therefore a tool to indicate earnings trends in given interest rate scenarios and may not indicate actual expected results.

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The December 31, 2018 simulation analysis, which shows little interest rate sensitivity, indicates that Bancorp is asset sensitive as increases in interest rates of 100 to 200 basis points have a positive effect on net interest income. If rates immediately rise 200 basis points, net interest income would increase 5.58%. Bancorp's excess liquidity held in interest bearing deposit accounts and other short-term investments, along with variable rate loans gives the Company significant assets that will reprice as rates move. Asset balances subject to immediate repricing cause an estimated decline in net interest income in down 100 and 200 basis point rate scenarios as rates on non-maturity deposits cannot be lowered sufficiently to offset declining interest income. These estimates are summarized below.

	<b>Net interest income % change</b>
Increase 200 bp	5.58
Increase 100 bp	2.79
Decrease 100 bp	(1.69)
Decrease 200 bp	(12.89)

Approximately 60% of Bancorp's loan portfolio has fixed rates and 40% of its loan portfolio is priced at variable rates. With the Prime rate increasing four times in 2018 to 5.50%, Bancorp's variable rate loans are beyond their floors and will reprice as rates change. This effect is captured in the simulation analysis above.

Undesignated derivative instruments described in Note 22 to Bancorp's consolidated financial statements are recognized on the consolidated balance sheet at fair value, with changes in fair value due to changes in prevailing interest rates, recorded in other non-interest income. Because of matching terms of offsetting contracts, in addition to collateral provisions which mitigate the impact of non-performance risk, changes in fair value subsequent to initial recognition have a minimal effect on earnings, and are therefore not included in the simulation analysis results above.

Derivatives designated as cash flow hedges described in Note 22 to Bancorp's consolidated financial statements are recognized on the consolidated balance sheet at fair value, with changes in fair value due to changes in prevailing interest rates, recorded net of tax in other comprehensive income.

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The following table presents the increases in net interest income due to changes in rate and volume computed on a tax-equivalent basis and indicates how net interest income in 2018 and 2017 was impacted by volume increases and the higher average interest rate environment. Tax-equivalent adjustments are based on a federal income tax rate of 21% in 2018 and 35% in 2017 and 2016. The change in interest due to both rate and volume has been allocated to the change due to rate and the change due to volume in proportion to the relationship of the absolute dollar amounts of the change in each.

**Taxable Equivalent Rate/Volume Analysis**

(In thousands)	<b>2018/2017 Increase (decrease) due to Net</b>		<b>2017/2016 Increase (decrease) due to Net</b>			
	<b>Rate</b>	<b>Volume</b>	<b>Rate</b>	<b>Volume</b>	<b>Rate</b>	<b>Volume</b>
	<b>change</b>	<b>change</b>	<b>change</b>	<b>change</b>	<b>change</b>	<b>change</b>
<b>Interest income</b>						
Loans	\$18,352	\$8,559	\$9,793	\$8,096	\$1,866	\$6,230
Federal funds sold and interest bearing due from banks	(23 )	654	(677 )	839	714	125
Mortgage loans held for sale	(25 )	35	(60 )	(46 )	24	(70 )
Securities						
Taxable	636	1,205	(569 )	(86 )	142	(228 )
Tax-exempt	(552 )	(151 )	(401 )	(152 )	79	(231 )
<b>Total interest income</b>	<b>18,388</b>	<b>10,302</b>	<b>8,086</b>	<b>8,651</b>	<b>2,825</b>	<b>5,826</b>
<b>Interest expense</b>						
Deposits						
Interest bearing demand deposits	2,434	2,312	122	596	540	56
Savings deposits	132	122	10	132	127	5
Money market deposits	2,789	2,942	(153 )	1,263	1,172	91
Time deposits	2,111	1,813	298	41	129	(88 )
Securities sold under agreements to repurchase	23	39	(16 )	(2 )	(17 )	15
Federal funds purchased and other short-term borrowings	653	302	351	106	117	(11 )
Federal Home Loan Bank advances	(31 )	(2 )	(29 )	192	106	86
<b>Total interest expense</b>	<b>8,111</b>	<b>7,528</b>	<b>583</b>	<b>2,328</b>	<b>2,174</b>	<b>154</b>
<b>Net interest income</b>	<b>\$10,277</b>	<b>\$2,774</b>	<b>\$7,503</b>	<b>\$6,323</b>	<b>\$651</b>	<b>\$5,672</b>

Bancorp's tax equivalent net interest income increased \$10.3 million for the year ended December 31, 2018 compared with the same period of 2017, while 2017 increased \$6.3 million compared with 2016.

Overall, net interest income for the comparative periods was positively impacted by an increase in the average rate earned on assets, which exceeded the increase in the average cost of deposits, and by an increase in non-interest bearing deposits. As shown in the table above, net interest income for 2018 compared with 2017 was positively impacted, most significantly by an increase in loan volume and interest rates earned on loans. Interest rates earned on taxable securities also positively impacted net interest income. Declines in balances of all earning asset categories aside from loans negatively impacted net interest income. Increases in rates paid on deposits and federal funds purchased and other short-term borrowings also negatively impacted net interest income.

For the year 2017 compared with 2016, net interest income was positively impacted, most significantly by an increase in loan volume and to a lesser extent interest rates earned on loans. Investments in federal funds sold and interest bearing due from banks volume and rates positively impacted net interest income. Declines in securities volumes, increased rates paid on deposit balances, and increased rates paid on federal funds purchased, other short-term borrowings, and FHLB advances negatively impacted net interest income. Overall net interest income for the comparative periods was positively impacted by an increase in the average rate earned on assets, which exceeded the increase in the average rate paid on deposits.

Table of Contents**Provision for Loan and Lease Losses**

In determining the provision, management considers many factors. Among these are the quality of the loan portfolio, underlying collateral, previous loss experience, size and composition of the loan portfolio and an assessment of the impact of current economic conditions on borrowers' ability to pay. The provision for years ended 2018, 2017, and 2016, along with resulting ratios are summarized below:

(Dollars in thousands)	<b>2018</b>	<b>2017</b>	<b>2016</b>
Provision (credit) for loan and lease losses	\$2,705	\$2,550	\$3,000
Allowance to loans at year end	1.00 %	1.03 %	1.04 %
Allowance to average loans for year	1.01	1.08	1.11

The provision represents a charge to earnings necessary to maintain an allowance that, in management's evaluation, is adequate to provide coverage for inherent losses on outstanding loans and leases. The allowance is calculated after considering credit quality factors, and ultimately relies on an overall internal analysis of risk in the loan portfolio. Based on this analysis, the provision is determined and recorded. The provision reflects results of an allowance methodology that is driven by risk ratings, historical losses, specific loan loss allocations, and qualitative factors. The 2018 provision reflected a number of factors, including loan growth, and other quantitative and qualitative considerations. Key indicators of loan quality remained consistent with prior years. Bancorp considers present asset quality metrics to be strong. Recognizing the cyclical nature of the lending business, this trend will most likely normalize over the long term. More information on this process can be found in the "allowance for loan and lease losses" section.

Non-performing loans decreased to \$3.4 million at December 31, 2018 from \$7.4 million at year-end 2017, consistent with the decline in non-accrual loans. Troubled debt restructurings (TDRs) currently accruing interest, decreased from \$869 thousand at December 31, 2017 to \$42 thousand at December 31, 2018, declining as a result of payoffs in full of two loans and scheduled payments applied to principal on two remaining loans. The ratio of non-performing loans to total loans was 0.13% at December 31, 2018, compared with 0.31% at December 31, 2017 with both ratios representing historic lows. Another key metric, net charge-offs, totaled 0.08% of average loans for 2018, as compared with 0.07% reported for 2017. See "Financial Condition-Non-performing Loans and Assets" for further discussion of non-performing loans. See "Financial Condition-Summary of Loan and Lease Loss Experience" for further discussion of loans charged off during the year.

Bancorp's loan portfolio is diversified with no significant concentrations of credit. Geographically, most loans are extended to borrowers in the metropolitan areas of Louisville, Indianapolis and Cincinnati. The adequacy of the allowance is monitored on an ongoing basis and it is the opinion of management that the balance of the allowance at December 31, 2018 is adequate to absorb probable losses inherent in the loan portfolio as of the financial statement date. See "Financial Condition - Allowance for loan and lease losses" for more information on the allowance.



Table of Contents**Non-Interest Income**

The following table provides a comparison of components of non-interest income for years ended 2018, 2017 and 2016. Below the table is a discussion of significant changes and trends.

(Dollars in thousands)	2018	2017	2016	2018/2017		2017/2016			
				Change		Change			
				\$	%	\$	%		
Wealth management and trust services	\$21,536	\$20,505	\$19,155	\$1,031	5.0 %	\$1,350	7.0 %		
Deposit service charges	5,759	6,172	6,037	(413 )	(6.7 )	135	2.2		
Debit and credit cards	6,769	5,979	5,655	790	13.2	324	5.7		
Treasury management	4,571	4,297	3,867	274	6.4	430	11.1		
Mortgage banking	2,568	3,221	3,897	(653 )	(20.3 )	(676 )	(17.3 )		
Loss on sale of securities	—	(232 )	—	232	100.0	(232 )	(100.0)		
Net investment product sales commissions and fees	1,677	1,629	1,563	48	2.9	66	4.2		
Bank owned life insurance	1,129	1,159	871	(30 )	(2.6 )	288	33.1		
Other	1,337	1,769	1,875	(432 )	(24.4 )	(106 )	(5.7 )		
	\$45,346	\$44,499	\$42,920	\$847	1.9 %	\$1,579	3.7 %		

**Wealth Management and Trust**

The largest component of non-interest income is WM&T revenue. The magnitude of WM&T revenue distinguishes Bancorp from other community banks of similar asset size. Trust assets under management totaled \$2.8 billion at December 31, 2018, unchanged from the \$2.8 billion at December 31, 2017. Assets under management are stated at market value. WM&T revenue, which constitutes an average of 47% of non-interest income, increased \$1.0 million, or 5.0%, for 2018 compared with 2017. The 2018 increase in WM&T revenue was the result of both a rising stock market for much of the year and continued addition of new clients added. Recurring fees, which generally comprise over 97% of the WM&T revenue, increased \$789 thousand, or 3.9%, in 2018, compared with 2017. Recurring fees earned for managing accounts are based on a percentage of market value of the assets under management and are typically assessed on a monthly basis. Some revenues of the WM&T department, most notably executor, insurance, and some employee benefit plan-related fees, are non-recurring in nature and the timing of these revenues corresponds with the related administrative activities, and is also based on the market value of assets under management. Total non-recurring fees increased \$242 thousand for 2018, compared with 2017 due to an increase in estate fees. Contracts between WM&T and their clients do not permit performance based fees and accordingly, none of the fees earned by WM&T are performance based. Management believes the WM&T department will continue to factor significantly in Bancorp's financial results and provide strategic diversity to revenue streams. Management is optimistic that the WM&T department will deliver consistent growth in 2019, but notes that increased market volatility could affect



near-term results.

The following table provides information regarding assets under management by WM&T as of December 31, 2018 and 2017. This table highlights that:

Approximately 80% of AUM is actively managed.

Corporate retirement plan accounts consist primarily of participant directed assets.

The amount of custody and safekeeping accounts is insignificant, and

The majority of managed assets are in personal trust and investment advisory accounts.

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Assets Under Management by Account Type (In thousands)	As of December 31, 2018		As of December 31, 2017	
	Managed	Non-managed (1)	Managed	Non-managed (1)
Personal trust accounts	\$532,254	\$ 80,167	\$535,931	\$ 98,358
Personal individual retirement accounts	344,900	2,363	350,841	7,407
Corporate retirement accounts	47,884	390,619	54,688	400,793
Investment advisory accounts	1,077,904	34,214	1,079,569	21,213
Foundation and endowment accounts	187,492	1,020	208,314	–
Total accounts	\$2,190,434	\$ 508,383	\$2,229,343	\$ 527,771
Custody and safekeeping accounts	–	66,058	–	52,385
Totals	\$2,190,434	\$ 574,441	\$2,229,343	\$ 580,156
Total managed and non-managed assets	\$2,764,875		\$2,809,499	

(1) Non-managed assets represent those for which WM&T does not have investment discretion.

The table below presents data regarding WM&T managed assets by class of investment as of December 31, 2018 and 2017. Managed assets are invested in instruments for which market values can be readily determined, the majority of which are sensitive to market fluctuations. This table demonstrates that:

The composition of managed assets is divided approximately 60% in equities and 40% in fixed income, and this composition is relatively consistent from year to year, and  
The Bank has no proprietary mutual funds.

**Managed Assets by Class of Investment**

(In thousands)	As of December 31,	
	2018	2017
Non-interest bearing deposits	\$–	\$–
Interest bearing deposits	139,779	127,237
US Treasury and government agency obligations	53,513	43,582
State, county and municipal obligations	128,057	135,056
Money market mutual funds	8,627	7,811
Equity mutual funds	485,961	560,605
Other mutual funds - fixed, balanced, and municipal	290,352	304,765
Other notes and bonds	155,701	124,380
Common and preferred stocks	801,690	843,006
Real estate mortgages	352	369
Real estate	49,840	49,344
Other miscellaneous assets (1)	76,562	33,188

Total managed assets \$2,190,434 \$2,229,343

(1) Includes client directed instruments including rights, warrants, annuities, insurance policies, unit investment trusts, and oil and gas rights.

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The table below provides information regarding fee income earned by Bancorp's WM&T department for the years ended December 31, 2018, 2017 and 2016. It demonstrates that WM&T fee revenue is earned most significantly from personal trust and investment advisory accounts. Fees are based on AUM and tailored for individual accounts and/or relationships. WM&T uses a fee structure that considers and tailors based on type of account and other factors. For example, fee structures are in place for investment management, irrevocable trusts, revocable trusts, IRA accounts, and accounts holding only fixed income securities. There are also fee structures for estate settlements, which are non-recurring, and retirement plan services which can include a one-time conversion fee with recurring AUM fees to follow. All fees are based on market value of each account and are tiered based on account size, with larger relationships paying a lower percentage of AUM in fees. Fees are agreed upon at the time an account is opened and these and any subsequent revisions are communicated in writing to the customer. Fees earned are not performance based nor are they based on investment strategy or transactions.

### Wealth Management and Trust Services Income

(In thousands)	Years Ended December 31,		
	2018	2017	2016
Personal trust accounts	\$7,322	\$7,285	\$7,142
Personal individual retirement accounts	4,994	4,829	4,649
Investment advisory accounts	8,395	7,464	6,521
Foundation and endowment accounts	552	540	491
Custody and safekeeping accounts	161	152	104
Brokerage and insurance services	53	40	45
Other	59	195	203
Total	\$21,536	\$20,505	\$19,155

### Additional sources of non-interest income

Deposit service charges decreased \$413 thousand, or 6.7%, for 2018 compared with 2017. Service charge income is driven by transaction volume, which can fluctuate throughout the year. The decreases for 2018 are primarily due to customers transitioning away from fee based accounts towards fee free checking offerings and a reduction in fees related to overdrawn checking accounts. Management expects this source of revenue to slowly decline due to anticipated changes in customer behavior, including reduced check volume, and ongoing regulatory restrictions.

Deposit service charges increased \$135 thousand, or 2.2%, for 2017 compared with 2016. The increase for 2017 was primarily due to the introduction of a new checking account in the third quarter of 2016. This product provides ancillary services to customers, while carrying a monthly service charge. Fees earned on this product in 2017 totaled \$846 thousand compared with \$440 thousand in 2016. Another significant component of service charges is related to

fees earned on checking account overdrafts, which declined \$145 thousand in 2018 compared with 2017.

Debit and credit card revenue increased \$790 thousand, or 13.2%, for 2018 compared with 2017. This revenue stream is impacted by both growth in the customer base and corresponding debit and credit card usage. Debit card interchange income increased \$386 thousand or 7.9% in 2018, as compared with 2017. Looking forward to 2019, Bancorp expects a slight decrease in interchange rates as service providers gravitate to lower cost options within the market, however, growth in number of accounts and transaction volume is anticipated to offset the decline in rates. Commercial credit card income increased \$376 thousand, or 33.9%, year over year. Volume, which is dependent upon customer behavior and new accounts, is expected to continue to increase in 2019. In contrast, interchange income is based on rates set by service providers in a competitive market.

Debit and credit card revenue increased \$324 thousand or 5.7% in 2017 compared with 2016 due largely to increased volume resulting from newly offered commercial credit cards, offset by decreased debit card revenue.

Treasury management revenue primarily consists of fees earned for cash management services provided to commercial customers. This category has been a growing source of revenue for Bancorp including an increase in 2018 of \$274 thousand or 6.4% compared with 2017. Treasury management revenue increased \$430 thousand or 11.1% in 2017 compared with 2016. Bancorp expects this category to continue to grow in 2019 at a pace comparable to 2018 due to an expanding customer base and as more existing customers take advantage of offered services.

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Mortgage banking revenue primarily includes gains on sales of mortgage loans. Bancorp's originates residential mortgage loans to be sold in the secondary market. Interest rates on loans sold are locked with the investor prior to closing the loans, thus Bancorp bears no interest rate risk related to these loans. The Company offers conventional, Veterans Affairs and Federal Housing Administration financing, for purchases and refinances, as well as programs for first-time home buyers. Interest rates on mortgage loans directly impact the volume of business transacted by the mortgage banking division. Mortgage banking revenue decreased \$653 thousand, or 20.3%, in 2018 compared with 2017 after having decreased \$676 thousand or 17.3% in 2017 compared with 2016. As interest rates have risen, Bancorp has experienced a slowing of refinancing activity. In Bancorp's primary market of Louisville, Kentucky, the housing inventory was generally low throughout 2018, also contributing to the declines.

In 2018 and 2016, Bancorp did not sell any securities available for sale. In 2017, Bancorp sold an equity security realizing a loss of \$263 thousand. One security was called prior to maturity in 2017 resulting in the receipt of a \$31 thousand pre-payment penalty. Management has the intent and ability to hold all remaining investment securities available for sale for the foreseeable future.

Net investment product sales commissions and fees increased \$48 thousand, or 2.9% in 2018, corresponding to overall brokerage volume. Net investment product sales commissions increased \$66 thousand or 4.2% in 2017 despite Department of Labor regulations that resulted in fee restructuring, and in many cases reductions, for many types of investment products. Investment products commissions and fees consist primarily of stock, bond, and mutual fund sales, as well as wrap fees on accounts. Wrap fees are charges for investment programs that bundle together a suite of services, such as brokerage, advisory, research and management, and are based on a percentage of assets. Bancorp deploys its brokers primarily through its branch network via an arrangement with a third party broker-dealer, while larger managed accounts are serviced in the Bank's WM&T department.

Bank owned life insurance ("BOLI") assets represent the cash surrender value of life insurance policies on certain key employees who have provided consent for Bancorp to be the beneficiary of a portion of such policies. The related change in cash surrender value and any death benefits received under the policies are recorded as non-interest income. This income helps offset costs of various employee benefits. Income related to BOLI decreased \$30 thousand, or 2.6% in 2018. The decrease is attributable to decreasing crediting rates on investments. BOLI income in 2018 included life insurance proceeds of \$382 thousand. BOLI income increased \$288 thousand or 33.1% in 2017 compared with 2016 as a result of life insurance proceeds of \$348 thousand.

Other non-interest income decreased \$432 thousand, or 24.4%, during 2018 compared with 2017. Included in this category is interest rate swap fee income, which totaled \$119 thousand and \$227 thousand for 2018 and 2017, respectively. Opportunities to earn swap fee income are sporadic due to the specialized nature of these type of transactions. Other non-interest income decreased \$106 thousand or 5.7% during 2017 compared with 2016. Swap fees in 2017 declined \$300 thousand compared with 2016 while income related to exiting tax credit partnerships increased \$154 thousand in 2017 compared with 2016. This category contains a variety of other income sources, none of which resulted in individually significant variances in either comparison.



Table of Contents**Non-interest expenses**

The following table provides a comparison of components of non-interest expenses for years ended 2018, 2017 and 2016. Below the table is a discussion of significant changes and trends.

(Dollars in thousands)	2018	2017	2016	2018/2017		2017/2016	
				Change		Change	
	\$			\$	%	\$	%
Compensation	\$46,104	\$42,581	\$40,814	\$3,523	8.3 %	\$1,767	4.3 %
Employee benefits	10,098	9,987	8,368	111	1.1	1,619	19.3
Net occupancy and Equipment	7,653	7,393	7,422	260	3.5	(29 )	(0.4 )
Technology and Communications	8,897	7,957	7,040	940	11.8	917	13.0
Marketing and business Development	3,099	2,716	2,464	383	14.1	252	10.2
Postage, printing and Supplies	1,558	1,475	1,521	83	5.6	(46 )	(3.0 )
Legal and professional	2,614	2,393	1,869	221	9.2	524	28.0
FDIC insurance	961	960	1,181	1	0.1	(221 )	(18.7)
Amortization/impairment of investments in tax credit partnerships	1,237	7,124	4,458	(5,887)	(82.6)	2,666	59.8
Capital and deposits based taxes	3,325	3,440	2,800	(115 )	(3.3 )	640	22.9
Other	3,963	4,394	3,001	(431 )	(9.8 )	1,393	46.4
	\$89,509	\$90,420	\$80,938	\$(911 )	(1.0 )%	\$9,482	11.7 %

Compensation, which includes salaries, incentives, bonuses, and stock based compensation, increased \$3.5 million or 8.3% in 2018 compared with 2017, and \$1.8 million or 4.3% in 2017, as compared with 2016. The increases reflected higher salaries, increased production and performance based compensation, including stock compensation, and the addition of personnel associated with growth and operational support. At December 31, 2018, Bancorp had 591 full-time equivalent employees compared with 580 at December 31, 2017 and 578 at December 31, 2016.

Employee benefits consists of all personnel related expense not included in compensation, with the two most significant items being health insurance and payroll taxes. Employee benefits increased \$111 thousand or 1.1% in 2018 compared with 2017, primarily due to increased health insurance costs year over year. Bancorp is self-insured, and health insurance costs fluctuate based on levels of claims. The increase in employee benefits in 2017 compared with 2016 was due primarily to increased health insurance costs year over year of \$1.4 million.

Net occupancy and equipment expense increased \$260 thousand, or 3.5%, from 2018 to 2017. This category primarily includes rent, depreciation, and maintenance, variances for which were not individually significant. In 2017 this category expense decreased \$29 thousand or 0.4% compared with 2016. At December 31, 2018, Bancorp had 38



banking center locations, including the main office, and a separate operations center. Costs of capital asset additions flow through the statement of income over lives of the assets in the form of depreciation expense.

Technology and communications expenses increased \$940 thousand, or 11.8%, from 2017 to 2018, and \$917 thousand or 13.0% in 2017, as compared with 2016 largely due to increases in computer operations additions and improvements. This category includes computer software amortization, equipment depreciation, and expenditures related to investments in new technology needed to maintain and improve the quality of customer delivery channels, information security, and internal resources.

Marketing and business development expenses include all costs associated with promoting Bancorp, community investment, retaining customers and acquiring new business. Category expense increased \$383 thousand or 14.1% in 2018 compared with 2017, due largely to advertising costs associated with deposit gathering campaigns in the second and third quarters of 2018. Expense in 2017 compared with 2016 increased \$252 thousand or 10.2% due largely to an increase in community donations within Bancorp's market areas offset somewhat by decreased advertising expense.

Postage, printing and supplies expenses increased \$83 thousand or 5.6% in 2018 compared with 2017. The increase year over year was comprised of numerous items, none of which were individually significant. Expense in 2017 decreased \$46 thousand or 3.0% compared with 2016. The decline year over year was comprised of numerous items, none of which were individually significant.

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Legal and professional fees increased \$221 thousand to \$2.6 million in 2018 from \$2.4 million in 2017 due to costs associated with Bancorp's pending acquisition. Legal and professional fees increased \$524 thousand in 2017 compared with 2016. Legal fees increased \$174 thousand or 34% in 2017 compared with 2016 primarily due to increased litigation costs arising through the normal course of business. Professional and consulting fees increased \$350 thousand or 26.5% due to increased fees associated with out-sourcing assistance for loan review and tax services.

FDIC insurance expense was unchanged in 2018, as compared with 2017. During 2016, the FDIC revised the assessment criteria to more closely align FDIC assessments with each financial institution's risks. Bancorp benefited from this change which resulted in 2017 expense decreasing \$221 thousand or 18.7% compared with 2016.

Capital and deposit based taxes decreased \$115 thousand or 3.3% in 2018, as compared with 2017 as a result of reduced local deposit-based tax expense. In 2017 capital and deposit based taxes increased \$640 thousand, or 22.9% due to increased capital-based franchise tax.

Amortization/impairment of investments in tax credit partnership decreased \$5.9 million for the year ended December 31, 2018 compared with the same period of 2017. The 2017 expense represented a \$2.7 million increase compared with 2016. These partnerships generate federal income tax credits. For each of Bancorp's investments in tax credit partnerships, the tax benefit compared to related expenses results in a positive effect on net income. The amounts of credits and corresponding expenses can vary widely depending upon the timing and magnitude of investments. See the Income Taxes section below for details on these credits and expenses.

Other non-interest expenses decreased \$431 thousand, or 9.8% for the year ended December 31, 2018 compared with the same period of 2017. Expenses for 2017 included a \$266 thousand liability accrual related to an estimated loss from certain administrative proceedings arising in the course of business.

Other non-interest expenses increased \$1.4 million, or 46.4% for the year ended December 31, 2017 compared with the same period of 2016. Significant items impacting the variance consisting of the following:

A recovery of \$588 thousand in 2016 related to an impairment loss recognized in 2008.

A decrease of \$370 thousand on gains from the sale of repossessed assets, as 2017 net gains totaled \$39 thousand compared with \$409 thousand in 2016.

A \$266 thousand liability accrual in 2017 related to an estimated loss from certain administrative proceedings arising in the course of our business.

Expenses associated with a checking account product increased \$137 thousand in 2017 over 2016.

Fraud related losses increased \$165 thousand in 2017 compared with 2016.

Bancorp's efficiency ratio for 2018 of 55.92% decreased from 60.61% in 2017. Excluding amortization of investments in tax credit partnerships, the adjusted efficiency ratio, a non-GAAP measure, would have been 55.15% and 55.84% for 2018 and 2017, respectively. See the Non-GAAP Financial Measures section for details on reconciliation to US GAAP measures.

