

SI Financial Group, Inc.
Form 10-Q
November 08, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
 QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934

For the Quarterly Period Ended September 30, 2018

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

For the Transition Period from _____ to _____

Commission File Number: 0-54241

SI FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Maryland 80-0643149
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

803 Main Street, Willimantic, Connecticut 06226
(Address of principal executive offices) (Zip Code)

(860) 423-4581
(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See 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.

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

As of November 2, 2018, there were 12,033,611 shares of the registrant's common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

SI FINANCIAL GROUP, INC.

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts / Unaudited)

	September 30, 2018	December 31, 2017
ASSETS:		
Cash and due from banks:		
Noninterest-bearing	\$ 16,915	\$ 16,872
Interest-bearing	59,829	66,614
Total cash and cash equivalents	76,744	83,486
Available for sale securities, at fair value	147,576	154,053
Loans held for sale	1,368	835
Loans receivable (net of allowance for loan losses of \$14,227 at September 30, 2018 and \$12,334 at December 31, 2017)	1,276,373	1,237,174
Federal Home Loan Bank stock, at cost	9,308	9,856
Federal Reserve Bank stock, at cost	3,638	3,636
Bank-owned life insurance	34,397	33,726
Premises and equipment, net	19,099	19,409
Goodwill and other intangibles	16,442	16,893
Accrued interest receivable	5,209	4,784
Deferred tax asset, net	6,943	6,412
Other real estate owned, net	608	1,226
Other assets	9,430	9,466
Total assets	\$ 1,607,135	\$ 1,580,956
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 243,688	\$ 220,877
Interest-bearing	1,006,405	987,170
Total deposits	1,250,093	1,208,047
Mortgagors' and investors' escrow accounts	2,838	4,418
Federal Home Loan Bank advances	152,780	170,094
Junior subordinated debt owed to unconsolidated trust	8,248	8,248
Accrued expenses and other liabilities	23,164	21,668
Total liabilities	1,437,123	1,412,475
Shareholders' Equity:		
Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)	—	—
Common stock (\$.01 par value; 35,000,000 shares authorized; 12,033,734 and 12,242,434 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively)	120	122
Additional paid-in-capital	126,178	126,540
Unallocated common shares held by ESOP	(2,328)	(2,688)
Unearned restricted shares	(227)	(235)

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Retained earnings	49,628	46,176
Accumulated other comprehensive loss	(3,359) (1,434
Total shareholders' equity	170,012	168,481
Total liabilities and shareholders' equity	\$ 1,607,135	\$ 1,580,956

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In Thousands, Except Per Share Amounts / Unaudited)

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Interest and dividend income:				
Loans, including fees	\$13,493	\$12,326	\$39,188	\$36,758
Securities:				
Taxable interest	854	891	2,030	2,465
Tax-exempt interest	13	14	41	42
Dividends	199	184	566	538
Other	295	234	847	546
Total interest and dividend income	14,854	13,649	42,672	40,349
Interest expense:				
Deposits	2,528	1,922	6,579	5,555
Federal Home Loan Bank advances	779	802	2,408	2,577
Subordinated debt and other borrowings	82	60	228	173
Total interest expense	3,389	2,784	9,215	8,305
Net interest income	11,465	10,865	33,457	32,044
Provision for loan losses	1,009	171	2,022	501
Net interest income after provision for loan losses	10,456	10,694	31,435	31,543
Noninterest income:				
Service fees	1,736	1,723	5,217	5,165
Wealth management fees	5	20	23	539
Increase in cash surrender value of bank-owned life insurance	230	133	671	395
Mortgage banking	343	519	901	1,140
Net loss on disposal of equipment	(2)	(4)	(2)	(4)
Other	607	124	1,822	1,428
Total noninterest income	2,919	2,515	8,632	8,663
Noninterest expenses:				
Salaries and employee benefits	5,386	5,052	15,898	15,485
Occupancy and equipment	1,668	1,662	5,175	5,138
Computer and electronic banking services	1,350	1,345	3,926	4,015
Outside professional services	268	379	967	1,172
Marketing and advertising	203	173	666	580
Supplies	141	121	436	383
FDIC deposit insurance and regulatory assessments	192	178	530	590
Core deposit intangible amortization	150	150	451	451
Other real estate owned operations	103	117	271	484
Other	491	481	1,536	1,725
Total noninterest expenses	9,952	9,658	29,856	30,023

