



Catskill Hudson Bancorp, Inc.

Consolidated Financial Statements

Years Ended December 31, 2018 and 2017



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Independent Auditors' Report

To the Stockholders and Board of Directors of Catskill Hudson Bancorp, Inc.:

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Catskill Hudson Bancorp, Inc. and its subsidiary, which comprise the consolidated statements of financial condition as of December 31, 2018, and the related consolidated statements of net income, comprehensive income, stockholders' equity, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the 2018 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Catskill Hudson Bancorp, Inc. and subsidiary as of December 31, 2018, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The consolidated financial statements of Catskill Hudson Bancorp, Inc. and subsidiary as of and for the year ended December 31, 2017 were audited by other auditors whose report, dated April 12, 2018, expressed an unmodified opinion.

Handwritten signature in black ink that reads "Wolf + Company, P.C." in a cursive style.

Boston, Massachusetts
May 7, 2019

Catskill Hudson Bancorp, Inc.

Consolidated Statements of Financial Condition

December 31, 2018 and 2017

(In Thousands)

	<u>2018</u>	<u>2017</u>
Assets		
Cash and cash equivalents	\$ 37,409	\$ 30,267
Certificates of deposit	28	240
Securities available for sale, at fair value	108,844	122,491
Securities held to maturity, fair value 2018 \$6,055; 2017 \$6,265	6,282	6,502
Loans, net of allowance for loan losses 2018 \$2,785; 2017 \$3,165	300,111	274,024
Restricted investment in bank stocks	700	731
Premises and equipment, net	5,136	2,843
Bank-owned life insurance	1,845	1,814
Accrued interest receivable and other assets	<u>3,567</u>	<u>3,518</u>
Total assets	<u>\$ 463,922</u>	<u>\$442,430</u>
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Interest bearing	350,356	336,613
Noninterest bearing	<u>77,829</u>	<u>70,621</u>
Total deposits	<u>428,185</u>	<u>407,234</u>
Subordinated debentures	10,822	10,799
Junior subordinated debentures	3,299	3,299
Accrued interest payable and other liabilities	<u>1,021</u>	<u>853</u>
Total liabilities	<u>443,327</u>	<u>422,185</u>
Commitments and contingencies (See Notes 5 and 14)		
Stockholders' equity		
Preferred stock	-	-
Common stock	709	708
Treasury stock (8,416 shares at December 31, 2018 and 2017)	(152)	(152)
Additional paid-in capital	7,311	7,278
Retained earnings	15,687	14,131
Accumulated other comprehensive loss	<u>(2,960)</u>	<u>(1,720)</u>
Total stockholders' equity	<u>20,595</u>	<u>20,245</u>
Total liabilities and stockholders' equity	<u>\$ 463,922</u>	<u>\$ 442,430</u>

The accompanying notes are an integral part of these consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Consolidated Statements of Net Income

Years Ended December 31, 2018 and 2017

(In Thousands, Except Per Share Data)

	<u>2018</u>	<u>2017</u>
Interest income:		
Loans	\$ 13,601	\$ 11,855
Securities:		
Taxable	2,447	2,616
Tax-exempt	665	808
Other	4	3
Total interest and dividend income	<u>16,717</u>	<u>15,282</u>
Interest expense:		
Deposits	2,249	1,669
Borrowings	966	900
Total interest expense	<u>3,215</u>	<u>2,569</u>
Net interest income	13,502	12,713
Provision for loan losses	-	255
Net interest income, after provision for loan losses	<u>13,502</u>	<u>12,458</u>
Noninterest income:		
Service fees	948	945
Net realized gains on sales of securities available for sale	12	113
Other operating income	99	77
Total noninterest income	<u>1,059</u>	<u>1,135</u>
Noninterest expenses:		
Salaries and employee benefits	6,829	6,055
Occupancy	1,667	1,348
Depreciation and amortization	801	715
Data processing fees	570	533
Stationary, supplies and printing	196	170
Professional fees	209	264
Bank service fees	463	434
FDIC insurance	248	270
Other operating expenses	1,410	1,225
Total operating expenses	<u>12,393</u>	<u>11,014</u>
Income before income tax expense	2,168	2,579
Income tax expense	325	934
Net income	<u>\$ 1,843</u>	<u>\$ 1,645</u>
Earnings per common share		
Basic and diluted	\$ 2.64	\$ 2.37

The accompanying notes are an integral part of these consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2018 and 2017

(In Thousands)

	<u>2018</u>	<u>2017</u>
Net income	<u>\$ 1,843</u>	<u>\$ 1,645</u>
Other comprehensive income (loss):		
Securities available-for-sale:		
Unrealized gains (losses) arising during the year	(1,556)	1,054
Reclassification adjustment for gains realized in income ⁽¹⁾	<u>(12)</u>	<u>(113)</u>
	(1,568)	941
Tax effects	<u>328</u>	<u>(296)</u>
Other comprehensive income (loss)	<u>(1,240)</u>	<u>645</u>
Comprehensive income	<u>\$ 603</u>	<u>\$ 2,290</u>

(1) Amounts are reclassified out of accumulated other comprehensive loss and included in net realized gains on sales of securities available for sale in the consolidated statements of net income. The related income tax expense for the years ended December 31, 2018 and 2017, amounted to \$3,000 and \$38,000, respectively.