## Income Taxes

A three year comparison of income tax expense and effective tax rate follows:

(Dollars in thousands)	<b>2018</b>	<b>2017</b>	<b>2016</b>
Income tax expense	\$12,031	\$17,139	\$15,244
Effective tax rate	17.81 %	31.06 %	27.1 %

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The decrease in the effective tax rate from 2017 to 2018 was due to the decrease in the federal marginal income tax rate from 35% to 21% effective January 1, 2018, as a result of the Tax Cuts and Jobs Act enacted on December 22, 2017. The 2017 effective tax rate was significantly increased by a \$5.9 million charge, also due to the Tax Cuts and Jobs Act, to revalue Bancorp's net deferred tax asset. The increase was somewhat offset by the positive effects of federal income tax credits and stock-based compensation. Bancorp invests in certain partnerships that yield federal income tax credits. Taken as a whole, the tax benefit of these investments exceeds amortization/impairment expense associated with them, resulting in a positive impact on net income. The timing and magnitude of these transactions may vary widely.

The increase in the effective tax rate, 2016 to 2017, was primarily the result of a non-cash charge of \$5.9 million resulting from tax reform offset partially by higher utilization of federal income tax credits in 2017. Bancorp invests in certain partnerships that yield federal income tax credits. For each of Bancorp's investments in tax credit partnerships the tax benefit compared to related expenses results in a positive effect on net income. Also partially offsetting the effect of the tax reform related charge was the adoption of ASU 2016-09 "Compensation – Stock Compensation Improvements to Employee Share-Based Payment Accounting." The standard requires excess tax benefits and deficiencies related to share-based payment awards to be reflected in the statement of operations as a component of the provision for income taxes. For 2017 Bancorp recorded a benefit of \$1.5 million for such excess benefits against the provision for income tax expense. Prior to adoption of ASU 2016-09, these tax benefits were recorded directly to additional paid-in capital. Tax benefits recorded to capital for 2016 was \$1.7 million.

**Financial Condition****Earning Assets and Interest Bearing Liabilities**

Summary information with regard to Bancorp's financial condition follows:

(Dollars in thousands)	2018	2017	2016	2018/2017		2017/2016	
				Change	%	Change	%
Average earning assets	\$2,998,526	\$2,872,717	\$2,730,949	\$125,809	4.4%	\$141,768	5.2%
Average interest bearing liabilities	2,063,709	1,980,873	1,895,258	82,836	4.2	85,615	4.5
Average total assets	3,159,726	3,037,581	2,886,396	122,145	4.0	151,185	5.2
Total year end assets	3,302,924	3,239,646	3,039,481	63,278	2.0	200,165	6.6

Bancorp continues to experience growth in earning assets primarily in the area of loans. From 2017 to 2018, average loans increased 9.4%, or \$214.4 million, compared with 6.7% or \$143.3 million from 2016 to 2017. Growth has been all organic and each of Bancorp's three markets participated in accelerated loan production and net loan growth. Bancorp was able to achieve 5.8% annual loan growth in 2018 despite elevated levels of commercial real estate (CRE) and commercial and industrial loan payoffs, resulting from borrowers moving elsewhere for permanent financing and CRE loans for which collateral was sold. These repayments were largely anticipated. Loan growth during 2018 reflected ongoing expansion in key lending categories such as commercial and industrial lending and owner-owner occupied commercial real estate lending. Bancorp has remained well under regulatory guidelines for commercial investment real estate. Utilization rates on lines of credit excluding construction loans were 51%, 52% and 51% as of December 31 2018, 2017 and 2016, respectively. Somewhat offsetting loan growth, average securities available-for-sale decreased \$43.9 million, or 9.6% from 2017 to 2018, compared with decreasing \$21.0 million, or 4.4% from 2016 to 2017. Average federal funds sold and interest bearing due from banks likewise decreased 40.7% or \$46.0 million in 2018, as excess cash balances were used to fund loan growth. In 2017 federal funds sold increased \$20.1 million or 21.6%, as compared with 2016.

The increase in average interest bearing liabilities from 2017 to 2018 occurred primarily in demand deposits, time deposits, and federal funds purchased and other short-term borrowings. Average total interest bearing deposit accounts increased 3.6% and average non-interest bearing deposit accounts increased 2.8% in 2018. Average time deposits increased 17.5% or \$41.5 million in 2018, as compared with decreasing 5.9% or \$14.8 million in 2017. Bancorp was successful in increasing time deposits in 2018 in all markets, particularly in the Louisville market, through an aggressive deposit gathering campaign. The Company also purchased \$30 million of brokered deposits in 2018, after having no brokered deposits in 2017. Bancorp continued to utilize fixed rate advances from the FHLB during 2018 as these rates compared favorably to similar term time deposits. Bancorp had an average of \$48.8 million in outstanding FHLB advances in 2018 compared with \$50.3 million in 2017. Securities sold under agreement to repurchase averaged \$62.6 million in 2018 compared with \$70.2 million in 2017. Securities sold under agreements to repurchase represent excess funds from certain commercial customers as part of a cash management service.

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At December 31, 2018, Bancorp had excess cash balances resulting from seasonal deposits of approximately \$88 million. These funds are invested in short-term investments, as deposit balances are expected to return to normal levels during the first two quarters of 2019. While these accounts are profitable, the excess investment is expected to have a negative effect on net interest margin for the first six months of 2019 since short term rates are significantly lower than rates for longer term earning assets.

**Average Balances and Interest Rates – Taxable Equivalent Basis**

(Dollars in thousands)	Year 2018			Year 2017			Year 2016		
	Average balances	Interest	Average rate	Average balances	Interest	Average rate	Average balances	Interest	Average rate
Earning assets:									
Federal funds sold and interest bearing due from banks	\$67,083	\$1,307	1.95 %	\$113,088	\$1,330	1.18 %	\$92,994	\$491	0.53 %
Mortgage loans held for sale	2,549	166	6.51	3,545	191	5.39	4,881	237	4.86
Securities									
Taxable	377,126	8,492	2.25	406,342	8,030	1.98	419,422	8,197	1.95
Tax-exempt FHLB stock and other securities	37,943	1,006	2.65	52,614	1,558	2.96	60,516	1,710	2.83
Loans, net of unearned income	9,348	509	5.45	7,016	335	4.77	6,347	254	4.00
Total earning assets	2,504,477	118,600	4.74	2,290,112	100,248	4.38	2,146,789	92,152	4.29
Less allowance	2,998,526	130,080	4.34 %	2,872,717	111,692	3.89 %	2,730,949	103,041	3.77 %
	25,130			24,974			23,454		
	2,973,396			2,847,743			2,707,495		
Non interest earning assets:									
Cash and due from banks	42,783			41,621			41,043		
Premises and equipment	42,773			41,793			41,813		

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All other assets	100,774			106,424			96,045		
Total assets	\$3,159,726			\$3,037,581			\$2,886,396		
Interest bearing liabilities:									
Deposits									
Interest bearing demand deposits	\$811,748	\$4,008	0.49 %	\$757,023	\$1,574	0.21 %	\$717,800	\$978	0.14 %
Savings deposits	156,212	311	0.20	148,510	179	0.12	135,051	47	0.03
Money market deposits	660,222	5,529	0.84	697,182	2,740	0.39	658,837	1,477	0.22
Time deposits	278,888	3,593	1.29	237,368	1,482	0.62	252,170	1,441	0.57
Securities sold under agreements to repurchase	62,580	157	0.25	70,187	134	0.19	62,670	136	0.22
Federal funds purchased and other short-term borrowings	45,293	835	1.84	20,303	182	0.90	23,275	76	0.33
FHLB advances	48,766	924	1.89	50,300	955	1.90	45,455	763	1.68
Total interest bearing liabilities	2,063,709	15,357	0.74 %	1,980,873	7,246	0.37 %	1,895,258	4,918	0.26 %
Non-interest bearing liabilities									
Non-interest bearing demand deposits	703,453			684,044			650,036		
Accrued interest payable and other liabilities	45,523			44,866			36,951		
Total liabilities	2,812,685			2,709,783			2,582,245		
Stockholders' equity	347,041			327,798			304,151		
Total liabilities and	\$3,159,726			\$3,037,581			\$2,886,396		

stockholders'  
equity

Net interest income	\$ 114,723	\$ 104,446	\$ 98,123
Net interest spread	3.60 %	3.52 %	3.51 %
Net interest margin	3.83 %	3.64 %	3.59 %

Notes:

Yields on municipal securities have been computed on a fully tax-equivalent basis using a federal income tax rate of 21% in 2018, and 35% in 2017 and 2016.

The approximate tax-equivalent adjustments to interest income were \$307,000, \$793,000 and \$834,000 for the years ended December 31, 2018, 2017 and 2016, respectively.

Average balances for loans include the principal balance of non-accrual loans and exclude participation loans accounted for as secured borrowings. The average balance of these participation loans totaled \$15,459,000, \$18,744,000 and \$12,364,000 for the years ended December 31, 2018, 2017 and 2016.

Loan interest income includes loan fees and is computed on a fully tax-equivalent basis using the federal income tax rate of 21% for 2018, and 35% for 2017 and 2016. Loan fees, net of deferred costs, included in interest income amounted to \$1,300,000, \$1,063,000 and \$1,402,000 in 2018, 2017 and 2016, respectively.



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The primary purpose of the securities portfolio is to provide another source of interest income, as well as liquidity management. In managing the composition of the balance sheet, Bancorp seeks a balance between earnings sources and credit and liquidity considerations.

Securities available for sale include securities that may be sold in response to changes in interest rates, resultant prepayment risk and other factors related to interest rate and prepayment risk changes. Securities available for sale are carried at fair value with unrealized gains or losses, net of tax effect, included in stockholders' equity.

All of Bancorp's securities are available for sale. Carrying value is summarized as follows:

(In thousands)	<b>As of December 31,</b>	
	<b>2018</b>	<b>2017</b>
U.S. Treasury obligations	\$-	\$149,984
Government sponsored enterprise obligations	261,039	213,844
Mortgage-backed securities – government agencies	146,277	161,507
Obligations of states and political subdivisions	29,679	49,189
	\$436,995	\$574,524

At December 31, 2017 securities available for sale included \$150 million of short-term U.S. Treasury obligation purchased in conjunction with a tax savings strategy. At December 31, 2018, Bancorp did not make a similar purchase.

Maturity distribution and weighted average interest rates of debt securities available for sale at December 31, 2018 are as follows:

(Dollars in thousands)	<b>Within one year</b>		<b>After one but within five years</b>		<b>After five but within ten years</b>		<b>After ten years</b>	
	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>
Government sponsored enterprise obligations	\$110,426	2.06%	\$47,822	1.75%	\$3,471	2.08%	\$99,320	2.71%

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Mortgage-backed securities – government agencies	4,555	2.01	5,775	2.39	36,826	2.04	99,121	2.49
Obligations of states and political subdivisions	9,813	2.16	15,438	2.11	4,428	1.80	–	–
	\$124,794	2.07%	\$69,035	1.88%	\$44,725	2.02%	\$198,441	2.60%

Actual maturities for mortgage-backed securities may differ from contractual maturities due to prepayments on underlying collateral.

Table of Contents**Loan Portfolio**

Bancorp's primary source of income is interest on loans. Composition of loans as of December 31 for each of the last five years follows:

(In thousands)	2018	2017	2016	2015	2014
Commercial and industrial	\$ 833,524	\$ 779,014	\$ 736,841	\$ 644,398	\$ 571,754
Construction and development, excluding undeveloped land	225,050	195,912	192,348	134,482	95,733
Undeveloped land (1)	30,092	18,988	21,496	21,185	21,268
Real estate mortgage:					
Commercial investment	588,610	594,902	538,886	436,989	448,567
Owner Occupied commercial	426,373	398,685	408,292	420,666	380,237
1-4 family residential	276,017	262,110	249,498	226,575	211,548
Home equity - first lien	49,500	57,110	55,325	50,115	43,779
Home equity - junior lien	70,947	63,981	67,519	63,066	66,268
Subtotal: Real estate mortgage	1,411,447	1,376,788	1,319,520	1,197,411	1,150,399
Consumer	48,058	38,868	35,170	35,531	29,396
Total loans	\$2,548,171	\$2,409,570	\$2,305,375	\$2,033,007	\$1,868,550

(1) Undeveloped land consists of land acquired for development by the borrower, but for which no development has yet taken place.

Bancorp's loan portfolio increased \$139 million, or 5.8%, during 2018 as a result of record loan production and stable utilization of available lines of credit while being challenged by elevated levels of prepayments and payoffs.

Bancorp occasionally enters into loan participation agreements with other banks to diversify credit risk. For certain sold participation loans, Bancorp has retained effective control of the loans, typically by restricting the participating institutions from pledging or selling their share of the loan without permission from Bancorp. US GAAP requires the participated portion of these loans to be recorded as secured borrowings. These participated loans are included in commercial and industrial and real estate mortgage loan totals above, and a corresponding liability is recorded in other liabilities. At December 31, 2018 and 2017, total participated portions of loans of this nature were \$10.5 million and \$18.2 million respectively.

The following tables detail amounts of loans at December 31, 2018 which, based on remaining scheduled repayments of principal, are due in the periods indicated. Also shown are commercial and industrial loans due after one year and

construction, development and undeveloped land loans due after one year, classified according to sensitivity to changes in interest rates.

(In thousands)	<b>Maturing</b>			
	<b>Within</b>	<b>After one</b>	<b>After</b>	<b>Total</b>
	<b>one</b>	<b>but</b>	<b>five</b>	
	<b>year</b>	<b>within five</b>	<b>years</b>	
		<b>years</b>		
Commercial and industrial	\$332,150	\$362,745	\$138,629	\$833,524
Construction and development including undeveloped land	74,709	105,388	75,045	255,142
Real estate mortgage	151,369	711,505	548,573	1,411,447
Consumer	32,308	15,297	453	48,058
<b>Total loans</b>	<b>\$590,536</b>	<b>\$1,194,935</b>	<b>\$762,700</b>	<b>\$2,548,171</b>

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Commercial and industrial loans due after one year (In thousands)	Interest sensitivity	
	Fixed rate	Variable rate
Due after one but within five years	\$215,643	\$147,102
Due after five years	62,635	75,994
	\$278,278	\$223,096

**Construction and development**

including undeveloped land due after one year (In thousands)	Interest sensitivity	
	Fixed rate	Variable rate
Due after one but within five years	\$31,630	\$73,758
Due after five years	17,242	57,803
	\$48,872	\$131,561

To limit interest rate sensitivity on commercial and commercial real estate loans, whenever possible, Bancorp seeks to structure loans with maturity dates longer than five years with a rate adjustment occurring no longer than five years from origination date.

**Non-performing Loans and Assets**

Information summarizing non-performing assets, including non-accrual loans follows:

(Dollars in thousands)	December 31,				
	2018	2017	2016	2015	2014
Non-accrual loans (1)	\$2,611	\$6,511	\$5,295	\$7,693	\$5,199
Troubled debt restructurings (TDRs)	42	869	974	1,060	6,352
Loans past due 90 days or more and still accruing	745	2	438	176	329
Non-performing loans	3,398	7,382	6,707	8,929	11,880
Other real estate owned	1,018	2,640	5,033	4,541	5,977
Non-performing assets	\$4,416	\$10,022	\$11,740	\$13,470	\$17,857
Non-performing loans as a percentage of total loans	0.13 %	0.31 %	0.29 %	0.44 %	0.64 %
Non-performing assets as a percentage of total assets	0.13 %	0.31 %	0.39 %	0.48 %	0.70 %

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Allowance for loan loss as a percentage of non- performing loans	751	%	337	%	358	%	251	%	210	%
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(1) Includes TDRs previously accruing of:	\$-		\$-		\$-		\$400		\$-	
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Loans accounted for as TDRs included modifications from original terms such as those due to bankruptcy proceedings, certain changes to amortization periods or extended suspension of principal payments due to customer financial difficulties. To the extent that Bancorp chooses to work with borrowers by providing reasonable concessions rather than initiating collection, this would result in an increase in loans accounted for as TDRs. TDRs that are in non-accrual status are reported as non-accrual loans. Loans accounted for as TDRs are individually evaluated for impairment and are reported as non-performing loans. The table above includes information regarding loans reported as TDRs that moved from an accrual status to non-accrual during the periods reporting. (See (1) above)

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As of December 31, 2018, TDRs consisted of two loans totaling \$42 thousand. See note (5) to Bancorp's consolidated financial statements for additional information regarding loans classified as troubled debt restructurings.

The following table sets forth major classifications of non-accrual loans:

<b>Non-accrual loans by type</b> (In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Commercial and industrial	\$ 192	\$ 321
Construction and development, excluding undeveloped land	318	664
Undeveloped land	474	474
Real estate mortgage - commercial investment	138	52
Real estate mortgage - owner occupied commercial	586	3,332
Real estate mortgage - 1-4 family residential	760	1,637
Home equity	143	31
Consumer	—	—
Total	\$2,611	\$6,511

Loans are placed in a non-accrual income status when prospects for recovering both principal and accrued interest are considered doubtful or when a default of principal or interest has existed for 90 days or more, unless such a loan is well secured and in the process of renewal. Interest income recorded on non-accrual loans was \$93 thousand, \$338 thousand, and \$307 thousand for 2018, 2017, and 2016, respectively. Interest income that would have been recorded if non-accrual loans were on a current basis in accordance with their original terms was \$391 thousand, \$159 thousand, and \$149 thousand for 2018, 2017, and 2016, respectively.

In addition to non-performing loans discussed above, there were loans, which are accruing interest, for which payments were current or less than 90 days past due where borrowers are experiencing elevated financial difficulties. These potential problem loans totaled approximately \$23.4 million, \$18.7 million, and \$9.3 million at December 31, 2018, 2017, and 2016, respectively. These relationships are monitored closely for possible future inclusion in non-performing loans. Management believes it has adequately reflected credit exposure in these loans in its determination of the allowance.

Non-performing assets as a percentage of total assets decreased 18 basis points from 2017 to 2018, reflecting improved credit quality and asset growth. At December 31, 2018 and 2017, the carrying value of other real estate owned ("OREO") was \$1.0 million and \$2.6 million, respectively. In 2018, Bancorp recorded impairment charges on such OREO totaling \$32 thousand, compared with \$171 thousand in 2017 and \$62 thousand in 2016.

### **Allowance for Loan and Lease Losses**

An allowance has been established to provide for probable losses on loans that may not be fully repaid. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries. Loans are typically charged off when management deems them uncollectible and after underlying collateral has been liquidated; however, collection efforts continue and future recoveries may occur. Periodically, loans are partially charged off to the net realizable value based upon evaluation of related underlying collateral, including Bancorp's proclivity for resolution.

Bancorp's lending policies and procedures center on mitigating credit risk and include procedures to identify and measure this risk. These procedures begin with lenders assigning a risk rating to each of their credits, and this rating is confirmed in the loan approval process for new and renewed loans. Internal loan review, through a year-round process of examining individually significant obligor relationships, concentrations, and a broad sample of Bancorp's portfolio, tests the reliability of these risk assessments. Additionally, a review of this process is an integral part of regulatory bank examinations.



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Adversely rated credits are included on a classified loan list which incorporates loans requiring closer monitoring due to borrower's circumstances. Loans are added to the classified loan list when circumstances are detected which might affect the borrower's ability to comply with terms of the loan. This could include any of the following:

- Delinquency of a scheduled loan payment,
- Deterioration in the borrower's or guarantor's financial condition identified in a review of periodic financial statements, which will impair repayment or collection,
- Decrease in value of collateral securing the loan, or
- Change in the economic environment in which the borrower operates.

Classified loans require detailed status reports, including recommended corrective actions, prepared periodically by the responsible loan officer. These reports are reviewed by management. Classified loans are also discussed quarterly with the Risk Committee of the Bank's Board of Directors.

Changes in loan risk ratings are typically initiated by the responsible loan officer, but may also be initiated by internal loan review or the Bank's loan committees at any time.

In determining the allowance and related provision, these principal elements are considered:

Specific allocations are based upon probable losses on individually evaluated impaired loans. These loans are measured based on the present value of future cash flows discounted at the loans' effective interest rate or at estimated fair value of the loans' collateral, if applicable. Other objective factors such as payment history and financial condition of the borrower or guarantor may be used as well.

Allocations for loans not defined as impaired are based on estimates for pools of loans with similar risk based upon Bancorp's historical net loss percentages by loan type.

Additional allowance allocations are based on environmental or qualitative factors not necessarily associated with a specific credit or loan category and represent management's effort to ensure that the overall allowance appropriately reflects changes in trends, conditions and other relevant factors that may cause estimated credit losses to differ from historical experience. Management considers a number of environmental or qualitative factors, including local and general economic business factors and trends and portfolio concentrations.

Allocation of the allowance by loan category is a result of the analysis above. The same procedures used to determine requirements for the allowance establish the distribution of the allowance by loan category. Distribution of the allowance will change from period to period due to changes in the identified risk in each loan segment, changes in the aggregate loan balances by loan category, and changes in management's view of the environmental or qualitative factors noted above. Although the allowance is comprised of specific and general allocations, the entire allowance is available to absorb any credit losses.

Historical net loss percentages are updated quarterly based on actual losses experienced by each loan type. Perception of risk with respect to particular loans within the portfolio will change over time as a result of characteristics and performance of those loans, overall economic and market trends, and actual and expected trends in non-performing loans. In the first quarter of 2018, Bancorp extended the historical period used to capture Bancorp's historical loss ratios from 28 quarters to 32 quarters. This extension of the historical period used to capture Bancorp's historical loss ratios was applied to all classes and segments of our loan portfolio. Expansion of the look-back period for the quantitative historical loss rate caused us to review the overall methodology for qualitative factors to ensure we were appropriately capturing risk not addressed in the quantitative historical loss rate. Management believes extension of the look-back period is appropriate to capture the impact of a full economic cycle and provides sufficient loss observations to develop a reliable estimate.

Bancorp's allowance calculation includes allocations to loan portfolio segments at December 31, 2018 for qualitative factors including, among other factors, local economic and business conditions, quality and experience of lending staff and management, exceptions to lending policies, levels of and trends in past due loans and loan classifications, concentrations of credit such as collateral type, trends in portfolio growth, trends in the value of underlying collateral for collateral-dependent loans, effect of other external factors such as the national economic and business trends, and the quality and depth of the loan review function. Bancorp utilizes the sum of all allowance amounts derived as described above as the appropriate level of allowance. Changes in criteria used in this evaluation or availability of new information could cause the allowance to be increased or decreased in future periods. Based on this quantitative and qualitative analysis, provisions (reductions) are made to the allowance. Such provisions (reductions) are reflected as a charge against (benefit to) current earnings in Bancorp's consolidated statements of income.

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Adequacy of the allowance is monitored by executive management and reported quarterly to the Audit Committee of the Board of Directors. This committee has approved the overall allowance methodology. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the adequacy of Bancorp's allowance. Such agencies may require Bancorp to make additional provisions to the allowance based upon their judgments about information available to them at the time of their examinations. As of balance sheet date, using the current model, management believes that the allowance is adequate to absorb probable inherent losses on existing loans that may become uncollectible.

In June of 2016 FASB issued ASU 2016-13, *Classification of Credit Losses on Financial Instruments*, which will significantly change the way entities recognize impairment of many financial assets by requiring immediate recognition of estimated credit losses expected to occur over the remaining life of the asset, determined at origination of the relationship. Implementation of this standard, which is required for interim and annual reporting periods beginning after December 15, 2019, could have a significant impact on the level of the allowance, capital as a result of the expected cumulative effect, and on earnings of Bancorp. See "Provision for Loan Losses" for further discussion of the allowance.

**Summary of Loan and Lease Loss Experience**

The following table summarizes average loans outstanding, changes in the allowance arising from loans charged off and recoveries on loans previously charged off by loan category and additions to the allowance charged (credited) to expense.

(Dollars in thousands)	<b>Year ended December 31,</b>				
	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Average loans	\$2,519,936	\$2,308,856	\$2,159,153	\$1,919,201	\$1,773,011
Balance of allowance for loan and lease losses at beginning of year	\$24,885	\$24,007	\$22,441	\$24,920	\$28,522
Loans charged off					
Commercial and industrial	(2,404 )	(1,782 )	(1,216 )	(4,065 )	(661 )
Construction and development, excluding undeveloped land	–	–	(133 )	(26 )	(250 )
Undeveloped land	–	–	–	–	(1,753 )
Real estate mortgage	(132 )	(98 )	(576 )	(693 )	(993 )
Consumer	(476 )	(549 )	(568 )	(597 )	(587 )
Total loans charged off	(3,012 )	(2,429 )	(2,493 )	(5,381 )	(4,244 )
Recoveries of loans previously charged off					
Commercial and industrial	554	202	279	98	243

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Construction and development, excluding undeveloped land	–	–	21	–	–	
Undeveloped land	–	–	–	1,400	166	
Real estate mortgage	62	154	342	155	120	
Consumer	340	401	417	499	513	
Total recoveries	956	757	1,059	2,152	1,042	
Net loans charged off	(2,056 )	(1,672 )	(1,434 )	(3,229 )	(3,202 )	
Provision	2,705	2,550	3,000	750	(400 )	
Balance at end of year	\$25,534	\$24,885	\$24,007	\$22,441	\$24,920	
Net charge-offs to average loans	0.08	% 0.07	% 0.07	% 0.17	% 0.18	%

See “Provision for Loan and lease Losses” for discussion of the provision for loan losses and 2018 charge-offs.

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The following table sets forth allocation of the allowance to loan categories shown. Although specific allocations exist, the entire allowance is available to absorb losses in any particular loan category.

(In thousands)	<b>December 31,</b>				
	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Commercial and industrial	\$11,965	\$11,276	\$10,483	\$8,645	\$11,819
Construction and development, excluding undeveloped land	1,760	1,724	1,923	1,760	721
Undeveloped land	752	521	684	814	1,545
Real estate mortgage	10,681	11,012	10,573	10,875	10,541
Consumer	376	352	344	347	294
Total allowance	\$25,534	\$24,885	\$24,007	\$22,441	\$24,920

Changes in the allocation of the allowance from year to year in various categories are influenced by the level of net charge-offs in respective categories and other factors including, but not limited to, an evaluation of the impact of current economic conditions and trends, risk allocations tied to specific loans or groups of loans and changes in qualitative allocations. Management believes that allocations for each loan category are reflective of risk inherent in the portfolio.