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Income before income tax provision	3,423	3,551	10,211	10,183
Income tax provision	719	1,307	2,147	3,378
Net income	\$2,704	\$2,244	\$8,064	\$6,805
Earnings per share:				
Basic	\$0.23	\$0.19	\$0.68	\$0.57
Diluted	\$0.23	\$0.19	\$0.68	\$0.57

See accompanying notes to unaudited interim consolidated financial statements.

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

	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net income	\$2,704	\$2,244	\$8,064	\$6,805
Other comprehensive income (loss), net of tax:				
Net unrealized holding gains (losses) on available for sale securities				
Other comprehensive income (loss)	(482)	47	(1,925)	202
Comprehensive income	\$2,222	\$2,291	\$6,139	\$7,007

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018
(In Thousands, Except Share Data / Unaudited)

	Common Stock		Unallocated		Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity	
	Shares	Dollars	Additional Paid-in Capital	Common Shares Held by ESOP				
Balance at December 31, 2017	12,242,434	\$ 122	\$ 126,540	\$ (2,688)	\$ (235)	\$ 46,176	\$ (1,434)	\$ 168,481
Comprehensive income	—	—	—	—	—	8,064	(1,925)	6,139
Cash dividends declared (\$0.18 per share)	—	—	—	—	—	(2,135)	—	(2,135)
Equity incentive plans compensation	—	—	148	—	8	—	—	156
Allocation of 36,477 ESOP shares	—	—	166	360	—	—	—	526
Stock options exercised	6,300	—	71	—	—	—	—	71
Common shares repurchased	(215,000)	(2)	(747)	—	—	(2,477)	—	(3,226)
Balance at September 30, 2018	12,033,734	\$ 120	\$ 126,178	\$ (2,328)	\$ (227)	\$ 49,628	\$ (3,359)	\$ 170,012

See accompanying notes to unaudited interim consolidated financial statements.

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

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$8,064	\$6,805
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,022	501
Employee stock ownership plan expense	526	544
Equity incentive plan expense	156	346
Amortization of investment premiums and discounts, net	1,009	745
Amortization of loan premiums and discounts, net	709	881
Depreciation and amortization of premises and equipment	1,714	1,666
Amortization of core deposit intangible	451	451
Deferred income tax provision (benefit)	(20)	105
Loans originated for sale	(55,329)	(38,379)
Proceeds from sale of loans held for sale	54,915	38,506
Net gain on sales of loans held for sale	(371)	(896)
Net loss on disposal of equipment	2	4
Net loss on sales or write-downs of other real estate owned	82	393
Increase in cash surrender value of bank-owned life insurance	(671)	(395)
Change in operating assets and liabilities:		
Accrued interest receivable	(425)	(300)
Other assets	288	(630)
Accrued expenses and other liabilities	1,496	(3,163)
Net cash provided by operating activities	14,618	7,184
Cash flows from investing activities:		
Purchases of available for sale securities	(30,966)	(32,008)
Proceeds from maturities of and principal repayments on available for sale securities	33,998	22,391
Purchases of Federal Home Loan Bank stock	—	(69)
Purchases of Federal Reserve Bank stock	(2)	(7)
Redemption of Federal Home Loan Bank stock	548	2,214
Loan principal originations, net of principal collections	(6,839)	12,867
Purchases of loans	(35,201)	(22,280)
Proceeds from sales of other real estate owned	646	288
Purchases of premises and equipment	(1,406)	(1,410)
Net cash used in investing activities	(39,222)	(18,014)