The accompanying notes are an integral part of these consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Consolidated Statements of Changes in Stockholders' Equity

Years Ended December 31, 2018 and 2017

(In Thousands, Except Per Share Data)

	Common Stock	Treasury Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance at December 31, 2016	\$ 703	\$ (152)	\$ 7,221	\$ 12,453	\$ (2,026)	\$ 18,199
Comprehensive income	-	-	-	1,645	645	2,290
Changes in enacted income tax rate	-	-	-	339	(339)	-
Common stock dividends declared, \$0.44 per share	-	-	-	(306)	-	(306)
Common stock issued	5	-	57	-	-	62
Balance at December 31, 2017	708	(152)	7,278	14,131	(1,720)	20,245
Comprehensive income	-	-	-	1,843	(1,240)	603
Common stock dividends declared, \$0.33 per share	-	-	-	(287)	-	(287)
Common stock issued	1	-	33	-	-	34
Balance at December 31, 2018	<u>\$ 709</u>	<u>\$ (152)</u>	<u>\$ 7,311</u>	<u>\$ 15,687</u>	<u>\$ (2,960)</u>	<u>\$ 20,595</u>

The accompanying notes are an integral part of these consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Consolidated Statements of Cash Flows

Years Ended December 31, 2018 and 2017

(In Thousands)

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Net income	\$ 1,843	\$ 1,645
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	-	255
Depreciation and amortization	847	761
Net realized gains on sales of securities available for sale	(12)	(113)
Net amortization of securities	220	705
Net loss on sale and valuation of other real estate owned	-	77
Loss on the sale of premises	185	-
Bank owned life insurance income	(31)	(34)
Deferred income tax expense	584	351
Net change in:		
Accrued interest receivable and other assets	(273)	477
Accrued interest payable and other liabilities	168	152
Net cash provided by operating activities	<u>3,531</u>	<u>4,276</u>
Cash flows from investing activities:		
Securities available-for-sale activity:		
Purchases	(285,421)	(171,623)
Proceeds from sales	4,217	40,692
Proceeds from maturities and principal repayments	293,072	158,732
Securities held-to-maturity activity:		
Purchases	(1,296)	(2,191)
Proceeds from maturities and principal repayments	1,505	3,363
Net decrease in certificates of deposit	212	240
Loan originations, net of principal payments	(25,672)	(33,249)
Net redemption of restricted investment in bank stock	31	12
Purchases of premise and equipment	(3,830)	(662)
Net proceeds from the sale of premises	95	-
Net proceeds from the sale of other real estate owned	-	40
Net cash used in investing activities	<u>(17,087)</u>	<u>(4,646)</u>

(continued)

The accompanying notes are an integral part of these consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Consolidated Statements of Changes of Cash Flows (Concluded)

Years Ended December 31, 2018 and 2017

(In Thousands)

Cash flows from financing activities:		
Net change in deposits	20,951	(1,095)
Common stock dividends paid	(287)	(306)
Common stock issuance	34	62
Net cash provided by (used in) financing activities	20,698	(1,339)
Net increase (decrease) cash and cash equivalents	7,142	(1,709)
Cash and cash equivalents, beginning of year	30,267	31,976
Cash and cash equivalents, end of year	\$ 37,409	\$ 30,267
Supplementary cash flows information		
Interest paid	\$ 3,117	\$ 2,558
Income taxes paid	9	250
Supplementary schedule of noncash financing activities		
Sale of other real estate owned through loans	\$ -	\$ 21
Bank financed sale of premises and equipment	320	-

The accompanying notes are an integral part of these consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2018 and 2017

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Catskill Hudson Bancorp, Inc. (the “Company”) provides a full range of commercial banking services through its wholly-owned subsidiary, Catskill Hudson Bank (the “Bank”). The Bank’s operations are conducted in thirteen branches located in the counties of Sullivan, Orange, Ulster, Albany and Saratoga. The Bank is regulated by the Federal Deposit Insurance Corporation and the New York State Department of Financial Services. The Company is regulated by the Federal Reserve Bank of New York.

The Company also has another wholly-owned subsidiary, Catskill Hudson Statutory Trust I (“Trust I”). Trust I was formed for the purpose of issuing trust preferred securities, the proceeds of which were advanced to the Company and contributed to the Bank as additional capital.

Basis of Consolidation

The consolidated financial statements include the accounts of the Company and the Bank. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accounts of Trust I are not included in the consolidated financial statements as discussed in Note 9.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. 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 and the realizability of deferred income tax assets.

Fair value hierarchy

The Company groups its assets that are measured at fair value in three levels, based on the markets in which the assets are traded, and the reliability of the assumptions used to determine fair value.

Level 1 – Valuation is based on quoted prices in active markets for identical assets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Fair value hierarchy (concluded)

Level 2 – Valuation is based on observable inputs other than Level 1 prices, such as quoted prices for similar assets; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets.

Level 3 – Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets. Level 3 assets include assets whose value is determined using unobservable inputs to pricing models, discounted cash flow methodologies, or similar techniques, as well as assets for which the determination of fair value requires significant management judgment or estimation.

Investment Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held-to-maturity” and recorded at amortized cost. Securities not classified as held-to-maturity are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of the related deferred income tax effect.

Purchase premiums and discounts are recognized in interest income using methods that approximate the interest method. Purchase premiums on callable debt securities are amortized to the first call date while all other premiums and discounts are amortized over the terms of the securities. Gains and losses on the sale of securities are determined using the specific identification method.

Declines in fair value of securities below their cost that are deemed to be other-than-temporary are separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) the intent and ability of the Company to retain its investment in the issuer for a reasonable period of time sufficient to allow for any anticipated recovery in fair value, (4) whether it is likely the Company intends to sell or will have to sell the security prior to recovery, and (5) whether the change in fair value is due to a deterioration in the credit quality of the issuer or is due to non-credit related market conditions. There were no other-than-temporary impairment losses during 2018 or 2017.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses, charge-offs and any deferred origination fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Company is generally amortizing these amounts over the contractual life of the loan using the effective yield method. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

The loans receivable portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following classes: commercial and commercial real estate. Consumer loans consist of the following classes: residential mortgage, installment, home equity, and other consumer.