Selected ratios relating to the allowance follow:

	<b>Years ended</b>		
	<b>December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
Provision to average loans	0.11 %	0.11 %	0.14 %
Net charge-offs to average loans	0.08	0.07	0.07
Allowance to average loans	1.01	1.08	1.11
Allowance to year end loans	1.00	1.03	1.04

**Deposits**

Average amounts of deposits in Bancorp and average rates paid on such deposits for the years indicated are summarized as follows:

<b>Years ended December 31,</b>		
<b>2018</b>	<b>2017</b>	<b>2016</b>

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(Dollars in thousands)	<b>Average balance</b>	<b>Average rate</b>	<b>Average balance</b>	<b>Average rate</b>	<b>Average balance</b>	<b>Average rate</b>
Non-interest bearing demand deposits	\$703,453	–	\$684,044	–	\$650,036	–
Interest bearing demand deposits	811,748	0.49 %	757,023	0.21 %	717,800	0.14 %
Savings deposits	156,212	0.20	148,510	0.12	135,051	0.03
Money market deposits	660,222	0.84	697,182	0.39	658,837	0.22
Time deposits	278,888	1.29	237,368	0.62	252,170	0.57
	\$2,610,523		\$2,524,127		\$2,413,894	

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Maturities of time deposits of \$250,000 or more at December 31, 2018, are summarized as follows:

(In thousands)	Amount
3 months or less	\$ 11,335
Over 3 through 6 months	7,769
Over 6 through 12 months	13,008
Over 12 months	23,070
	\$55,182

**Securities Sold Under Agreement to Repurchase**

Securities sold under agreements to repurchase represent excess funds from certain commercial customers as part of a cash management service. These agreements have maturities of one business day from the transaction date. Bancorp considers these a core funding since they represent excess cash balances of relationship business customers.

Information regarding securities sold under agreements to repurchase follows:

(Dollars in thousands)	Years ended December 31					
	2018		2017		2016	
	Amount	Rate	Amount	Rate	Amount	Rate
Securities sold under agreements to repurchase						
Year end	\$36,094	0.27%	\$70,473	0.17%	\$67,595	0.21%
Average during year	62,580	0.25	70,187	0.19	62,670	0.22
Maximum month end balance during year	\$74,725		\$75,365		\$72,029	

**Liquidity**

The role of liquidity management is to ensure funds are available to meet depositors' withdrawal and borrowers' credit demands while at the same time maximizing profitability. This is accomplished by balancing changes in demand for funds with changes in supply of those funds. Liquidity is provided by short-term liquid assets that can be converted to

cash, investment securities available for sale, various lines of credit available to Bancorp, and the ability to attract funds from external sources, principally deposits. Management believes it has the ability to increase deposits at any time by offering rates slightly higher than market rate.

Bancorp's Asset/Liability Committee is comprised of senior management and has direct oversight responsibility for Bancorp's liquidity position and profile. A combination of reports provided to management details internal liquidity metrics, composition and level of the liquid asset portfolio, timing differences in short-term cash flow obligations, and exposure to contingent draws on Bancorp's liquidity.

Bancorp's most liquid assets are comprised of cash and due from banks, federal funds sold, and available for sale marketable investment securities. Federal funds sold and interest bearing deposits totaled \$147.0 million at December 31, 2018. Federal funds sold normally have overnight maturities while interest bearing deposits in banks are accessible on demand. These investments are used for general daily liquidity purposes. The fair value of the available for sale investment portfolio was \$437.0 million at December 31, 2018. The portfolio includes maturities of approximately \$120.2 million over the next twelve months. Combined with federal funds sold and interest bearing deposits from banks, these offer substantial resources to meet either loan growth or reductions in Bancorp's deposit funding base. Bancorp pledges portions of its investment securities portfolio to secure public fund deposits, cash balances of certain wealth management and trust accounts, and securities sold under agreements to repurchase. At December 31, 2018, total investment securities pledged for these purposes comprised 81% of the available for sale investment portfolio, leaving \$82 million of unpledged securities.



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Bancorp has a large base of core customer deposits, defined as time deposits less than or equal to \$250,000, demand, savings, and money market deposit accounts. At December 31, 2018, such deposits totaled \$2.7 billion and represented 97% of Bancorp's total deposits. Because these core deposits are less volatile and are often tied to other products of Bancorp through long lasting relationships, they do not place undue pressure on liquidity. However, many of Bancorp's individual depositors currently maintain historically high balances. These excess balances may be more sensitive to market rates, with potential decreases possibly straining Bancorp's liquidity position.

As of December 31, 2018, Bancorp had brokered deposits totaling \$29.8 million.

Other sources of funds available to meet daily needs include sales of securities under agreements to repurchase. Also, Bancorp is a member of the FHLB of Cincinnati. As a member of the FHLB, Bancorp has access to credit products of the FHLB. Bancorp views these borrowings as a potential low cost alternative to brokered deposits. At December 31, 2018, the amount of available credit from the FHLB totaled \$537 million. See Note 11 to Bancorp's consolidated financial statements for further information regarding advances from the FHLB. Also, Bancorp has available federal funds purchased lines with correspondent banks totaling \$105 million.

Over the normal course of business, Bancorp enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through Bancorp's various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of Bancorp's liquidity.

## **Sources and Uses of Cash**

Cash flow is provided primarily through financing activities of Bancorp which include raising deposits and borrowing of funds from institutional sources such as advances from FHLB and federal funds purchased as well as scheduled loan repayments. These funds are primarily used to facilitate investment activities of Bancorp which include making loans and purchasing securities for the investment portfolio. Another important source of cash is from net income of the Bank from operating activities. As discussed in Note 18 to Bancorp's consolidated financial statements, as of January 1 of any year the Bank may pay dividends in an amount equal to the Bank's net income of the prior two years less any dividends paid for the same two years. Regulatory approval is required for dividends exceeding these amounts. Prior to declaration of dividends, management considers the effect such payments will have on total stockholders' equity and capital ratios. For more specific information, see the consolidated statement of cash flows in Bancorp's consolidated financial statements.

## **Commitments**

In the normal course of business, Bancorp is party to activities that contain credit, market and operational risk that are not reflected in whole or in part in Bancorp's consolidated financial statements. Such activities include traditional off-balance sheet credit-related financial instruments, commitments under operating leases and long-term debt.

Bancorp provides customers with off-balance sheet credit support through loan commitments and standby letters of credit. Summarized credit-related financial instruments, including both commitments to extend credit and letters of credit at December 31, 2018 are as follows:

(In thousands)	<b>Amount of commitment expiration per period</b>				
	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>Over 5 years</b>
Unused loan commitments	\$813,713	\$456,096	\$118,129	\$59,237	\$180,251
Standby letters of credit	20,891	17,438	3,319	–	134

Since some of the unused commitments are expected to expire or may not be fully used, the total amount of commitments in the preceding table does not necessarily represent future cash requirements.

In addition to owned banking facilities, Bancorp has entered into long-term leasing arrangements for certain branch facilities. Bancorp also has required future payments for a non-qualified defined benefit retirement plan, long-term debt and the maturity of time deposits. See Note 11, Note 16 and Note 19 to Bancorp's consolidated financial statements for further information on Federal Home Loan Bank advances, the defined benefit retirement plan and operating leases.

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Required payments under such commitments at December 31, 2018 are as follows:

(In thousands)	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 Years	Over 5 years
Time deposit maturities	\$346,715	\$172,321	\$160,197	\$14,097	\$100
Federal Home Loan Bank advances	48,177	31,420	4,222	2,565	9,970
Operating leases (1)	23,236	2,016	3,918	3,953	13,349
Defined benefit retirement plan	3,446	84	84	–	3,278
Other	400	400	–	–	–

(1) Includes assumed renewals

**Capital**

Information pertaining to Bancorp's capital balances and ratios follows:

(Dollars in thousands, except share data)	Years ended December 31		
	2018	2017	2016
Stockholders' equity	\$366,500	\$333,644	\$313,872
Dividends per share	0.96	0.80	0.72
Dividend payout ratio, based on basic EPS	39.18 %	47.34 %	38.95 %
Tier 1 risk-based capital	13.00	12.57	12.10
Total risk-based capital	13.91	13.52	13.04
Leverage ratio	11.33	10.70	10.54

Bancorp increased its cash dividends declared to stockholders during 2018 to an annual dividend of \$0.96, up from \$0.80 per share in 2017 and \$0.72 in 2016. This represents a payout ratio of 39.18% based on basic EPS and an annual yield of 3.05% based upon an annualized fourth quarter dividend rate and year-end closing stock price. Since 2008, Bancorp has had no share buyback plan.

Bank holding companies and their subsidiary banks are required by regulators to meet risk-based capital standards. These standards, or ratios, measure the relationship of capital to a combination of balance sheet and off-balance sheet risks. The value of both balance sheet and off-balance sheet items are adjusted to reflect credit risks. The increase in risk-based capital ratios from 2017 to 2018 resulted from capital growth in retained earnings outpacing loan growth. Note 23 to the consolidated financial statements provide more details of regulatory capital requirements, as well as capital ratios of Bancorp and the Bank. The Bank exceeds regulatory capital ratios required to be well capitalized.

Regulatory framework does not define well capitalized for holding companies. Management considers the effects of growth on capital ratios as it contemplates plans for expansion.

Final rules implementing the Basel III regulatory capital reforms became effective for Bancorp and Bank on January 1, 2015, and included new minimum risk-based capital and leverage ratios. Management believes that as of December 31, 2018, Bancorp met the requirements to be considered well-capitalized under these rules.

One component of equity is accumulated other comprehensive income (loss) which, for Bancorp, consists of net unrealized gains or losses on securities available for sale, net unrealized gains or losses on cash flow hedges, and a minimum pension liability, all net of taxes. Other comprehensive loss for the year ended December 31, 2017 also included a disproportionate tax effect created when the net deferred tax asset was remeasured in 2017 as a result of the enacted tax legislation. Accumulated other comprehensive loss was \$5.1 million at December 31, 2018, as compared with accumulated other comprehensive loss of \$1.9 million at December 31, 2017. The \$3.2 million decrease is primarily a reflection of the effect of the changing interest rate environment during fiscal year 2018 on the valuation of Bancorp's portfolio of securities available for sale.

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The following table presents various key financial ratios:

	<b>Years ended December</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
Return on average assets	1.76 %	1.25 %	1.42 %
Return on average stockholders' equity	16.00	11.61	13.49
Average stockholders' equity to average assets	10.98	10.79	10.54

Addressing the decline from 2016 to 2017 in Bancorp's returns on average assets and average stockholders' equity, the tax reform related DTA charge in 2017 reduced those ratios by 0.20% and 1.81%, respectively.

**Fair Value Measurements**

Bancorp follows the provisions of authoritative guidance for fair value measurements. This guidance is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by US GAAP. It prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in US GAAP.

Authoritative guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement date. The guidance, which requires fair value measurements to be classified as Level 1 (quoted prices), Level 2 (based on observable inputs) or Level 3 (based on significant unobservable, internally-derived inputs), is discussed in more detail in Note 20 to the consolidated financial statements.

Bancorp's investment securities available for sale and interest rate swaps are recorded at fair value on a recurring basis. Other accounts including mortgage loans held for sale, mortgage servicing rights, impaired loans and OREO may be recorded at fair value on a non-recurring basis, generally in the application of lower of cost or market adjustments or write-downs of specific assets.

The portfolio of investment securities available for sale is comprised of U.S. Treasury and other U.S. government obligations, debt securities of U.S. government-sponsored corporations (including mortgage-backed securities), and obligations of state and political subdivisions. U.S. Treasury securities are priced using quoted prices of identical securities in an active market. These measurements are classified as Level 1 in the hierarchy above. All other

securities are priced using standard industry models or matrices with various assumptions such as yield curves, volatility, prepayment speeds, default rates, time value, credit rating and market prices for similar instruments. These assumptions are generally observable in the market place and can be derived from or supported by observable data. These measurements are classified as Level 2 in the hierarchy above.

Interest rate swaps are valued using primarily Level 2 inputs. Fair value measurements generally based on benchmark forward yield curves and other relevant observable market data. For purposes of potential valuation adjustments to derivative positions, Bancorp evaluates the credit risk of its counterparties as well as its own credit risk. To date, Bancorp has not realized any losses due to a counterparty's inability to perform and the change in value of derivative assets and liabilities attributable to credit risk was not significant during 2018.

Mortgage servicing rights ("MSRs"), carried in other assets, are recorded at fair value upon capitalization, are amortized to correspond with estimated servicing income, and are periodically assessed for impairment based on fair value at the reporting date. Fair value is based on a valuation model that calculates the present value of estimated net servicing income. The model incorporates assumptions that market participants would use in estimating future net servicing income. These measurements are classified as Level 3. At December 31, 2018 and 2017 there was no valuation allowance for MSRs, as fair value exceeded carrying value.

Loans are measured for impairment and, if indicated, a specific allocation is established based on the value of underlying collateral. Impaired loans include non-accrual loans and loans accounted for as troubled debt restructuring. For impaired loans, fair value amounts represent only those impaired loans with specific valuation allowances and collateral dependent impaired loans charged down to their carrying value. At December 31, 2018 and December 31, 2017, carrying value of impaired loans measured at fair value on a non-recurring basis was \$925 thousand and \$2.6 million, respectively. These measurements are classified as Level 3.

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OREO, which is carried in other assets at the lower of cost or fair value, is periodically assessed for impairment based on fair value at the reporting date. Fair value is determined from external appraisals using judgments and estimates of external professionals. Many of these inputs are not observable and, accordingly, these measurements are classified as Level 3. For the purposes of the tables in Note 20, fair value for OREO is equal to the carrying value of only parcels of OREO for which carrying value equals appraised value. If a parcel of OREO has a carrying value below its appraised value, it is not considered to be carried at fair value, and is therefore not included in the table in Note 20. The losses represent write-downs which occurred during the period indicated. At December 31, 2018 and 2017, the carrying value of OREO was \$1 million and \$2.6 million, respectively.

See Note 20 to Bancorp's consolidated financial statements for details of fair value measurements.

**Non-GAAP Financial Measures**

Bancorp considers various ratios when evaluating capital adequacy, including tangible common equity to tangible assets, and tangible common equity per share, both of which are non-GAAP measures. Bancorp believes these ratios are important because of their widespread use by investors as means to evaluate capital adequacy, as they better reflect the level of capital available to withstand unexpected market conditions.

The following table reconciles Bancorp's calculation of these measures to amounts reported under US GAAP.

(In thousands, except per share data)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Total equity	\$366,500	\$333,644
Less: core deposit intangible	(1,057 )	(1,225 )
Less: goodwill	(682 )	(682 )
 Tangible common equity	 \$364,761	 \$331,737
 Total assets	 \$3,302,924	 \$3,239,646
Less: core deposit intangible	(1,057 )	(1,225 )
Less: goodwill	(682 )	(682 )
 Total tangible assets	 \$3,301,185	 \$3,237,739
 Total shareholders' equity to total assets	 11.10 %	 10.30 %
Tangible common equity ratio	11.05 %	10.25 %
 Number of outstanding shares	 22,749	 22,679

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Book value per share	\$16.11	\$14.71
Tangible common equity to tangible assets	16.03	14.63

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In addition to the efficiency ratio normally presented, Bancorp considers an adjusted efficiency ratio which is a non-GAAP measure. Bancorp believes this ratio is important because of it provides a comparable ratio after eliminating the fluctuation in non-interest expenses related to amortization/impairment of investments in tax credit partnerships. The following table reconciles Bancorp's calculation of this measure to the ratio reported under US GAAP.

(Amounts in thousands)	<b>2018</b>	<b>2017</b>		
Non-interest expenses	\$89,509	\$90,420		
Net interest income, fully tax-equivalent	114,723	104,446		
Non-interest income	45,346	44,499		
Less: securities gains (losses) included in non-interest income	–	(232 )		
Total revenue	\$160,069	\$149,177		
Efficiency ratio	55.92	%	60.61	%
Non-interest expenses	\$89,509	\$90,420		
Less: amortization/impairment of investments in tax credit partnerships	(1,237 )	(7,124 )		
Adjusted non-interest expenses	88,272	83,296		
Net interest income (tax-equivalent)	114,723	104,446		
Non-interest income	45,346	44,731		
Less: securities gains (losses) included in non-interest income	–	(232 )		
Total revenue	\$160,069	\$149,177		
Adjusted efficiency ratio	55.15	%	55.84	%

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

Information required by this item is included in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Form 10-K.

**Item 8. Financial Statements and Supplementary Data**

The following consolidated financial statements of Bancorp, and reports of independent registered public accounting firms and management are included below:

Consolidated Balance Sheets - December 31, 2018 and 2017

Consolidated Statements of Income - years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Comprehensive Income - years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Changes in Stockholders' Equity - years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Cash Flows - years ended December 31, 2018, 2017 and 2016

Notes to Consolidated Financial Statements

Reports of Independent Registered Public Accounting Firms

Management's Report on Consolidated Financial Statements

Table of Contents**Consolidated Balance Sheets**

(Dollars in thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
<b>Assets</b>		
Cash and due from banks	\$51,892	\$41,982
Federal funds sold and interest bearing due from banks	147,047	97,266
Cash and cash equivalents	198,939	139,248
Mortgage loans held for sale	1,675	2,964
Securities available for sale (amortized cost of \$443,742 in 2018 and \$577,406 in 2017)	436,995	574,524
Federal Home Loan Bank stock and other securities	10,370	7,646
Loans	2,548,171	2,409,570
Less allowance	25,534	24,885
Net loans	2,522,637	2,384,685
Premises and equipment, net	44,764	41,655
Bank owned life insurance	32,273	32,049
Accrued interest receivable	8,360	8,369
Other assets	46,911	48,506
<b>Total assets</b>	<b>\$3,302,924</b>	<b>\$3,239,646</b>
<b>Liabilities</b>		
Deposits		
Non-interest bearing	\$711,023	\$674,697
Interest bearing	2,083,333	1,903,598
Total deposits	2,794,356	2,578,295
Securities sold under agreements to repurchase	36,094	70,473
Federal funds purchased	10,247	161,352
Accrued interest payable	762	232
Other liabilities	46,788	46,192
Federal Home Loan Bank advances	48,177	49,458
<b>Total liabilities</b>	<b>2,936,424</b>	<b>2,906,002</b>
Commitments and contingent liabilities (note 19)		
<b>Stockholders' equity</b>		
Preferred stock, no par value; 1,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock, no par value; 40,000,000 shares authorized; 22,749,139 and 22,679,362 shares issued and outstanding in 2018 and 2017, respectively	36,689	36,457
Additional paid-in capital	36,797	31,924
Retained earnings	298,156	267,193
Accumulated other comprehensive loss	(5,142 )	(1,930 )

<b>Total stockholders' equity</b>	366,500	333,644
<b>Total liabilities and stockholders' equity</b>	\$3,302,924	\$3,239,646

See accompanying notes to consolidated financial statements.

Table of Contents**Consolidated Statements of Income**

(In thousands, except per share data)	<b>Years ended December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
<b>Interest income</b>			
Loans	\$118,467	\$99,924	\$91,833
Federal funds sold and interest bearing deposits	1,307	1,330	491
Mortgage loans held for sale	166	191	237
Securities			
Taxable	9,001	8,365	8,451
Tax-exempt	832	1,089	1,195
<b>Total interest income</b>	<b>129,773</b>	<b>110,899</b>	<b>102,207</b>
<b>Interest expense</b>			
Deposits	13,441	5,975	3,943
Securities sold under agreements to repurchase and other short term borrowing	992	316	212
Long term debt	924	955	763
<b>Total interest expense</b>	<b>15,357</b>	<b>7,246</b>	<b>4,918</b>
<b>Net interest income</b>	<b>114,416</b>	<b>103,653</b>	<b>97,289</b>
Provision for loan and lease losses	2,705	2,550	3,000
<b>Net interest income after provision for loan losses</b>	<b>111,711</b>	<b>101,103</b>	<b>94,289</b>
<b>Non-interest income</b>			
Wealth management and trust services	21,536	20,505	19,155
Deposit service charges	5,759	6,172	6,037
Debit and credit cards	6,769	5,979	5,655
Treasury management	4,571	4,297	3,867
Mortgage banking	2,568	3,221	3,897
(Loss) on sale of securities available for sale	-	(232 )	-
Net investment product sales commissions and fees	1,677	1,629	1,563
Bank owned life insurance	1,129	1,159	871
Other	1,337	1,769	1,875
<b>Total non-interest income</b>	<b>45,346</b>	<b>44,499</b>	<b>42,920</b>
<b>Non-interest expenses</b>			
Compensation	46,104	42,581	40,814
Employee benefits	10,098	9,987	8,368
Net occupancy and equipment	7,653	7,393	7,422
Technology and communication	8,897	7,957	7,040
Marketing and business development	3,099	2,716	2,464
Postage, printing and supplies	1,558	1,475	1,521
Legal and professional	2,614	2,393	1,869
FDIC insurance	961	960	1,181
Amortization/impairment of investments in tax credit partnerships	1,237	7,124	4,458
Capital and deposit based taxes	3,325	3,440	2,800

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Other	3,963	4,394	3,001
<b>Total non-interest expenses</b>	<b>89,509</b>	<b>90,420</b>	<b>80,938</b>
<b>Income before income taxes</b>	<b>67,548</b>	<b>55,182</b>	<b>56,271</b>
<b>Income tax expense</b>	<b>12,031</b>	<b>17,139</b>	<b>15,244</b>
<b>Net income</b>	<b>\$55,517</b>	<b>\$38,043</b>	<b>\$41,027</b>
<b>Net income per share, basic</b>	<b>\$2.45</b>	<b>\$1.69</b>	<b>\$1.84</b>
<b>Net income per share, diluted</b>	<b>\$2.42</b>	<b>\$1.66</b>	<b>\$1.80</b>
Average common shares:			
Basic	22,619	22,532	22,356
Diluted	22,944	22,983	22,792

See accompanying notes to consolidated financial statements.

Table of Contents**Consolidated Statements of Comprehensive Income**

(In thousands)	<b>Years ended December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
<b>Net income</b>	\$55,517	\$38,043	\$41,027
Other comprehensive loss, before tax:			
Unrealized losses on securities available for sale:			
Unrealized losses arising during the period	(3,865 )	(1,252 )	(3,347 )
Unrealized gains on hedging instruments:			
Unrealized gains arising during the period	220	321	68
Minimum pension liability adjustment arising during the period	219	(79 )	2
Reclassification adjustment for securities losses reclassified out of other comprehensive income into loss on sale of securities available for sale	-	232	-
Other comprehensive loss before income tax benefit	(3,426 )	(778 )	(3,277 )
Income tax benefit related to items of other comprehensive income	(720 )	(347 )	(1,146 )
Other comprehensive loss, net of tax benefit	(2,706 )	(431 )	(2,131 )
<b>Comprehensive income</b>	<b>\$52,811</b>	<b>\$37,612</b>	<b>\$38,896</b>

See accompanying notes to consolidated financial statements.

Table of Contents**Consolidated Statements of Changes in Stockholders' Equity**

	<b>For each of the years in the three year period ended December 31, 2018</b>					
	<b>Common stock Number of Shares</b>	<b>Amount</b>	<b>Additional paid-in capital</b>	<b>Retained earnings</b>	<b>Accumulated other comprehensive income (loss)</b>	<b>Total</b>
(In thousands, except per share data)						
Balance December 31, 2015	14,919	\$ 10,616	\$ 44,180	\$ 231,091	\$ 632	\$ 286,519
Net income	–	–	–	41,027	–	41,027
Other comprehensive loss, net of tax	–	–	–	–	(2,131 )	(2,131 )
Stock compensation expense	–	–	2,473	–	–	2,473
Stock issued for stock-based awards, net of withholdings to satisfy employee tax obligations upon award	214	711	5,217	(3,804 )	–	2,124
3 for 2 stock split (see note 14)	7,494	24,956	(24,956 )	–	–	–
Cash dividends declared, \$0.72 per share	–	–	–	(16,140 )	–	(16,140 )
Shares repurchased or cancelled	(10 )	(33 )	(232 )	265	–	–
Balance December 31, 2016	22,617	\$ 36,250	\$ 26,682	\$ 252,439	\$ (1,499 )	\$ 313,872
Net income	–	–	–	38,043	–	38,043
Other comprehensive loss, net of tax	–	–	–	–	(431 )	(431 )
Stock compensation expense	–	–	2,892	–	–	2,892
Stock issued for stock-based awards, net of withholdings to satisfy employee tax obligations upon award	69	231	2,500	(5,336 )	–	(2,605 )
Cash dividends declared, \$0.80 per share	–	–	–	(18,127 )	–	(18,127 )
Shares repurchased or cancelled	(7 )	(24 )	(150 )	174	–	–
Balance December 31, 2017	22,679	\$ 36,457	\$ 31,924	\$ 267,193	\$ (1,930 )	\$ 333,644
Net income	–	–	–	55,517	–	55,517
Other comprehensive loss, net of tax	–	–	–	–	(2,706 )	(2,706 )
Stock compensation expense	–	–	4,027	–	–	4,027
Reclassification adjustment under Accounting Standards Update 2018-02	–	–	–	506	(506 )	–
Stock issued for stock-based awards, net of withholdings to satisfy employee tax obligations upon award	75	249	987	(3,394 )	–	(2,158 )
Cash dividends declared, \$0.96 per share	–	–	–	(21,824 )	–	(21,824 )
Shares repurchased or cancelled	(5 )	(17 )	(141 )	158	–	–
Balance December 31, 2018	22,749	\$ 36,689	\$ 36,797	\$ 298,156	\$ (5,142 )	\$ 366,500

See accompanying notes to consolidated financial statements.





Table of Contents**Consolidated Statements of Cash Flows**

(In thousands)	<b>Years ended December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
<b>Operating activities</b>			
Net income	\$55,517	\$38,043	\$41,027
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	2,705	2,550	3,000
Depreciation, amortization and accretion, net	5,782	13,640	11,142
Deferred income tax (benefit) expense	(268 )	3,971	276
Loss on sale of securities available for sale	–	232	–
Gain on sales of mortgage loans held for sale	(1,443 )	(1,989 )	(2,482 )
Origination of mortgage loans held for sale	(71,807 )	(97,623 )	(123,347)
Proceeds from sale of mortgage loans held for sale	74,539	99,861	129,416
Bank owned life insurance income	(1,129 )	(1,159 )	(871 )
Gain on other investment activities	(113 )	(92 )	(588 )
Net realized gain on sale of OREO	(102 )	(39 )	(409 )
Loss on the disposal of premises and equipment	56	–	202
Stock-based compensation expense	4,027	2,892	2,473
Excess tax benefits from stock-based compensation arrangements	(549 )	(1,463 )	(1,705 )
Net change in accrued interest receivable and other assets	(582 )	(13,848 )	(7,438 )
Net change in accrued interest payable and other liabilities	(744 )	8,700	12,566
<b>Net cash provided by operating activities</b>	<b>65,889</b>	<b>53,676</b>	<b>63,262</b>
<b>Investing activities</b>			
Purchases of securities available for sale	(768,407)	(661,086)	(478,798)
Proceeds from sale of securities available for sale	–	421	–
Proceeds from maturities and paydowns of securities available for sale	901,512	652,411	468,271
Purchase of Federal Home Loan Bank Stock	(2,724 )	(2,254 )	–
Proceeds from sale of Federal Home Loan Bank stock	–	955	–
Net increase in loans	(137,835)	(105,867)	(275,718)
Purchases of premises and equipment	(7,057 )	(2,786 )	(6,327 )
Proceeds from disposal of equipment	230	–	66
Proceeds from mortality benefit of bank owned life insurance	–	977	–
Proceeds from sale of OREO	3,895	2,432	1,826
Other investment activities	(1,184 )	92	1,108
<b>Net cash used in investing activities</b>	<b>(11,570 )</b>	<b>(114,705 )</b>	<b>(289,572)</b>
<b>Financing activities</b>			
Net change in deposits	216,061	57,747	148,846
Net change in securities sold under agreements to repurchase and federal funds purchased	(185,484)	116,856	27,966
Proceeds from Federal Home Loan Bank advances	120,000	120,000	289,000
Repayments of Federal Home Loan Bank advances	(121,281)	(121,617)	(281,393)
Proceeds (used for) and received from settlement of stock awards	(154 )	(216 )	2,337
Excess tax benefits from stock-based compensation arrangements	–	–	1,705
Common stock repurchases	(2,004 )	(2,389 )	(1,918 )

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Cash dividends paid	(21,766 )	(18,077 )	(16,093 )
<b>Net cash provided by financing activities</b>	<b>5,372</b>	<b>152,304</b>	<b>170,450</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>59,691</b>	<b>91,275</b>	<b>(55,860 )</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>139,248</b>	<b>47,973</b>	<b>103,833</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$198,939</b>	<b>\$139,248</b>	<b>\$47,973</b>
<b>Supplemental cash flow information:</b>			
Income tax payments	\$7,227	\$15,838	\$12,860
Cash paid for interest	14,827	7,158	4,901
<b>Supplemental non-cash activity:</b>			
Transfers from loans to foreclosed assets	\$2,170	\$-	\$1,916
Loans purchased not settled	4,992	-	-

See accompanying notes to consolidated financial statements.

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**Notes to Consolidated Financial Statements**

**(1) Summary of Significant Accounting Policies**

**Principles of Consolidation and Nature of Operations**

The consolidated financial statements include accounts of Stock Yards Bancorp, Inc. (“Bancorp”) and its wholly owned subsidiary, Stock Yards Bank & Trust Company (“the Bank”). Significant intercompany transactions and accounts have been eliminated in consolidation. Certain prior year amounts have been reclassified to conform to 2018 presentation. Bancorp has evaluated subsequent events for recognition or disclosure up to the date on which financial statements were issued and determined there were none.

In addition to traditional commercial and personal banking activities, Bancorp has a wealth management and trust department offering a wide range of investment management, retirement planning, trust and estate administration and financial planning services. Bancorp’s primary market area is Louisville, Kentucky and surrounding communities including southern Indiana. Other markets include Indianapolis, Indiana and Cincinnati, Ohio.

**Basis of Financial Statement Presentation and Use of Estimates**

The consolidated financial statements of Bancorp and its subsidiary have been prepared in conformity with U.S. generally accepted accounting principles (“US GAAP”) and conform to predominant practices within the banking industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of related revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates particularly susceptible to significant change relate to determination of the allowance, and income tax assets, liabilities and expense.

**Cash Equivalents and Cash Flows**

Cash and cash equivalents include cash and due from banks, federal funds sold and interest bearing due from banks as segregated in the accompanying consolidated balance sheets. The following supplemental cash flow information

addresses certain cash payments and noncash transactions for each of the years in the three-year period ended December 31, 2018 as follows:

(In thousands)	Years ended December 31,		
	2018	2017	2016
<b>Cash payments:</b>			
Income tax payments	\$7,227	\$15,838	\$12,860
Cash paid for interest	14,827	7,158	4,901
<b>Non-cash transactions:</b>			
Transfers from loans to OREO	\$2,170	\$-	\$1,916

### Securities

All of Bancorp's debt securities are available for sale. Equity securities, if held, are carried at fair value with changes in fair value recorded in net income. Securities available for sale include securities that may be sold in response to changes in interest rates, resultant prepayment risk and other factors related to interest rate and prepayment risk changes. Securities available for sale are carried at fair value with unrealized gains or losses, net of tax effect, included in stockholders' equity. Amortization of premiums and accretion of discounts are recorded using the interest method over the expected life of the security. Gains or losses on sales of securities are computed on a specific identification basis. Declines in fair value of investment securities available for sale (with certain exceptions noted below) that are deemed to be other-than-temporary are charged to earnings as a realized loss, and a new cost basis for the securities is established. In evaluating other-than-temporary impairment, management considers the length of time and extent to which fair value has been less than cost, financial condition and near-term prospects of the issuer, and the intent and ability of Bancorp to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Declines in fair value of debt securities below amortized cost are deemed to be other-than-temporary in circumstances where: (1) Bancorp has the intent to sell a security; (2) it is more likely than not that Bancorp will be required to sell the security before recovery of its amortized cost basis; or (3) Bancorp does not expect to recover the entire amortized cost basis of the security. If Bancorp intends to sell a security or if it is more likely than not that Bancorp will be required to sell the security before recovery, an other-than-temporary impairment write-down is recognized in earnings equal to the difference between the security's amortized cost basis and its fair value. If Bancorp does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into an amount representing credit loss, which is recognized in earnings, and an amount related to all other factors, which is recognized in other comprehensive income. Declines in value judged to be other-than-temporary are included in other non-interest expense in the consolidated statements of income. See Note 4 to Bancorp's consolidated financial statements for additional information on investment securities.

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**Mortgage Loans Held for Sale**

Mortgage loans held for sale are initially recorded at the lower of cost or market value on an individual loan basis. The sales prices of all of these loans are covered by investor commitments.

**Loans**

Loans are stated at the unpaid principal balance plus deferred loan origination fees, net of deferred loan costs. Loan fees, net of any costs, are deferred and amortized over the life of the related loan on an effective yield basis. Interest income on loans is recorded on the accrual basis except for those loans in a non-accrual income status. Loans are placed in a non-accrual income status when prospects for recovering both principal and accrued interest are considered doubtful or when a default of principal or interest has existed for 90 days or more unless such loan is well secured and in the process of collection. When a loan is placed on non-accrual status, any interest previously accrued but not yet collected is reversed against current income. No interest income is recorded while a loan is on non-accrual until principal has been fully collected. Non-accrual loans may be returned to accrual status once prospects for recovering both principal and accrued interest are reasonably assured. Loans are accounted for as troubled debt restructurings (TDRs) when Bancorp, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. If a loan is restructured at a market rate for a new loan with comparable risk, no principal forgiveness has been granted, and the loan is not impaired based on the terms specified by the restructuring agreement, it shall be removed from TDR status generally after six months of performance.

Loans are classified as impaired when it is probable Bancorp will be unable to collect interest and principal according to terms of the loan agreement. These loans are measured at the estimated fair value of the loans' collateral, if applicable, or on the present value of future cash flows discounted at the loans' effective interest rate. Impaired loans consist of loans in non-accrual status and loans accounted for as troubled debt restructuring.

**Allowance for loan and lease losses**

The allowance is management's estimate of probable losses inherent in the loan portfolio as of the balance sheet date. Loan losses are charged against the allowance when management believes uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Bancorp's allowance methodology is driven by risk ratings, historical losses, and qualitative factors. Assumptions include many factors such as changes in borrowers' financial condition or historical loss ratios related to certain loan

portfolios which may or may not be indicative of future losses. To the extent that management's assumptions prove incorrect, the results from operations could be materially affected by a higher or lower provision. Consistent with Bancorp's methodology, in the first quarter of 2018, Bancorp extended the historical period used to capture Bancorp's historical loss ratios from 28 quarters to 32 quarters. This extension of the historical period used to capture Bancorp's historical loss ratios was applied to all classes and segments of the loan portfolio. Expansion of the look-back period for the quantitative historical loss rate caused us to review the overall methodology for the qualitative factors to ensure we were appropriately capturing the risk not addressed in the quantitative historical loss rate. By extending the look-back period to 32 quarters to capture historical loss data for a full economic cycle, the allowance level increased approximately \$1.3 million compared with a 28 quarter look-back period as of March 31, 2018. Management believes extension of the look-back period is appropriate to capture the impact of a full economic cycle and provides sufficient loss observations to develop a reliable estimate. Management will continue to evaluate appropriateness of the look-back period based on the status of the economic cycle.

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Bancorp's allowance calculation includes allocations to loan portfolio segments for qualitative factors including, among other factors, local economic and business conditions, the quality and experience of lending staff and management, exceptions to lending policies, levels of and trends in past due loans and loan classifications, concentrations of credit such as collateral type, trends in portfolio growth, trends in the value of underlying collateral for collateral-dependent loans, effect of other external factors such as the national economic and business trends, and the quality and depth of the loan review function. Bancorp utilizes the sum of all allowance amounts derived as described above as the appropriate level of allowance. Changes in the criteria used in this evaluation or the availability of new information could cause the allowance to be increased or decreased in future periods.

Based on this quantitative and qualitative analysis, provisions (reductions) are made to the allowance. Such provisions (reductions) are reflected as a charge against (benefit to) current earnings in Bancorp's consolidated statements of income.

The adequacy of the allowance is monitored by executive management and reported quarterly to the Audit Committee of the Board of Directors. This committee has approved the overall methodology. Various regulatory agencies, as an integral part of their examination process, periodically review the adequacy of Bancorp's allowance. Such agencies may require Bancorp to make additional provisions to the allowance based upon their judgments about information available to them at the time of their examinations.

The accounting policy related to the allowance is applicable to the commercial banking segment of Bancorp.

### **Acquired loans**

Bancorp acquired loans in 2013 as part of the acquisition referenced in Note 3 to the consolidated financial statements. Acquired loans were initially recorded at their acquisition date fair values. Credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans were based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, default rates, loss severity, collateral values, discount rates, payment speeds, prepayment risk, and liquidity risk at the time of acquisition.

Acquired loans that had evidence of deterioration in credit quality since origination and for which it was probable, at acquisition, that Bancorp would be unable to collect all contractually required payments were specifically identified and analyzed. The excess of cash flows expected at acquisition over the estimated fair value is referred to as accretable discount and is recognized as interest income over the remaining life of the loan. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as non-accretable discount. Subsequent decreases to the expected cash flows require Bancorp to evaluate the need for an



allowance for loan losses on these loans. Charge-offs of the principal amount on credit-impaired acquired loans would be first applied to non-accretable discount. Periodically the loans are re-evaluated to determine if subsequent credit deterioration has occurred or if cash flow expectations have improved. Based upon the evaluation loans may be reclassified between the accretable and non-accretable categories.

For acquired loans that are not deemed impaired at acquisition, the methods used to estimate the required allowance for loan losses for acquired loans is the same for originated loans except that any initial fair value adjustment is taken into consideration when calculating any required allowance.

### **Premises and Equipment**

Premises and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation of premises and equipment is computed using straight-line methods over the estimated useful lives of the assets ranging from 3 to 40 years. Leasehold improvements are amortized on the straight-line method over terms of the related leases, including expected renewals, or over the useful lives of the improvements, whichever is shorter. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized.

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### **Other Assets**

Bank owned life insurance (“BOLI”) is carried at net realizable value, which considers applicable surrender charges. Also, Bancorp maintains life insurance policies in conjunction with its non-qualified defined benefit and non-qualified compensation plans.

Other real estate is carried at the lower of cost or estimated fair value minus estimated selling costs. Any write downs to fair value at the date of acquisition are charged to the allowance. In certain situations, improvements to prepare assets for sale are capitalized if those costs increase the estimated fair value of the asset. Expenses incurred in maintaining assets, write downs to reflect subsequent declines in value, and realized gains or losses are reflected in operations and are included in non-interest income and expense.

Mortgage servicing rights (MSRs) are amortized in proportion to and over the period of estimated net servicing income, considering appropriate prepayment assumptions. MSRs are evaluated quarterly for impairment by comparing the carrying value to fair value.

Goodwill is measured and evaluated at least annually for impairment. No impairment charges have been deemed necessary or recorded to date, as the fair value is substantially in excess of the carrying value.

### **Securities Sold Under Agreements to Repurchase**

Bancorp enters into sales of securities under agreement to repurchase. Such repurchase agreements are considered financing agreements, and mature within one business day from the transaction date. Accordingly, the obligation to repurchase assets sold is reflected as a liability in the consolidated balance sheets of Bancorp. Repurchase agreements are collateralized by debt securities which are owned and under the control of Bancorp. These agreements are used in conjunction with collateralized corporate customer cash management accounts.

### **Income Taxes**

Bancorp accounts for income taxes using the asset and liability method. The objective of the asset and liability method is to establish deferred tax assets and liabilities for temporary differences between the financial reporting and the tax bases of Bancorp’s assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or

settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the statement of income in the period that includes the enactment date. The Tax Cuts and Jobs Act was enacted on December 22, 2017 required an immediate recalculation of Bancorp's net deferred tax asset. These balances were previously recorded using a 35% Federal marginal tax rate. The remeasurement was made using the 21% Federal marginal tax rate which became effective January 1, 2018, and resulted in \$5.9 million of additional income tax expense in the fourth quarter of 2017.

Bancorp periodically invests in certain partnerships with customers that yield historic tax credits, which are accounted for using the flow through method, which approximates the equity method, and/or low-income housing tax credits as well as tax deductible losses, which are accounted for using the effective yield method for older transactions or proportional amortization method for more recent transactions. The tax benefit of these investments exceeds amortization/impairment expense associated with them, resulting in a positive impact on net income.

Realization of deferred tax assets associated with the investment in partnerships is dependent upon generating sufficient taxable capital gain income prior to their expiration. A valuation allowance to reflect management's estimate of the temporary deductible differences that may expire prior to their utilization has been recorded at year-end 2018 and 2017.

To the extent unrecognized income tax benefits become realized or the related accrued interest is no longer necessary, Bancorp's provision for income taxes would be favorably impacted. As of December 31, 2018, the gross amount of unrecognized tax benefits was \$29 thousand, as compared with \$40 thousand as of December 31, 2017, details of which are included in Note 8 to these consolidated financials. If recognized, the tax benefits would reduce tax expense and accordingly, increase net income. The amount of unrecognized tax benefits may increase or decrease in the future for various reasons including adding amounts for current tax year positions, expiration of open income tax returns due to statutes of limitation, changes in management's judgment about the level of uncertainty, status of examination, litigation and legislative activity and the addition or elimination of uncertain tax positions. Stock Yards Bancorp, Inc. and its wholly-owned subsidiary file consolidated income tax returns in applicable jurisdictions.

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Bancorp's policy is to report interest and penalties, if any, related to unrecognized tax benefits in income tax expense. As of December 31, 2018 and 2017, the amount accrued for the potential payment of interest and penalties was immaterial.

## **Net Income Per Share**

Basic net income per common share is determined by dividing net income by the weighted average number of shares of common stock outstanding. Diluted net income per share is determined by dividing net income by the weighted average number of shares of common stock outstanding plus the weighted average number of shares that would be issued upon exercise of dilutive options and stock appreciation rights, assuming proceeds are used to repurchase shares under the treasury stock method.

## **Comprehensive Income**

Comprehensive income is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. For Bancorp, this includes net income, changes in unrealized gains and losses on available for sale investment securities and cash flow hedging instruments, net of reclassification adjustments and taxes, and minimum pension liability adjustments, net of taxes.

## **Segment Information**

Bancorp provides a broad range of financial services to individuals, corporations and others through its 38 full service banking locations as of December 31, 2018. These services include loan and deposit services, cash management services, securities brokerage activities, mortgage origination and wealth management and trust activities. Bancorp's operations are considered by management to be aggregated in two reportable operating segments: commercial banking and wealth management and trust.

## **Stock-Based Compensation**

For all awards, stock-based compensation expense is recognized over the period in which it is earned based on the grant-date fair value of the portion of stock-based payment awards that are ultimately expected to vest, reduced for estimated forfeitures. US GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in

subsequent periods if actual forfeitures differ from those estimates.

## Derivatives

Bancorp uses derivative financial instruments as part of its interest rate risk management, including interest rate swaps. US GAAP establishes accounting and reporting standards for derivative instruments and hedging activities. As required by US GAAP, Bancorp's interest rate swaps are recognized as other assets and liabilities in the consolidated balance sheet at fair value. Accounting for changes in fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. To qualify for hedge accounting, Bancorp must comply with detailed rules and documentation requirements at inception of the hedge, and hedge effectiveness is assessed at inception and periodically throughout the life of each hedging relationship. Hedge ineffectiveness, if any, is measured periodically throughout the life of the hedging relationship.

For derivatives designated as cash flow hedges, the effective portion of changes in fair value of the derivative is initially reported in other comprehensive income and subsequently reclassified to interest income or expense when the hedged transaction affects earnings, while the ineffective portion of changes in fair value of derivative, if any, is recognized immediately in other noninterest income. Bancorp assesses effectiveness of each hedging relationship by comparing cumulative changes in cash flows of the derivative hedging instrument with cumulative changes in cash flows of the designated hedged item or transaction. No component of the change in the fair value of the hedging instrument is excluded from the assessment of hedge effectiveness.

Periodically, Bancorp enters into an interest rate swap transaction with a borrower, who desires to hedge exposure to rising interest rates, while at the same time entering into an offsetting interest rate swap, with substantially matching terms, with another approved independent counterparty. Because of matching terms of offsetting contracts and collateral provisions mitigating any non-performance risk, changes in fair value subsequent to initial recognition have an insignificant effect on earnings. Because these derivative instruments have not been designated as hedging instruments, the derivative instruments are recognized on the consolidated balance sheet at fair value, with changes in fair value, due to changes in prevailing interest rates, recorded in other noninterest income.

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Bancorp had no fair value hedging relationships at December 31, 2018 or 2017. Bancorp does not use derivatives for trading or speculative purposes. See Note 22 to the consolidated financial statements for more information regarding derivatives.

**Recently Adopted Accounting Pronouncements**

Accounting Standards Update (ASU) 2014-09, *Revenue – Revenue from Contracts with Customers*. Bancorp adopted ASU 2014-09 and all related amendments (ASC 606), which created a single framework for recognizing revenue from contracts with customers that fall within its scope and revised when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, effective January 1, 2018 using the full retrospective method. The great majority of Bancorp's revenue consists of interest income generated by loans, leases, securities, and other investments, which is outside the scope of ASC 606. Significant judgements related to the nature and timing of revenue recognition were not impacted by implementing ASU 2014-09. Existing accrual practices for income earned but not collected proved consistent with the change in guidance to recognize revenue upon satisfying a performance obligation and as such no adjustment to retained earnings was needed. Services within the scope of ASC 606 include deposit service charges, WM&T revenue, investment product sales commissions and fees, interchange income, and the sale of other foreclosed assets. See note 20 for more revenue recognition details.

The only impact to financial statement presentation was reclassification from expense to contra income costs incurred to obtain and fulfill contracts associated with investment product sales. All periods presented in these financial statements have been adjusted to reflect the reclassification, the effect of which can be seen below.

(In thousands)	<b>For years ended December</b>		
	<b>31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
Non-interest income			
Investment product sales commissions and fees under legacy GAAP	\$2,224	\$2,200	\$2,145
Less variable costs	(547 )	(571 )	(582 )
Net investment product sales commissions and fees reported	1,677	1,629	1,563
Non-interest expense			
Compensation under legacy GAAP	46,107	42,584	40,817
Less variable costs reclassified above	(3 )	(3 )	(3 )
Compensation expense as reported	46,104	42,581	40,814
Technology and communication expense under legacy GAAP	9,441	8,525	7,619
Less variable costs reclassified above	(544 )	(568 )	(579 )
Technology and communication expense as reported	8,897	7,957	7,040
Net impact	\$-	\$-	\$-

ASU 2016-01, *Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. Bancorp adopted ASU 2016-01 effective January 1, 2018. The most significant impact to Bancorp was a change in valuation methods for the loan portfolio for fair value reporting. GAAP no longer allows for valuing financial instruments for fair value purposes using an “entrance” pricing methodology. The use of an “exit” price methodology requires greater assumptions regarding life of loan losses and is a more complex calculation, the results of which are documented in note 21.

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ASU 2018-02, *Income Statement Reporting Comprehensive Income (Topic 220), Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. Bancorp adopted ASU 2018-02 in the first quarter of 2018. Stranded items in accumulated other comprehensive income resulting from the Tax Cuts and Jobs Act enacted on December 22, 2017 totaling \$506 thousand were reclassified into retained earnings.

**Recently Issued Accounting Pronouncements**

In February 2016, FASB issued ASU No. 2016-02, *Leases*, which requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. Lessees will recognize on the balance sheet a lease liability representing an obligation to make lease payments and a right-of-use asset representing its right to use the underlying asset for lease term. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The standard should be applied at the beginning of the earliest period presented using a modified retrospective approach in the first quarter of 2019 with earlier application permitted as of the beginning of an interim or annual reporting period. Bancorp has evaluated existing lease commitments and expects to record a \$16.6 million right-of-use asset and \$17.9 million lease liability during the first quarter of 2019. Bancorp's financial condition and results of operations are not otherwise expected to be impacted. The FASB issued additional ASUs updating ASU 2016-02. Bancorp included these ASUs in its evaluation and implementation efforts relative to ASU 2016-02.

ASU 2018-10, *Codification Improvements to Topic 842: Leases*, which affects narrow aspects of the guidance.

ASU 2018-11, *Leases (Topic 842): Targeted Improvements*, which modifies acceptable transition methods so that entities may recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption as opposed to applying a modified retrospective transition method.

In June 2016, FASB issued ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, which will significantly change the way entities recognize impairment of many financial assets by requiring immediate recognition of estimated credit losses expected to occur over their remaining life. This standard will likely have a significant impact on the way Bancorp recognizes credit impairment on loans. Under current US GAAP, credit impairment losses are determined using an incurred-loss model, which recognizes credit losses only when it is probable that all contractual cash flows will not be collected. Initial recognition of loss under CECL differs from current US GAAP because recognition of credit losses will not be based on any triggering event. This should generally result in credit impairment being recognized earlier and immediately after the financial asset is originated or purchased. Bancorp continues to evaluate existing accounting processes, internal controls, and technology capabilities to determine what additional changes will be needed to address the new requirements. These processes and controls require significant judgment, collection and analysis of additional data, and use of estimates. Technology and other resources have been upgraded or modified to capture additional data to support the accounting and disclosure requirements. The new guidance is effective for annual and interim reporting periods beginning after December 15,



2019. While the impact of implementing the CECL model cannot be quantified at this time, Bancorp expects to recognize a one-time cumulative-effect adjustment to the allowance in the first quarter of 2020. Interagency guidance issued in December 2018 allows for a three year phase-in of the cumulative-effect adjustment for regulatory capital reporting.

In January 2017, the FASB issued ASU 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, which requires an entity to no longer perform a hypothetical purchase price allocation to measure goodwill impairment. Instead, impairment will be measured using the difference between the carrying amount and the fair value of the reporting unit. The changes are effective for public business entities that are SEC filers, for annual and interim periods in fiscal years beginning after December 15, 2019. All entities may early adopt the standard for goodwill impairment tests with measurement dates after January 1, 2017. Bancorp does not expect adoption of this standard to have a significant impact on the consolidated financial statements of the Company.

In August 2017, the FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements for Accounting for Hedging Activities*, which amends hedge accounting recognition and presentation requirements under ASC 815. This ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2018. Early adoption of this standard is permitted upon its issuance. Bancorp does not expect adoption of this standard to have a significant impact on the consolidated financial statements of the Company.

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In June 2018, FASB issued ASU 2018-07, *Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*, which expands the scope of topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. Consistent with the accounting for employee share-based payment awards, nonemployee share-based payment awards will be measured at grant-date fair value of the equity instruments obligated to be issued when the good has been delivered or the service rendered and any other conditions necessary to earn the right to benefit from the instruments have been satisfied. This ASU is effective for all entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. Bancorp does not expect adoption of this standard to have a significant impact on the consolidated financial statements of the company.

In October 2018, FASB issued ASU 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*, to expand the number of benchmark interest rates that can be used in accounting hedge transactions. The ASU adds the OIS rate based on SOFR as a U.S. benchmark interest rate to facilitate the transition from the London Interbank Offered Rate (LIBOR) to SOFR and provides sufficient time to prepare for changes to interest-rate risk hedging strategies for both risk management and hedge accounting purposes. Bancorp has identified all transactions currently tied to LIBOR, has educated customers, and does not expect the transition to have a significant impact on the consolidated financial statements of the Company. This ASU is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2018.

### **(2) Restrictions on Cash and Due from Banks**

At December 31, 2018, Bancorp's interest-bearing cash accounts and non-interest bearing deposits held at other financial institutions exceeded the \$250,000 federally insured limits by approximately \$1.2 million. Each correspondent bank's financial performance and market rating are reviewed on a quarterly basis to ensure the Company has deposits only at institutions providing minimal risk for those exceeding federally insured limits. Additionally, Bancorp had approximately \$143.0 million at the Federal Home Loan Bank and Federal Reserve Bank, which are government-sponsored entities not insured by the FDIC. Bancorp is required to maintain an average reserve balance in cash or with the Federal Reserve Bank relating to customer deposits. The amount of those required reserve balances was approximately \$9.0 million and \$8.1 million at December 31, 2018 and 2017, respectively, and is included in federal funds sold and interest bearing due from banks in the consolidated balance sheet.

### **(3) Acquisitions**

Effective December 19, 2018, Bancorp executed a definitive Share Purchase Agreement ("agreement"), pursuant to which Bancorp will acquire all of the outstanding common stock of privately held King Bancorp, Inc. ("King"). King,

headquartered in Louisville, is the holding company for King Southern Bank, which operates five branches – three in the greater Louisville area and two in Nelson County, approximately 60 miles southeast of Louisville.

Under the terms of the Agreement, the Company will acquire all of King's outstanding common stock in an all-cash transaction, resulting in a total cash payment to King's existing shareholders of approximately \$28 million. The Company will fund the cash payment through existing resources on-hand.

The acquisition is expected to close during second quarter of 2019, subject to customary regulatory approval and completion of closing conditions. As of September 30, 2018, King had approximately \$195 million in assets, \$168 million in loans, \$126 million in deposits and \$16 million in tangible common equity.

In 2013, Bancorp completed the acquisition of 100% of the outstanding shares of THE BANCORP, Inc. ("Oldham"), parent company of THE BANK – Oldham County, Inc. The transaction was accounted for using acquisition accounting and, accordingly, assets acquired, liabilities assumed and consideration transferred were recorded at estimated fair value on the acquisition date. Bancorp recorded a core deposit intangible of \$2.5 million which is being amortized using methods that anticipate the life of the underlying deposits to which the intangible is attributable. At December 31, 2018, the unamortized core deposit intangible was \$1.1 million. See Note 7 for details on the core deposit intangible.

Table of Contents**(4) Securities**

All of Bancorp's securities are available for sale. Amortized cost, unrealized gains and losses, and fair value of these securities follow:

(In thousands) <b>December 31, 2018</b>	<b>Amortized cost</b>	<b>Unrealized Gains</b>	<b>Losses</b>	<b>Fair value</b>
Government sponsored enterprise obligations	\$ 264,234	\$ 156	\$(3,351)	\$ 261,039
Mortgage-backed securities - government agencies	149,748	282	(3,753)	146,277
Obligations of states and political subdivisions	29,760	107	(188 )	29,679
Total securities available for sale	\$ 443,742	\$ 545	\$(7,292)	\$ 436,995

(In thousands) <b>December 31, 2017</b>	<b>Amortized cost</b>	<b>Unrealized Gains</b>	<b>Losses</b>	<b>Fair value</b>
U.S. Treasury and other U.S. government obligations	\$ 149,996	\$-	\$(12 )	\$ 149,984
Government sponsored enterprise obligations	214,852	474	(1,482)	213,844
Mortgage-backed securities - government agencies	163,571	383	(2,447)	161,507
Obligations of states and political subdivisions	48,987	365	(163 )	49,189
Total securities available for sale	\$ 577,406	\$ 1,222	\$(4,104)	\$ 574,524

In 2018 Bancorp did not sell any securities. Bancorp sold a corporate equity security in 2017 for a loss of \$263 thousand. One security was called prior to maturity in the third quarter of 2017 resulting in the receipt of a \$31 thousand pre-payment penalty. The penalty income was classified as a realized gain on the call of available for sale securities. In 2016, Bancorp did not sell any securities. Management has the intent and ability to hold all remaining investment securities available for sale for the foreseeable future.

A summary of the securities available for sale by maturity as of December 31, 2018 is shown below.

(In thousands) <b>Securities available for sale</b>	<b>Amortized cost</b>	<b>Fair value</b>
Due within 1 year	\$ 120,523	\$ 120,239
Due after 1 but within 5 years	64,141	63,260

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Due after 5 but within 10 years	8,059	7,899
Due after 10 years	101,271	99,320
Mortgage-backed securities - government agencies	149,748	146,277
Total securities available for sale	\$ 443,742	\$ 436,995

Actual maturities may differ from contractual maturities because some issuers have the right to call or prepay obligations with or without call or prepayment penalties. The investment portfolio includes agency mortgage-backed securities, which are guaranteed by agencies such as the FHLMC, FNMA, and GNMA. These securities differ from traditional debt securities primarily in that they may have uncertain principal payment dates and are priced based on estimated prepayment rates on the underlying collateral.

Securities with a carrying value of \$355.1 million and \$384.7 million were pledged at December 31, 2018 and 2017, respectively, to secure accounts of commercial depositors in cash management accounts, public deposits, and uninsured cash balances for WM&T accounts.

At December 31, 2018 and 2017, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of stockholders' equity.

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Securities with unrealized losses not recognized in the statements of income are as follows:

(In thousands)	Less than 12 months		12 months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
<b>December 31, 2018</b>						
Government sponsored enterprise obligations	\$96,740	\$ (38 )	\$149,320	\$ (3,313 )	\$246,060	\$ (3,351 )
Mortgage-backed securities - government agencies	3,108	(5 )	120,848	(3,748 )	123,956	(3,753 )
Obligations of states and political subdivisions	814	(1 )	17,639	(187 )	18,453	(188 )
Total temporarily impaired securities	\$100,662	\$ (44 )	\$287,807	\$ (7,248 )	\$388,469	\$ (7,292 )
<b>December 31, 2017</b>						
U.S. Treasury and U.S. obligations	\$149,984	\$ (12 )	\$-	\$ -	\$149,984	\$ (12 )
Government sponsored enterprise obligations	95,139	(586 )	49,870	(896 )	145,009	(1,482 )
Mortgage-backed securities - government agencies	69,290	(440 )	67,047	(2,007 )	136,337	(2,447 )
Obligations of states and political subdivisions	22,366	(107 )	5,064	(56 )	27,430	(163 )
Total temporarily impaired securities	\$336,779	\$ (1,145 )	\$121,981	\$ (2,959 )	\$458,760	\$ (4,104 )

Applicable dates for determining when securities are in an unrealized loss position are December 31, 2018 and 2017. As such, it is possible that a security had a market value lower than its amortized cost on other days during the past twelve months, but is not in the “Securities with an unrealized loss of less than 12 months” category above.

Unrealized losses on Bancorp’s investment securities portfolio have not been recognized as expense because the securities are of high credit quality, and the decline in fair values is due to changes in the prevailing interest rate environment since the purchase date. Fair value is expected to recover as securities reach their maturity date and/or the interest rate environment returns to conditions similar to when these securities were purchased. Because management does not intend to sell the investments, and it is not likely that Bancorp will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, Bancorp does not consider these securities to be other-than-temporarily impaired at December 31, 2018.

FHLB stock and other securities are investments held by Bancorp which are not readily marketable and are carried at cost. This category consists of holdings of Federal Home Loan Bank of Cincinnati (“FHLB”) stock which are required

for access to FHLB borrowing, and are classified as restricted securities.

Table of Contents**(5) Loans**

Composition of loans by primary loan portfolio class follows:

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Commercial and industrial	\$833,524	\$779,014
Construction and development, excluding undeveloped land	225,050	195,912
Undeveloped land	30,092	18,988
Real estate mortgage:		
Commercial investment	588,610	594,902
Owner occupied commercial	426,373	398,685
1-4 family residential	276,017	262,110
Home equity - first lien	49,500	57,110
Home equity - junior lien	70,947	63,981
Subtotal: Real estate mortgage	1,411,447	1,376,788
Consumer	48,058	38,868
Total loans	\$2,548,171	\$2,409,570

Fees and costs of originating loans are deferred at origination and amortized over the life of the loan. Loan balances reported herein include deferred loan origination fees, net of deferred loan costs. At December 31, 2018 and 2017, net deferred loan origination costs exceeded deferred loan origination fees, resulting in net negative balances of \$592 thousand and \$600 thousand, respectively.

Bancorp's credit exposure is diversified with secured and unsecured loans to individuals and businesses. No specific industry concentration exceeds ten percent of loans. While Bancorp has a diversified loan portfolio, a customer's ability to honor contracts is somewhat dependent upon the economic stability and/or industry in which that customer does business. Loans outstanding and related unfunded commitments are primarily concentrated within Bancorp's current market areas, which encompass the Louisville, Indianapolis and Cincinnati metropolitan markets.

Bancorp occasionally enters into loan participation agreements with other banks in the ordinary course of business to diversify credit risk. For certain sold participation loans, Bancorp has retained effective control of the loans, typically by restricting the participating institutions from pledging or selling their share of the loan without permission from



Bancorp. US GAAP requires the participated portion of these loans to be recorded as secured borrowings. The participated portions of these loans are included in the commercial and industrial loan (C&I) totals above, and a corresponding liability is reflected in other liabilities. At December 31, 2018 and 2017, the total participated portions of loans of this nature were \$10.5 million and \$18.2 million respectively.

Loans to directors and their associates, including loans to companies for which directors are principal owners and executive officers are presented in the following table.

(In thousands)	<b>Year ended</b>	
	<b>December 31,</b>	
<b><u>Loans to directors and executive officers</u></b>	<b>2018</b>	<b>2017</b>
Balance as of January 1	\$629	\$969
Effect of changes in composition of directors and executive officers	51,415	–
Repayment of term loans	–	(175)
Changes in balances of revolving lines of credit	643	(165)
Balance as of December 31	\$52,687	\$629



Allowance for loans collectively evaluated  
for impairment

Allowance for loans acquired with deteriorated credit quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
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Considerations by Bancorp in computing its allowance are determined based on the various risk characteristics of each loan segment. Relevant risk characteristics are as follows:

**Commercial and industrial loans:** Loans in this category are made to businesses. Generally these loans are secured by assets of the business and repayment is expected from cash flows of the business. A decline in the strength of the business or a weakened economy and resultant decreased consumer and/or business spending may have a negative effect on credit quality in this loan category.

**Construction and development, excluding undeveloped land:** Loans in this category primarily include owner-occupied and investment construction loans and commercial development projects. In most cases, construction loans require only interest to be paid during construction. Upon completion or stabilization, the construction loan may convert to permanent financing in the real estate mortgage segment, requiring principal amortization. Repayment of development loans is derived from sale of lots or units including any pre-sold units. Credit risk is affected by construction delays, cost overruns, market conditions and availability of permanent financing, to the extent such permanent financing is not being provided by Bancorp.

**Undeveloped land:** Loans in this category are secured by land acquired for development by the borrower, but for which no development has yet taken place. Credit risk is primarily dependent upon financial strength of the borrower, but can also be affected by market conditions and time to sell lots at an adequate price. Credit risk is also affected by availability of permanent financing, including to the end user, to the extent such permanent financing is not being provided by Bancorp.

**Real estate mortgage:** Loans in this category are made to and secured by owner-occupied residential real estate, owner-occupied real estate used for business purposes, and income-producing investment properties. For owner-occupied residential and owner-occupied commercial real estate, repayment is dependent on financial strength of the borrower. For income-producing investment properties, repayment is dependent on financial strength of both the tenants and the borrower. Underlying properties are generally located in Bancorp's primary market area. Cash flows of income producing investment properties may be adversely impacted by a downturn in the economy as reflected in increased vacancy rates, which in turn, will have an effect on credit quality and property values. Overall health of the economy, including unemployment rates and real estate values, has an effect on credit quality in this loan category.

**Consumer:** Loans in this category may be either secured or unsecured and repayment is dependent on credit quality of the individual borrower and, if applicable, adequacy of collateral securing the loan. Therefore, overall health of the economy, including unemployment rates, as well as home and securities prices, will have a significant effect on credit quality in this loan category.

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The following tables present loans individually evaluated for impairment as of December 31, 2018 and 2017.

(In thousands)	<b>Recorded investment</b>	<b>Unpaid principal balance</b>	<b>Related allowance</b>	<b>Average recorded investment</b>	<b>Interest income recognized</b>
<b>December 31, 2018</b>					
Loans with no related allowance recorded:					
Commercial and industrial	\$ 192	\$ 707	\$ –	\$ 161	\$ –
Construction and development, excluding undeveloped land	318	489	–	437	–
Undeveloped land	474	506	–	474	–
Real estate mortgage					
Commercial investment	138	138	–	35	–
Owner occupied commercial	586	1,023	–	1,503	–
1-4 family residential	760	760	–	1,242	–
Home equity - first lien	–	–	–	–	–
Home equity - junior lien	143	143	–	73	–
Subtotal: Real estate mortgage	1,627	2,064	–	2,853	–
Consumer	–	–	–	23	–
Subtotal	\$ 2,611	\$ 3,766	\$ –	\$ 3,948	\$ –
Loans with an allowance recorded:					
Commercial and industrial	\$ 28	\$ 28	\$ 28	\$ 1,851	\$ 2
Construction and development, excluding undeveloped land	–	–	–	–	–
Undeveloped land	–	–	–	24	–
Real estate mortgage					
Commercial investment	–	–	–	–	–
Owner occupied commercial	–	–	–	897	–
1-4 family residential	14	14	14	14	1
Home equity - first lien	–	–	–	–	–
Home equity - junior lien	–	–	–	–	–
Subtotal: Real estate mortgage	14	14	14	911	1
Consumer	–	–	–	–	–
Subtotal	\$ 42	\$ 42	\$ 42	\$ 2,786	\$ 3
Total:					
Commercial and industrial	\$ 220	\$ 735	\$ 28	\$ 2,012	2
Construction and development, excluding undeveloped land	318	489	–	437	–
Undeveloped land	474	506	–	498	–

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Real estate mortgage					
Commercial investment	138	138	–	35	–
Owner occupied commercial	586	1,023	–	2,400	–
1-4 family residential	774	774	14	1,256	1
Home equity - first lien	–	–	–	–	–
Home equity - junior lien	143	143	–	73	–
Subtotal: Real estate mortgage	1,641	2,078	14	3,764	1
Consumer	–	–	–	23	–
Total	\$ 2,653	\$ 3,808	\$ 42	\$ 6,734	3



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(In thousands)	<b>Recorded investment</b>	<b>Unpaid principal balance</b>	<b>Related allowance</b>	<b>Average recorded investment</b>	<b>Interest income recognized</b>
<b>December 31, 2017</b>					
Loans with no related allowance recorded:					
Commercial and industrial	\$ 1,142	\$ 2,202	\$ –	\$ 411	\$ –
Construction and development, excluding undeveloped land	664	834	–	559	–
Undeveloped land	474	506	–	425	–
Real estate mortgage					
Commercial investment	52	53	–	110	–
Owner occupied commercial	3,332	3,789	–	1,678	–
1-4 family residential	1,637	1,657	–	935	–
Home equity - first lien	–	–	–	–	–
Home equity - junior lien	31	31	–	186	–
Subtotal: Real estate mortgage	5,052	5,530	–	2,909	–
Consumer	–	–	–	–	–
Subtotal	\$ 7,332	\$ 9,072	\$ –	\$ 4,304	\$ –
Loans with an allowance recorded:					
Commercial and industrial	\$ 34	\$ 34	\$ 34	\$ 1,882	78
Construction and development, excluding undeveloped land	–	–	–	–	–
Undeveloped land	–	–	–	48	–
Real estate mortgage					
Commercial investment	–	–	–	–	–
Owner occupied commercial	–	–	–	–	–
1-4 family residential	14	14	14	5	–
Home equity - first lien	–	–	–	–	–
Home equity - junior lien	–	–	–	–	–
Subtotal: Real estate mortgage	14	14	14	5	–
Consumer	–	–	–	46	–
Subtotal	\$ 48	\$ 48	\$ 48	\$ 1,981	\$ 78
Total:					
Commercial and industrial	\$ 1,176	\$ 2,236	\$ 34	\$ 2,293	78
Construction and development, excluding undeveloped land	664	834	–	559	–
Undeveloped land	474	506	–	473	–
Real estate mortgage					
Commercial investment	52	53	–	110	–
Owner occupied commercial	3,332	3,789	–	1,678	–
1-4 family residential	1,651	1,671	14	940	–

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Home equity - first lien	–	–	–	–	–
Home equity - junior lien	31	31	–	186	–
Subtotal: Real estate mortgage	5,066	5,544	14	2,914	–
Consumer	–	–	–	46	–
Total	\$ 7,380	\$ 9,120	\$ 48	\$ 6,285	\$ 78

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Differences between recorded investment amounts and unpaid principal balance amounts less related allowance are due to partial charge-offs which have occurred over the life of loans and fair value adjustments recorded for loans acquired. Interest paid on impaired or non-accrual loans that was used to reduce principal was \$93 thousand, \$338 thousand and \$307 thousand in 2018, 2017 and 2016, respectively. Interest income that would have been recorded if non-accrual loans were on a current basis in accordance with their original terms was \$391 thousand, \$159 thousand and \$149 thousand in 2018, 2017 and 2016, respectively. No interest income was recognized on a cash basis in 2018, 2017, or 2016.

Impaired loans include non-accrual loans and loans accounted for as troubled debt restructurings (TDRs), which continue to accrue interest. Non-performing loans include the balance of impaired loans plus any loans over 90 days past due and still accruing interest. Loans past due more than 90 days or more and still accruing interest amounted to \$745 thousand and \$2 thousand at December 31, 2018 and 2017, respectively.

The following table presents the recorded investment in non-accrual loans as of December 31, 2017 and 2016.

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Commercial and industrial	\$192	\$321
Construction and development, excluding undeveloped land	318	664
Undeveloped land	474	474
Real estate mortgage		
Commercial investment	138	52
Owner occupied commercial	586	3,332
1-4 family residential	760	1,637
Home equity - first lien	—	—
Home equity - junior lien	143	31
Subtotal: Real estate mortgage	1,627	5,052
Consumer	—	—
Total	\$2,611	\$6,511

In the course of working with borrowers, Bancorp may elect to restructure contractual terms of certain loans. A troubled debt restructuring (TDRs) occurs when, for economic or legal reasons related to a borrower's financial difficulties, Bancorp grants a concession to the borrower that it would not otherwise consider. Bancorp had \$42 thousand and \$869 thousand of accruing loans classified as TDRs, at December 31, 2018 and 2017, respectively. No loans were classified as TDR in 2018 or 2016. Two loans were designated as TDRs during 2017. A commercial loan with a pre- and post-modification recorded investment of \$39 thousand was given a payment concession so as to enable the borrower to fulfill the loan agreement. A 1-4 family residential loan with a pre-modification recorded

investment of \$12 thousand was renewed with interest capitalized resulting in a post-modification recorded investment of \$14 thousand. Specific reserves for the full amounts of both loans were established. Two other commercial loans were considered TDRs as of December 31, 2017. Loans reported in 2016 as TDRs consisted of two commercial loans, to a single borrower, and one consumer loan. No loans classified as TDRs in 2016, 2017 or 2018 subsequently defaulted within 12 months.

Loans accounted for as TDRs are individually evaluated for impairment. At December 31, 2018 loans reported as TDRs had a total allowance allocation of \$42 thousand, compared with \$48 thousand at December 31, 2017. At December 31, 2018 and 2017, Bancorp had no outstanding commitments to lend additional funds to borrowers whose loans have been classified as TDRs. As of December 31, 2018 formal foreclosure proceedings were in process on consumer mortgage loans with a total recorded investment of \$528 thousand, compared with \$62 thousand as of December 31, 2017.

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The following table presents aging of the recorded investment in loans as of December 31, 2018 and 2017.

(In thousands)				<b>90 or more days past due (includes non-accrual)</b>	<b>Total past due</b>	<b>Total loans</b>	<b>Recorded investment &gt; 90 days and accruing</b>
<b>December 31, 2018</b>	<b>Current</b>	<b>30-59 days past due</b>	<b>60-89 days past due</b>				
Commercial and industrial	\$832,923	\$197	\$200	\$ 204	\$601	\$833,524	\$ 12
Construction and development, excluding undeveloped land	224,732	–	–	318	318	225,050	–
Undeveloped land	29,552	66	–	474	540	30,092	–
Real estate mortgage							
Commercial investment	586,884	1,382	107	237	1,726	588,610	99
Owner occupied Commercial	421,143	2,732	1,377	1,121	5,230	426,373	535
1-4 family residential	274,547	374	336	760	1,470	276,017	–
Home equity - first lien	49,321	179	–	–	179	49,500	–
Home equity - junior lien	70,467	182	56	242	480	70,947	99
Subtotal: Real estate mortgage	1,402,362	4,849	1,876	2,360	9,085	1,411,447	733
Consumer	48,058	–	–	–	–	48,058	–
<b>Total</b>	<b>\$2,537,627</b>	<b>\$5,112</b>	<b>\$2,076</b>	<b>\$ 3,356</b>	<b>\$10,544</b>	<b>\$2,548,171</b>	<b>\$ 745</b>
<b>December 31, 2017</b>							
Commercial and industrial	\$776,118	\$2,571	\$4	\$ 321	\$2,896	\$779,014	\$ –
Construction and development, excluding undeveloped land	194,936	–	312	664	976	195,912	–
Undeveloped land	18,514	–	–	474	474	18,988	–
Real estate mortgage							
Commercial investment	594,242	608	–	52	660	594,902	–
Owner occupied commercial	394,623	455	275	3,332	4,062	398,685	–
1-4 family residential	259,994	172	307	1,637	2,116	262,110	–
Home equity - first lien	56,938	172	–	–	172	57,110	–
Home equity - junior lien	63,667	87	194	33	314	63,981	2
Subtotal: Real estate mortgage	1,369,464	1,494	776	5,054	7,324	1,376,788	2
Consumer	38,699	86	83	–	169	38,868	–
<b>Total</b>	<b>\$2,397,731</b>	<b>\$4,151</b>	<b>\$1,175</b>	<b>\$ 6,513</b>	<b>\$11,839</b>	<b>\$2,409,570</b>	<b>\$ 2</b>



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Consistent with regulatory guidance, Bancorp categorizes loans into credit 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. Pass-rated loans include all risk-rated loans other than those classified as other assets especially mentioned, substandard, and doubtful, which are defined below:

**Other assets especially mentioned (“OAEM”):** Loans classified as OAEM have a potential weakness that deserves management’s close attention. These potential weaknesses may result in deterioration of repayment prospects for the loan or of Bancorp’s credit position at some future date.

**Substandard:** Loans classified as substandard are inadequately protected by the paying capacity of the obligor or of collateral pledged, if any. Loans so classified have well-defined weaknesses that may jeopardize repayment of the debt. Default is a distinct possibility if the deficiencies are not corrected.

**Substandard non-performing:** Loans classified as substandard non-performing have deteriorated beyond the characteristics of substandard loans and have been placed on non-accrual status or have been accounted for as troubled debt restructurings.

**Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

As of December 31, 2018 and 2017, internally assigned risk grades of loans by category were as follows:

(In thousands) <b>December 31, 2018</b>	<b>Pass</b>	<b>OAEM</b>	<b>Substandard</b>	<b>Substandard non-performing</b>	<b>Doubtful</b>	<b>Total</b>
Commercial and industrial	\$803,073	\$11,516	\$18,703	\$232	\$—	\$833,524
Construction and development, excluding undeveloped land	220,532	4,200	—	318	—	225,050
Undeveloped land	29,618	—	—	474	—	30,092
Real estate mortgage						
Commercial investment	586,543	1,815	15	237	—	588,610
Owner occupied commercial	411,722	9,030	4,500	1,121	—	426,373
1-4 family residential	273,537	1,544	162	774	—	276,017
Home equity - first lien	49,500	—	—	—	—	49,500
Home equity - junior lien	70,437	249	19	242	—	70,947
Subtotal: Real estate mortgage	1,391,739	12,638	4,696	2,374	—	1,411,447

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Consumer	48,058	–	–	–	–	48,058
Total	\$2,493,020	\$28,354	\$23,399	\$3,398	\$–	\$2,548,171
<b>December 31, 2017</b>						
Commercial and industrial	\$751,628	\$12,032	\$14,178	\$1,176	\$–	\$779,014
Construction and development, excluding undeveloped land	195,248	–	–	664	–	195,912
Undeveloped land	18,484	–	30	474	–	18,988
Real estate mortgage						
Commercial investment	591,232	3,599	19	52	–	594,902
Owner occupied Commercial	383,455	8,683	3,215	3,332	–	398,685
1-4 family residential	256,968	2,477	1,014	1,651	–	262,110
Home equity - first lien	57,110	–	–	–	–	57,110
Home equity - junior lien	63,471	247	230	33	–	63,981
Subtotal: Real estate mortgage	1,352,236	15,006	4,478	5,068	–	1,376,788
Consumer	38,747	117	4	–	–	38,868
Total	\$2,356,343	\$27,155	\$18,690	\$7,382	\$–	\$2,409,570



Table of Contents**(6) Premises and Equipment**

A summary of premises and equipment follows:

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Land	\$9,664	\$8,908
Buildings and improvements	47,726	45,285
Furniture and equipment	21,793	19,360
Construction in progress	1,051	1,496
	80,234	75,049
Accumulated depreciation and amortization	(35,470)	(33,394)
Total premises and equipment	\$44,764	\$41,655

December 31, 2017 balances reflect a correction of incorrectly reported year-end balances in Note 6 of the 2017 Form 10-K, which were presented as \$7,118, \$47,924, and \$18,511 for land, buildings and improvements, and furniture and equipment, respectively.

Depreciation expense related to premises and equipment was \$3.7 million in 2018, \$3.5 million in 2017 and \$3.2 million in 2016.

**(7) Other Assets**

A summary of major components of other assets follows:

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Cash surrender value of life insurance other than BOLI	\$15,029	\$16,213

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Net deferred tax asset	10,193	9,206
Investments in income tax credit related ventures	4,537	3,216
Prepaid assets	3,072	2,856
Other short term receivables	1,939	2,215
Core deposit intangible	1,057	1,225
Mortgage servicing rights (MSRs)	1,022	875
OREO and other foreclosed property	1,018	2,640
Goodwill	682	682
Other	8,362	9,378
Total	\$46,911	\$48,506

Bancorp maintains life insurance policies other than BOLI in conjunction with its non-qualified defined benefit retirement and non-qualified compensation plans.

Mortgage servicing rights (MSRs) are initially recognized at fair value when mortgage loans are sold and amortized in proportion to and over the period of estimated net servicing income, considering appropriate prepayment assumptions. MSRs are evaluated quarterly for impairment by comparing carrying value to fair value. Estimated fair values of MSRs at December 31, 2018 and 2017 were \$3.6 million and \$3.1 million, respectively. Total outstanding principal balances of loans serviced by Bancorp were \$327.9 million and \$344.5 million at December 31, 2018, and 2017 respectively.

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Changes in the net carrying amount of MSRs are shown in the following table.

(In thousands)	2018	2017
Balance at January 1	\$875	\$921
Originations	302	225
Amortization	(155 )	(271)
Balance at December 31	\$1,022	\$875

**(8) Income Taxes**

Components of income tax expense (benefit) from operations were as follows:

(In thousands)	For years ended December 31,		
	2018	2017	2016
Current income tax expense			
Federal	\$11,567	\$12,622	\$14,270
State	732	546	698
Total current income tax expense	12,299	13,168	14,968
Deferred income tax expense (benefit)			
Federal	(52 )	3,783	192
State	(44 )	(4 )	36
Total deferred income tax expense (benefit)	(96 )	3,779	228
Change in valuation allowance	(172 )	192	48
Total income tax expense	\$12,031	\$17,139	\$15,244

Components of income tax (benefit) expense recorded directly to stockholders' equity were as follows:

(In thousands)	For years ended December 31,		
	2018	2017	2016
Unrealized (loss) gain on securities available for sale	\$(812)	\$(531)	\$(1,171)
Reclassification adjustment for securities losses realized in income	-	81	-

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Reclassification adjustment for securities impairment realized in income	–	–	–
Unrealized (loss) gain on derivatives	46	112	24
Minimum pension liability adjustment	46	(9 )	1
Compensation expense for tax purposes in excess of amounts recognized for financial reporting purposes	–	–	(1,705)
Total income tax (benefit) expense recorded directly to stockholders' equity	\$(720)	\$(347)	\$(2,851)

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An analysis of the difference between statutory and effective tax rates from operations follows:

	<b>For years ended</b>		
	<b>December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
U.S. federal income tax rate	21.0%	35.0 %	35.0%
Tax credits	(1.8 )	(14.4 )	(9.7 )
Stock based compensation	(0.8 )	(2.6 )	–
Net deferred tax asset remeasurement	(0.5 )	10.8	–
Other, net	(0.5 )	0.9	0.3
Cash surrender value of life insurance	(0.4 )	(1.5 )	(0.9 )
Tax exempt interest income	(0.4 )	(1.2 )	(1.2 )
Amortization/impairment of investments in tax credit partnerships	0.4	3.4	2.8
State income taxes	0.8	0.7	0.8
Effective income tax rate	17.8%	31.1 %	27.1%

Bancorp’s effective income tax rate decreased to 17.8% in 2018 from 31.1% in 2017. The decrease was largely a result of the reduction of the marginal federal tax rate from 35% to 21% effective January 1, 2018, as a result of the Tax Cuts and Jobs Act enacted on December 22, 2017. That tax reform also resulted in higher taxes in 2017 from a one-time \$5.9 million charge to remeasure Bancorp’s net deferred tax asset. The 2017 effective tax rate included significantly more tax savings from stock-based compensation deductions and federal income tax credits.

The increase in effective tax rate from 2016 to 2017 was the result of the one-time, non-cash charge resulting from the remeasurement of deferred taxes as a result of tax reform somewhat offset by higher utilization of tax credits during the year. The Tax Cuts and Jobs Act was enacted in December 2017 requiring an immediate recalculation of Bancorp’s net deferred tax asset which resulted in \$5.9 million of additional income tax expense in the fourth quarter of 2017. The effective tax rate in 2017 was also reduced by the adoption of ASU 2016-09 “Compensation – Stock Compensation Improvements to Employee Share-Based Payment Accounting”. The standard requires excess tax benefits and deficiencies related to stock-based payment awards to be reflected in the statement of operations as a component of the provision for income taxes. For 2017 Bancorp recorded a benefit of \$1.5 million for such excess benefits against the provision for income tax expense. Prior to adoption of ASU 2016-09, these tax benefits were recorded directly to additional paid-in capital. Tax benefits recorded to capital for 2016 were \$1.7 million.

In December 2017, the U.S. Securities and Exchange Commission (“SEC”) released Staff Accounting Bulletin No. 118 (“SAB 118”) to address any uncertainty or diversity of views in practice in accounting for the income tax effects of tax reform in situations where a registrant does not have the necessary information available, prepared or analyzed in reasonable detail to complete this accounting in the reporting period that includes the enactment date. SAB 118 allows a measurement period not to extend beyond one year from the tax reform’s enactment date to complete the necessary accounting. Bancorp believes it has completed necessary analyses and recorded income tax effects of tax reform within the measurement period.



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The effects of temporary differences that gave rise to significant portions of deferred tax assets and deferred tax liabilities follows:

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Deferred tax assets		
Allowance for loan and lease loss	\$5,567	\$5,422
Deferred compensation	4,703	4,148
Accrued expenses	968	798
Securities	756	121
Investments in tax credit partnerships	543	565
Loans	434	442
Other assets	181	186
Write-downs and costs associated with OREO	7	39
Total deferred tax assets	13,159	11,721
Deferred tax liabilities		
Property and equipment	1,154	764
Loan costs	632	588
Leases	336	149
Other liabilities	267	260
Core deposit intangible	230	267
Mortgage servicing rights	193	161
Total deferred tax liabilities	2,812	2,189
Valuation allowance	(154 )	(326 )
Net deferred tax asset	\$10,193	\$9,206

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more likely than not that some portion of the entire deferred tax asset will not be realized. Ultimate realization of deferred tax assets is dependent upon generation of future taxable income during periods in which those temporary differences become deductible. Management considers scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projection for future taxable income over periods which the temporary differences resulting in remaining deferred tax assets are deductible, management believes it is more likely than not that Bancorp will realize the benefits of these deductible differences, net of the valuation allowance, at December 31, 2018.

Realization of deferred tax assets associated with investment in tax credit partnerships is dependent upon generating sufficient taxable capital gain income prior to their expiration. A valuation allowance of \$154 thousand and \$326 thousand to reflect management's estimate of the temporary deductible differences that may expire prior to their utilization has been recorded as of December 31, 2018 and 2017, respectively.

US GAAP provides guidance on financial statement recognition and measurement of tax positions taken, or expected to be taken, in tax returns. As December 31, 2018 and 2017, the gross amount of unrecognized tax benefits, including penalties and interest, was \$29 thousand. If recognized, tax benefits would reduce tax expense and accordingly, increase net income. The amount of unrecognized tax benefits may increase or decrease in the future for various reasons including adding amounts for current year tax positions, expiration of open income tax returns due to statutes of limitation, changes in management's judgment about the level of uncertainty, status of examination, litigation and legislative activity and addition or elimination of uncertain tax positions. Federal and state income tax returns are subject to examination for the years after 2014.



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A reconciliation of the amount of unrecognized tax benefits follows:

(In thousands)	<b>2018</b>	<b>2017</b>
Balance as of January 1	\$40	\$40
Increases - current year tax positions	–	11
Increases - prior year tax positions	–	–
Settlements	–	–
Lapse of statute of limitations	(11)	(11)
Balance as of December 31	\$29	\$40

**(9) Deposits**

Composition of interest bearing deposits follows:

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
Interest bearing demand	\$892,867	\$833,450
Savings	155,007	152,348
Money market	688,744	682,226
Time deposits of \$250,000 or greater	55,182	38,439
Other time deposits	291,533	197,135
Total interest bearing deposits	\$2,083,333	\$1,903,598

Interest expense related to certificates of deposit and other time deposits in denominations of \$250 thousand or more was \$431 thousand, \$161 thousand and \$231 thousand, respectively, for the years ended December 31, 2018, 2017 and 2016.

At December 31, 2018, the scheduled maturities of time deposits were as follows (in thousands):

2019	\$172,321
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2020	123,832
2021	36,365
2022	6,429
2023	7,668
2024 and thereafter	100

Total time deposits \$346,715

Deposits of directors and their associates, including deposits of companies for which directors are principal owners, and executive officers were \$42.0 million and \$28.5 million at December 31, 2018 and 2017, respectively.

At December 31, 2018 and 2017, Bancorp had \$886 thousand and \$614 thousand, respectively, of deposits accounts in overdraft status and thus have been reclassified to loans on the accompanying consolidated balance sheets.

At December 31, 2018, Bancorp had \$29.8 million in brokered deposits, compared with no brokered deposits as of December 31, 2017.

Table of Contents**(10) Securities Sold Under Agreements to Repurchase**

Securities sold under agreements to repurchase are a funding source of Bancorp and are primarily used by commercial customers in conjunction with collateralized corporate cash management accounts. Such repurchase agreements are considered financing agreements and mature within one business day from the transaction date. At December 31, 2018, all of these financing arrangements had overnight maturities and were secured by government sponsored enterprise obligations and government agency mortgage-backed securities which were owned and controlled by Bancorp.

Information concerning securities sold under agreements to repurchase is summarized as follows:

(Dollars in thousands)	2018	2017
Average balance during the year	\$62,580	\$70,187
Average interest rate during the year	0.25 %	0.19 %
Maximum month-end balance during the year	\$74,725	\$75,365

**(11) Advances from the Federal Home Loan Bank**

Bancorp had outstanding borrowings of \$48.2 million at December 31, 2018, via fourteen separate fixed-rate advances. For two advances totaling \$30 million, both of which are non-callable, interest payments are due monthly, with principal due at maturity. For the remaining advances totaling \$18.2 million, principal and interest payments are due monthly based on an amortization schedule.

The following is a summary of the contractual maturities and average effective rates of outstanding advances:

(In thousands)	December 31, 2018		December 31, 2017	
	Advance	Fixed Rate	Advance	Fixed Rate
2019	\$30,000	2.54 %	\$30,000	1.48 %
2020	1,691	2.23	1,741	2.23
2021	215	2.12	288	2.12

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2024	2,240	2.36	2,454	2.36
2025	4,626	2.42	5,149	2.42
2026	8,185	1.99	8,564	1.99
2028	1,220	1.49	1,262	1.49
Total	\$48,177	2.39 %	\$49,458	1.74 %

Payments based on amortization schedules over the next five years are as follows:

(In thousands)

2019	\$31,420
2020	2,924
2021	1,298
2022	1,268
2023	1,297
2024 and beyond	9,970

In addition to fixed-rate advances listed above, at December 31, 2017, Bancorp had a \$150 million cash management advance from the FHLB. This advance matured in the first week of January 2018 and was used to manage Bancorp's overall cash position. Due to the short-term nature of the advance, it was recorded on the consolidated balance sheet within federal funds purchased. No cash management advances were outstanding as of December 31, 2018.

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Advances from the FHLB are collateralized by certain commercial and residential real estate mortgage loans under a blanket mortgage collateral agreement and FHLB stock. Bancorp views the borrowings as an effective alternative to brokered deposits to fund loan growth. At December 31, 2018, the amount of available credit from the FHLB totaled \$537 million. Bancorp also has \$105 million in federal funds lines available from correspondent banks.

**(12) Other Comprehensive Income (Loss)**

The following table illustrates activity within the balances in accumulated other comprehensive income (loss) by component, and is shown for the years ended December 31, 2018, 2017, and 2016. The tables also include \$506 thousand reclassified from AOCI to retained earnings related to the adoption of ASU 2018-02 in the first quarter of 2018. ASU 2018-02 provided for the reclassification of tax effects stranded in other comprehensive income as a result of the 2017 Tax Cuts and Jobs Act into retained earnings. The Tax Reform reduced the US Federal corporate tax rate from 35% to 21% effective January 1, 2018. As a result, Bancorp was required to remeasure its net deferred tax assets at the lower rate and recognize the adjustment through income tax expense in 2017. The adjustment through income tax expense left items presented in AOCI, for which the related income tax effects were originally recognized in other comprehensive income, unadjusted for the new tax rate. The reclassification upon adoption of ASU 2018-02 results in AOCI reflecting the new tax rate.

(In thousands)	<b>Net unrealized gains (losses) on securities available for sale</b>	<b>Net unrealized gains (losses) on cash flow hedges</b>	<b>Minimum pension liability adjustment</b>	<b>Total</b>
Balance at December 31, 2015	\$ 965	\$ (60 )	\$ (273 )	\$632
Other comprehensive (loss) income before reclassifications	(2,176 )	44	1	(2,131)
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current period other comprehensive (loss) income	(2,176 )	44	1	(2,131)
Balance at December 31, 2016	\$ (1,211 )	\$ (16 )	\$ (272 )	\$(1,499)
Other comprehensive (loss) income before reclassifications	(721 )	209	(70 )	(582 )
Amounts reclassified from accumulated other comprehensive income	151	-	-	151
Net current period other comprehensive (loss) income	(570 )	209	(70 )	(431 )
Balance at December 31, 2017 (1)	\$ (1,781 )	\$ 193	\$ (342 )	\$(1,930)

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Other comprehensive income (loss) before reclassifications	(3,053 )	174	173	(2,706)
Amounts reclassified from accumulated other comprehensive income	—	—	—	—
Net current period other comprehensive income (loss)	(3,053 )	174	173	(2,706)
Reclassification adjustment for adoption of ASU 2018-02	(496 )	41	(51 )	(506 )
Balance at December 31, 2018	\$ (5,330 )	\$ 408	\$ (220 )	\$ (5,142)

December 31, 2017 AOCI component balances reflect a correction of incorrectly reported year-end balances in (1) Note 12 of the 2017 Form 10-K, which were presented as \$(2,278), \$234, and \$(392) for securities available for sale, cash flow hedges, and minimum pension liability, respectively.

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The following table illustrates activity within the reclassifications out of accumulated other comprehensive income (loss), for the years ended December 31, 2018, 2017 and 2016.

<b>Details of accumulated other comprehensive income (loss) components</b>	<b>Amount reclassified from accumulated other comprehensive income (loss)</b>	<b>Affected line item in the consolidated statements of income</b>
	For the years ended December 31,	
(In thousands)	2018	2017
	2017	2016
Unrealized gains (losses) on securities available for sale:		
Realized loss on sale of available for sale securities	\$- \$(232)	\$ - Loss on sale of securities
Effect of income taxes	- 81	- Income tax expense
Reclassifications, net of income taxes	\$- \$(151)	\$ -

**(13) Preferred Stock and Common Stock**

Bancorp has a class of preferred stock (no par value; 1,000,000 shares authorized); the relative rights, preferences and other terms of the class or any series within the class will be determined by the Board of Directors prior to any issuance. None of this stock has been issued to date.

At Bancorp's 2015 Annual Meeting of Shareholders, shareholders approved increasing the number of authorized common shares from 20,000,000 to 40,000,000.

**(14) Stock Split**

On April 29, 2016 Bancorp declared a 3 for 2 stock split effected as a 50% stock dividend to shareholders of record on May 13, 2016, paid May 27, 2016 in the form of a 50% stock dividend. Share and per share information has been adjusted as necessary to reflect this split.

**(15) Net Income per Share and Common Stock Dividends**

The following table reflects numerators (net income) and denominators (average shares outstanding) for basic and diluted net income per share computations:

(In thousands, except per share data)	<b>2018</b>	<b>2017</b>	<b>2016</b>
Net income, basic and diluted	\$55,517	\$38,043	\$41,027
Average shares outstanding, basic	22,619	22,532	22,356
Effect of dilutive shares	325	451	436
Average shares outstanding including dilutive shares	22,944	22,983	22,792
Net income per share, basic	\$2.45	\$1.69	\$1.84
Net income per share, diluted	\$2.42	\$1.66	\$1.80

SARs of 146 thousand granted at prices ranging from \$35.90 to \$40.00 were outstanding at December 31, 2018, but were not included in the computation of diluted EPS because they were antidilutive. They could, however, be dilutive to EPS in the future.



Table of Contents**(16) Employee Benefit Plans**

Bancorp has a combined employee stock ownership and profit sharing plan (“KSOP”). The plan is a defined contribution plan and is available to all employees meeting certain eligibility requirements. In general, for employees who work more than 1,000 hours per year, Bancorp matches employee contributions up to 6% of the employee’s salary, and contributes an amount of Bancorp stock equal to 2% of the employee’s salary. Employer matching expenses related to contributions to the plan for 2018, 2017, and 2016 were \$2.2 million, \$2.0 million and \$1.9 million, respectively, and are recorded on the consolidated statements of income within employee benefits. Employee and employer contributions are made in accordance with the terms of the plan. As of December 31, 2018 and 2017, the KSOP held 568 thousand and 577 thousand shares of Bancorp stock, respectively.

In addition Bancorp has non-qualified plans into which directors and certain senior officers may defer director fees or salary/incentives. Bancorp matched certain executives’ deferrals into the senior officers’ plan amounting to approximately \$250 thousand, \$232 thousand and \$293 thousand in 2018, 2017 and 2016 respectively. At December 31, 2018 and 2017, the amounts included in other liabilities in the consolidated financial statements for this plan were \$8.6 million and \$8.2 million, respectively, were comprised primarily of participants’ contributions, and represented the fair value of mutual fund investments directed by participants.

Bancorp sponsors an unfunded non-qualified defined benefit retirement plan for three key officers (one current and two retired), and has no plans to increase the number of or the benefits to participants. Benefits vest based on 25 years of service. Participants are fully vested. Bancorp uses a December 31 measurement date for this plan. The accumulated benefit obligation for the plan included in other liabilities in the consolidated financial statements was \$2.1 million as of December 31, 2018 and December 31, 2017. Actuarially determined pension costs are expensed and accrued over the service period, and benefits are paid from Bancorp’s assets. Bancorp maintains life insurance policies, for which it is the beneficiary, on participants and certain former executives. Income from these policies helps offset costs of benefits. The liability for Bancorp’s plan met the benefit obligation as of December 31, 2018 and 2017. Net periodic benefit cost was immaterial for all periods.

Benefits expected to be paid in each year from 2019 to 2023 and beyond are listed in the table below.

(In thousands)	
2019	\$84
2020	84
2021	–
2022	–
2023	–
Beyond 2023	3,278

Total future payments \$3,446

Expected benefits to be paid are based on the same assumptions used to measure Bancorp's benefit obligation at December 31, 2018. There are no obligations for other post-retirement and post-employment benefits.

**(17) Stock-Based Compensation**

The fair value of all stock-based awards granted, net of estimated forfeitures, is recognized as compensation expense over the respective service period.

Bancorp currently has one stock-based compensation plan. Shareholders approved the 2015 Omnibus Equity Compensation Plan and authorized the shares available from the expiring 2005 plan for future awards under the 2015 plan. In 2018 shareholders approve an additional 500 thousand shares for issuance under the plan. As of December 31, 2018, there were 647 thousand shares available for future awards. The 2005 Stock Incentive Plan expired in April 2015. SARs granted under this plan expire as late as 2025.

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Bancorp had no stock options outstanding at December 31, 2018. Stock appreciation rights (“SARs”) granted have a vesting schedule of 20% per year and expire ten years after the grant date unless forfeited due to employment termination. Fair values are determined using the Black Scholes pricing model as described later in this note.

Restricted shares granted to officers vest over five years. For all grants prior to 2015, grantees are entitled to dividend payments during the vesting period. For grants in 2015 and forward, forfeitable dividends are deferred until shares are vested. Fair value of restricted shares is equal to market value of the shares on the date of grant.

Grants of performance stock units (“PSUs”) vest based upon a single three-year performance period, which begins January 1 of the first year of the performance period. Because grantees are not entitled to dividend payments during the performance period, the fair value of these PSUs is estimated based upon the market value of the underlying shares on the date of grant, adjusted for non-payment of dividends. Grants require a one year post-vesting holding period and the fair value of such grants incorporates a liquidity discount related to the holding period of 4.3%, 5.1% and 4.5% for 2018, 2017 and 2016 grants, respectively.

Grants of restricted stock units (“RSUs”) to directors are time-based and vest 12 months after grant date. Because grantees are entitled to deferred dividend payments at the end of the vesting period, fair value of the RSUs equals market value of underlying shares on the date of grant.

Bancorp has recognized stock-based compensation expense for SARs, PSUs, and RSUs, within employee benefits for employees, and within other non-interest expense for directors, in the consolidated statements of income as follows:

(In thousands)	For years ended		
	December 31,		
	2018	2017	2016
Stock-based compensation expense before income taxes	\$4,027	\$2,892	\$2,473
Less: deferred tax benefit	(846 )	(607 )	(866 )
Reduction of net income	\$3,181	\$2,285	\$1,607

Beginning in 2017 Bancorp’s net income reflects the implementation of ASU 2016-09 which changed the way excess tax benefits and deficiencies related to stock-based compensation are recorded. Prior to 2017, these were recorded directly to additional paid-in capital and, thus did not affect earnings. Beginning in 2017, these are recorded as a tax expense or benefit in the income statement. These benefits resulted in \$549 thousand and \$1.5 million increases in net income for 2018 and 2017, respectively. This tax benefit is not reflected in the table above.

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As of December 31, 2018 Bancorp has \$5.2 million of unrecognized stock-based compensation expense that will be recorded as compensation expense over the next five years as awards vest. In 2018 Bancorp used cash of \$154 thousand for the purchase of shares upon the vesting of restricted stock units. This compares with cash used of \$216 thousand in 2017 for the purchase of shares upon the vesting of restricted stock units net of cash received for options exercised.

Fair values of Bancorp's SARs are estimated at the date of grant using the Black-Scholes option pricing model, a leading formula for calculating the value of stock options and SARs. This model requires the input of assumptions, changes to which can materially affect the fair value estimate. The following assumptions were used in SAR valuations at the grant date in each year:

<b>Assumptions</b>	<b>2018</b>	<b>2017</b>	<b>2016</b>
Dividend yield	2.56 %	2.72 %	2.94 %
Expected volatility	20.17%	19.47%	19.31%
Risk free interest rate	2.96 %	2.29 %	1.70 %
Expected life of SARs (in years)	7.0	7.0	7.3

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Dividend yield and expected volatility are based on historical information for Bancorp corresponding to the expected life of SARs granted. Expected volatility is the volatility of underlying shares for the expected term calculated on a monthly basis. The risk free interest rate is the implied yield currently available on U.S. Treasury issues with a remaining term equal to the expected life of the awards. Expected life of SARs is based on actual experience of past like-term SARs. Bancorp evaluates historical exercise and post-vesting termination behavior when determining the expected life.

A summary of stock option and SARs activity and related information for the years ended December 31, 2017 and 2018 follows.

	<b>Options and SARs (In thousands)</b>	<b>Exercise price</b>	<b>Weighted average exercise price</b>	<b>Aggregate intrinsic value (In thousands)</b>	<b>Weighted average fair value</b>	<b>Weighted average remaining contractual life (In years)</b>
At December 31, 2016						
Vested and exercisable	475	\$14.02-24.56	\$ 15.72	\$ 14,820	\$ 3.16	4.3
Unvested	260	15.24 -33.08	21.53	6,623	3.43	7.8
Total outstanding	735	14.02 -33.08	17.78	21,443	3.26	5.5
Activity during 2017						
SARs granted	46	40.00 -40.00	40.00	–	6.34	
Exercised	(77)	)14.02 -17.89	15.41	1,855	3.18	
Forfeited	–	–	–	–	–	
At December 31, 2017						
Vested and exercisable	490	14.02 -33.08	16.46	10,408	3.16	4.0
Unvested	214	15.26 -40.00	26.46	2,515	4.17	7.7
Total outstanding	704	14.02 -40.00	19.51	12,923	3.47	5.1
Activity during 2018						
SARs granted	100	35.90 -39.32	37.75	–	6.07	
Exercised	(73)	)14.02 -19.37	15.32	1,654	3.43	
Forfeited	–	–	–	–	–	
At December 31, 2018						
Vested and exercisable	492	14.02 -40.00	17.69	7,505	3.21	3.8
Unvested	239	19.37 -40.00	32.15	917	5.09	8.0
Total outstanding	731	14.02 -40.00	22.42	8,422	3.82	5.2
Vested year-to-date	75	\$15.26-40.00	\$ 23.38	\$ 776	\$ 3.77	

Intrinsic value for stock options and SARs is defined as the amount by which the current market price of the underlying stock exceeds the exercise or grant price.

The aggregate intrinsic value of stock options and SARs exercised in 2018, 2017 and 2016 was \$1.7 million, \$1.9 million and \$4.2 million, respectively. The aggregate intrinsic value of stock options and SARs exercised was calculated as the difference in the closing price of Bancorp's common shares on the date of exercise and the exercise price, multiplied by the number of shares exercised.

The weighted average Black-Scholes fair values of SARs granted in 2018, 2017 and 2016 were \$6.07, \$6.34 and \$3.56, respectively.

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SARs outstanding, stated in thousands, at December 31, 2018 were as follows:

<b>Expiration</b>	<b>Number of SARs outstanding</b>	<b>SARs exercisable</b>	<b>Weighted average exercise price of SARs outstanding</b>
2019	24	24	\$ 14.76
2020	44	44	14.02
2021	74	74	15.86
2022	117	117	15.25
2023	80	80	15.26
2024	83	64	19.37
2025	76	45	22.99
2026	88	35	25.84
2027	45	9	40.00
2028	100	–	37.75
	731	492	\$ 22.42

A summary of Bancorp granted shares of restricted common stock, for the three year period ending December 31, 2018, follows.

	<b>Number</b>	<b>Grant date weighted-average value</b>
Unvested at December 31, 2015	156	\$ 18.98
Shares awarded	51	25.78
Restrictions lapsed and shares released to employees/directors	(49 )	17.98
Shares forfeited	(13 )	20.69
Unvested at December 31, 2016	145	\$ 21.57
Shares awarded	29	44.85
Restrictions lapsed and shares released to employees/directors	(47 )	19.79
Shares forfeited	(8 )	25.18
Unvested at December 31, 2017	119	\$ 27.62
Shares awarded	40	35.89
Restrictions lapsed and shares released to employees/directors	(44 )	23.62
Shares forfeited	(5 )	31.35
Unvested at December 31, 2018	110	\$ 32.09





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Bancorp awarded performance-based restricted stock units (“PSUs”) to executive officers of Bancorp, the three-year performance period for which began January 1 of the award year, as follows:

<b>Grant year</b>	<b>Vesting period in years</b>	<b>Fair value at grant date</b>	<b>Expected shares to be awarded</b>
2016	3	\$22.61	69,161
2017	3	35.66	61,893
2018	3	31.54	50,352

In the first quarter of 2018, Bancorp awarded 6,525 RSUs to directors of Bancorp with a grant date fair value of \$247 thousand.

Bancorp has no equity compensation plans which have not been approved by shareholders. The following table provides detail of the number of shares to be issued upon exercise of outstanding stock-based awards and remaining shares available for future issuance under Bancorp’s equity compensation plan as of December 31, 2018.

<b>Plan category</b> (Shares in thousands)	<b>Number of shares to be issued upon exercise/vesting</b>	<b>Weighted average exercise price</b>	<b>Shares available for future issuance (a)</b>
Equity compensation plans approved by security holders:			
Stock appreciation rights (SARs)	(b)	(b)	647
Restricted common stock	110	N/A	(a)
Performance stock units	(c)	N/A	(a)
Restricted stock units	7	N/A	(a)
Total shares	117		647

(a) Under the 2015 Omnibus Equity Compensation Plan, shares of stock are authorized for issuance as incentive and nonqualified stock options, SARs, restricted stock, and restricted stock units

(b) At December 31, 2018, approximately 731 thousand SARs were outstanding at a weighted average grant price of \$22.42. The number of shares to be issued upon exercise will be determined based on the difference between the

grant price and the market price at the date of exercise.

The number of shares to be issued is dependent upon Bancorp achieving certain predefined performance targets (c) and ranges from zero shares to approximately 203 thousand shares. As of December 31, 2018, the expected shares to be awarded are approximately 181 thousand.

**(18) Dividend**

Bancorp's principal source of cash revenue is dividends paid to it as the sole shareholder of the Bank. At any balance sheet date, the Bank's regulatory dividend restriction represents the Bank's net income of the current year plus the prior two years less any dividends paid for the same time period. At December 31, 2018, the Bank may pay an amount equal to \$84.4 million in dividends to Bancorp without regulatory approval subject to ongoing capital requirements of the Bank.

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As of December 31, 2018, Bancorp had various commitments outstanding that arose in the normal course of business, including standby letters of credit and commitments to extend credit, which are properly not reflected in the consolidated financial statements. In management's opinion, commitments to extend credit of \$834.6 million including standby letters of credit of \$20.9 million represent normal banking transactions. Commitments to extend credit were \$688.3 million, including letters of credit of \$14.8 million, as of December 31, 2017. Commitments to extend credit are agreements to lend to a customer contingent upon availability of collateral and no existing violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses. Commitments to extend credit are mainly comprised of commercial lines of credit, construction and home equity credit lines and credit cards issued to commercial customers. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Bancorp uses the same credit and collateral policies in making commitments and conditional guarantees as for on-balance sheet instruments. Bancorp evaluates each customer's creditworthiness on a case by case basis. The amount of collateral obtained is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, equipment, and real estate. However, should commitments be drawn upon and should our customers default on their resulting obligation to us, our maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those instruments. At December 31, 2018, Bancorp accrued \$350 thousand in other liabilities for losses on unfunded credit commitments.

Standby letters of credit and financial guarantees written are conditional commitments issued by Bancorp to guarantee performance of a customer to a third party. Those guarantees are primarily issued to support private commercial transactions. Standby letters of credit generally have maturities of one to two years.

Bancorp leases certain facilities under non-cancelable operating leases. Future minimum lease commitments for these leases, including presumed renewal periods, are outlined in the table below.

(In thousands)

<b>Period</b>	<b>Total amount</b>
One year or less	\$2,016
One to three years	3,918
Three to five years	3,953
After five years	13,349
<b>Total</b>	<b>\$23,236</b>

Rent expense, net of sublease income, was \$2.0 million in 2018, \$1.9 million in 2017, and \$1.8 million in 2016.

Certain commercial customers require confirmation of Bancorp's letters of credit by other banks since Bancorp does not have a rating by a national rating agency. Terms of the agreements range from 1 to 11 months. If an event of default on all contracts had occurred at December 31, 2018, Bancorp would have been required to make payments of approximately \$1.6 million. The maximum amount payable under those contracts was \$1.6 million. No payments have ever been required as a result of default on these contracts. These agreements are normally secured by collateral acceptable to Bancorp, which limits credit risk associated with the agreements.

Also, as of December 31, 2018, in the normal course of business, there were pending legal actions and proceedings in which claims for damages are asserted. Management, after discussion with legal counsel, believes the ultimate result of these legal actions and proceedings will not have a material adverse effect on the consolidated financial position or results of operations of Bancorp.

#### **(20) Assets and Liabilities Measured and Reported at Fair Value**

Bancorp follows the provisions of authoritative guidance for fair value measurements. This guidance is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by US GAAP. The guidance also prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in US GAAP. Bancorp adopted ASU 2016-01, *Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, effective January 1, 2018. The most significant change impacting Bancorp was a change in valuation methods for the loan portfolio for fair value reporting. GAAP no longer allows for valuing financial instruments for fair value purposes using an “entrance” pricing methodology. The use of an “exit” price methodology requires greater assumptions regarding life of loan losses and is a more complex calculation, the results of which can be seen below.

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Authoritative guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement date. The guidance also establishes a hierarchy to group assets and liabilities carried at fair value in three levels based upon markets in which the assets and liabilities trade and reliability of assumptions used to determine fair value.

These levels are:

Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions would reflect our own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques could include pricing models, discounted cash flows and other similar techniques.

Authoritative guidance requires maximization of use of observable inputs and minimization of use of unobservable inputs in fair value measurements. Where there exists limited or no observable market data, Bancorp derives its own estimates by generally considering characteristics of the asset/liability, the current economic and competitive environment and other factors. For this reason, results cannot be determined with precision and may not be realized on an actual sale or immediate settlement of the asset or liability.

Bancorp's investment securities available for sale and interest rate swaps are recorded at fair value on a recurring basis. Other accounts including mortgage servicing rights, impaired loans and OREO may be recorded at fair value on a non-recurring basis, generally in the application of lower of cost or market adjustments or write-downs of specific assets.

The portfolio of investment securities available for sale is comprised of U.S. Treasury and other U.S. government obligations, debt securities of U.S. government-sponsored corporations (including mortgage-backed securities), obligations of state and political subdivisions and corporate equity securities. U.S. Treasury and corporate equity securities are priced using quoted prices of identical securities in an active market. These measurements are classified as Level 1 in the hierarchy above. All other securities are priced using standard industry models or matrices with various assumptions such as yield curves, volatility, prepayment speeds, default rates, time value, credit rating and market prices for similar instruments. These assumptions are observable in the market place and can be derived from or supported by observable data. These measurements are classified as Level 2 in the hierarchy above.

Interest rate swaps are valued using primarily Level 2 inputs. Fair value measurements are based on benchmark forward yield curves and other relevant observable market data. For purposes of potential valuation adjustments to derivative positions, Bancorp evaluates the credit risk of its counterparties as well as its own credit risk. To date, Bancorp has not realized any losses due to counterparty's inability to perform and the change in value of derivative assets and liabilities attributable to credit risk was not significant during 2018.

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Below are carrying values of assets measured at fair value on a recurring basis.

(In thousands)	<b>Fair value at December 31, 2018</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Investment securities available for sale:				
Government sponsored enterprise obligations	261,039	–	261,039	–
Mortgage-backed securities - government agencies	146,277	–	146,277	–
Obligations of states and political subdivisions	29,679	–	29,679	–
Total investment securities available for sale	436,995	–	436,995	–
Interest rate swaps	1,035	–	1,035	–
Total assets	\$438,030	\$ –	\$438,030	\$ –
<b>Liabilities</b>				
Interest rate swaps	\$543	\$ –	\$543	\$ –

(In thousands)	<b>Fair value at December 31, 2017</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Investment securities available for sale:				
U.S. Treasury and other U.S. government obligations	\$149,984	\$149,984	\$–	\$ –
Government sponsored enterprise obligations	213,844	–	213,844	–
Mortgage-backed securities - government agencies	161,507	–	161,507	–
Obligations of states and political subdivisions	49,189	–	49,189	–
Total investment securities available for sale	574,524	149,984	424,540	–
Interest rate swaps	579	–	579	–
Total assets (1)	\$575,103	\$149,984	\$425,119	\$ –
<b>Liabilities</b>				
Interest rate swaps (1)	\$283	\$–	\$283	\$ –

(1) December 31, 2017 fair value balances reflect a correction of incorrectly reported year-end balances in Note 20 of the 2017 Form 10-K, which were presented as \$575,079, \$425,095, and \$259, for total assets, total level 2 assets, and interest rate swap liabilities, respectively.

Bancorp had no financial instruments classified within Level 3 of the valuation hierarchy for assets and liabilities measured at fair value on a recurring basis at December 31, 2018 or 2017.

MSRs are recorded at fair value upon capitalization, are amortized to correspond with estimated servicing income, and are periodically assessed for impairment based on fair value at the reporting date. Fair value is based on a valuation model that calculates the present value of estimated net servicing income. The model incorporates assumptions that market participants would use in estimating future net servicing income. These measurements are classified as Level 3. At December 31, 2018 and 2017 there was no valuation allowance for mortgage servicing rights, as fair value exceeded cost. Accordingly, MSRs are not included in either table below for December 31, 2018 or 2017. See Note 7 for more information regarding MSRs.



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For impaired loans in the table below, fair value is calculated as carrying value of loans with a specific valuation allowance, less the specific allowance, and the carrying value of collateral dependent loans that have been charged down to their fair value. Fair value of impaired loans was primarily measured based on the value of collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. Bancorp determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. As of December 31, 2018, total impaired collateral dependent loans charged down to their fair value and impaired loans with a valuation allowance were \$967 thousand, and the specific allowance totaled \$42 thousand, resulting in a fair value of \$925 thousand, compared with total collateral dependent loans charged down to their fair value and impaired loans with a valuation allowance of \$2.6 million, and the specific allowance allocation totaling \$48 thousand, resulting in a fair value of \$2.6 million at December 31, 2017. Losses represent charge offs and changes in specific allowances for the period indicated.

OREO, which is carried at the lower of cost or fair value, is periodically assessed for impairment based on fair value at the reporting date. Fair value is based on appraisals performed by external parties which use judgments and assumptions that are property-specific and sensitive to changes in the overall economic environment. Appraisals may be further discounted based on management's historical knowledge and/or changes in market conditions from the date of the most recent appraisal. Many of these inputs are not observable and, accordingly, these measurements are classified as Level 3. For OREO in the table below, fair value is the carrying value of only parcels of OREO which have a carrying value equal to appraised value. Losses represent write-downs which occurred during the period indicated. At December 31, 2018 and 2017, carrying value of all OREO was \$1.0 million and \$2.6 million, respectively.

Below are carrying values of assets measured at fair value on a non-recurring basis.

(In thousands)	<b>Fair value at December 31, 2018</b>				
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total losses</b>
Impaired loans	\$925	\$ -	\$ -	\$925	\$(514)
OREO	1,018	-	-	1,018	(32)
Total	\$1,943	\$ -	\$ -	\$1,943	\$(546)

(In thousands)	<b>Fair value at December 31, 2017</b>				
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total losses</b>

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Impaired loans	\$2,569	\$	-	\$	-	\$2,569	\$(121)
OREO	2,640		-		-	2,640	(171)
Total	\$5,209	\$	-	\$	-	\$5,209	\$(292)

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In the case of the securities portfolio, Bancorp monitors the valuation technique utilized by pricing agencies to ascertain when transfers between levels have occurred. The nature of the remaining assets and liabilities is such that transfers in and out of any level are expected to be rare. For the years ended December 31, 2018, 2017 and 2016, there were no transfers between Levels 1, 2, or 3. For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2018, the significant unobservable inputs used in the fair value measurements are presented below.

	<b>Carrying</b>	<b>Valuation</b>	<b>Significant</b>	<b>Weighted</b>	
(Dollars in thousands)	<b>amount</b>	<b>technique</b>	<b>unobservable</b>	<b>average</b>	
			<b>input</b>	<b>of</b>	
				<b>input</b>	
Impaired loans - collateral dependent	\$ 925	Appraisal	Appraisal discounts (%)	9.9	%
OREO	1,018	Appraisal	Appraisal discounts (%)	12.2	

**(21) Disclosure of Financial Instruments Not Reported at Fair Value**

US GAAP requires disclosure of the fair value of financial assets and liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or nonrecurring basis. Carrying amounts, estimated fair values, and placement in the fair value hierarchy of Bancorp's financial instruments are as follows:

(In thousands)	<b>Carrying</b>	<b>Fair value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>December 31, 2018</b>	<b>amount</b>				
<b>Financial assets</b>					
Cash and short-term investments	\$198,939	\$198,939	\$198,939	\$-	\$-
Mortgage loans held for sale	1,675	1,743	-	1,743	-
Federal Home Loan Bank stock and other securities	10,370	10,370	-	10,370	-
Loans, net	2,522,637	2,508,587	-	-	2,508,587
Accrued interest receivable	8,360	8,360	8,360	-	-
<b>Financial liabilities</b>					
Deposits	2,794,356	2,792,914	-	-	2,792,914
Securities sold under agreement to repurchase	36,094	36,094	-	36,094	-
Federal funds purchased	10,247	10,247	-	10,247	-
FHLB Advances	48,177	47,227	-	47,227	-
Accrued interest payable	762	762	762	-	-
<b>December 31, 2017</b>					

**Financial assets**

Cash and short-term investments	\$139,248	\$139,248	\$139,248	\$-	\$-
Mortgage loans held for sale	2,964	2,964	-	2,964	-
Federal Home Loan Bank stock and other securities	7,646	7,646	-	7,646	-
Loans, net	2,384,685	2,338,464	-	-	2,338,464
Accrued interest receivable	8,369	8,369	8,369	-	-

**Financial liabilities**

Deposits	2,578,295	2,576,385	-	-	2,576,385
Securities sold under agreement to repurchase	70,473	70,473	-	70,473	-
Federal funds purchased	161,352	161,352	-	161,352	-
FHLB Advances	49,458	48,642	-	48,642	-
Accrued interest payable	232	232	232	-	-

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Fair value estimates are made at a specific point in time based on relevant market information and information about financial instruments. Because no market exists for a significant portion of Bancorp's financial instruments, fair value estimates are based on judgments regarding future expected losses, 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. Therefore, calculated fair value estimates in many instances cannot be substantiated by comparison to independent markets and, in many cases, may not be realizable in a current sale of the instrument. Changes in assumptions could significantly affect estimates.

**(22) Derivative Financial Instruments**

Periodically, Bancorp enters into an interest rate swap transaction with a borrower, who desires to hedge exposure to rising interest rates, while at the same time entering into an offsetting interest rate swap, with substantially matching terms, with another approved independent counterparty. These are undesignated derivative instruments and are recognized on the consolidated balance sheet at fair value. Because of matching terms of offsetting contracts and collateral provisions mitigating any non-performance risk, changes in fair value subsequent to initial recognition are expected to have an insignificant effect on earnings. Exchanges of cash flows related to the undesignated interest rate swap agreements for 2017 were offsetting and therefore had no net effect on Bancorp's earnings or cash flows.

Interest rate swap agreements derive their value from underlying interest rates. These transactions involve both credit and market risk. Notional amounts are amounts on which calculations, payments, and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Bancorp is exposed to credit-related losses in the event of nonperformance by counterparties to these agreements. Bancorp mitigates credit risk of its financial contracts through credit approvals, limits, collateral, and monitoring procedures, and does not expect any counterparties to fail their obligations.

At December 31, 2018 and 2017 Bancorp had outstanding undesignated interest rate swap contracts as follows:

(Dollar amounts in thousands)	<b>Receiving</b>		<b>Paying</b>	
	<b>December 31, 2018</b>	<b>December 31, 2017</b>	<b>December 31, 2018</b>	<b>December 31, 2017</b>
Notional amount	\$55,505	\$ 54,964	\$55,505	\$ 54,964

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Weighted average maturity (years)	8.0	8.7	8.0	8.7
Fair value	\$ 519	\$ 259	\$ 543	\$ 283

In 2016, Bancorp entered into an interest rate swap to hedge cash flows of a \$10 million rolling fixed-rate three-month FHLB borrowing. The swap began in December 2016 and ends in December 2021. In 2015, Bancorp entered into an interest rate swap to hedge cash flows of a \$20 million rolling fixed-rate three-month FHLB borrowing. The swap began in December 2015 and matures in December 2020. For purposes of hedging, rolling fixed rate advances are considered to be floating rate liabilities. Interest rate swaps involve exchange of Bancorp's floating rate interest payments for fixed rate swap payments on underlying principal amounts. These swaps were designated, and qualified, for cash-flow hedge accounting. For derivative instruments that are designated and qualify as cash flow hedging instruments, the effective portion of gains or losses is reported as a component of other comprehensive income, and is subsequently reclassified into earnings as an adjustment to interest expense in periods in which the hedged forecasted transaction affects earnings.

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The following table details Bancorp's derivative position designated as a cash flow hedge, and the fair values as of December 31, 2018 and 2017.

(Dollars in thousands)

<b>Notional amount</b>	<b>Maturity date</b>	<b>Receive (variable) index</b>	<b>Pay fixed swap rate</b>	<b>Fair value December 31, 2018</b>	<b>Fair value December 31, 2017</b>
\$10,000	12/6/2021	US 3 Month LIBOR	1.89 %	\$ 193	\$ 106
20,000	12/6/2020	US 3 Month LIBOR	1.79	323	190
\$30,000			1.82 %	\$ 516	\$ 296

**(23) Regulatory Matters**

Bancorp and the Bank are subject to various capital requirements prescribed by banking regulations and administered by state and federal banking agencies. Under these requirements, Bancorp and the Bank must meet minimum amounts and percentages of Tier 1, common equity Tier 1, and total capital, as defined, to risk weighted assets and Tier 1 capital to average assets. Risk weighted assets are determined by applying certain risk weightings prescribed by regulations to various categories of assets and off-balance sheet commitments. Capital and risk weighted assets may be further subject to qualitative judgments by regulators as to components, risk weighting and other factors. Failure to meet capital requirements can result in certain mandatory, and possibly discretionary, corrective actions prescribed by regulations or determined to be necessary by regulators, which could materially affect the unaudited consolidated financial statements.

In 2013, the Federal Reserve Board and the FDIC approved rules that substantially amended the regulatory risk-based capital rules applicable to Bancorp and Bank. The rules implemented the regulatory capital reforms of the Basel Committee on Banking Supervision reflected in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III") and changes required by the Dodd-Frank Act. Basel III regulatory capital reforms became effective for Bancorp and Bank on January 1, 2015, and included new minimum risk-based capital and leverage ratios. For Bancorp, key differences under Basel III include risk weighting for loan commitments under one year and higher risk weighting for certain commercial real estate and construction loans. These differences resulted in higher risk-weighted assets, and therefore, somewhat lower risk-based capital ratios. Bancorp and the Bank met all capital requirements to which they were subject as of December 31, 2018 and 2017.







(1) Ratio is computed in relation to average assets.

NA – Not applicable. Regulatory framework does not define well capitalized for holding companies.

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Table of Contents**(24) Stock Yards Bancorp, Inc. (parent company only)****Condensed Balance Sheets**

(In thousands)	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
<b>Assets</b>		
Cash on deposit with subsidiary bank	\$7,655	\$10,648
Investment in and receivable from subsidiaries	356,118	321,617
Other assets	3,147	1,521
<b>Total assets</b>	<b>\$366,920</b>	<b>\$333,786</b>
<b>Liabilities and stockholders' equity</b>		
Other liabilities	\$420	\$142
Total stockholders' equity	366,500	333,644
<b>Total liabilities and stockholders' equity</b>	<b>\$366,920</b>	<b>\$333,786</b>

**Condensed Statements of Income**

(In thousands)	<b>Years ended December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
Income - dividends and interest from subsidiaries	\$21,403	\$18,160	\$16,147
Other income	12	82	1
Less expenses	4,818	3,255	2,235
Income before income taxes and equity in undistributed net income of subsidiary	16,597	14,987	13,913
Income tax benefit	(1,713)	(1,985)	(987)
Income before equity in undistributed net income of subsidiary	18,310	16,972	14,900
Equity in undistributed net income of subsidiary	37,207	21,071	26,127
<b>Net income</b>	<b>55,517</b>	<b>38,043</b>	<b>41,027</b>
<b>Comprehensive Income</b>	<b>\$52,811</b>	<b>\$37,612</b>	<b>\$38,896</b>

Table of Contents**Condensed Statements of Cash Flows**

(In thousands)	<b>Years ended December 31</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
<b>Operating activities</b>			
Net income	\$55,517	\$38,043	\$41,027
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(37,207)	(21,071)	(26,127)
Gain on sale of fixed assets	(10 )	–	–
Stock compensation expense	4,027	2,892	2,473
Excess tax benefits from stock-based compensation arrangements	(549 )	(1,463 )	(1,705 )
Recover of impairment loss on other assets held for investment	–	–	(588 )
Depreciation, amortization and accretion, net	–	4	10
Proceeds from liquidation of private investment fund	–	(81 )	–
Decrease (increase) in other assets	(1,080 )	5,943	(990 )
Increase in other liabilities	220	10	11
<b>Net cash provided by operating activities</b>	<b>20,918</b>	<b>24,277</b>	<b>14,111</b>
<b>Investing activities</b>			
Proceeds from sale of other assets held for investment	–	–	1,108
Proceeds from sale of fixed assets	13	–	–
Proceeds from liquidation of private investment fund	–	81	–
<b>Net cash provided by investing activities</b>	<b>13</b>	<b>81</b>	<b>1,108</b>
<b>Financing activities</b>			
Common stock repurchases	(2,004 )	(2,389 )	2,337
Excess tax benefit from stock-based compensation arrangements	–	–	1,705
Cash used for settlement of stock awards	(154 )	(216 )	(1,918 )
Cash dividends paid	(21,766)	(18,077)	(16,093)
<b>Net cash used in financing activities</b>	<b>(23,924)</b>	<b>(20,682)</b>	<b>(13,969)</b>
<b>Net increase (decrease) in cash</b>	<b>(2,993 )</b>	<b>3,676</b>	<b>1,250</b>
<b>Cash at beginning of year</b>	<b>10,648</b>	<b>6,972</b>	<b>5,722</b>
<b>Cash at end of year</b>	<b>\$7,655</b>	<b>\$10,648</b>	<b>\$6,972</b>

**(25) Segments**

Bancorp's principal activities include commercial banking and WM&T. Commercial banking provides a full range of loan and deposit products to individual consumers and businesses, plus origination of consumer mortgages and investment product sales. WM&T provides investment management, trust and estate administration, and retirement plan services.

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Financial information for each business segment reflects that which is specifically identifiable or allocated based on an internal allocation method. Income taxes are allocated based on the effective federal income tax rate adjusted for any tax exempt activity. All tax exempt activity and provision have been allocated to the commercial banking segment. Measurement of the performance of the business segments is based on the management structure of Bancorp and is not necessarily comparable with similar information for any other financial institution. Information presented is also not necessarily indicative of the segments' operations if they were independent entities.

Principally, all of the net assets of Stock Yards Bancorp, Inc. are involved in the commercial banking segment. Bancorp has goodwill of \$682,000 related to a bank acquisition in 1996 which has been assigned to the commercial banking segment. Assets assigned to WM&T consist of premises and equipment, net of accumulated depreciation.

Selected financial information by business segment follows:

(In thousands)	<b>Commercial banking</b>	<b>Wealth management and trust</b>	<b>Total</b>
<b>Year ended December 31, 2018</b>			
Net interest income	\$ 114,161	\$ 255	\$ 114,416
Provision	2,705	–	2,705
Investment management and trust services	–	21,536	21,536
All other non-interest income	23,810	–	23,810
Non-interest expense	76,963	12,546	89,509
Income before income taxes	58,303	9,245	67,548
Income tax expense	10,025	2,006	12,031
Net income	\$ 48,278	\$ 7,239	\$ 55,517
Segment assets	\$ 3,301,108	\$ 1,816	\$ 3,302,924
<b>Year ended December 31, 2017</b>			
Net interest income	\$ 103,352	\$ 301	\$ 103,653
Provision	2,550	–	2,550
Investment management and trust services	–	20,505	20,505
All other non-interest income	23,994	–	23,994
Non-interest expense	78,181	12,239	90,420
Income before income taxes	46,615	8,567	55,182
Income tax expense	14,080	3,059	17,139
Net income	\$ 32,535	\$ 5,508	\$ 38,043
Segment assets	\$ 3,237,656	\$ 1,990	\$ 3,239,646
<b>Year ended December 31, 2016</b>			
Net interest income	\$ 97,021	\$ 268	\$ 97,289

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Provision	3,000	–	3,000
Investment management and trust services	–	19,155	19,155
All other non-interest income	23,765	–	23,765
Non-interest expense	69,648	11,290	80,938
Income before income taxes	48,138	8,133	56,271
Income tax expense	12,340	2,904	15,244
Net income	\$ 35,798	\$ 5,229	\$ 41,027
Segment assets	\$ 3,037,394	\$ 2,087	\$ 3,039,481

Table of Contents**(26) Quarterly Operating Results (unaudited)**

Following is a summary of quarterly operating results for 2018, 2017 and 2016:

	<b>2018</b>			
	<b>4th quarter</b>	<b>3rd quarter</b>	<b>2nd quarter</b>	<b>1st quarter</b>
Interest income	\$35,004	\$33,021	\$32,004	\$29,744
Interest expense	5,092	4,500	3,330	2,435
Net interest income	29,912	28,521	28,674	27,309
Provision	-	735	1,235	735
Net interest income after provision	29,912	27,786	27,439	26,574
Non-interest income	11,576	11,426	11,435	10,909
Non-interest expenses	24,565	21,781	22,136	21,027
Income before income taxes	16,923	17,431	16,738	16,456
Income tax expense	2,265	3,555	3,159	3,052
Net income	\$14,658	\$13,876	\$13,579	\$13,404
Basic earnings per share	\$0.65	\$0.61	\$0.60	\$0.59
Diluted earnings per share	0.64	0.60	0.59	0.58
	<b>2017</b>			
(In thousands, except per share data)	<b>4th quarter</b>	<b>3rd quarter</b>	<b>2nd quarter</b>	<b>1st quarter</b>
Interest income	\$29,098	\$28,120	\$27,026	\$26,655
Interest expense	2,069	1,947	1,781	1,449
Net interest income	27,029	26,173	25,245	25,206
Provision	900	150	600	900
Net interest income after provision	26,129	26,023	24,645	24,306
Non-interest income	11,407	10,945	11,525	10,622
Non-interest expenses	27,048	21,168	21,209	20,995
Income before income taxes	10,488	15,800	14,961	13,933
Income tax expense	5,542	4,096	4,359	3,142
Net income	\$4,946	\$11,704	\$10,602	\$10,791
Basic earnings per share	\$0.22	\$0.52	\$0.47	\$0.48
Diluted earnings per share	0.22	0.51	0.46	0.47



(In thousands, except per share data)	<b>2016</b>			
	<b>4th quarter</b>	<b>3rd quarter</b>	<b>2nd quarter</b>	<b>1st quarter</b>
Interest income	\$26,372	\$25,944	\$25,169	\$24,722
Interest expense	1,293	1,182	1,212	1,231
Net interest income	25,079	24,762	23,957	23,491
Provision	500	1,250	750	500
Net interest income after provision	24,579	23,512	23,207	22,991
Non-interest income	11,165	11,202	10,629	9,924
Non-interest expenses	21,119	20,364	20,051	19,404
Income before income taxes	14,625	14,350	13,785	13,511
Income tax expense	4,009	3,883	3,676	3,676
Net income	\$10,616	\$10,467	\$10,109	\$9,835
Basic earnings per share	\$0.47	\$0.47	\$0.45	\$0.44
Diluted earnings per share	0.46	0.46	0.45	0.44

Note: The sum of earnings per share of each of the quarters in 2018, 2017 and 2016 may not add to the year-to-date amount reported in Bancorp's consolidated financial statements due to rounding.

Table of Contents**(27) Revenue from contracts with customers**

Bancorp adopted Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers and all related amendments (ASC 606), which created a single framework for recognizing revenue from contracts with customers that fall within its scope and revised when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, effective January 1, 2018 using the full retrospective method. Bancorp recognizes revenue upon satisfying a performance obligation as services are rendered to a customer. All of Bancorp's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. The only impact to financial statement presentation was reclassification from expense to contra income costs incurred to obtain and fulfill contracts associated with investment product sales. All periods presented in these financial statements have been adjusted to reflect the reclassification. The table below presents the Company's sources of non-interest income for years ended December 31, 2018, 2017, and 2016 respectively. Items outside the scope of ASC 606 are noted as such.

**Revenue by operating segment**

(In thousands, except per share data)	<b>Years ended December 31,</b>		
	<b>2018</b>	<b>2017</b>	<b>2016</b>
<b>Wealth Management and Trust</b>			
Wealth management and trust services	\$21,536	\$20,505	\$19,155
<b>Commercial</b>			
Deposit service charges	5,759	6,172	6,037
Debit and credit cards	6,769	5,979	5,655
Treasury management	4,571	4,297	3,867
Mortgage banking (1)	2,568	3,221	3,897
(Loss) on sale of securities available for sale (1)	–	(232 )	–
Net investment product sales commissions and fees	1,677	1,629	1,563
Bank owned life insurance (1)	1,129	1,159	871
Other (2)	1,337	1,769	1,875
<b>Total Commercial non-interest income</b>	<b>23,810</b>	<b>23,994</b>	<b>23,765</b>
<b>Total non-interest income</b>	<b>\$45,346</b>	<b>\$44,499</b>	<b>\$42,920</b>

(1) Not within scope of ASC 606

(2) Includes safe box deposit fees of \$177 thousand, \$165 thousand, and \$168 thousand included within the scope of ASC 606 in 2018, 2017, and 2016, respectively

Revenue sources within the scope of ASC 606 are discussed below.

The Company earns fees from its deposit customers for transactions-based, account management, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payments fees, and ACH fees, are recognized at the time the transaction is executed as that is when the company fulfills the performance obligation. Account management fees are earned over the course of a month and charged in the month in which the services are provided. Overdraft fees are recognized at the point in time that the overdraft occurs. Deposit service charges are withdrawn from customer's account balances.

Treasury management transaction fees are recognized at the time the transaction is executed as that is when the company fulfills the performance obligation. Account management fees are earned over the course of a month and charged in the month in which the services are provided. Treasury management fees are withdrawn from customer's account balances.

The Wealth Management and Trust Group provides customers fiduciary and investment management services as agreed upon in asset management contracts. Contracts require WM&T to provide a series of distinct services for which fees are earned over time. Contracts are cancellable upon demand with fees typically based upon the asset value of investments. Revenue is accrued and recognized monthly based upon month-end asset values and collected from the customer predominately in the following month except for a small percentage of fees collected quarterly. Contracts between WM&T and clients do not permit performance based fees and accordingly, none of the fees earned by WM&T are performance based.

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Investment products sales commissions and fees represent the Bank's share of transaction fees and wrap fees resulting from investment services and programs provided through an agent relationship with a third party broker-dealer. Transaction fees are assessed at the time of the transaction. Those fees are collected and recognized on a monthly basis. Trailing fees are based upon market value and are assessed, collected, and recognized on a quarterly basis. Variable costs considered costs of obtaining the contracts related to investment product sales activities include incentive compensation expense and trading activity charges. Incentive compensation has been reclassified from compensation expense and the trading activity fees from technology and communication in prior years' presentation to a reduction of income.

Debit and credit card interchange revenue represents fees assessed within the payment card system for acceptance of card based transactions. Interchange fees are assessed as the performance obligation is satisfied, which is at the point in time the card transaction is authorized. Revenue is collected and recognized daily through the payment network settlement process.

Bancorp did not establish any contract assets or liabilities as a result of adopting ASC 606, nor were any recognized during 2018. Trust fees receivable as of December 31, 2018 were \$1.9 million compared with \$2.2 million as of December 31, 2017.

Bancorp's revenue on the consolidated statement of income is categorized by product type, which effectively depicts how the nature, timing, and extent of cash flows are affected by economic factors.

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**Report of Independent Registered Public Accounting Firm**

Audit Committee, Board of Directors and Stockholders

Stock Yards Bancorp, Inc.

Louisville, Kentucky

***Opinion on the Financial Statements***

We have audited the accompanying consolidated balance sheet of Stock Yards Bancorp, Inc. (the “Company”) as of December 31, 2018, the related consolidated statements of income, comprehensive income, changes in stockholders’ equity and cash flows for the year then ended, and the related notes (collectively referred to as the “financial statements”). In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework) and our report dated February 28, 2019, expressed an unqualified opinion thereon.

***Basis for Opinion***

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audit.

We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities

and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/ **BKD, llp**

We have served as the Company's auditor since 2018.

Indianapolis, Indiana

February 28, 2019

Name of Engagement Executive: Michael S. Moore

Federal Employer Identification Number: 44-0160260

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**Report of Independent Registered Public Accounting Firm**

**To the Board of Directors and Stockholders  
Stock Yards Bancorp, Inc.:**

*Opinion on the Consolidated Financial Statements*

We have audited the accompanying consolidated balance sheet of Stock Yards Bancorp, Inc. and subsidiary (the Company) as of December 31, 2017, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2017 and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles.

*Basis for Opinion*

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

*(signed) KPMG LLP*

We served as the Company's auditor from 1988 to 2018

Louisville, Kentucky

March 13, 2018

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**Management's Report on Consolidated Financial Statements**

The accompanying consolidated financial statements and other financial data were prepared by the management of Stock Yards Bancorp, Inc. (Bancorp), which has the responsibility for the integrity of the information presented. The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and, as such, include amounts that are the best estimates and judgments of management with consideration given to materiality.

Management is further responsible for maintaining a system of internal controls designed to provide reasonable assurance that the books and records reflect the transactions of Bancorp and that its established policies and procedures are carefully followed. Management believes that Bancorp's system, taken as a whole, provides reasonable assurance that transactions are executed in accordance with management's general or specific authorization; transactions are recorded as necessary to permit preparation of financial statements in conformity with U.S. generally accepted accounting principles and to maintain accountability for assets; access to assets is permitted only in accordance with management's general or specific authorization, and the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Management also seeks to assure the objectivity and integrity of Bancorp's financial data by the careful selection and training of qualified personnel, an internal audit function and organizational arrangements that provide an appropriate division of responsibility.

BKD LLP, the independent registered public accounting firm that audited the consolidated financial statements of Bancorp included in this Annual Report on Form 10-K, has issued a report on Bancorp's internal control over financial reporting as of December 31, 2018. The report expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018.

The Board of Directors provides its oversight role for the consolidated financial statements through the Audit Committee. The Audit Committee meets periodically with management, the internal auditors, and the independent auditors, each on a private basis, to review matters relating to financial reporting, the internal control systems, and the scope and results of audit efforts. The internal and independent auditors have unrestricted access to the Audit Committee, with and without the presence of management, to discuss accounting, auditing, and financial reporting matters. The Audit Committee also recommends the appointment of the independent auditors to the Board of Directors, and ultimately has sole authority to appoint or replace the independent auditors.

/s/ James A. Hillebrand  
James A. Hillebrand  
Chief Executive Officer

/s/ Nancy B. Davis  
Nancy B. Davis  
Executive Vice  
President  
and Chief Financial  
Officer

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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

**None**

**Item 9A. Controls and Procedures**

**Disclosure Controls and Procedures**

Bancorp maintains disclosure controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the Securities and Exchange Commission (SEC), and to record, process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on their evaluation of Bancorp's disclosure controls and procedures which took place as of December 31, 2018, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that Bancorp is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required time periods.

Based on the evaluation of Bancorp's disclosure controls and procedures by the Chief Executive and Chief Financial Officers; no changes occurred during the fiscal quarter ended December 31, 2018 in Bancorp's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, Bancorp's internal control over financial reporting.

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**Management's Report on Internal Control Over Financial Reporting**

The management of Stock Yards Bancorp, Inc. and subsidiary (Bancorp) is responsible for establishing and maintaining adequate internal control over financial reporting. Bancorp's internal control over financial reporting is a process designed under the supervision of Bancorp's Chief Executive Officer and Chief Financial Officer, and effected by Bancorp's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. This process includes those policies and procedures that:

1. Pertain to the maintenance of records, that in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Bancorp;
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of Bancorp are being made only in accordance with authorizations of management and directors of Bancorp; and
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Bancorp's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

Management has assessed the effectiveness of its internal control over financial reporting as of December 31, 2018, based on the control criteria established in a report entitled *Internal Control – Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on such assessment, management has concluded that Bancorp's internal control over financial reporting is effective as of December 31, 2018.

BKD LLP, the independent registered public accounting firm that audited the consolidated financial statements of Bancorp included in this Annual Report on Form 10-K, has also audited Bancorp's internal control over financial reporting as of December 31, 2018. Their report expressed an unqualified opinion on the effectiveness of Bancorp's internal control over financial reporting as of December 31, 2018.

/s/ James A. Hillebrand  
James A. Hillebrand  
Chief Executive Officer

/s/ Nancy B. Davis  
Nancy B. Davis  
Executive Vice President  
and Chief Financial  
Officer

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**Report of Independent Registered Public Accounting Firm**

Audit Committee, Board of Directors and Stockholders

Stock Yards Bancorp, Inc.

Louisville, Kentucky

***Opinion on the Internal Control Over Financial Reporting***

We have audited Stock Yards Bancorp, Inc.'s (the "Company") internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of the Company as of December 31, 2018 and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the year then ended and our report dated February 28, 2019, expressed an unqualified opinion thereon.

***Basis for Opinion***

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

***Definitions and Limitations of Internal Control Over Financial Reporting***

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

/s/ **BKD, llp**

Indianapolis, Indiana

February 28, 2019

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**Item 9B. Other Information**

None

**Part III**

**Item 10. Directors, Executive Officers and Corporate Governance**

Information regarding the directors and executive officers of Bancorp is incorporated herein by reference to the discussion under the headings, “ITEM 1. ELECTION OF ELEVEN DIRECTORS,” and “SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE” in Bancorp’s Proxy Statement to be filed with the Securities and Exchange Commission for the 2019 Annual Meeting of Shareholders (“Proxy Statement”) and the section captioned EXECUTIVE OFFICERS OF THE REGISTRANT in this Form 10-K.

Information regarding the Audit Committee is incorporated herein by reference to the discussion under the heading, “BOARD OF DIRECTORS’ MEETINGS AND COMMITTEES” in Bancorp’s Proxy Statement.

Information regarding principal occupation of directors of Bancorp follows:

Paul J. Bickel III – Founder and President, U.S. Specialties

J. McCauley Brown – Retired Vice President, Brown-Forman Corporation;

Charles R. Edinger, III – President, J. Edinger & Son., Inc.;

David P. Heintzman –Retired Chief Executive Officer, Stock Yards Bancorp, Inc. and Stock Yards Bank & Trust Company;

Donna Heitzman – Retired portfolio manager, KKR Prisma Capital;

Carl G. Herde – Vice President/Finance, Kentucky Hospital Association;

James A. Hillebrand –Chief Executive Officer, Stock Yards Bancorp, Inc. and Stock Yards Bank & Trust Company;

Richard A. Lechleiter – President, Catholic Education Foundation of Louisville;

Richard Northern – Partner, Wyatt, Tarrant & Combs LLP;

Stephen M. Priebe – President, Hall Contracting of Kentucky;

John L. Schutte – Chief Executive Officer, GeriMed, Inc.

Norman Tasman – President, Tasman Industries Inc. and Tasman Hide Processing Inc.;

Kathy C. Thompson – Senior Executive Vice President, Stock Yards Bancorp, Inc. and Stock Yards Bank & Trust Company;

The Board of Directors of Bancorp has adopted a code of ethics for its chief executive officer and financial executives. A copy of the code of ethics is filed as an exhibit to this Annual Report.

### **Item 11. Executive Compensation**

Information regarding the compensation of Bancorp’s executive officers and directors is incorporated herein by reference to the discussion under the heading, “EXECUTIVE COMPENSATION AND OTHER INFORMATION – REPORT ON EXECUTIVE COMPENSATION” in Bancorp’s Proxy Statement.

Information regarding the Compensation Committee is incorporated herein by reference to the discussion under the heading, “TRANSACTIONS WITH MANAGEMENT AND OTHERS” in Bancorp’s Proxy Statement. The report of the Compensation Committee shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed soliciting material or subject to Regulation 14A of the Exchange Act or incorporated by reference in any filing under the Exchange Act or the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.

### **Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this item is incorporated herein by reference to the discussion under the headings, “ITEM 1. ELECTION OF ELEVEN DIRECTORS” and “SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT,” in Bancorp’s Proxy Statement.

The information required by this item concerning equity compensation plan information is included in Note 17 of the Notes to Consolidated Financial Statements.



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**Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by this item is incorporated herein by reference to the discussion under the headings, “ITEM 1. ELECTION OF ELEVEN DIRECTORS” and “TRANSACTIONS WITH MANAGEMENT AND OTHERS,” in Bancorp’s Proxy Statement.

**Item 14. Principal Accounting Fees and Services**

The information required by this item is incorporated herein by reference to the discussion under the heading, “REPORT OF THE AUDIT COMMITTEE” in Bancorp’s Proxy Statement.

**Part IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a) 1. The following financial statements are included in this Form 10-K:

Consolidated Balance Sheets – December 31, 2018 and 2017

Consolidated Statements of Income - years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Comprehensive Income - years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Changes in Stockholders’ Equity - years ended December 31, 2018, 2017 and 2016

Consolidated Statements of Cash Flows - years ended December 31, 2018, 2017 and 2016

Notes to Consolidated Financial Statements

Reports of Independent Registered Public Accounting Firms

(a)  
2. List of Financial Statement Schedules

Schedules to the consolidated financial statements of Bancorp are omitted since they are either not required under the related instructions, are inapplicable, or the required information is shown in the consolidated financial statements or notes thereto.

(a) List of Exhibits  
3. Exhibit Number

- 3.1 Second Amended and Restated Articles of Incorporation of S.Y. Bancorp, Inc., filed with the Secretary of State of Kentucky on April 25, 2013. Exhibit 3.1 to Form 8-K filed April 25, 2013, is incorporated by reference herein.
- 3.2 Articles of Amendment to the Second Amended and Restated Articles of Incorporation to change the name of the company to Stock Yards Bancorp, Inc., filed with the Secretary of State of Kentucky on April 23, 2014. Exhibit 3.1 to Form 8-K filed April 25, 2014, is incorporated by reference herein.
- 3.3 Articles of Amendment to the Second Amended and Restated Articles of Incorporation to increase the number of authorized shares of common stock and adopt majority voting in uncontested director elections, filed with the Secretary of State of Kentucky on April 23, 2015. Exhibit 3.1 to Form 8-K filed April 27, 2015, is incorporated by reference herein.
- 3.4 Bylaws of Bancorp as currently in effect. Exhibit 3.1 to Form 8-K/A filed October 1, 2018, is incorporated by reference herein.
- 10.1\* Stock Yards Bank & Trust Company Executive Nonqualified Deferred Compensation Plan (as Amended and Restated in 2009), as filed as Exhibit 10.4 to Form 8-K filed on December 19, 2008, is incorporated by reference herein.
- 10.2\* Stock Yards Bank & Trust Company Director Nonqualified Deferred Compensation Plan (as Amended and Restated in 2009), as filed as Exhibit 10.3 to Form 8-K filed on December 19, 2008, is incorporated by reference herein.
- 10.3\* Form of Stock Yards Bank & Trust Company Executive Nonqualified Deferred Compensation Plan Employer Contribution Agreement, as filed as Exhibit 10.3 to Form 8-K filed on October 23, 2006, is incorporated by reference herein.

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- 10.4\* Stock Yards Bank & Trust Company 2009 Restated Senior Officers Security Plan Exhibit 10.1 to Form 8-K filed December 19, 2008, is incorporated by reference herein.
- 10.5\* Form of Change in Control Severance Agreement (Dishman, Stinnett and Croce), as filed as Exhibit 10.5 to Form 8-K filed January 28, 2010, is incorporated by reference herein.
- 10.6\* S.Y. Bancorp, Inc. 2005 Stock Incentive Plan, as filed as Exhibit 10.1 to Form 8-K filed May 2, 2005, is incorporated by reference herein.
- 10.7\* Amendment No. 1 to S. Y. Bancorp, Inc. 2005 Stock Incentive Plan, as filed as Exhibit 10.1 to Form 8-K filed on April 22, 2010, is incorporated by reference herein.
- 10.8\* Form of Employer Contribution Agreement, Nancy Davis, Participant, as filed as Exhibit 10.4 to Form 8-K filed on October 23, 2006, is incorporated by reference herein.
- 10.9\* Terms of Restricted Stock Program, as filed as Exhibit 10.1 to Form 8-K filed on February 26, 2007, is incorporated by reference herein.
- 10.10\* Form of Restricted Stock Agreement (3 year vesting), as filed as Exhibit 10.2 to Form 8-K filed on February 26, 2007, is incorporated by reference herein.
- 10.11\* Form of Stock Option Grant and Agreement (6 months vesting), as filed as Exhibit 10.1 to Form 8-K filed on January 19, 2006, is incorporated by reference herein.
- 10.12\* Form of Stock Option Grant and Agreement (5 year vesting), as filed as Exhibit 10.2 to Form 8-K filed on January 19, 2006, is incorporated by reference herein.
- 10.13\* Form of Stock Appreciation Right Grant Agreement (6 month vesting), as filed as Exhibit 10.1 to Form 8-K filed on February 22, 2008, is incorporated by reference herein.
- 10.14\* Form of Stock Appreciation Right Grant Agreement (5 year vesting), as filed as Exhibit 10.2 to Form 8-K filed on February 22, 2008, is incorporated by reference herein.
- 10.15\* Form of Indemnification Agreement between Stock Yards Bank & Trust Company, S.Y. Bancorp, Inc. and each member of the Board of Directors. Exhibit 10.3 to Annual Report on Form 10-K for the year ended December 31, 2001, of Bancorp is incorporated by reference herein.
- 10.16\* Form of Restricted Stock Award Agreement (5 year vesting) between S.Y. Bancorp, Inc. and each recipient of restricted stock. Exhibit 10.21 to Annual Report on Form 10-K for the year ended December 31, 2010, of Bancorp is incorporated by reference herein.
- 10.17\* Form of Director Restricted Stock Award Agreement (1 year vesting) between S.Y. Bancorp, Inc. and each member of the Board of Directors. Exhibit 10.22 to Annual Report on Form 10-K for the year ended December 31, 2010, of Bancorp is incorporated by reference herein.
- 10.18\* Amendment No. 2 to the S. Y. Bancorp, Inc. 2005 Stock Incentive Plan, as filed as Exhibit 10.1 to Form 8-K filed on April 22, 2011, is incorporated by reference herein.
- 10.19\* Form of S.Y. Bancorp, Inc. Restricted Stock Unit Grant Agreement for grants prior to 2014, as filed as Exhibit 10.2 to Form 8-K filed on April 22, 2011, is incorporated by reference herein.
- 10.20\* Form of Stock Appreciation Right Grant Agreement (5 year vesting) between S.Y. Bancorp, Inc. and each recipient of stock appreciation rights. Exhibit 10.25 to Annual Report on Form 10-K for the year ended December 31, 2012, of Bancorp is incorporated by reference herein.
- 10.21\* Form of S.Y. Bancorp, Inc. Restricted Stock Unit Grant Agreement 2012 and Amendment thereto, as filed as Exhibit 10.1 to Form 8-K filed on March 20, 2013, is incorporated by reference herein.
- 10.22\* Form of Annual Cash Incentive Plan, as filed as Exhibit 10.1 to Form 8-K filed on April 26, 2013, is incorporated by reference herein.
- 10.23\* Amendment No. 3 to the S. Y. Bancorp, Inc. 2005 Stock Incentive Plan, as filed as Exhibit 10.1 to Form 8-K filed on November 22, 2013, is incorporated by reference herein.
- 10.24\* Amendment No. 1 to the Director Nonqualified Deferred Compensation Plan, as filed as Exhibit 10.2 to Form 8-K filed on November 22, 2013, is incorporated by reference herein.
- 10.25\* Form of Director Restricted Stock Unit Award Agreement, as filed as Exhibit 10.3 to Form 8-K filed on November 22, 2013, is incorporated by reference herein.

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- 10.26\* Form of Amended and Restated Change in Control Severance Agreement (for David Heintzman, Ja Hillebrand, Kathy Thompson and Nancy Davis), as filed as Exhibit 10.1 to Form 8-K filed on December 17, 2013, is incorporated by reference herein.
- 10.27\* Form of Annual Cash Bonus Plan (as amended December 16, 2013), as filed as Exhibit 10.2 to Form 8-K filed on December 17, 2013, is incorporated by reference herein.
- 10.28\* Form of Restricted Stock Unit Grant Agreement for grants awarded 2014 and later, as filed as Exhibit 10.3 to Form 8-K filed on December 17, 2013, is incorporated by reference herein.

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10.29*	<u>Form of Amendment No. 1 Stock Yards Bank &amp; Trust Company Executive Nonqualified Deferred Compensation Plan, as filed as Exhibit 10.1 to Form 8-K filed on December 18, 2014, is incorporated by reference herein.</u>
10.30*	<u>Form of Amendment No. 2 Stock Yards Bank &amp; Trust Company Director Nonqualified Deferred Compensation Plan, as filed as Exhibit 10.2 to Form 8-K filed on December 18, 2014, is incorporated by reference herein.</u>
10.31*	<u>Form of Restricted Stock Unit Grant Agreement as filed as Exhibit 10.1 to Form 8-K filed on March 19, 2015, is incorporated by reference herein.</u>
10.32*	<u>Amendment to Form of Restricted Stock Unit Grant Agreement as filed as Exhibit 10.1 to Form 8-K/A filed on March 19, 2015, is incorporated by reference herein.</u>
10.33*	<u>Stock Yards Bancorp, Inc. 2015 Omnibus Equity Compensation Plan, as filed as Exhibit 10.1 to Form 8K, on April 27, 2015 is incorporated by reference herein.</u>
10.34*	<u>Form of Performance-Vested Stock Units (PSU's) Agreement, as filed as Exhibit 10.1 to Form 8-K filed on March 17, 2016, is incorporated by reference herein.</u>
10.35*	<u>Form of Stock Appreciation Rights (SARS) Agreement, as filed as Exhibit 10.2 to Form 8-K filed on March 17, 2016, is incorporated by reference herein.</u>
10.36*	<u>Form of Performance-Vested Stock Unit Grant Agreement, as filed as Exhibit 10.1 to Form 8-K filed on March 27, 2017, is incorporated by reference herein.</u>
10.37B*	<u>Amendment No. 1 to the Stock Yards Bancorp 2015 Omnibus Equity Compensation Plan, as filed as Exhibit 10.37 to Form 10-K filed on March 13, 2018, is incorporated by reference herein.</u>
10.38*	<u>Amendment No. 2 to the Stock Yards Bancorp 2015 Omnibus Equity Compensation Plan, as filed as Exhibit 10.1 to Form 8-K filed on May 1, 2018, is incorporated by reference herein.</u>
10.39*	<u>Executive Transition Agreement by and among David P. Heintzman, Stock Yards Bancorp, Inc., and Stock Yards Bank &amp; Trust Company, as filed as Exhibit 10.1 to Form 8-K filed on May 29, 2018, is incorporated by reference herein.</u>
10.40*	<u>Amended and Restated Change in Control Severance Agreement between Stock Yards Bank &amp; Trust Company and Phillip S. Poindexter, as filed as Exhibit 10.2 to Form 8-K filed on May 29, 2018, is incorporated by reference herein.</u>
10.41*	<u>Form of Stock Appreciation Rights Grant Agreement, as filed as Exhibit 10.1 to Form 8-K filed on October 5, 2018, is incorporated by reference herein.</u>
10.42*	<u>Executive Transition Agreement by and among Nancy B. Davis, Stock Yards Bancorp, Inc., and Stock Yards Bank &amp; Trust Company, as filed as Exhibit 10.1 to Form 8-K filed on November 23, 2018 is incorporated by reference herein.</u>
14	<u>Code of Ethics for the Chief Executive Officer and Financial Executives.</u>
21	<u>Subsidiary of the Registrant.</u>
23.1	<u>Consent of BKD LLP</u>
23.2	<u>Consent of KPMG LLP</u>
31.1	<u>Certifications pursuant to Section 302 of the Sarbanes-Oxley Act by James A Hillebrand.</u>
31.2	<u>Certifications pursuant to Section 302 of the Sarbanes-Oxley Act by Nancy B. Davis.</u>
32.1	<u>Certifications pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by David P. Heintzman.</u>
32.2	<u>Certifications pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Nancy B. Davis.</u>
101	The following financial statements from the Stock Yards Bancorp, Inc. December 31, 2018 Annual Report on Form 10-K, filed on February 28, 2019, formatted in eXtensible Business Reporting Language (XBRL):

(1) Consolidated Balance Sheets



- (2) Consolidated Statements of Income
- (3) Consolidated Statements of Comprehensive Income
- (4) Consolidated Statements of Changes in Stockholders' Equity
- (5) Consolidated Statements of Cash Flows
- (6) Notes to Consolidated Financial Statements

\* Indicates matters related to executive compensation or other management contracts.

Copies of the foregoing Exhibits will be furnished to others upon request and payment of Bancorp's reasonable expenses in furnishing the exhibits.

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(b) Exhibits

The exhibits listed in response to Item 15(a) 3 are filed or furnished as a part of this report.

(c) Financial Statement Schedules

None

**Item 16. Form 10-K Summary**

None

**Where You Can Find More Information**

Bancorp is subject to the informational requirements of the Securities Exchange Act of 1934 and accordingly files its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and other information with the Securities and Exchange Commission (“SEC”). Bancorp’s public filings are also maintained on the SEC’s Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC. The address of that web site is <http://www.sec.gov>. In addition, Bancorp’s annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act may be accessed free of charge through Bancorp’s web site after we have electronically filed such material with, or furnished it to, the SEC. The address of that web site is <http://www.syb.com>.

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**Signatures**

Pursuant to the requirements of Section 13 or 15(d) 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.

**February 28, 2019** STOCK YARDS  
BANCORP, INC.

BY: /s/ James A.  
Hillebrand  
James A.  
Hillebrand  
Chief Executive  
Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ James A. Hillebrand James A. Hillebrand	Chief Executive Officer and Director (principal executive officer)	February 28, 2019
/s/ Nancy B. Davis Nancy B. Davis	Executive Vice President and Chief Financial Officer (principal financial officer)	February 28, 2019
/s/ Michael B. Newton Michael B. Newton	Senior Vice President and Principal Accounting Officer	February 28, 2019
/s/ David P. Heintzman David P. Heintzman	Chairman of the Board	February 28, 2019
/s/ Paul J. Bickel III Paul J. Bickel III	Director	February 28, 2019
/s/ J. McCauley Brown J. McCauley Brown	Director	February 28, 2019
/s/ Charles R. Edinger, III Charles R. Edinger, III	Director	February 28, 2019

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/s/ Donna L. Heitzman Donna L. Heitzman	Director	February 28, 2019
/s/ Carl G. Herde Carl G. Herde	Director	February 28, 2019
/s/ Richard A. Lechleiter Richard A. Lechleiter	Director	February 28, 2019
/s/ Richard Northern Richard Northern	Director	February 28, 2019
/s/ Stephen M. Priebe Stephen M. Priebe	Director	February 28, 2019
/s/ John L. Schutte John L. Schutte	Director	February 28, 2019
/s/ Norman Tasman Norman Tasman	Director	February 28, 2019
/s/ Kathy C. Thompson Kathy C. Thompson	Senior Executive Vice President and Director	February 28, 2019