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

	Nine Months Ended September 30, 2018 2017	
Cash flows from financing activities:		
Net increase in deposits	42,046	83,404
Net decrease in mortgagors' and investors' escrow accounts	(1,580)	(1,462)
Proceeds from Federal Home Loan Bank advances	14,817	14,500
Repayments of Federal Home Loan Bank advances	(32,131)	(65,444)
Cash dividends on common stock	(2,135)	(1,778)
Stock options exercised	71	361
Common shares repurchased	(3,226)	(205)
Net cash provided by financing activities	17,862	29,376
Net change in cash and cash equivalents	(6,742)	18,546
Cash and cash equivalents at beginning of period	83,486	73,186
Cash and cash equivalents at end of period	\$76,744	\$91,732
Supplemental cash flow information:		
Interest paid	\$9,200	\$8,356
Income taxes paid, net	2,731	5,670
Transfer of loans to other real estate owned	110	894
Stock options exercised by net-share settlement	—	163

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2018 AND 2017 AND DECEMBER 31, 2017

NOTE 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

SI Financial Group, Inc. (the “Company”) is the holding company for Savings Institute Bank and Trust Company (the “Bank”). Established in 1842, the Bank is a community-oriented financial institution headquartered in Willimantic, Connecticut. The Bank provides a variety of financial services to individuals, businesses and municipalities through its 23 offices in eastern Connecticut and Rhode Island. Its primary products include savings, checking and certificate of deposit accounts, residential and commercial mortgage loans, commercial business loans, construction loans and consumer loans. The Company does not conduct any material business other than owning all of the stock of the Bank and making payments on the subordinated debentures held by the Company.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank, and the Bank’s wholly-owned subsidiaries, SI Mortgage Company and SI Realty Company, Inc. All significant intercompany accounts and transactions have been eliminated.

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, the instructions to Form 10-Q and Rule 10.01 of Regulation S-X of the Securities and Exchange Commission and general practices within the banking industry. Accordingly, certain information and footnote disclosures required by GAAP for complete financial statements have been omitted. Information in the accompanying interim consolidated financial statements and notes to the financial statements of the Company as of September 30, 2018 and for the three and nine months ended September 30, 2018 and 2017 is unaudited. These unaudited interim consolidated financial statements and related notes should be read in conjunction with the audited consolidated financial statements of the Company and the accompanying notes for the year ended December 31, 2017 contained in the Company’s Annual Report on Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the periods covered herein. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the operating results for the year ending December 31, 2018 or for any other period.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities, as of the date of the balance sheets and reported amounts of revenues and expenses for the periods presented. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred income taxes and the impairment of long-lived assets such as goodwill and other intangibles.

Reclassifications

Amounts in the Company's prior year consolidated financial statements are reclassified to conform to the current year presentation. Such reclassifications had no effect on net income.

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SI FINANCIAL GROUP, INC.

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SEPTEMBER 30, 2018 AND 2017 AND DECEMBER 31, 2017

Loans Receivable

Loans receivable are stated at current unpaid principal balances, net of the allowance for loan losses and deferred loan origination fees and costs. Management has the ability and intent to hold its loans receivable for the foreseeable future or until maturity or pay-off.

A loan is impaired when, based on current information and events, it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan by loan basis for residential and commercial mortgage loans and commercial business loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not typically identify individual consumer loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring ("TDR") agreement.

Troubled Debt Restructurings

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and concessions have been made to the original contractual terms due to the borrower's financial condition that would not otherwise be considered for a borrower with similar risk characteristics, such as reductions of interest rates, deferral of interest or principal payments, or maturity extensions, the modification is considered a TDR. Modified terms are dependent upon the financial position and needs of the individual borrower. If the modification agreement is violated, the loan is handled by the Company's Collections Department for resolution, which may result in foreclosure.

Management considers all nonaccrual loans, with the exception of certain consumer loans, to be impaired. Also, all TDRs are initially classified as impaired and follow the Company's nonaccrual policy. However, if the loan was current prior to modification, nonaccrual status would not be required. If the loan was on nonaccrual prior to modification or if the payment amount significantly increases, the loan will remain on nonaccrual for a period of at least six months. Loans qualify for return to accrual status once the borrower has demonstrated the willingness and the ability to perform in accordance with the restructured terms of the loan agreement for a period of not less than six consecutive months. In most cases, loan payments less than 90 days past due are considered minor collection delays and the related loans are generally not considered impaired.