Commercial lending, including commercial real estate loans, generally present a higher level of risk than residential mortgage loans. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effect of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project or business. If the cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

For all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Loans (concluded)

well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through the provision for loan losses charged to earnings. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential consumer loans are generally charged off no later than 120 days past due on a contractual basis, earlier in the event of bankruptcy, or if there is an amount deemed uncollectible.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Company's past loan loss experience, adjusted for known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Allowance for Loan Losses (continued)

covers pools of loans, grouped by loan class, not considered impaired. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these classes of loans adjusted by qualitative factors, as deemed appropriate. These qualitative risk factors encompass:

1. Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.
3. Nature and volume of the portfolio and terms of loans.
4. Experience, ability, and depth of lending management and staff.
5. Volume and severity of past due, classified and nonaccrual loans as well as loan modifications.
6. Quality of the Company's loan review system, and the degree of oversight by the Company's Board of Directors.
7. Existence and effect of any concentrations of credit and changes in the level of such concentrations.
8. Effect of external factors, such as competition and legal and regulatory requirements.

Each factor is incorporated as part of qualitative adjustments to the allowance based on management's best judgment using relevant information available at the time of the evaluation. The qualitative adjustments are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual 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. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Allowance for Loan Losses (continued)

the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging's or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual residential mortgage loans, installment loans, home equity loans, and other consumer loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement ("TDR").

Loans whose terms are modified are classified as TDRs if the Company grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a TDR generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date at a below market interest rate based on the credit risk associated with the loan. Non-accrual TDRs are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as TDRs are designated as impaired.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Allowance for Loan Losses (concluded)

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

On an annual basis, the Company formally reviews the ratings on all commercial loans through the use of an independent third-party. Management uses the result of these review as part of its annual review process. In addition, management utilizes delinquency reports, the watch list, and other loan reports to monitor credit quality of other loan classes.

In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination. Based on management's comprehensive analysis of the loan portfolio, management believes the allowance for loan losses at December 31, 2018 is adequate.

Restricted Investment in Bank Stocks

Restricted investment in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost and consists of the common stock of the Federal Home Loan Bank ("FHLB") and Atlantic Community Bancshares, Inc. ("ACBI").

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Premises and Equipment

Premises and equipment are carried at cost, less accumulated depreciation, and are depreciated using the straight line method over the estimated useful lives of the assets. In the case of leasehold improvements, amortization is recorded over the shorter of the lease term or the estimated useful life of the related assets, as follows:

	<u>Years</u>
Buildings and leasehold improvements	10 - 30
Furniture, fixtures and equipment	3 - 7
Software	3 - 7

Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, loan foreclosure are initially recorded at fair value less estimated selling costs at the date of foreclosure, establishing a new cost basis. Any write-downs based on the asset's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, property held for sale is carried at the lower of the new basis that was established at the time of foreclosure or fair value less any costs to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of the property to the lower of its cost or fair value less cost to sell. The Company did not have foreclosed real estate at December 31, 2018 and 2017. There is one residential real estate loan in the amount of \$32,000 in the process of foreclosure at December 31, 2018. Foreclosed assets are included in accrued interest receivable and other assets in the consolidated statements of financial condition.

Bank Owned Life Insurance

Bank owned life insurance policies are reflected at the cash surrender value of the underlying policies on the consolidated statements of financial condition. Income from the increase in the cash surrender value of the policies is included with other operating income on the consolidated statements of net income and are not subject to income taxes.

Advertising Costs

The Company follows the policy of charging the costs of advertising to expense as incurred. Advertising costs, included in other operating expenses, totaled \$45,000 and \$58,000 for years ended December 31, 2018 and 2017, respectively.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Income Taxes

Current income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities. Changes in tax rates and laws are recognized in the period in which they are enacted.

Deferred income tax expense (benefit) results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Company accounts for income taxes in accordance with current income tax accounting guidance for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

Uncertain tax positions are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment.

The Company recognizes interest and penalties on income taxes, if any, as a component of income tax expense. Tax years subject to examination by tax authorities are the years ended December 31, 2017, 2016 and 2015.

Earnings Per Share

Earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares outstanding during the year. The weighted average number of shares outstanding during 2018 and 2017 was 699,416 and 694,793, respectively. Basic and diluted earnings per share are the same as the Company has not issued any common stock equivalents.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Off-Balance-Sheet Financial Instruments

In the ordinary course of business, the Company has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the consolidated financial statements when they are funded or related fees are incurred or received.

Reclassifications

Certain amounts appearing in the prior years' consolidated financial statements may have been reclassified to conform with the current year's presentation. These reclassifications, if any, did not have any impact on stockholders' equity or net income.

Comprehensive Income

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

Recent accounting pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The amendments in this ASU created Topic 606, *Revenue from Contracts with Customers*, and supersede the revenue recognition requirements in Topic 605, *Revenue Recognition*, including most industry-specific revenue recognition guidance throughout the Industry Topics of the Codification. The core principle of Topic 606 is that an entity recognizes 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. For nonpublic companies, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 31, 2019. The Bank's largest source of revenues from customers, interest income, is specifically excluded from the scope of this ASU and all other sources of revenues are currently recognized in a manner consistent with this ASU. As a result, management does not believe this ASU will have a material impact on the consolidated financial statements.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (concluded)

Recent accounting pronouncements (concluded)

In February 2016, FASB issued ASU 2016-02, *Leases (Topic 842)*. This ASU requires companies that lease assets to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. For nonpublic companies, the amendments are effective for years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020, with early adoption permitted. Management is currently evaluating the impact to the consolidated financial statements of adopting this ASU; however, based on future minimum rent commitments at December 31, 2018, the impact would not be material to the consolidated financial statements.

In June 2016, FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. Among other things, these amendments require the measurement of all expected credit losses for certain financial assets, such as loans, held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This ASU, as amended, is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Management is currently evaluating the impact to the consolidated financial statements of adopting this ASU. Although no financial statement impacts have been calculated, the adoption of this ASU is expected to significantly change the approach management uses in calculating the allowance for loan losses.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU amends the disclosure requirements for fair value measurements to improve the effectiveness of the disclosure. The amendments remove and modify certain disclosure requirements. In 2018, the Bank early adopted this ASU which did not have a material impact on the consolidated financial statements.

2. CASH AND CASH EQUIVALENTS

The Company is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The required reserve at December 31, 2018 and 2017 was substantially satisfied by vault cash. The Company maintains cash deposits in other depository institutions that occasionally exceed the amount of deposit insurance available. Management periodically assesses the financial condition of these institutions and believes that the risk of any possible credit loss is minimal.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

3. INVESTMENT SECURITIES

The amortized cost and fair value of investment securities, with gross unrealized gains and losses, are as follows at December 31, 2018 and 2017:

	December 31, 2018			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
(In Thousands)				
Available for sale:				
U.S. treasuries	\$ 21,977	\$ 3	\$ -	\$ 21,980
Government-sponsored enterprise bonds	1,996	1	-	1,997
Government-sponsored mortgage-backed securities	66,957	6	(2,728)	64,235
State and local municipal	21,659	37	(1,064)	20,632
Total securities available for sale	<u>\$ 112,589</u>	<u>\$ 47</u>	<u>\$ (3,792)</u>	<u>\$ 108,844</u>
Held to maturity:				
State and local municipal	<u>\$ 6,282</u>	<u>\$ 24</u>	<u>\$ (251)</u>	<u>\$ 6,055</u>
December 31, 2017				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)				
Available for sale:				
U.S. treasuries	\$ 24,988	\$ 1	\$ -	\$ 24,989
Government-sponsored mortgage-backed securities	73,151	4	(1,816)	71,339
State and local municipal	26,529	208	(574)	26,163
Total securities available for sale	<u>\$ 124,668</u>	<u>\$ 213</u>	<u>\$ (2,390)</u>	<u>\$ 122,491</u>
Held to maturity:				
State and local municipal	<u>\$ 6,502</u>	<u>\$ 6</u>	<u>\$ (243)</u>	<u>\$ 6,265</u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

INVESTMENT SECURITIES (continued)

The following tables set forth the Company's investment in securities with unrealized losses of less than twelve months and unrealized losses of twelve months or more at December 31, 2018 and 2017:

	<u>Less Than Twelve Months</u>		<u>Over Twelve Months</u>		<u>Total</u>	
	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(In Thousands)					
December 31, 2018:						
Available-for-sale:						
Government-sponsored mortgage-backed securities	\$ (58)	\$ 2,928	\$ (2,670)	\$ 59,703	\$ (2,728)	\$ 62,631
State and local municipal	(44)	5,216	(1,020)	11,443	(1,064)	16,659
	<u>\$ (102)</u>	<u>\$ 8,144</u>	<u>\$ (3,690)</u>	<u>\$ 71,146</u>	<u>\$ (3,792)</u>	<u>\$ 79,290</u>
Held-to Maturity:						
State and local municipal	<u>\$ (5)</u>	<u>\$ 690</u>	<u>\$ (246)</u>	<u>\$ 4,222</u>	<u>\$ (251)</u>	<u>\$ 4,912</u>

	<u>Less Than Twelve Months</u>		<u>Over Twelve Months</u>		<u>Total</u>	
	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(In Thousands)					
December 31, 2017:						
Available-for-sale:						
Government-sponsored mortgage-backed securities	\$ (114)	\$ 10,743	\$ (1,702)	\$ 59,849	\$ (1,816)	\$ 70,592
State and local municipal	(15)	1,169	(559)	10,970	(574)	12,139
	<u>\$ (129)</u>	<u>\$ 11,912</u>	<u>\$ (2,261)</u>	<u>\$ 70,819</u>	<u>\$ (2,390)</u>	<u>\$ 82,731</u>
Held-to Maturity:						
State and local municipal	<u>\$ (114)</u>	<u>\$ 1,044</u>	<u>\$ (129)</u>	<u>\$ 4,418</u>	<u>\$ (243)</u>	<u>\$ 5,462</u>

The total number of securities with an unrealized loss of 12 months or more was 73 at December 31, 2018. The total number of securities with an unrealized loss of less than 12 months was 17 at December 31, 2018. At December 31, 2018 and 2017, unrealized depreciation as a percent of amortized cost amounted to 4.6% and 2.9%, respectively.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

INVESTMENT SECURITIES (concluded)

Unrealized losses on these securities have not been recognized into earnings because the issuers of the securities are of high credit quality, management has the ability and intent to hold these securities for the foreseeable future and does not believe they will have to sell the securities or be required to sell the securities, and the declines in fair value are principally due to market interest rates and not a result of credit risk. The fair values of these securities are expected to recover as they approach maturity and/or market interest rates fluctuate.

The amortized cost and fair value of debt securities at December 31, 2018, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or repay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Within 1 year	\$ 24,338	\$ 24,342	\$ 745	\$ 744
Over 1 year through 5 years	628	620	621	613
Over 5 years through 10 years	4,484	4,506	2,224	2,198
Over 10 years	16,182	15,141	2,692	2,500
Mortgage-backed securities	66,957	64,235	-	-
	\$ 112,589	\$ 108,844	\$ 6,282	\$ 6,055

Debt securities with a carrying value of \$91,412,000 and \$107,102,000 were pledged to secure public deposits at December 31, 2018 and 2017, respectively. Proceeds from sales of securities available for sale during 2018 and 2017 were \$4,217,000 and \$40,692,000, respectively. Gross realized gains on securities available for sale that were sold during 2018 and 2017 totaled \$17,000 and \$216,000, respectively. Gross realized losses on securities available for sale that were sold during 2018 and 2017 totaled \$5,000 and \$103,000, respectively.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

4. LOANS

Loans consist of the following at December 31, 2018 and 2017:

	December 31,	
	2018	2017
	(In Thousands)	
Commercial loans:		
Commercial	\$ 42,990	\$ 47,567
Commercial real estate	243,988	213,616
Consumer loans:		
Residential mortgage	7,053	4,894
Installment	2,111	3,283
Home equity	5,895	7,083
Other consumer	156	88
	<u>302,193</u>	<u>276,531</u>
Allowance for loan losses	(2,785)	(3,165)
Net deferred loan costs	<u>703</u>	<u>658</u>
	<u><u>\$ 300,111</u></u>	<u><u>\$ 274,024</u></u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (continued)

The following tables present the classes of the loan portfolio summarized by credit rating within the Company's internal risk rating system as of December 31, 2018 and 2017:

	Pass	Special Mention	Substandard	Doubtful	Total
<u>December 31, 2018</u>			(In Thousands)		
Commercial	\$ 41,508	\$ 247	\$ 1,235	\$ -	\$ 42,990
Commercial real estate	236,692	593	6,703	-	243,988
Residential mortgage	6,715	-	338	-	7,053
Installment	2,111	-	-	-	2,111
Home equity	5,895	-	-	-	5,895
Other consumer	156	-	-	-	156
	<u>\$ 293,077</u>	<u>\$ 840</u>	<u>\$ 8,276</u>	<u>\$ -</u>	<u>\$ 302,193</u>
	Pass	Special Mention	Substandard	Doubtful	Total
<u>December 31, 2017</u>			(In Thousands)		
Commercial	\$ 45,715	\$ 460	\$ 1,392	\$ -	\$ 47,567
Commercial real estate	204,909	3,276	5,431	-	213,616
Residential mortgage	4,063	466	365	-	4,894
Installment	3,276	-	7	-	3,283
Home equity	7,083	-	-	-	7,083
Other consumer	88	-	-	-	88
	<u>\$ 265,134</u>	<u>\$ 4,202</u>	<u>\$ 7,195</u>	<u>\$ -</u>	<u>\$ 276,531</u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (continued)

The following tables summarize information in regards to impaired loans by loan portfolio class as of December 31, 2018 and 2017:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u> (In Thousands)	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<u>December 31, 2018</u>					
With no related allowance recorded:					
Commercial	\$ 6	\$ 6	\$ -		
Commercial real estate	3,083	3,083	-		
Residential mortgage	-	-	-		
Installment	-	-	-		
Home equity	261	261	-		
Other consumer	-	-	-		
With an allowance recorded:					
Commercial	\$ 799	\$ 799	\$ 600		
Commercial real estate	401	401	50		
Residential mortgage	-	-	-		
Installment	-	-	-		
Home equity	-	-	-		
Other consumer	-	-	-		
Total:					
Commercial	\$ 805	\$ 805	\$ 600	\$ 318	\$ 32
Commercial real estate	3,484	3,484	50	3,433	203
Residential mortgage	-	-	-	-	-
Installment	-	-	-	3	-
Home equity	261	261	-	267	9
Other consumer	-	-	-	-	-

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (continued)

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>December 31, 2017</u>			(In Thousands)		
With no related allowance recorded:					
Commercial	\$ 7	\$ 7	\$ -		
Commercial real estate	3,547	3,547	-		
Residential mortgage	-	-	-		
Installment	7	7	-		
Home equity	218	218	-		
Other consumer	-	-	-		
With an allowance recorded:					
Commercial	\$ 800	\$ 800	\$ 300		
Commercial real estate	203	203	60		
Residential mortgage	-	-	-		
Installment	-	-	-		
Home equity	-	-	-		
Other consumer	-	-	-		
Total:					
Commercial	\$ 807	\$ 807	\$ 300	\$ 670	\$ 48
Commercial real estate	3,750	3,750	60	3,887	192
Residential mortgage	-	-	-	-	-
Installment	7	7	-	8	-
Home equity	218	218	-	287	15
Other consumer	-	-	-	-	-

The following table presents nonaccrual loans by classes of the loan portfolio as of December 31, 2018 and 2017:

	2018	2017
	(In Thousands)	
Commercial	\$ 6	\$ 6
Commercial real estate	207	586
Residential mortgage	114	68
Installment	-	7
Home equity	-	-
Other consumer	-	-
	\$ 327	\$ 667

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (continued)

The performance and credit quality of the loan portfolio is also monitored by the analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following tables present the classes of the loan portfolio summarized by the past due status as of December 31, 2018 and 2017:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due (In Thousands)	Current	Total Loans Receivables	Loans Receivable > 90 Days Past Due and Accruing
<u>December 31, 2018</u>							
Commercial	\$ 4	\$ -	\$ 6	\$ 10	\$ 42,980	\$ 42,990	\$ -
Commercial real estate	-	-	608	608	243,380	243,988	401
Residential mortgage	406	317	127	850	6,203	7,053	13
Installment	21	1	-	22	2,089	2,111	-
Home equity	-	-	-	-	5,895	5,895	-
Other consumer	-	-	-	-	156	156	-
	<u>\$ 431</u>	<u>\$ 318</u>	<u>\$ 741</u>	<u>\$ 1,490</u>	<u>\$ 300,703</u>	<u>\$ 302,193</u>	<u>\$ 414</u>
<u>December 31, 2017</u>							
Commercial	\$ -	\$ 39	\$ 6	\$ 45	\$ 47,522	\$ 47,567	\$ -
Commercial real estate	1,941	-	1,026	2,967	210,649	213,616	440
Residential mortgage	-	-	133	133	4,761	4,894	65
Installment	30	-	7	37	3,246	3,283	-
Home equity	-	-	-	-	7,083	7,083	-
Other consumer	-	-	-	-	88	88	-
	<u>\$ 1,971</u>	<u>\$ 39</u>	<u>\$ 1,172</u>	<u>\$ 3,182</u>	<u>\$ 273,349</u>	<u>\$ 276,531</u>	<u>\$ 505</u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (continued)

The following tables summarize the activity in the allowance for loan losses by loan class for the years ended December 31, 2018 and 2017 and information in regards to the allowance for loan losses and the recorded investment in loans receivable by loan class as of December 31, 2018 and 2017:

	Allowance for Loan Losses				Ending Balance	Ending Balance Impaired Loans	Ending Balance Non-impaired Loans
	Beginning Balance	Charge Offs	Recoveries	Provisions (In Thousands)			
<u>December 31, 2018</u>							
Commercial	\$ 854	\$ (40)	\$ 33	\$ 10	\$ 857	\$ 600	\$ 257
Commercial real estate	1,659	(350)	1	58	1,368	50	1,318
Residential mortgage	17	(2)	-	10	25	-	25
Installment	34	(17)	2	12	31	-	31
Home equity	39	-	-	(8)	31	-	31
Other consumer	1	(7)	-	12	6	-	6
Unallocated	561	-	-	(94)	467	-	467
	<u>\$ 3,165</u>	<u>\$ (416)</u>	<u>\$ 36</u>	<u>\$ -</u>	<u>\$ 2,785</u>	<u>\$ 650</u>	<u>\$ 2,135</u>

	Loans Receivable		
	Ending Balance	Ending Balance Impaired Loans	Ending Balance Non-impaired Loans
<u>December 31, 2018</u>			
Commercial	\$ 42,990	\$ 805	\$ 42,185
Commercial real estate	243,988	3,484	240,504
Residential mortgage	7,053	-	7,053
Installment	2,111	-	2,111
Home equity	5,895	261	5,634
Other consumer	156	-	156
	<u>\$ 302,193</u>	<u>\$ 4,550</u>	<u>\$ 297,643</u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (continued)

	Allowance for Loan Losses				Ending Balance	Ending Balance Impaired Loans	Ending Balance Non-impaired Loans
	Beginning Balance	Charge Offs	Recoveries	Provisions (In Thousands)			
<u>December 31, 2017</u>							
Commercial	\$ 1,682	\$ (278)	\$ 56	\$ (606)	\$ 854	\$ 300	\$ 554
Commercial real estate	1,370	(222)	24	487	1,659	60	1,599
Residential mortgage	6	(17)	-	28	17	-	17
Installment	56	(33)	2	9	34	-	34
Home equity	18	-	-	21	39	-	39
Other consumer	1	(5)	-	5	1	-	1
Unallocated	250	-	-	311	561	-	561
	<u>\$ 3,383</u>	<u>\$ (555)</u>	<u>\$ 82</u>	<u>\$ 255</u>	<u>\$ 3,165</u>	<u>\$ 360</u>	<u>\$ 2,805</u>

	Loans Receivable		
	Ending Balance	Ending Balance Impaired Loans	Ending Balance Non-impaired Loans
<u>December 31, 2017</u>		(In Thousands)	
Commercial	\$ 47,567	\$ 807	\$ 46,760
Commercial real estate	213,616	3,750	209,866
Residential mortgage	4,894	-	4,894
Installment	3,283	7	3,276
Home equity	7,083	218	6,865
Other	88	-	88
	<u>\$ 276,531</u>	<u>\$ 4,782</u>	<u>\$ 271,749</u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

LOANS (concluded)

The Company identifies loans for potential restructure primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future.

The following table shows loans whose terms have been modified under TDRs during the year ended December 31, 2018. There were no loans modified under TDRs during the year ended December 31, 2017.

	<u>Number of Contacts</u>	<u>Pre- Modification Outstanding Recorded Investments</u>	<u>Post- Modification Outstanding Recorded Investments</u>
<u>December 31, 2018</u>		(Dollars in Thousands)	
Commercial real estate	1	\$ 439	\$ 465

The loan modified in 2018 included capitalization of past due amounts and was given a deferment of principal payments for 12 months.

There were no defaults during the years ended December 31, 2018 and 2017 for TDRs that defaulted within 12 months of the restructuring.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

5. PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31, 2018 and 2017:

	December 31,	
	2018	2017
	(In Thousands)	
Building	\$ 1,171	\$ 1,269
Data processing equipment	2,663	2,457
Office and other equipment	2,041	1,669
Leasehold improvements	1,602	1,424
Land	2,432	168
	9,909	6,987
Accumulated depreciation and amortization	(4,773)	(4,144)
	\$ 5,136	\$ 2,843

Depreciation expense for the years ended December 31, 2018 and 2017 amounted to \$847,000 and \$761,000, respectively.

At December 31, 2018, the Company leased branch facilities and its corporate office under noncancelable operating leases. Future minimum rental payments under these leases are as follows:

Year Ending December 31,	
(In Thousands)	
2019	\$ 1,048
2020	906
2021	593
2022	439
2023	264
Thereafter	246
	\$ 3,496

The leases contain options to extend for periods of three to five years, the cost of which is not included above. Rent expense under the operating leases totaled \$868,000 in 2018 and \$689,000 in 2017.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

6. DEPOSITS

Time deposits in denominations of \$250,000 and over were \$21,720,000 and \$22,566,000 at December 31, 2018 and 2017, respectively.

The aggregate amount of demand deposits overdrafts that were reclassified as loans were \$108,000 and \$33,000 as of December 31, 2018 and 2017, respectively.

At December 31, 2018, scheduled maturities of time deposits are as follows:

Year Ending December 31, <u>(In Thousands)</u>	
2019	\$ 76,390
2020	20,955
2021	10,004
2022	2,928
2023	<u>722</u>
	<u>\$ 110,999</u>

7. BORROWINGS

The Bank has arranged for a \$3,500,000 overnight line of credit with a correspondent bank. The line bears interest at the federal funds rate in effect at the time of the borrowing plus .375%. The terms of the line, which is generally unsecured, require the Bank to identify and segregate in a separate account specific securities pledged as collateral for any amounts borrowed over \$1,500,000. The collateral must consist of securities with a market value of at least 125%, marked to market on a daily basis, of borrowings in excess of the unsecured limit. There were no borrowings on the line at December 31, 2018 and 2017.

The Bank has arranged for four unsecured federal funds overnight lines of credit with four correspondent banks. The lines bear interest at the federal funds rate. The maximum available credit is \$5,000,000 for two of the lines, \$3,000,000 on another line and one line has a maximum available credit of \$6,000,000. There were no borrowings on any of the lines at December 31, 2018 and 2017.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

BORROWINGS (concluded)

The Company has a borrowing agreement with the FHLB of New York with an available funding capacity for overnight advances of approximately \$231,991,000 as of December 31, 2018. This limit is further restricted by the Company's ability to provide eligible collateral to support its obligations to the FHLB as well as the ability to meet the FHLB's stock purchase requirement. Advances from the FHLB are collateralized by a blanket lien against the Company's qualifying assets with variable interest rates according to the current rate of the Overnight Advance Program of the FHLB.

8. SUBORDINATED DEBENTURES

The Company issued \$11,000,000 in subordinated debentures on October 28, 2016. The debentures bear interest at a fixed rate of 7.25%. Interest is payable quarterly. The debentures mature on October 28, 2026. The debentures may be redeemed in whole or in part on or after October 28, 2021 at 100% of the principal amount plus accrued interest. At December 31, 2018, the amount of the subordinated debentures, net of amortized acquisition costs totaling \$178,000, is \$10,822,000.

9. JUNIOR SUBORDINATED DEBENTURES

The Company issued \$3,299,000 in junior subordinated debentures on October 13, 2006 that are due December 15, 2036, to Trust I. The Company owns all of the \$99,000 in common equity of the trust and the debentures are the sole asset of the trust. The trust issued \$3,200,000 of floating-rate trust capital securities in a non-public offering. The floating-rate capital securities provide for quarterly distributions at a variable coupon rate, reset quarterly, based on three-month LIBOR plus 1.75%. The interest rate was 4.54% and 3.34% at December 31, 2018 and 2017, respectively. The securities are callable by the Company, subject to regulatory approval, at par. The Company unconditionally guarantees the trust capital securities. The terms of the junior subordinated debentures and the common equity of the trust mirror the terms of the trust capital securities issued by the trust. The Company used the net proceeds from this offering to fund an additional \$3,200,000 capital investment in the Bank to fund its operations and future growth.

The accounts of Trust I are not included in the consolidated financial statements of the Company. However, for regulatory purposes, the trust capital securities qualify as Tier I capital of the Company subject to a 25% of capital limitation under risk-based capital guidelines. The portion that exceeds the 25% of capital limitation qualifies as Tier II capital. At December 31, 2018 and 2017, all of the Company's trust capital securities qualified as Tier I capital.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

10. STOCKHOLDERS' EQUITY

Common stock of the Company is as follows at December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Authorized shares, \$1.00 par value	1,000,000	1,000,000
Issued shares	708,750	707,500
Outstanding shares	700,334	699,084

11. RETIREMENT PLANS

The Bank has a 401(k) defined contribution retirement plan covering substantially all of its employees as they become eligible. Employer matching contributions to the plan are allowed under the plan. Matching contributions totaled \$111,000 and \$80,000 for 2018 and 2017, respectively. Additional contributions to the plan are permitted based on management's discretion.

12. INCOME TAXES

Income tax expense (benefit) in the consolidated statements of net income are comprised of:

	<u>2018</u>	<u>2017</u>
	(In Thousands)	
Current	\$ (259)	\$ 583
Deferred	584	351
	<u>\$ 325</u>	<u>\$ 934</u>

The provision for income taxes differs from that computed by applying statutory rates to income before income taxes primarily due to the effects of tax-exempt income and state taxes.

On December 22, 2017, the federal income tax rate changed from 34 percent to 21 percent for tax years beginning on or after January 1, 2018 as a result of the Tax Cuts and Jobs Act. Included in deferred income tax expense for 2017 is \$293,000 related to the write-down of net deferred tax assets from the historic 34 percent to the newly enacted 21 percent tax rate on December 22, 2017.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

INCOME TAXES (concluded)

Deferred income tax assets and liabilities, included in accrued interest receivable and other assets in the consolidated statements of condition, resulting from temporary differences are summarized as follows:

	<u>2018</u>	<u>2017</u>
	(In Thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 46	\$ 66
Non-accrual interest	15	-
Federal alternative minimum tax credit	261	821
Core deposit premium	7	5
Available for sale securities	787	457
Total deferred tax asset	<u>1,116</u>	<u>1,349</u>
Deferred tax liabilities:		
Premises and equipment	(18)	(7)
Deferred loan costs	(148)	(138)
Total deferred tax liabilities	<u>(166)</u>	<u>(145)</u>
Net deferred tax asset	<u>\$ 950</u>	<u>\$ 1,204</u>

A valuation allowance is required against deferred tax assets if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. The full realization of the tax benefits associated with the carryforwards depends predominately upon the recognition of ordinary income during the carryforward period. Management has concluded that no valuation allowance for deferred tax assets was required at December 31, 2018 and 2017.

The Company did not have any uncertain tax positions at December 31, 2018 and 2017.

13. RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Bank has and expects to continue to have transactions, including loans and deposit accounts with the Company's and the Bank's executive officers and directors, and their affiliates. The aggregate amount of loans to such related parties at December 31, 2018 and 2017 was \$5,718,000 and \$6,752,000, respectively. During 2018, there were \$745,000 in new loans to such related parties, additional advances on existing loans were \$1,982,000, and repayments amounted to \$3,761,000. During 2017, there were \$228,000 in new loans to such related parties, additional advances on existing loans were \$2,425,000, and repayments amounted to \$2,368,000.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

RELATED PARTY TRANSACTIONS (concluded)

The Bank held deposits of \$10,386,000 and \$9,212,000 for related parties at December 31, 2018 and 2017, respectively.

14. OTHER COMMITMENTS AND CONTINGENCIES

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the statements of financial condition. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments summarized as follows at December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
	(In Thousands)	
Commitments to extended credit:		
Commitments to grant loans	\$ 14,259	\$ 20,049
Unfunded commitments under commercial lines of credit	43,221	43,663
Unfunded commitments under consumer lines of credit	3,355	4,104
Standby letters of credit	3,291	1,893

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Bank upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

Standby letters of credit are conditional lending commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Generally, letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

OTHER COMMITMENTS AND CONTINGENCIES (concluded)

to extend credit. The Bank generally holds collateral supporting those commitments. The amount of the liability related to guarantees under standby letters of credit was not material at December 31, 2018 and 2017.

The terms of the Subordinated Debentures discussed in Note 8 and the Junior Subordinated Debentures discussed in Note 9 contain certain covenants. Management believes the Company has complied with all covenants during 2018 and 2017.

Various legal claims also arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

15. CONCENTRATIONS OF CREDIT

Most of the Bank's business activity is with customers in the Bank's market area. The majority of those customers are depositors of the Bank. Investments in state and local government securities also involve governmental entities within the Bank's market area. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit is set forth in Note 14. The Bank, as matter of policy, does not extend credit to any single borrower, or group of related borrowers in excess of its legal lending limit.

16. REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The Bank is subject to legal limitations on the amount of dividends that can be paid to the Company. With the exception of the restrictions described above, at December 31, 2018, approximately \$4,340,000 was available for the declaration of dividends. For all practical purposes, the Company could not declare dividends in excess of this amount.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

REGULATORY MATTERS (concluded)

Federal banking regulations require minimum ratios of total capital, common equity Tier 1 capital, Tier 1 capital to risk-weighted assets and a minimum leverage ratio for all banking organizations, as set forth in the following table. Additionally, community banking institutions must maintain a capital conservation buffer in an amount greater than 2.5% of total risk-weighted assets to avoid being subject to limitations on capital distributions and discretionary bonuses. The capital conservation buffer and certain deductions from and adjustments to regulatory capital and risk-weighted assets are being phased in over several years. The required minimum conservation buffer is 1.875% as of December 31, 2018 and will increase to 2.5% on January 1, 2019. Management believes that the Bank's capital levels will exceed the capital conservation buffer when fully phased in.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized an institution must maintain capital ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. Management believes, as of December 31, 2018 and 2017, that the Bank met all capital adequacy requirements to which they are subject. In addition, the Bank exceeds the required 1.875% capital conservation buffer at December 31, 2018. The Bank's actual capital amounts and ratios as of December 31, 2018 and 2017 are also presented in the following table:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in Thousands)						
<u>December 31, 2018</u>						
Total capital (to risk weighted assets)	\$ 39,498	11.86%	\$ 26,650	8.00%	\$ 33,312	10.00%
Tier 1 capital (to risk weighted assets)	36,712	11.02	19,987	6.00	26,650	8.00
Common equity Tier 1 capital (to risk weighted assets)	36,712	11.02	14,990	4.50	21,653	6.50
Tier 1 capital (to average assets)	36,712	7.76	18,925	4.00	23,657	5.00
<u>December 31, 2017</u>						
Total capital (to risk weighted assets)	\$ 38,088	12.48%	\$ 24,415	8.00%	\$ 30,519	10.00%
Tier 1 capital (to risk weighted assets)	34,923	11.45	18,300	6.00	24,401	8.00
Common equity Tier 1 capital (to risk weighted assets)	34,923	11.45	13,725	4.50	19,825	6.50
Tier 1 capital (to average assets)	34,923	7.61	18,356	4.00	22,945	5.00

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

17. FAIR VALUE MEASUREMENTS

Determination of fair values

The Bank uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Bank's various assets and liabilities. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including discount rates and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the asset or liability.

The following methods were used by the Company in estimating the fair value of assets measured at fair value:

Securities available for sale: All fair value measurements are obtained from a third-party pricing service and are not adjusted by management. Securities measured at fair value in Level 2 are based on pricing models that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data.

Impaired loans: Fair value is based upon independent third-party appraisals of the properties.

Assets measured at fair value on a recurring basis

Assets measured at fair value on a recurring basis at December 31, 2018 and 2017 are summarized below:

	December 31, 2018			Total
	Level 1	Level 2	Level 3	Fair Value
	(In Thousands)			
Securities available for sale	<u>\$ -</u>	<u>\$ 108,844</u>	<u>\$ -</u>	<u>\$ 108,844</u>

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Continued)

FAIR VALUE MEASUREMENTS (concluded)

Assets measured at fair value on a recurring basis (concluded)

	December 31, 2017			
	Level 1	Level 2	Level 3	Total Fair Value
	(In Thousands)			
Securities available for sale	\$ -	\$ 122,491	\$ -	\$ 122,491

There were no liabilities measured at fair value on a recurring basis at December 31, 2018 or 2017.

Assets measured at fair value on a non-recurring basis

The Bank may also be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets. The following tables summarize the fair value hierarchy used to determine each adjustment and the carrying value of the related assets as of December 31, 2018 and 2017.

	December 31, 2018				Year Ended December 31, 2018
	Level 1	Level 2	Level 3	Total Fair Value	Total Losses
	(In Thousands)				
Impaired loans	\$ -	\$ -	\$ 550	\$ 550	\$ 350

	December 31, 2017				Year Ended December 31, 2017
	Level 1	Level 2	Level 3	Total Fair Value	Total Losses
	(In Thousands)				
Impaired loans	\$ -	\$ -	\$ 1,267	\$ 1,267	\$ 300

There were no liabilities measured at fair value on a non-recurring basis at December 31, 2018 and 2017.

Catskill Hudson Bancorp, Inc.

Notes to Consolidated Financial Statements (Concluded)

18. SUBSEQUENT EVENTS

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2018 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through May 7, 2019, which is the date these financial statements were available to be issued.