Impaired classification may be removed after a year following the restructure if the borrower demonstrates compliance with the modified terms and the restructuring agreement specifies an interest rate equal to that which would be provided to a borrower with similar risk characteristics at the time of restructuring.

Allowance for Loan Losses

The allowance for loan losses, a material estimate which could change significantly in the near-term, is established through a provision for loan losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level management considers adequate to absorb losses in the loan portfolio. Loan losses are charged against the allowance for loan losses when management believes the uncollectibility of the principal loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses when

received.

Management's judgment in determining the adequacy of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is evaluated on a monthly basis by management and is based on the evaluation of the known and inherent risk characteristics and size and composition of the loan portfolio, the assessment of current economic

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SI FINANCIAL GROUP, INC.

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and real estate market conditions, adverse situations that may affect a borrower's ability to repay, estimated value of any underlying collateral, historical loan loss experience, the amount and trends of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.

The allowance for loan losses consists of the following key elements:

Specific allowance for identified impaired loans. For loans identified as impaired, an allowance is established when the present value of expected cash flows, or observable market price of the loan or fair value of the collateral if the loan is collateral dependent, of the impaired loan is lower than the carrying value of that loan. In the determination of the allowance for loan losses, management may obtain independent appraisals for significant properties, when necessary.

General valuation allowance. The general component represents a valuation allowance on the remainder of the loan portfolio, after excluding impaired loans. For this portion of the allowance, loans are segregated by category and assigned an allowance percentage based on historical loan loss experience adjusted for qualitative factors stratified by the following loan segments: residential one- to four-family, multi-family and commercial real estate, construction, commercial business and consumer. Management uses a rolling average of historical losses based on the time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: changes in lending policies and procedures, including changes in underwriting standards and collections, charge-off and recovery practices; changes in national, regional and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments; changes in the size and composition of the loan portfolio and in the terms of the loans; changes in the experience, ability and depth of lending and underwriting management and other relevant staff; changes in the volume and severity of past due loans, the volume of nonaccrual loans and the volume and severity of adversely classified or graded loans; changes in the quality of the loan review system; changes in the underlying collateral for collateral-dependent loans; the existence and effect of any concentrations of credit and changes in the level of such concentrations; the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the portfolio.

The qualitative factors are determined based on the following various risk characteristics for each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

Residential – One to Four Family – The Bank primarily originates conventional loans with loan-to-value ratios less than 95% and generally originates loans with loan-to-value ratios in excess of 80% only when secured by first liens on owner-occupied one- to four-family residences. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance or additional collateral. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality of this segment.

Multi-family and Commercial – Loans in this segment are originated to acquire, develop, improve or refinance multi-family and commercial real estate where the property is the primary collateral securing the loan, and the income generated from the property is the primary repayment source. The underlying cash flows generated by the properties

can be impacted by the economy as evidenced by increased vacancy rates. Payments on loans secured by income-producing properties often depend on the successful operation and management of the properties. Management continually monitors the cash flows of these loans.

• Construction – This segment includes loans to individuals and, to a lesser extent, builders to finance the construction of residential dwellings. The Bank also originates construction loans for commercial

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development projects. Upon the completion of construction, the loan generally converts to a permanent mortgage loan. Credit risk is affected by cost overruns, whether estimates of the sale price of the property are correct, the time it takes to sell at an adequate price and market conditions.

Commercial Business – Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. The Bank provides loans to investors in the time share industry, which are secured by consumer receivables, and provides loans for capital improvements to condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners. Additionally, the Bank purchases loans primarily out of our market area from a company specializing in medical loan originations, which are secured by medical equipment.

Consumer – Loans in this segment primarily include home equity lines of credit (representing both first and second liens) and, to a lesser extent, loans secured by marketable securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

In computing the allowance for loan losses, we do not assign a general valuation allowance to the Small Business Administration ("SBA") and United States Department of Agriculture ("USDA") loans that we purchase as such loans are fully guaranteed. These loans are included in commercial business loans.

The majority of the Company's loans are collateralized by real estate located in eastern Connecticut and Rhode Island. To a lesser extent, certain commercial real estate loans are secured by collateral located outside of our primary market area with concentrations in Massachusetts and New Hampshire. Accordingly, the collateral value of a substantial portion of the Company's loan portfolio and real estate acquired through foreclosure is susceptible to changes in local market conditions.

Although management believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and the Company's results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making the determinations. Furthermore, while management believes it has established the allowance for loan losses in conformity with GAAP, our regulators, in reviewing the loan portfolio, may request us to increase our allowance for loan losses based on judgments different from ours. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, the existing allowance for loan losses may not be adequate or increases may be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.

Interest and Fees on Loans

Interest on loans is accrued and included in net interest income based on contractual rates applied to principal amounts outstanding. Accrual of interest is discontinued when loan payments are 90 days or more past due, based on contractual terms, or when, in the judgment of management, collectibility of the loan or loan interest becomes uncertain. Subsequent recognition of income occurs only to the extent payment is received subject to management's

assessment of the collectibility of the remaining interest and principal. A nonaccrual loan is restored to accrual status when it is no longer delinquent and collectibility of interest and principal is no longer in doubt and the borrower has made regular payments in accordance with the terms of the loan over a period of at least six months. Interest collected on nonaccrual loans is recognized only to the extent cash payments are

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SI FINANCIAL GROUP, INC.

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SEPTEMBER 30, 2018 AND 2017 AND DECEMBER 31, 2017

received, and may be recorded as a reduction to principal if the collectibility of the principal balance of the loan is unlikely.

Loan origination fees, direct loan origination costs and loan purchase premiums are deferred, and the net amount is recognized as an adjustment of the related loan's yield utilizing the interest method over the contractual life of the loan. In addition, discounts related to fair value adjustments for loans receivable acquired in a business combination or asset purchase are accreted into earnings over the contractual term as an adjustment of the related loan's yield. The Company periodically evaluates the cash flows expected to be collected for loans acquired with deteriorated credit quality. Changes in the expected cash flows compared to the expected cash flows as of the date of acquisition may impact the accretable yield or result in a charge to the provision for loan losses to the extent of a shortfall.

Common Share Repurchases

The Company is chartered in Maryland. Maryland law does not provide for treasury shares, rather shares repurchased by the Company constitute authorized but unissued shares. GAAP states that accounting for treasury stock shall conform to state law. Therefore, the cost of shares repurchased by the Company is allocated to common stock, additional paid-in capital and retained earnings balances.

Recent Accounting Pronouncements

Revenue from Contracts with Customers (Topic 606): In May 2014, the Financial Accounting Standards Board ("FASB") issued guidance that improves the revenue recognition requirements for contracts with customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve the core principle, a company should apply a five step approach to revenue recognition. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or entered into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. Accordingly, the guidance does not apply to, among other things, the following: receivables (i.e. loans), debt and equity investments, equity method investments, joint ventures, derivatives and hedging, financial instruments and transfers and servicing. This guidance became effective for fiscal years beginning after December 15, 2017. Significantly all of the Company's revenues are excluded from the scope of the guidance; therefore, adoption of this guidance on January 1, 2018 did not have a material impact on the Company's consolidated financial statements.

Financial Instruments (Subtopic 825-10): In January 2016, the FASB issued guidance addressing certain aspects of recognition, measurement, presentation and disclosure of financial instruments. Targeted improvements to GAAP include the requirement for equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income and the elimination of the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost. The amendments in this update became effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this guidance on January 1, 2018 did not have a material impact on the Company's consolidated financial statements.

Leases (Topic 842): In February 2016, the FASB issued amended guidance to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. An entity that elects

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to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. It is expected that assets and liabilities will increase based on the present value of remaining lease payments for leases in place at the adoption date; however, based on the current level of long-term leases in place, this is not expected to be material to the Company's consolidated financial statements.

Financial Instruments - Credit Losses (Topic 326): In June 2016, the FASB issued guidance that significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The update will replace today's "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to (1) financial assets subject to credit losses and measured at amortized cost and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The CECL model does not apply to available for sale ("AFS") debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to current accounting guidance, except that losses will be recognized as allowances rather than reductions in the amortized cost of the securities. The update also simplifies the accounting model for purchased credit-impaired debt securities and loans. Disclosure requirements under the update have been expanded to include the entity's assumptions, models and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by year of origination. The update is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted for interim and annual periods beginning after December 15, 2018. The update requires a modified retrospective transition under which a cumulative effect to equity will be recognized in the period of adoption. Management has developed a focus team that is reviewing and monitoring additional developments and accounting guidance to determine the impact to the Company's consolidated financial statements. Management is evaluating the models and related requirements and is developing an implementation plan.

Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments (Topic 230): In August 2016, the FASB issued guidance to reduce the existing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This update provides guidance on eight specific cash flow issues. The update became effective for fiscal years beginning after December 15, 2017, and for interim periods within those fiscal years. The amendments in this update should be applied using a retrospective transition method to each period presented. The adoption of this guidance on January 1, 2018 did not have a material impact on the Company's consolidated financial statements.

Intangibles - Goodwill and Other - Simplifying the Test for Goodwill Impairment (Topic 350): In January, 2017, the FASB issued guidance aimed at simplifying the subsequent measurement of goodwill. Under these amendments, an entity should perform its annual or interim goodwill impairment test by comparing the fair value of reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from tax deductible

goodwill on the carrying amount of a reporting unit when measuring the goodwill impairment loss, if applicable. The Board also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. Therefore, the same impairment assessment applies to all reporting units. An entity is required to disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets. An entity still has the option to perform the qualitative assessment for a reporting unit to

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determine if the quantitative impairment test is necessary. The amendments in this update should be applied on a prospective basis and are effective for annual goodwill impairment tests in fiscal years beginning after December 15, 2019. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): In March 2017, the FASB issued guidance shortening the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. The amendments in this update should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements due to limited holdings with callable features.

Compensation - Stock Compensation (Topic 718): In May 2017, the FASB issued guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. An entity should account for the effects of a modification unless all of the following are met: 1) the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified; 2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; and 3) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. The amendments in this update became effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The amendments in this update should be applied prospectively to an award modified on or after the adoption date. The adoption of this guidance on January 1, 2018 did not have a material impact on the Company's consolidated financial statements.

Fair Value Measurement (Topic 820): In August 2018, the FASB issued guidance which removes, modifies and adds disclosure requirements related to fair value measurements. The amendments in this update become effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2019. Certain amendments are to be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption. All other amendments should be applied retrospectively to all periods presented upon their effective date. Early adoption is permitted. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the net income available to common shareholders by the weighted average number of common shares outstanding during the period. Unvested restricted shares are considered outstanding in the computation of basic earnings per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings per share is computed in a manner similar to basic earnings per

share except that the weighted average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's common stock equivalents relate solely to stock options. Repurchased common shares and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings per share calculations.

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Anti-dilutive shares are common stock equivalents with weighted average exercise prices in excess of the weighted average market value for the periods presented, and are not considered in diluted earnings per share calculations. The Company had anti-dilutive common shares outstanding of 136,000 and 135,181 for the three and nine months ended September 30, 2018, respectively, and 130,000 for both the three and nine months ended September 30, 2017.

The computation of earnings per share is as follows:

	Three Months		Nine Months	
	Ended	Ended	Ended	Ended
	September 30,	September 30,	September 30,	September 30,
	2018	2017	2018	2017
	(Dollars in Thousands, Except Per Share Amounts)			
Net income	\$2,704	\$2,244	\$8,064	\$6,805

Weighted average common shares outstanding: