

FIRST BUSINESS FINANCIAL SERVICES, INC.

Form 10-Q

April 27, 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 March 31, 2018

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 001-34095

FIRST BUSINESS FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Wisconsin

39-1576570

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

401 Charmany Drive, Madison, WI 53719

(Address of Principal Executive Offices) (Zip Code)

(608) 238-8008

Registrant's telephone number, including area code

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

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

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

| | | | | |
|--|---|--|--|--|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> | Non-accelerated filer <input type="checkbox"/> | Smaller reporting company <input type="checkbox"/> | Emerging growth company <input type="checkbox"/> |
|--|---|--|--|--|

(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the registrant's sole class of common stock, par value \$0.01 per share, on April 26, 2018 was 8,764,420 shares.

Table of Contents

FIRST BUSINESS FINANCIAL SERVICES, INC.
INDEX — FORM 10-Q

| | |
|--|-----------|
| <u>PART I. Financial Information</u> | <u>1</u> |
| <u>Item 1. Financial Statements</u> | <u>1</u> |
| <u>Consolidated Balance Sheets (Unaudited)</u> | <u>1</u> |
| <u>Consolidated Statements of Income (Unaudited)</u> | <u>2</u> |
| <u>Consolidated Statements of Comprehensive Income (Unaudited)</u> | <u>3</u> |
| <u>Consolidated Statements of Changes in Stockholders' Equity (Unaudited)</u> | <u>4</u> |
| <u>Consolidated Statements of Cash Flows (Unaudited)</u> | <u>5</u> |
| <u>Notes to Unaudited Consolidated Financial Statements</u> | <u>6</u> |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>37</u> |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | <u>54</u> |
| <u>Item 4. Controls and Procedures</u> | <u>55</u> |
| <u>PART II. Other Information</u> | <u>55</u> |
| <u>Item 1. Legal Proceedings</u> | <u>55</u> |
| <u>Item 1A. Risk Factors</u> | <u>55</u> |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | <u>55</u> |
| <u>Item 3. Defaults Upon Senior Securities</u> | <u>55</u> |
| <u>Item 4. Mine Safety Disclosures</u> | <u>55</u> |
| <u>Item 5. Other Information</u> | <u>56</u> |
| <u>Item 6. Exhibits</u> | <u>56</u> |
| <u>Signatures</u> | <u>57</u> |

Table of Contents

PART I. Financial Information

Item 1. Financial Statements

First Business Financial Services, Inc.

Consolidated Balance Sheets

| | March 31, 2018 | December 31, 2017 |
|---|--------------------------------------|----------------------|
| | (Unaudited) | |
| | (In Thousands, Except Share Data) | |
| Assets | | |
| Cash and due from banks | \$22,232 | \$ 17,059 |
| Short-term investments | 39,090 | 35,480 |
| Cash and cash equivalents | 61,322 | 52,539 |
| Securities available-for-sale, at fair value | 127,961 | 126,005 |
| Securities held-to-maturity, at amortized cost | 41,885 | 37,778 |
| Loans held for sale | 3,429 | 2,194 |
| Loans and leases receivable, net of allowance for loan and lease losses of \$18,638 and \$18,763, respectively | 1,544,852 | 1,482,832 |
| Premises and equipment, net | 3,247 | 3,156 |
| Foreclosed properties | 1,484 | 1,069 |
| Bank-owned life insurance | 40,614 | 40,323 |
| Federal Home Loan Bank stock, at cost | 8,650 | 5,670 |
| Goodwill and other intangible assets | 12,579 | 12,652 |
| Accrued interest receivable and other assets | 32,194 | 29,848 |
| Total assets | \$1,878,217 | \$ 1,794,066 |
| Liabilities and Stockholders' Equity | | |
| Deposits | \$1,371,158 | \$ 1,394,331 |
| Federal Home Loan Bank advances and other borrowings | 308,912 | 207,898 |
| Junior subordinated notes | 10,022 | 10,019 |
| Accrued interest payable and other liabilities | 16,645 | 12,540 |
| Total liabilities | 1,706,737 | 1,624,788 |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 2,500,000 shares authorized, none issued or outstanding | — | — |
| Common stock, \$0.01 par value, 25,000,000 shares authorized, 9,023,040 and 9,021,985 shares issued, 8,764,420 and 8,763,539 shares outstanding at March 31, 2018 and December 31, 2017, respectively | 90 | 90 |
| Additional paid-in capital | 78,906 | 78,620 |
| Retained earnings | 101,329 | 98,906 |
| Accumulated other comprehensive loss | (1,741 |) (1,238) |
| Treasury stock, 258,620 and 258,446 shares at March 31, 2018 and December 31, 2017, respectively, at cost | (7,104 |) (7,100) |
| Total stockholders' equity | 171,480 | 169,278 |
| Total liabilities and stockholders' equity | \$1,878,217 | \$ 1,794,066 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

First Business Financial Services, Inc.

Consolidated Statements of Income (Unaudited)

For the Three
Months Ended
March 31,
2018 2017
(In Thousands,
Except Per Share
Data)

| | | |
|---|----------|----------|
| Interest income | | |
| Loans and leases | \$19,661 | \$17,522 |
| Securities | 856 | 779 |
| Short-term investments | 205 | 146 |
| Total interest income | 20,722 | 18,447 |
| Interest expense | | |
| Deposits | 2,830 | 2,673 |
| Federal Home Loan Bank advances and other borrowings | 1,416 | 612 |
| Junior subordinated notes | 274 | 274 |
| Total interest expense | 4,520 | 3,559 |
| Net interest income | 16,202 | 14,888 |
| Provision for loan and lease losses | 2,476 | 572 |
| Net interest income after provision for loan and lease losses | 13,726 | 14,316 |
| Non-interest income | | |
| Trust and investment service fees | 1,898 | 1,629 |
| Gain on sale of Small Business Administration loans | 269 | 360 |
| Service charges on deposits | 784 | 765 |
| Loan fees | 527 | 458 |
| Increase in cash surrender value of bank-owned life insurance | 292 | 311 |
| Commercial loan swap fees | 633 | 199 |
| Other non-interest income | 264 | 341 |
| Total non-interest income | 4,667 | 4,063 |
| Non-interest expense | | |
| Compensation | 9,071 | 8,683 |
| Occupancy | 529 | 475 |
| Professional fees | 1,035 | 1,010 |
| Data processing | 611 | 584 |
| Marketing | 333 | 370 |
| Equipment | 343 | 283 |
| Computer software | 742 | 683 |
| FDIC insurance | 299 | 380 |
| Collateral liquidation costs | 1 | 92 |
| Impairment of tax credit investments | 113 | 113 |
| SBA recourse (benefit) provision | (295) |) 6 |
| Other non-interest expense | 1,125 | 881 |
| Total non-interest expense | 13,907 | 13,560 |
| Income before income tax expense | 4,486 | 4,819 |
| Income tax expense | 837 | 1,422 |
| Net income | \$3,649 | \$3,397 |
| Earnings per common share | | |

| | | |
|------------------------------|--------|--------|
| Basic | \$0.42 | \$0.39 |
| Diluted | 0.42 | 0.39 |
| Dividends declared per share | 0.14 | 0.13 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

2

Table of ContentsFirst Business Financial Services, Inc.
Consolidated Statements of Comprehensive Income (Unaudited)

| | For the Three Months Ended March 31, 2018 2017 (In Thousands) | |
|---|--|---------|
| Net income | \$3,649 | \$3,397 |
| Other comprehensive loss, before tax | | |
| Securities available-for-sale: | | |
| Unrealized securities losses arising during the period | (1,359) | (83) |
| Securities held-to-maturity: | | |
| Amortization of net unrealized losses transferred from available-for-sale | 19 | 26 |
| Interest rate swaps: | | |
| Unrealized gains on interest rate swaps arising during the period | 672 | — |
| Income tax benefit | 165 | 3 |
| Total other comprehensive loss | (503) | (54) |
| Comprehensive income | \$3,146 | \$3,343 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

First Business Financial Services, Inc.

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

| | Common Shares Outstanding | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total |
|---|-----------------------------------|-----------------|----------------------------------|----------------------|---|-------------------|-----------|
| | (In Thousands, Except Share Data) | | | | | | |
| Balance at December 31, 2016 | 8,715,856 | \$ 90 | \$ 77,542 | \$91,317 | \$ (522) | \$(6,777) | \$161,650 |
| Net income | — | — | — | 3,397 | — | — | 3,397 |
| Other comprehensive loss | — | — | — | — | (54) | — | (54) |
| Share-based compensation - restricted shares, net | 2,550 | — | 276 | — | — | — | 276 |
| Cash dividends (\$0.13 per share) | — | — | — | (1,133) | — | — | (1,133) |
| Treasury stock purchased | (99) | — | — | — | — | (2) | (2) |
| Balance at March 31, 2017 | 8,718,307 | \$ 90 | \$ 77,818 | \$93,581 | \$ (576) | \$(6,779) | \$164,134 |

| | Common Shares Outstanding | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total |
|---|-----------------------------------|-----------------|----------------------------------|----------------------|---|-------------------|-----------|
| | (In Thousands, Except Share Data) | | | | | | |
| Balance at December 31, 2017 | 8,763,539 | \$ 90 | \$ 78,620 | \$98,906 | \$ (1,238) | \$(7,100) | \$169,278 |
| Net income | — | — | — | 3,649 | — | — | 3,649 |
| Other comprehensive loss | — | — | — | — | (503) | — | (503) |
| Share-based compensation - restricted shares, net | 1,055 | — | 286 | — | — | — | 286 |
| Cash dividends (\$0.14 per share) | — | — | — | (1,226) | — | — | (1,226) |
| Treasury stock purchased | (174) | — | — | — | — | (4) | (4) |
| Balance at March 31, 2018 | 8,764,420 | \$ 90 | \$ 78,906 | \$101,329 | \$ (1,741) | \$(7,104) | \$171,480 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

First Business Financial Services, Inc.

Consolidated Statements of Cash Flows (Unaudited)

| | For the Three Months Ended March 31, 2018 2017 (In Thousands) | |
|---|--|-----------|
| Operating activities | | |
| Net income | \$3,649 | \$3,397 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Deferred income taxes, net | (3,903) | (75) |
| Impairment of tax credit investments | 113 | 113 |
| Provision for loan and lease losses | 2,476 | 572 |
| Depreciation, amortization and accretion, net | 362 | 384 |
| Share-based compensation | 286 | 276 |
| Increase in value of bank-owned life insurance policies | (292) | (311) |
| Origination of loans for sale | (24,035) | (17,123) |
| Sale of loans originated for sale | 23,069 | 14,681 |
| Gain on sale of loans originated for sale | (269) | (371) |
| Excess tax benefit from share-based compensation | (5) | (7) |
| Returns on investments in limited partnerships | — | 92 |
| Net decrease (increase) in accrued interest receivable and other assets | 2,522 | (159) |
| Net increase in accrued interest payable and other liabilities | 4,579 | 1,379 |
| Net cash provided by operating activities | 8,552 | 2,848 |
| Investing activities | | |
| Proceeds from maturities, redemptions and paydowns of available-for-sale securities | 7,179 | 9,434 |
| Proceeds from maturities, redemptions and paydowns of held-to-maturity securities | 755 | 730 |
| Purchases of available-for-sale securities | (10,584) | (10,902) |
| Purchases of held-to-maturity securities | (4,875) | (615) |
| Net increase in loans and leases | (64,892) | (30,021) |
| Investment in historic development entities | (689) | — |
| Investment in Federal Home Loan Bank stock | (4,798) | (3,495) |
| Proceeds from the sale of Federal Home Loan Bank stock | 1,818 | 844 |
| Purchases of leasehold improvements and equipment, net | (297) | (363) |
| Net cash used in investing activities | (76,383) | (34,388) |
| Financing activities | | |
| Net decrease in deposits | (23,173) | (46,133) |
| Repayment of Federal Home Loan Bank advances | (237,000) | (115,916) |
| Proceeds from Federal Home Loan Bank advances | 309,000 | 178,416 |
| Net increase in Federal Home Loan Bank line of credit | 29,000 | — |
| Net increase (decrease) in other borrowed funds | 17 | (310) |
| Cash dividends paid | (1,226) | (1,133) |
| Purchase of treasury stock | (4) | (2) |
| Net cash provided by financing activities | 76,614 | 14,922 |
| Net increase (decrease) in cash and cash equivalents | 8,783 | (16,618) |
| Cash and cash equivalents at the beginning of the period | 52,539 | 77,517 |
| Cash and cash equivalents at the end of the period | \$61,322 | \$60,899 |
| Supplementary cash flow information | | |

| | | |
|--|---------|---------|
| Cash paid during the period for: | | |
| Interest paid on deposits and borrowings | \$4,159 | \$3,386 |
| Income taxes paid | 19 | (314) |
| Non-cash investing and financing activities: | | |
| Transfer of loans from held-to-maturity to held-for-sale | — | 2,040 |
| Transfer from loans to foreclosed properties | 415 | — |

See accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents

Notes to Unaudited Consolidated Financial Statements

Note 1 — Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. The accounting and reporting practices of First Business Financial Services, Inc. (the “Corporation”), through our wholly-owned subsidiary, First Business Bank (“FBB” or the “Bank”), has been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). FBB operates as a commercial banking institution primarily in the Wisconsin and greater Kansas City markets. FBB also offers trust and investment services through First Business Trust & Investments (“FBTI”) and investment portfolio administrative services and asset/liability management services through First Business Consulting Services (“FBCS”), both divisions of FBB. The Bank provides a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Bank is subject to competition from other financial institutions and service providers and is also subject to state and federal regulations. FBB has the following wholly owned subsidiaries: First Business Capital Corp. (“FBCC”), First Madison Investment Corp. (“FMIC”), First Business Equipment Finance, LLC (“FBEF”), ABKC Real Estate, LLC (“ABKC”), Rimrock Road Investment Fund, LLC (“Rimrock Road”), BOC Investment, LLC (“BOC”), Mitchell Street Apartments Investment, LLC (“Mitchell Street”) and FBB Tax Credit Investment LLC (“FBB Tax Credit”). FMIC is located in and was formed under the laws of the state of Nevada.

Basis of Presentation. The accompanying unaudited Consolidated Financial Statements were prepared in accordance with GAAP and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the Corporation’s Consolidated Financial Statements and footnotes thereto included in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2017. The unaudited Consolidated Financial Statements include the accounts of the Corporation and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. In accordance with the provisions of Accounting Standards Codification (“ASC”) Topic 810, the Corporation’s ownership interest in FBFS Statutory Trust II (“Trust II”) has not been consolidated into the financial statements.

Management of the Corporation is required 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 as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that could significantly change in the near-term include the value of securities and interest rate swaps, level of the allowance for loan and lease losses, lease residuals, property under operating leases, goodwill, level of the Small Business Administration (“SBA”) recourse reserve and income taxes. The results of operations for the three month period ended March 31, 2018 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2018. Certain amounts in prior periods may have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the date of the issuance of the unaudited Consolidated Financial Statements. No significant subsequent events have occurred through this date requiring adjustment to the financial statements or disclosures.

The Corporation has not changed its significant accounting and reporting policies from those disclosed in the Corporation’s Form 10-K for the year ended December 31, 2017.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606),” with an original effective date for annual reporting periods beginning after December 15, 2016. The ASU is a converged standard between the FASB and the IASB that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The primary objective of the ASU is revenue recognition that represents the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, which defers the effective date of ASU 2014-09 to annual and interim reporting periods in fiscal years beginning after December 15, 2017. In March 2016, the FASB issued ASU No. 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net).” The ASU intends to improve the operability and

understandability of the implementation guidance of ASU 2014-09 on principal versus agent considerations. In April, May and December 2016, the FASB also issued ASU No. 2016-10, No. 2016-12 and No. 2016-20, respectively, related to Topic 606. The amendments do not change the core principles of the previously issued guidance, but instead further clarify and provide implementation guidance for certain aspects of the original ASU.

During the first quarter of 2018, the Company adopted ASU 2014-09 and all subsequent amendments to the ASU (collectively, “ASC 606”) using the modified retrospective method. The majority of the Company’s revenues are derived from interest

Table of Contents

income and other sources that are outside the scope of ASC 606. The primary revenue streams subject to the guidance include trust and investment services fee income, service charges on deposits and the sale of foreclosed properties. The Corporation completed an assessment and evaluated contracts to assess and quantify accounting methodology changes resulting from these standards.

Trust and investment service fees: The Corporation earns fees from contracts with customers for investment management, trust and estate management, company retirement plan and brokerage services to manage assets for investment and/or transact on their accounts. These fees are primarily earned over time as the Corporation provides the contracted monthly, quarterly or annual services and are generally assessed based on a tiered scale of the market value of assets under management or administration at the end of the period. Fees that are transaction-based are recognized at the point in time that the transaction is executed.

Service charges on deposits: The Corporation earns fees from deposit customers for account maintenance, information reporting, account reconciliation and transaction-based activity, such as overdraft and service fees. Transaction-based fees are recognized at the time the transaction is executed as that is the point in time the Corporation fulfills the customer's request. All other fees are earned over the course of a month, representing the period over which the Corporation satisfies the performance obligation.

Gain or loss on foreclosed properties: The Corporation records a gain or loss from the sale of foreclosed property when control of the property transfers to the buyer. If the Corporation finances the sale of the property to the buyer, the Corporation assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the foreclosed property is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Corporation adjusts the transaction price and related gain or loss on sale if a significant financing component is present.

The adoption of ASC 606 did not result in a change to the current accounting practices for any of the in-scope revenue streams; as such, no cumulative effect adjustment was recorded.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments (Subtopic 825-10)." The ASU amends certain aspects of recognition, measurement, presentation and disclosure of financial instruments. This amendment supersedes the guidance to classify equity securities with readily determinable fair values into different categories, requires equity securities to be measured at fair value with changes in the fair value recognized through net income and simplifies the impairment assessment of equity investments without readily determinable fair values. The amendment requires public business entities that are required to disclose the fair value of financial instruments measured at amortized cost on the balance sheet to measure that fair value using the exit price notion. The amendment requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option. The amendment requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or in the accompanying notes to the financial statements. The amendment reduces diversity in current practice by clarifying that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entity's other deferred tax assets. This amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendment by means of a cumulative-effect adjustment as of the beginning of the fiscal year of adoption, with the exception of the amendment related to equity securities without readily determinable fair values, which should be applied prospectively to equity investments that exist as of the date of adoption. The Corporation adopted the accounting standard during the first quarter of 2018 and modified its fair value disclosure of financial instruments to reflect an exit price notion. The modifications were substantially related to loans and lease receivables, deposits, Federal Home Loan Bank advances and other borrowings. The Corporation did not have any equity securities subject to the fair value adjustment. The adoption of the standard did not have a material impact on the Corporation's results of operations, financial position and liquidity.

Table of Contents

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” The ASU intends to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities and disclosing key information about leasing arrangements. The ASU will require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The new lease guidance simplifies the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Corporation intends to adopt the accounting standard during the first quarter of 2019, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity. The Corporation leases office space, loan production offices and specialty financing production offices under noncancelable operating leases which expire on various dates through 2029. The Corporation also leases office equipment. Future minimum lease payments for noncancelable operating leases as of March 31, 2018 was \$12.0 million.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments- Credit Losses (Topic 326).” The ASU replaces the incurred loss impairment methodology for recognizing credit losses with a methodology that reflects all expected credit losses. The ASU also requires consideration of a broader range of information to inform credit loss estimates, including such factors as past events, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures and any other financial asset not excluded from the scope that have the contractual right to receive cash. Entities will apply the amendments in the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The ASU is effective for public companies for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018. The Corporation intends to adopt the accounting standard during the first quarter of 2020, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity. A cross-functional team has been established and a third-party software solution has been obtained to assist with the implementation of the standard. Management is in the process of gathering necessary data and reviewing potential methods to calculate the expected credit losses.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows (Topic 230).” The ASU provides guidance on eight specific cash flow issues with the objective of reducing diversity in practice. The ASU is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The amendments in this update will be applied retrospectively to each prior period presented. The Corporation adopted the accounting standard during the first quarter of 2018 with no material impact on its results of operations, financial position and liquidity.

In May 2017, the FASB issued ASU No. 2017-09, “Compensation- Stock Compensation (Topic 718).” The ASU provides clarity about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The ASU is effective for all entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Corporation adopted the standard in the first quarter of 2018 with no material impact on its results of operations, financial position and liquidity.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement- Reporting Comprehensive Income (Topic 220)." The ASU allowed a reclassification from accumulated comprehensive income to retained earnings for stranded effects resulting from the Tax Cuts and Jobs Act. The ASU is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. The Corporation early adopted the standard in the fourth quarter of 2017, which resulted in a \$222,000 one-time reclassification from accumulated comprehensive income to retained earnings.

Table of Contents

Note 2 — Earnings per Common Share

Earnings per common share are computed using the two-class method. Basic earnings per common share are computed by dividing net income allocated to common shares by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends, or dividend equivalents, at the same rate as holders of the Corporation's common stock. Diluted earnings per share are computed by dividing net income allocated to common shares, adjusted for reallocation of undistributed earnings of unvested restricted shares, by the weighted average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents using the treasury stock method.

| | For the Three Months Ended March 31, 2018 2017 (Dollars in Thousands, Except Share Data) | |
|--|---|-----------|
| Basic earnings per common share | | |
| Net income | \$3,649 | \$ 3,397 |
| Less: earnings allocated to participating securities | 54 | 45 |
| Basic earnings allocated to common stockholders | \$3,595 | \$ 3,352 |
| Weighted-average common shares outstanding, excluding participating securities | 8,633,278 | 8,600,620 |
| Basic earnings per common share | \$0.42 | \$ 0.39 |
| Diluted earnings per common share | | |
| Earnings allocated to common stockholders | \$3,595 | \$ 3,352 |
| Weighted-average diluted common shares outstanding, excluding participating securities | 8,633,278 | 8,600,620 |
| Diluted earnings per common share | \$0.42 | \$ 0.39 |

Note 3 — Share-Based Compensation

The Corporation adopted the 2012 Equity Incentive Plan (the "Plan") during the quarter ended June 30, 2012. The Plan is administered by the Compensation Committee of the Board of Directors of the Corporation and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options, restricted stock, restricted stock units, dividend equivalent units and any other type of award permitted by the Plan. As of March 31, 2018, 210,780 shares were available for future grants under the Plan. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plan. The Corporation may issue new shares and shares from its treasury stock for shares delivered under the Plan.

Restricted Stock

Under the Plan, the Corporation may grant restricted stock to plan participants, subject to forfeiture upon the occurrence of certain events until the dates specified in the participant's award agreement. While restricted stock is subject to forfeiture, restricted stock participants may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. Restricted stock units do not have voting rights and are provided dividend equivalents. The restricted stock granted under the Plan is typically subject to a vesting period. Compensation expense is recognized over the requisite service period of generally four years for the entire award on a straight-line basis. Upon vesting of restricted stock, the benefit of tax deductions in excess of recognized compensation expense is reflected as an income tax benefit in the unaudited Consolidated Statements of Income.

Table of Contents

Restricted stock activity for the year ended December 31, 2017 and the three months ended March 31, 2018 was as follows:

| | Number of Restricted Shares/Units | Weighted Average Grant-Date Fair Value |
|---|---|---|
| Nonvested balance as of December 31, 2016 | 116,245 | \$ 21.13 |
| Granted | 71,130 | 21.67 |
| Vested | (48,550) | 21.51 |
| Forfeited | (8,384) | 21.65 |
| Nonvested balance as of December 31, 2017 | 130,441 | 21.43 |
| Granted | 1,055 | 21.43 |
| Vested | (1,238) | 22.70 |
| Forfeited | — | — |
| Nonvested balance as of March 31, 2018 | 130,258 | \$ 21.44 |

As of March 31, 2018, the Corporation had \$2.2 million of deferred unvested compensation expense, which the Corporation expects to recognize over a weighted-average period of approximately 2.70 years.

For the three months ended March 31, 2018 and 2017, share-based compensation expense related to restricted stock included in the unaudited Consolidated Statements of Income was \$286,000 and \$276,000, respectively.

Note 4 — Securities

The amortized cost and fair value of securities available-for-sale and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

| | As of March 31, 2018 | | | |
|--|----------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| Available-for-sale: | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$999 | \$ — | \$ (9) | \$990 |
| Municipal obligations | 8,291 | 1 | (111) | 8,181 |
| Collateralized mortgage obligations - government issued | 23,147 | 95 | (397) | 22,845 |
| Collateralized mortgage obligations - government-sponsored enterprises | 95,509 | 11 | (2,236) | 93,284 |
| Other securities | 2,695 | — | (34) | 2,661 |
| | \$130,641 | \$ 107 | \$ (2,787) | \$127,961 |

Table of Contents

| | As of December 31, 2017 | | | |
|--|-------------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| Available-for-sale: | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$999 | \$ 1 | \$ — | \$1,000 |
| Municipal obligations | 9,494 | 2 | (82) |) 9,414 |
| Collateralized mortgage obligations - government issued | 22,313 | 149 | (213) |) 22,249 |
| Collateralized mortgage obligations - government-sponsored enterprises | 91,480 | 24 | (1,199) |) 90,305 |
| Other securities | 3,040 | 3 | (6) |) 3,037 |
| | \$127,326 | \$ 179 | \$(1,500) |) \$126,005 |

The amortized cost and fair value of securities held-to-maturity and the corresponding amounts of gross unrealized gains and losses were as follows:

| | As of March 31, 2018 | | | |
|--|----------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| Held-to-maturity: | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$1,499 | \$ — | \$ (9) |) \$1,490 |
| Municipal obligations | 21,657 | 48 | (129) |) 21,576 |
| Collateralized mortgage obligations - government issued | 8,613 | — | (232) |) 8,381 |
| Collateralized mortgage obligations - government-sponsored enterprises | 10,116 | 15 | (169) |) 9,962 |
| | \$41,885 | \$ 63 | \$(539) |) \$41,409 |

| | As of December 31, 2017 | | | |
|--|-------------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| Held-to-maturity: | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$1,499 | \$ — | \$ (9) |) \$1,490 |
| Municipal obligations | 21,680 | 176 | (34) |) 21,822 |
| Collateralized mortgage obligations - government issued | 9,072 | 1 | (130) |) 8,943 |
| Collateralized mortgage obligations - government-sponsored enterprises | 5,527 | — | (86) |) 5,441 |
| | \$37,778 | \$ 177 | \$(259) |) \$37,696 |

U.S. government agency obligations - government-sponsored enterprises represent securities issued by the Federal Home Loan Bank (“FHLB”), the Federal Home Loan Mortgage Corporation (“FHLMC”) and Federal National Mortgage Association (“FNMA”). Municipal obligations include securities issued by various municipalities located primarily within the State of Wisconsin and are primarily general obligation bonds that are tax-exempt in nature. Collateralized mortgage obligations - government issued represent securities guaranteed by the Government National Mortgage Association. Collateralized mortgage obligations - government-sponsored enterprises include securities guaranteed by the FHLMC and the FNMA. Other securities

Table of Contents

represent certificates of deposit of insured banks and savings institutions with an original maturity greater than three months. No sales of available-for-sale securities occurred during the three months ended March 31, 2018 and 2017, respectively.

At March 31, 2018 and December 31, 2017, securities with a fair value of \$2.6 million and \$2.8 million, respectively, were pledged to secure interest rate swap contracts.

The amortized cost and fair value of securities by contractual maturity at March 31, 2018 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay certain obligations with or without call or prepayment penalties.

| | Available-for-Sale | | Held-to-Maturity | |
|------------------------------------|--------------------|------------|------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (In Thousands) | | | |
| Due in one year or less | \$3,894 | \$3,886 | \$1,700 | \$1,691 |
| Due in one year through five years | 19,198 | 18,836 | 10,819 | 10,786 |
| Due in five through ten years | 31,867 | 31,274 | 20,298 | 20,032 |
| Due in over ten years | 75,682 | 73,965 | 9,068 | 8,900 |
| | \$130,641 | \$127,961 | \$41,885 | \$41,409 |

The tables below show the Corporation's gross unrealized losses and fair value of available-for-sale investments aggregated by investment category and length of time that individual investments were in a continuous loss position at March 31, 2018 and December 31, 2017. At March 31, 2018, the Corporation held 158 available-for-sale securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. At March 31, 2018, the Corporation held 49 available-for-sale securities that had been in a continuous unrealized loss position for twelve months or greater.

The Corporation also has not specifically identified available-for-sale securities in a loss position that it intends to sell in the near term and does not believe that it will be required to sell any such securities. The Corporation reviews its securities on a quarterly basis to monitor its exposure to other-than-temporary impairment. Consideration is given to such factors as the length of time and extent to which the security has been in an unrealized loss position, changes in security ratings and an evaluation of the present value of expected future cash flows, if necessary. Based on the Corporation's evaluation, it is expected that the Corporation will recover the entire amortized cost basis of each security. Accordingly, no other-than-temporary impairment was recorded in the unaudited Consolidated Statements of Income for the three months ended March 31, 2018 and 2017.

A summary of unrealized loss information for securities available-for-sale, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

| | As of March 31, 2018 | | | | | |
|---|----------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In Thousands) | | | | | |
| Available-for-sale: | | | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$990 | \$ 9 | \$— | \$ — | \$990 | \$ 9 |
| Municipal obligations | 4,914 | 70 | 2,094 | 41 | 7,008 | 111 |
| | 11,220 | 153 | 6,531 | 244 | 17,751 | 397 |

Collateralized mortgage obligations - government
issued

Collateralized mortgage obligations -
government-sponsored enterprises

Other securities

| | | | | | |
|----------|----------|----------|----------|-----------|----------|
| 61,842 | 1,275 | 26,298 | 961 | 88,140 | 2,236 |
| 2,418 | 32 | 243 | 2 | 2,661 | 34 |
| \$81,384 | \$ 1,539 | \$35,166 | \$ 1,248 | \$116,550 | \$ 2,787 |

12

Table of Contents

| | As of December 31, 2017 | | | | | |
|--|-------------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In Thousands) | | | | | |
| Available-for-sale: | | | | | | |
| Municipal obligations | \$6,132 | \$ 43 | \$2,755 | \$ 39 | \$8,887 | \$ 82 |
| Collateralized mortgage obligations - government issued | 7,104 | 40 | 6,715 | 173 | 13,819 | 213 |
| Collateralized mortgage obligations - government-sponsored enterprises | 59,256 | 476 | 28,004 | 723 | 87,260 | 1,199 |
| Other securities | 1,954 | 6 | — | — | 1,954 | \$ 6 |
| | \$74,446 | \$ 565 | \$37,474 | \$ 935 | \$111,920 | \$ 1,500 |

The tables below show the Corporation's gross unrealized losses and fair value of held-to-maturity investments, aggregated by investment category and length of time that individual investments were in a continuous loss position at March 31, 2018 and December 31, 2017. At March 31, 2018, the Corporation held 81 held-to-maturity securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. There were 16 held-to-maturity securities that had been in a continuous loss position for twelve months or greater as of March 31, 2018. It is expected that the Corporation will recover the entire amortized cost basis of each held-to-maturity security based upon an evaluation of aforementioned factors. Accordingly, no other-than-temporary impairment was recorded in the unaudited Consolidated Statements of Income for the three months ended March 31, 2018 and 2017.

A summary of unrealized loss information for securities held-to-maturity, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

| | As of March 31, 2018 | | | | | |
|--|----------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In Thousands) | | | | | |
| Held-to-maturity: | | | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$— | \$ — | \$1,499 | \$ 9 | \$1,499 | \$ 9 |
| Municipal obligations | 14,446 | 120 | 258 | 9 | 14,704 | 129 |
| Collateralized mortgage obligations - government issued | 4,225 | 106 | 4,388 | 126 | 8,613 | 232 |
| Collateralized mortgage obligations - government-sponsored enterprises | 2,875 | 7 | 5,241 | 162 | 8,116 | 169 |
| | \$21,546 | \$ 233 | \$11,386 | \$ 306 | \$32,932 | \$ 539 |

Table of Contents

| | As of December 31, 2017 | | | | | |
|--|-------------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In Thousands) | | | | | |
| Held-to-maturity: | | | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$— | \$ — | \$1,499 | \$ 9 | \$1,499 | \$ 9 |
| Municipal obligations | 3,723 | 27 | 259 | 7 | 3,982 | 34 |
| Collateralized mortgage obligations - government issued | 3,868 | 51 | 4,677 | 79 | 8,545 | 130 |
| Collateralized mortgage obligations - government-sponsored enterprises | — | — | 5,527 | 86 | 5,527 | 86 |
| | \$7,591 | \$ 78 | \$11,962 | \$ 181 | \$19,553 | \$ 259 |

Note 5 — Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

| | March 31, 2018 | December 31, 2017 |
|---|-------------------|----------------------|
| | (In Thousands) | |
| Commercial real estate: | | |
| Commercial real estate — owner occupied | \$197,268 | \$200,387 |
| Commercial real estate — non-owner occupied | 484,151 | 470,236 |
| Land development | 46,379 | 40,154 |
| Construction | 156,020 | 125,157 |
| Multi-family | 136,098 | 136,978 |
| 1-4 family | 41,866 | 44,976 |
| Total commercial real estate | 1,061,782 | 1,017,888 |
| Commercial and industrial | 443,005 | 429,002 |
| Direct financing leases, net | 31,387 | 30,787 |
| Consumer and other: | | |
| Home equity and second mortgages | 8,270 | 7,262 |
| Other | 20,717 | 18,099 |
| Total consumer and other | 28,987 | 25,361 |
| Total gross loans and leases receivable | 1,565,161 | 1,503,038 |
| Less: | | |
| Allowance for loan and lease losses | 18,638 | 18,763 |
| Deferred loan fees | 1,671 | 1,443 |
| Loans and leases receivable, net | \$1,544,852 | \$1,482,832 |

As of March 31, 2018 and December 31, 2017, the total amount of the Corporation's ownership of SBA loans comprised of the following:

Table of Contents

| | March 31, | December 31, |
|---|----------------|--------------|
| | 2018 | 2017 |
| | (In Thousands) | |
| Retained, unguaranteed portions of sold SBA loans | \$28,348 | \$ 30,071 |
| Other SBA loans ⁽¹⁾ | 19,431 | 22,254 |
| Total SBA loans | \$47,779 | \$ 52,325 |

(1) Primarily consisted of SBA Express loans and impaired SBA loans that were repurchased from the secondary market, all of which were not saleable as of March 31, 2018 and December 31, 2017, respectively.

As of March 31, 2018 and December 31, 2017, \$8.0 million and \$11.1 million of SBA loans were considered impaired, respectively.

Loans transferred to third parties consist of the guaranteed portions of SBA loans which the Corporation sold in the secondary market, participation interests in other originated loans and residential real estate loans. The total principal amount of the guaranteed portions of SBA loans sold during the three months ended March 31, 2018 and 2017 was \$3.1 million and \$3.3 million, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, and therefore all of the loans transferred during the three months ended March 31, 2018 and 2017 have been derecognized in the unaudited Consolidated Financial Statements. The guaranteed portions of SBA loans were transferred at their fair value and the related gain was recognized upon the transfer as non-interest income in the unaudited Consolidated Financial Statements. The total outstanding balance of sold SBA loans at March 31, 2018 and December 31, 2017 was \$97.7 million and \$100.3 million, respectively.

The total principal amount of transferred participation interests in other originated commercial loans during the three months ended March 31, 2018 and 2017 was \$19.7 million and \$12.0 million, respectively, all of which were treated as sales and derecognized under the applicable accounting guidance at the time of transfer. No gain or loss was recognized on participation interests in other originated loans as they were transferred at or near the date of loan origination and the payments received for servicing the portion of the loans participated represents adequate compensation. The total outstanding balance of these transferred loans at March 31, 2018 and December 31, 2017 was \$108.7 million and \$106.4 million, respectively. As of March 31, 2018 and December 31, 2017, the total amount of the Corporation's partial ownership of these transferred loans on the unaudited Consolidated Balance Sheets was \$187.8 million and \$181.7 million, respectively. No loans in this participation portfolio were considered impaired as of March 31, 2018 and December 31, 2017. The Corporation does not share in the participant's portion of any potential charge-offs. The total amount of loan participations purchased on the unaudited Consolidated Balance Sheets as of March 31, 2018 and December 31, 2017 was \$650,000.

Table of Contents

The following tables illustrate ending balances of the Corporation's loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators as of March 31, 2018 and December 31, 2017:

| March 31, 2018 | | | | | |
|---|--------------|-----------|-----------|-----------|--------------|
| Category | I | II | III | IV | Total |
| (Dollars in Thousands) | | | | | |
| Commercial real estate: | | | | | |
| Commercial real estate — owner occupied | \$ 167,290 | \$ 15,592 | \$ 10,354 | \$ 4,032 | \$ 197,268 |
| Commercial real estate — non-owner occupied | 462,505 | 20,533 | 1,080 | 33 | 484,151 |
| Land development | 42,818 | 1,044 | — | 2,517 | 46,379 |
| Construction | 153,285 | 508 | 227 | 2,000 | 156,020 |
| Multi-family | 136,098 | — | — | — | 136,098 |
| 1-4 family | 32,221 | 7,640 | 1,071 | 934 | 41,866 |
| Total commercial real estate | 994,217 | 45,317 | 12,732 | 9,516 | 1,061,782 |
| Commercial and industrial | 351,392 | 24,916 | 56,240 | 10,457 | 443,005 |
| Direct financing leases, net | 29,622 | 317 | 1,448 | — | 31,387 |
| Consumer and other: | | | | | |
| Home equity and second mortgages | 8,261 | 7 | — | 2 | 8,270 |
| Other | 20,401 | — | — | 316 | 20,717 |
| Total consumer and other | 28,662 | 7 | — | 318 | 28,987 |
| Total gross loans and leases receivable | \$ 1,403,893 | \$ 70,557 | \$ 70,420 | \$ 20,291 | \$ 1,565,161 |
| Category as a % of total portfolio | 89.69 | % 4.51 | % 4.50 | % 1.30 | % 100.00 |
| December 31, 2017 | | | | | |
| Category | I | II | III | IV | Total |
| (Dollars in Thousands) | | | | | |
| Commercial real estate: | | | | | |
| Commercial real estate — owner occupied | \$ 166,018 | \$ 18,442 | \$ 8,850 | \$ 7,077 | \$ 200,387 |
| Commercial real estate — non-owner occupied | 441,246 | 27,854 | 1,102 | 34 | 470,236 |
| Land development | 36,470 | 1,057 | — | 2,627 | 40,154 |
| Construction | 121,528 | 757 | — | 2,872 | 125,157 |
| Multi-family | 136,978 | — | — | — | 136,978 |
| 1-4 family | 34,598 | 7,735 | 1,220 | 1,423 | 44,976 |
| Total commercial real estate | 936,838 | 55,845 | 11,172 | 14,033 | 1,017,888 |
| Commercial and industrial | 341,875 | 25,344 | 49,453 | 12,330 | 429,002 |
| Direct financing leases, net | 28,866 | 342 | 1,579 | — | 30,787 |
| Consumer and other: | | | | | |
| Home equity and second mortgages | 7,250 | 8 | — | 4 | 7,262 |
| Other | 17,745 | — | — | 354 | 18,099 |
| Total consumer and other | 24,995 | 8 | — | 358 | 25,361 |
| Total gross loans and leases receivable | \$ 1,332,574 | \$ 81,539 | \$ 62,204 | \$ 26,721 | \$ 1,503,038 |
| Category as a % of total portfolio | 88.66 | % 5.42 | % 4.14 | % 1.78 | % 100.00 |

Credit underwriting primarily through a committee process is a key component of the Corporation's operating philosophy. Commercial lenders have relatively low individual lending authority limits, and thus a significant portion of the Corporation's

Table of Contents

new credit extensions require approval from a loan approval committee regardless of the type of loan or lease, asset quality grade of the credit, amount of the credit or the related complexities of each proposal.

Each credit is evaluated for proper risk rating upon origination, at the time of each subsequent renewal, upon receipt and evaluation of updated financial information from the Corporation's borrowers or as other circumstances dictate. The Corporation uses a nine grade risk rating system to monitor the ongoing credit quality of its loans and leases. The risk rating grades follow a consistent definition and are then applied to specific loan types based on the nature of the loan. Each risk rating is subjective and, depending on the size and nature of the credit, subject to various levels of review and concurrence on the stated risk rating. In addition to its nine grade risk rating system, the Corporation groups loans into four loan and related risk categories which determine the level and nature of review by management. Category I — Loans and leases in this category are performing in accordance with the terms of the contract and generally exhibit no immediate concerns regarding the security and viability of the underlying collateral, financial stability of the borrower, integrity or strength of the borrowers' management team or the industry in which the borrower operates. The Corporation monitors Category I loans and leases through payment performance, continued maintenance of its personal relationships with such borrowers and continued review of such borrowers' compliance with the terms of their respective agreements.

Category II — Loans and leases in this category are beginning to show signs of deterioration in one or more of the Corporation's core underwriting criteria such as financial stability, management strength, industry trends or collateral values. Management will place credits in this category to allow for proactive monitoring and resolution with the borrower to possibly mitigate the area of concern and prevent further deterioration or risk of loss to the Corporation. Category II loans are considered performing but are monitored frequently by the assigned business development officer and by subcommittees of the Bank's Loan Committee.

Category III — Loans and leases in this category are identified by management as warranting special attention. However, the balance in this category is not intended to represent the amount of adversely classified assets held by the Bank. Category III loans and leases generally exhibit undesirable characteristics, such as evidence of adverse financial trends and conditions, managerial problems, deteriorating economic conditions within the related industry or evidence of adverse public filings and may exhibit collateral shortfall positions. Management continues to believe that it will collect all contractual principal and interest in accordance with the original terms of the contracts relating to the loans and leases in this category, and therefore Category III loans are considered performing with no specific reserves established for this category. Category III loans are monitored by management and subcommittees of the Bank's Loan Committee on a monthly basis and the Bank's Board of Directors at each of their regularly scheduled meetings.

Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases, with the exception of performing troubled debt restructurings, have been placed on non-accrual as management has determined that it is unlikely that the Bank will receive the contractual principal and interest in accordance with the original terms of the agreement. Impaired loans are individually evaluated to assess the need for the establishment of specific reserves or charge-offs. When analyzing the adequacy of collateral, the Corporation obtains external appraisals at least annually for impaired loans and leases. External appraisals are obtained from the Corporation's approved appraiser listing and are independently reviewed to monitor the quality of such appraisals. To the extent a collateral shortfall position is present, a specific reserve or charge-off will be recorded to reflect the magnitude of the impairment. Loans and leases in this category are monitored by management and subcommittees of the Bank's Loan Committee on a monthly basis and the Bank's Board of Directors at each of their regularly scheduled meetings.

Utilizing regulatory classification terminology, the Corporation identified \$30.6 million and \$32.7 million of loans and leases as Substandard as of March 31, 2018 and December 31, 2017, respectively. No loans and leases were identified as Doubtful as of March 31, 2018. The Corporation identified \$4.7 million of loans and leases as Doubtful as of December 31, 2017. Additionally, no loans were considered Special Mention, doubtful or Loss as of either March 31, 2018 or December 31, 2017. The population of Substandard loans is a subset of Category III and Category IV loans.

The delinquency aging of the loan and lease portfolio by class of receivable as of March 31, 2018 and December 31, 2017 was as follows:

Table of Contents

| | March 31, 2018 | | | | | | |
|----------------------------------|---------------------------|------------------------------|--|-------------------|-------------|---------------------------|---|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days Past Due | Total Past Due | Current | Total Loans and Leases | |
| | (Dollars in Thousands) | | | | | | |
| Accruing loans and leases | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | \$— | \$ — | \$— | \$— | \$193,290 | \$193,290 | |
| Non-owner occupied | 388 | — | — | 388 | 483,730 | 484,118 | |
| Land development | — | — | — | — | 43,862 | 43,862 | |
| Construction | — | — | — | — | 154,020 | 154,020 | |
| Multi-family | — | — | — | — | 136,098 | 136,098 | |
| 1-4 family | 545 | — | — | 545 | 40,588 | 41,133 | |
| Commercial and industrial | 1,618 | — | — | 1,618 | 430,934 | 432,552 | |
| Direct financing leases, net | — | — | — | — | 31,387 | 31,387 | |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | 129 | — | — | 129 | 8,141 | 8,270 | |
| Other | 1 | — | — | 1 | 20,400 | 20,401 | |
| Total | 2,681 | — | — | 2,681 | 1,542,450 | 1,545,131 | |
| Non-accruing loans and leases | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | 395 | — | 3,520 | 3,915 | 63 | 3,978 | |
| Non-owner occupied | 33 | — | — | 33 | — | 33 | |
| Land development | — | — | — | — | 2,517 | 2,517 | |
| Construction | — | — | 2,000 | 2,000 | — | 2,000 | |
| Multi-family | — | — | — | — | — | — | |
| 1-4 family | 162 | — | 529 | 691 | 42 | 733 | |
| Commercial and industrial | 2,960 | — | 6,510 | 9,470 | 983 | 10,453 | |
| Direct financing leases, net | — | — | — | — | — | — | |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | — | — | — | — | — | — | |
| Other | — | — | 316 | 316 | — | 316 | |
| Total | 3,550 | — | 12,875 | 16,425 | 3,605 | -20,030 | |
| Total loans and leases | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | 395 | — | 3,520 | 3,915 | 193,353 | 197,268 | |
| Non-owner occupied | 421 | — | — | 421 | 483,730 | 484,151 | |
| Land development | — | — | — | — | 46,379 | 46,379 | |
| Construction | — | — | 2,000 | 2,000 | 154,020 | 156,020 | |
| Multi-family | — | — | — | — | 136,098 | 136,098 | |
| 1-4 family | 707 | — | 529 | 1,236 | 40,630 | 41,866 | |
| Commercial and industrial | 4,578 | — | 6,510 | 11,088 | 431,917 | 443,005 | |
| Direct financing leases, net | — | — | — | — | 31,387 | 31,387 | |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | 129 | — | — | 129 | 8,141 | 8,270 | |
| Other | 1 | — | 316 | 317 | 20,400 | 20,717 | |
| Total | \$6,231 | \$ — | \$12,875 | \$19,106 | \$1,546,055 | \$1,565,161 | |
| Percent of portfolio | 0.40 | % —% | 0.82 | % 1.22 | % 98.78 | % 100.00 | % |

Table of Contents

| | December 31, 2017 | | | | | |
|----------------------------------|---------------------------|------------------------------|--|-------------------|-------------|---------------------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days Past Due | Total Past Due | Current | Total Loans and Leases |
| | (Dollars in Thousands) | | | | | |
| Accruing loans and leases | | | | | | |
| Commercial real estate: | | | | | | |
| Owner occupied | \$— | \$— | \$— | \$— | \$193,366 | \$193,366 |
| Non-owner occupied | — | — | — | — | 470,202 | 470,202 |
| Land development | — | — | — | — | 37,528 | 37,528 |
| Construction | — | 196 | — | 196 | 122,089 | 122,285 |
| Multi-family | — | — | — | — | 136,978 | 136,978 |
| 1-4 family | 496 | — | — | 496 | 43,319 | 43,815 |
| Commercial and industrial | 1,169 | 197 | — | 1,366 | 415,315 | 416,681 |
| Direct financing leases, net | — | — | — | — | 30,787 | 30,787 |
| Consumer and other: | | | | | | |
| Home equity and second mortgages | 106 | — | — | 106 | 7,156 | 7,262 |
| Other | — | — | — | — | 17,745 | 17,745 |
| Total | 1,771 | 393 | — | 2,164 | 1,474,485 | 1,476,649 |
| Non-accruing loans and leases | | | | | | |
| Commercial real estate: | | | | | | |
| Owner occupied | 405 | — | 4,836 | 5,241 | 1,780 | 7,021 |
| Non-owner occupied | — | — | — | — | 34 | 34 |
| Land development | — | — | — | — | 2,626 | 2,626 |
| Construction | — | — | 2,872 | 2,872 | — | 2,872 |
| Multi-family | — | — | — | — | — | — |
| 1-4 family | — | — | 948 | 948 | 213 | 1,161 |
| Commercial and industrial | 782 | — | 7,349 | 8,131 | 4,190 | 12,321 |
| Direct financing leases, net | — | — | — | — | — | — |
| Consumer and other: | | | | | | |
| Home equity and second mortgages | — | — | — | — | — | — |
| Other | — | — | 345 | 345 | 9 | 354 |
| Total | 1,187 | — | 16,350 | 17,537 | 8,852 | 26,389 |
| Total loans and leases | | | | | | |
| Commercial real estate: | | | | | | |
| Owner occupied | 405 | — | 4,836 | 5,241 | 195,146 | 200,387 |
| Non-owner occupied | — | — | — | — | 470,236 | 470,236 |
| Land development | — | — | — | — | 40,154 | 40,154 |
| Construction | — | 196 | 2,872 | 3,068 | 122,089 | 125,157 |
| Multi-family | — | — | — | — | 136,978 | 136,978 |
| 1-4 family | 496 | — | 948 | 1,444 | 43,532 | 44,976 |
| Commercial and industrial | 1,951 | 197 | 7,349 | 9,497 | 419,505 | 429,002 |
| Direct financing leases, net | — | — | — | — | 30,787 | 30,787 |
| Consumer and other: | | | | | | |
| Home equity and second mortgages | 106 | — | — | 106 | 7,156 | 7,262 |
| Other | — | — | 345 | 345 | 17,754 | 18,099 |
| Total | \$2,958 | \$393 | \$16,350 | \$19,701 | \$1,483,337 | \$1,503,038 |
| Percent of portfolio | 0.20 | % 0.03 | % 1.09 | % 1.32 | % 98.68 | % 100.00 |

Table of Contents

The Corporation's total impaired assets consisted of the following at March 31, 2018 and December 31, 2017, respectively.

| | March 31, 2018 | December 31, 2017 | | March 31, 2018 | December 31, 2017 |
|---|------------------------|----------------------|-------|-------------------|----------------------|
| | (Dollars in Thousands) | | | | |
| Non-accrual loans and leases | | | | | |
| Commercial real estate: | | | | | |
| Commercial real estate — owner occupied | \$3,978 | \$ 7,021 | | | |
| Commercial real estate — non-owner occupied | 33 | 34 | | | |
| Land development | 2,517 | 2,626 | | | |
| Construction | 2,000 | 2,872 | | | |
| Multi-family | — | — | | | |
| 1-4 family | 733 | 1,161 | | | |
| Total non-accrual commercial real estate | 9,261 | 13,714 | | | |
| Commercial and industrial | 10,453 | 12,321 | | | |
| Direct financing leases, net | — | — | | | |
| Consumer and other: | | | | | |
| Home equity and second mortgages | — | — | | | |
| Other | 316 | 354 | | | |
| Total non-accrual consumer and other loans | 316 | 354 | | | |
| Total non-accrual loans and leases | 20,030 | 26,389 | | | |
| Foreclosed properties, net | 1,484 | 1,069 | | | |
| Total non-performing assets | 21,514 | 27,458 | | | |
| Performing troubled debt restructurings | 261 | 332 | | | |
| Total impaired assets | \$21,775 | \$ 27,790 | | | |
| | | | | March 31, 2018 | December 31, 2017 |
| Total non-accrual loans and leases to gross loans and leases | | | 1.28 | % | 1.76 |
| Total non-performing assets to total gross loans and leases plus foreclosed properties, net | | | 1.37 | | 1.83 |
| Total non-performing assets to total assets | | | 1.15 | | 1.53 |
| Allowance for loan and lease losses to gross loans and leases | | | 1.19 | | 1.25 |
| Allowance for loan and lease losses to non-accrual loans and leases | | | 93.05 | | 71.10 |

As of March 31, 2018 and December 31, 2017, \$8.6 million and \$8.8 million of the non-accrual loans and leases were considered troubled debt restructurings, respectively. There were no unfunded commitments associated with troubled debt restructured loans and leases as of March 31, 2018.

Table of Contents

The following table provides the number of loans modified in a troubled debt restructuring and the pre- and post-modification recorded investment by class of receivable as of March 31, 2018 and December 31, 2017.

| | As of March 31, 2018 | | | As of December 31, 2017 | | |
|---|----------------------|---|---------------------------------------|-------------------------|--------------------------------------|---------------------------------------|
| | Number of Loans | Pre-Modification Recorded Investment (Dollars in Thousands) | Post-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Commercial real estate: | | | | | | |
| Commercial real estate — owner occupied | 3 | \$ 1,065 | \$ 868 | 3 | \$ 1,065 | \$ 880 |
| Commercial real estate — non-owner occupied | 1 | 158 | 33 | 1 | 158 | 34 |
| Land development | 1 | 5,745 | 2,516 | 1 | 5,745 | 2,626 |
| Construction | — | — | — | — | — | — |
| Multi-family | — | — | — | — | — | — |
| 1-4 family | 7 | 560 | 243 | 8 | 627 | 307 |
| Commercial and industrial | 10 | 8,759 | 4,913 | 10 | 8,759 | 4,951 |
| Consumer and other: | | | | | | |
| Home equity and second mortgage | 1 | 37 | 2 | 2 | 37 | 4 |
| Other | 1 | 2,077 | 316 | 2 | 2,094 | 345 |
| Total | 24 | \$ 18,401 | \$ 8,891 | 27 | \$ 18,485 | \$ 9,147 |

All loans and leases modified as a troubled debt restructuring are measured for impairment. The nature and extent of the impairment of restructured loans, including those which have experienced a default, is considered in the determination of an appropriate level of the allowance for loan and lease losses.

As of March 31, 2018 and December 31, 2017, the Corporation's troubled debt restructurings grouped by type of concession were as follows:

| | As of March 31, 2018 | | As of December 31, 2017 | |
|---|----------------------|--|-------------------------|---------------------|
| | Number of Loans | Recorded Investment (Dollars in Thousands) | Number of Loans | Recorded Investment |
| Commercial real estate: | | | | |
| Extension of term | — | \$ — | — | \$ — |
| Interest rate concession | 12 | 3,660 | 12 | 3,793 |
| Combination of extension of term and interest rate concession | — | — | 1 | 54 |
| Commercial and industrial: | | | | |
| Combination of extension of term and interest rate concession | 10 | 4,913 | 10 | 4,951 |
| Consumer and other: | | | | |
| Extension of term | 1 | 316 | 1 | 328 |
| Combination of extension of term and interest rate concession | 1 | 2 | 3 | 21 |
| Total | 24 | \$ 8,891 | 27 | \$ 9,147 |

During the three months ended March 31, 2018 and March 31, 2017 no loans were modified to a troubled debt restructuring.

There were no loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the three months ended March 31, 2018. There were three loans modified in a troubled debt restructuring

21

Table of Contents

during the previous 12 months which subsequently defaulted during the three months ended March 31, 2017. The total recorded investment of these loans was \$878,000 as of March 31, 2017.

The following represents additional information regarding the Corporation's impaired loans and leases, including performing troubled debt restructurings, by class:

As of and for the Three Months Ended March 31, 2018

| | Recorded Investment | Unpaid Principal Balance | Impairment Reserve | Average Recorded Investment ⁽¹⁾ | Foregone Interest Income | Interest Income Recognized | Net Foregone Interest Income |
|--------------------------------------|------------------------|--------------------------------|-----------------------|--|--------------------------------|----------------------------------|---------------------------------------|
| (In Thousands) | | | | | | | |
| With no impairment reserve recorded: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | \$4,032 | \$5,331 | \$ — | \$ 6,531 | \$ 134 | \$ 148 | \$ (14) |
| Non-owner occupied | 33 | 74 | — | 39 | 1 | — | 1 |
| Land development | 2,517 | 6,814 | — | 2,553 | 18 | — | 18 |
| Construction | 2,000 | 2,872 | — | 2,862 | 52 | — | 52 |
| Multi-family | — | — | — | — | — | — | — |
| 1-4 family | 934 | 1,204 | — | 1,351 | 20 | 18 | 2 |
| Commercial and industrial | 3,621 | 4,297 | — | 5,134 | 124 | 104 | 20 |
| Direct financing leases, net | — | — | — | — | — | — | — |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | 2 | 2 | — | 3 | — | 27 | (27) |
| Other | 316 | 982 | — | 330 | 14 | — | 14 |
| Total | 13,455 | 21,576 | — | 18,803 | 363 | 297 | 66 |
| With impairment reserve recorded: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | — | — | — | — | — | — | — |
| Non-owner occupied | — | — | — | — | — | — | — |
| Land development | — | — | — | — | — | — | — |
| Construction | — | — | — | — | — | — | — |
| Multi-family | — | — | — | — | — | — | — |
| 1-4 family | — | — | — | — | — | — | — |
| Commercial and industrial | 6,836 | 9,145 | 3,088 | 6,850 | 278 | — | 278 |
| Direct financing leases, net | — | — | — | — | — | — | — |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | — | — | — | — | — | — | — |
| Other | — | — | — | — | — | — | — |
| Total | 6,836 | 9,145 | 3,088 | 6,850 | 278 | — | 278 |
| Total: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | 4,032 | 5,331 | — | 6,531 | 134 | 148 | (14) |
| Non-owner occupied | 33 | 74 | — | 39 | 1 | — | 1 |
| Land development | 2,517 | 6,814 | — | 2,553 | 18 | — | 18 |
| Construction | 2,000 | 2,872 | — | 2,862 | 52 | — | 52 |
| Multi-family | — | — | — | — | — | — | — |
| 1-4 family | 934 | 1,204 | — | 1,351 | 20 | 18 | 2 |
| Commercial and industrial | 10,457 | 13,442 | 3,088 | 11,984 | 402 | 104 | 298 |
| Direct financing leases, net | — | — | — | — | — | — | — |
| Consumer and other: | | | | | | | |

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| | | | | | | | |
|----------------------------------|----------|----------|----------|-----------|--------|--------|--------|
| Home equity and second mortgages | 2 | 2 | — | 3 | — | 27 | (27) |
| Other | 316 | 982 | — | 330 | 14 | — | 14 |
| Grand total | \$20,291 | \$30,721 | \$ 3,088 | \$ 25,653 | \$ 641 | \$ 297 | \$ 344 |

22

Table of Contents

(1) Average recorded investment is calculated primarily using daily average balances.

| | As of and for the Year Ended December 31, 2017 | | | | | | |
|--------------------------------------|--|--------------------------------|-----------------------|--|--------------------------------|----------------------------------|---------------------------------------|
| | Recorded Investment | Unpaid Principal Balance | Impairment Reserve | Average Recorded Investment ⁽¹⁾ | Foregone Interest Income | Interest Income Recognized | Net Foregone Interest Income |
| | (In Thousands) | | | | | | |
| With no impairment reserve recorded: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | \$7,077 | \$7,077 | \$ — | \$ 5,549 | \$ 613 | \$ — | \$ 613 |
| Non-owner occupied | 34 | 75 | — | 1,830 | 97 | 226 | (129) |
| Land development | 2,627 | 5,297 | — | 3,092 | 84 | — | 84 |
| Construction | — | — | — | 2,000 | 134 | 214 | (80) |
| Multi-family | — | — | — | 1 | — | — | — |
| 1-4 family | 1,423 | 1,706 | — | 2,146 | 53 | 7 | 46 |
| Commercial and industrial | 5,465 | 6,502 | — | 3,634 | 858 | 7 | 851 |
| Direct financing leases, net | — | — | — | — | — | — | — |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | 4 | 3 | — | 7 | — | — | — |
| Other | 345 | 1,011 | — | 365 | 59 | — | 59 |
| Total | 16,975 | 21,671 | — | 18,624 | 1,898 | 454 | 1,444 |
| With impairment reserve recorded: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | — | — | — | — | — | — | — |
| Non-owner occupied | — | — | — | — | — | — | — |
| Land development | — | — | — | — | — | — | — |
| Construction | 2,872 | 2,872 | 415 | 2,252 | 158 | — | 158 |
| Multi-family | — | — | — | — | — | — | — |
| 1-4 family | — | — | — | — | — | — | — |
| Commercial and industrial | 6,865 | 8,813 | 4,067 | 12,288 | 639 | — | 639 |
| Direct financing leases, net | — | — | — | — | — | — | — |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | — | — | — | — | — | — | — |
| Other | 9 | 9 | 9 | — | — | — | — |
| Total | 9,746 | 11,694 | 4,491 | 14,540 | 797 | — | 797 |
| Total: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner occupied | 7,077 | 7,077 | — | 5,549 | 613 | — | 613 |
| Non-owner occupied | 34 | 75 | — | 1,830 | 97 | 226 | (129) |
| Land development | 2,627 | 5,297 | — | 3,092 | 84 | — | 84 |
| Construction | 2,872 | 2,872 | 415 | 4,252 | 292 | 214 | 78 |
| Multi-family | — | — | — | 1 | — | — | — |
| 1-4 family | 1,423 | 1,706 | — | 2,146 | 53 | 7 | 46 |
| Commercial and industrial | 12,330 | 15,315 | 4,067 | 15,922 | 1,497 | 7 | 1,490 |
| Direct financing leases, net | — | — | — | — | — | — | — |
| Consumer and other: | | | | | | | |
| Home equity and second mortgages | 4 | 3 | — | 7 | — | — | — |

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| | | | | | | | |
|-------------|----------|----------|----------|-----------|----------|--------|----------|
| Other | 354 | 1,020 | 9 | 365 | 59 | — | 59 |
| Grand total | \$26,721 | \$33,365 | \$ 4,491 | \$ 33,164 | \$ 2,695 | \$ 454 | \$ 2,241 |

(1) Average recorded investment is calculated primarily using daily average balances.

23

Table of Contents

The difference between the recorded investment of loans and leases and the unpaid principal balance of \$10.4 million and \$6.6 million as of March 31, 2018 and December 31, 2017, respectively, represents partial charge-offs of loans and leases resulting from losses due to the appraised value of the collateral securing the loans and leases being below the carrying values of the loans and leases. Impaired loans and leases also included \$261,000 and \$332,000 of loans as of March 31, 2018 and December 31, 2017, respectively, that were performing troubled debt restructurings, and although not on non-accrual, were reported as impaired due to the concession in terms. When a loan is placed on non-accrual, interest accrual is discontinued and previously accrued but uncollected interest is deducted from interest income. Cash payments collected on non-accrual loans are first applied to such loan's principal. Foregone interest represents the interest that was contractually due on the loan but not received or recorded. To the extent the amount of principal on a non-accrual loan is fully collected and additional cash is received, the Corporation will recognize interest income.

To determine the level and composition of the allowance for loan and lease losses, the Corporation categorizes the portfolio into segments with similar risk characteristics. First, the Corporation evaluates loans and leases for potential impairment classification. The Corporation analyzes each loan and lease determined to be impaired on an individual basis to determine a specific reserve based upon the estimated value of the underlying collateral for collateral-dependent loans, or alternatively, the present value of expected cash flows. The Corporation applies historical trends from established risk factors to each category of loans and leases that has not been individually evaluated for the purpose of establishing the general portion of the allowance.

A summary of the activity in the allowance for loan and lease losses by portfolio segment is as follows:

| | As of and for the Three Months Ended | | | |
|-----------------------------|--------------------------------------|---------------------------------|-----------------------|-----------|
| | March 31, 2018 | | | |
| | Commercial Real Estate | Commercial and Industrial | Consumer and Other | Total |
| | (Dollars in Thousands) | | | |
| Beginning balance | \$ 10,131 | \$ 8,225 | \$ 407 | \$ 18,763 |
| Charge-offs | (2,175) | (490) | (20) | (2,685) |
| Recoveries | 13 | 2 | 69 | 84 |
| Net charge-offs | (2,162) | (488) | 49 | (2,601) |
| Provision for credit losses | 2,021 | 414 | 41 | 2,476 |
| Ending balance | \$ 9,990 | \$ 8,151 | \$ 497 | \$ 18,638 |
| | As of and for the Three Months Ended | | | |
| | March 31, 2017 | | | |
| | Commercial Real Estate | Commercial and Industrial | Consumer and Other | Total |
| | (Dollars in Thousands) | | | |
| Beginning balance | \$ 12,384 | \$ 7,970 | \$ 558 | \$ 20,912 |
| Charge-offs | (67) | (55) | (87) | (209) |
| Recoveries | 104 | 246 | 41 | 391 |
| Net charge-offs | 37 | 191 | (46) | 182 |
| Provision for credit losses | 396 | (218) | 394 | 572 |
| Ending balance | \$ 12,817 | \$ 7,943 | \$ 906 | \$ 21,666 |

Table of Contents

The following tables provide information regarding the allowance for loan and lease losses and balances by type of allowance methodology.

| | As of March 31, 2018 | | | |
|---|---------------------------|---------------------------------|-----------------------|-------------|
| | Commercial Real Estate | Commercial and Industrial | Consumer and Other | Total |
| | (Dollars in Thousands) | | | |
| Allowance for loan and lease losses: | | | | |
| Collectively evaluated for impairment | \$9,990 | \$ 5,063 | \$ 497 | \$15,550 |
| Individually evaluated for impairment | — | 3,088 | — | 3,088 |
| Loans acquired with deteriorated credit quality | — | — | — | — |
| Total | \$9,990 | \$ 8,151 | \$ 497 | \$18,638 |
| Loans and lease receivables: | | | | |
| Collectively evaluated for impairment | \$1,052,266 | \$ 463,935 | \$ 28,669 | \$1,544,870 |
| Individually evaluated for impairment | 9,101 | 10,452 | 318 | 19,871 |
| Loans acquired with deteriorated credit quality | 415 | 5 | — | 420 |
| Total | \$1,061,782 | \$ 474,392 | \$ 28,987 | \$1,565,161 |
| | As of December 31, 2017 | | | |
| | Commercial Real Estate | Commercial and Industrial | Consumer and Other | Total |
| | (Dollars in Thousands) | | | |
| Allowance for loan and lease losses: | | | | |
| Collectively evaluated for impairment | \$9,716 | \$ 4,158 | \$ 398 | \$14,272 |
| Individually evaluated for impairment | 415 | 4,067 | 9 | 4,491 |
| Loans acquired with deteriorated credit quality | — | — | — | — |
| Total | \$10,131 | \$ 8,225 | \$ 407 | \$18,763 |
| Loans and lease receivables: | | | | |
| Collectively evaluated for impairment | \$1,003,855 | \$ 447,459 | \$ 25,003 | \$1,476,317 |
| Individually evaluated for impairment | 13,506 | 12,324 | 358 | 26,188 |
| Loans acquired with deteriorated credit quality | 527 | 6 | — | 533 |
| Total | \$1,017,888 | \$ 459,789 | \$ 25,361 | \$1,503,038 |

Note 6 — Other Assets

The Corporation is a limited partner in several limited partnership investments. The Corporation is not the general partner, does not have controlling ownership and is not the primary beneficiary in any of these limited partnerships and the limited partnerships have not been consolidated. These investments are accounted for using the equity method of accounting and are evaluated for impairment at the end of each reporting period.

Table of Contents

A summary of accrued interest receivable and other assets is as follows:

| | March 31, | December 31, |
|--|----------------|--------------|
| | 2018 | 2017 |
| | (In Thousands) | |
| Accrued interest receivable | \$5,403 | \$ 5,019 |
| Net deferred tax asset | 6,327 | 2,584 |
| Investment in historic development entities | 1,849 | 1,161 |
| Investment in a community development entity | 6,464 | 6,591 |
| Investment in limited partnerships | 4,333 | 4,261 |
| Investment in Trust II | 315 | 315 |
| Fair value of interest rate swaps | 961 | 942 |
| Prepaid expenses | 3,556 | 3,091 |
| Other assets | 2,986 | 5,884 |
| Total accrued interest receivable and other assets | \$32,194 | \$ 29,848 |

Note 7 — Deposits

The composition of deposits at March 31, 2018 and December 31, 2017 is shown below. Average balances represent year-to-date averages.

| | March 31, 2018 | | | December 31, 2017 | | |
|---|------------------------|-----------------|--------------|-------------------|-----------------|--------------|
| | Balance | Average Balance | Average Rate | Balance | Average Balance | Average Rate |
| | (Dollars in Thousands) | | | | | |
| Non-interest-bearing transaction accounts | \$240,422 | \$228,557 | — % | \$277,445 | \$230,907 | — % |
| Interest-bearing transaction accounts | 262,766 | 297,730 | 0.55 | 217,625 | 226,540 | 0.59 |
| Money market accounts | 498,310 | 514,837 | 0.66 | 515,077 | 583,241 | 0.47 |
| Certificates of deposit | 77,107 | 80,904 | 1.18 | 76,199 | 56,667 | 1.00 |
| Wholesale deposits | 292,553 | 300,855 | 1.77 | 307,985 | 361,712 | 1.70 |
| Total deposits | \$1,371,158 | \$1,422,883 | 0.80 | \$1,394,331 | \$1,459,067 | 0.74 |

Note 8 — FHLB Advances, Other Borrowings and Junior Subordinated Notes

The composition of borrowed funds at March 31, 2018 and December 31, 2017 is shown below. Average balances represent year-to-date averages.

| | March 31, 2018 | | | December 31, 2017 | | |
|---------------------------------|------------------------|--------------------------|-----------------------|-------------------|--------------------------|-----------------------|
| | Balance | Weighted Average Balance | Weighted Average Rate | Balance | Weighted Average Balance | Weighted Average Rate |
| | (Dollars in Thousands) | | | | | |
| Federal funds purchased | \$— | \$— | — % | \$— | \$66 | 1.22 % |
| FHLB advances | 284,500 | 217,517 | 1.84 | 183,500 | 105,276 | 1.40 |
| Line of credit | 10 | 10 | 4.32 | 10 | 328 | 3.64 |
| Other borrowings ⁽¹⁾ | 675 | 675 | 8.09 | 675 | 1,241 | 14.50 |
| Subordinated notes payable | 23,727 | 23,718 | 6.67 | 23,713 | 23,161 | 6.93 |
| Junior subordinated notes | 10,022 | 10,020 | 10.94 | 10,019 | 10,011 | 11.11 |
| | \$318,934 | \$251,940 | 2.68 | \$217,917 | \$140,083 | 3.14 |
| Short-term borrowings | \$93,010 | | | \$37,010 | | |
| Long-term borrowings | 225,924 | | | 180,907 | | |

\$318,934

\$217,917

(1) Weighted average rate of other borrowings reflects the cost of prepaying a secured borrowing during the second quarter of 2017.

As of March 31, 2018 and December 31, 2017, the Corporation was in compliance with its debt covenants under its third-party secured senior line of credit. Per the promissory note dated February 19, 2018, the Corporation pays a commitment fee on this line of credit. During both the three months ended March 31, 2018 and 2017, the Corporation incurred interest expense due to this fee of \$3,000.

Note 9 — Commitments and Contingencies

In the ordinary course of business, the Corporation sells the guaranteed portions of SBA loans, as well as participation interests in other originated loans, to third parties. The Corporation has a continuing involvement in each of the transferred lending arrangements by way of relationship management and servicing the loans, as well as being subject to normal and customary requirements of the SBA loan program and standard representations and warranties related to sold amounts. In the event of a

Table of Contents

loss resulting from default and a determination by the SBA that there is a deficiency in the manner in which the loan was originated, funded or serviced by the Corporation, the SBA may require the Corporation to repurchase the loan, deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of the principal loss related to the deficiency from the Corporation. The Corporation must comply with applicable SBA regulations in order to maintain the guaranty. In addition, the Corporation retains the option to repurchase the sold guaranteed portion of an SBA loan if the loan defaults.

Management has assessed estimated losses inherent in the outstanding guaranteed portions of SBA loans sold in accordance with ASC 450, Contingencies, and determined a recourse reserve based on the probability of future losses for these loans to be \$2.5 million at March 31, 2018, which is reported in accrued interest payable and other liabilities on the unaudited Consolidated Balance Sheets.

The summary of the activity in the SBA recourse reserve is as follows:

| | As of and for the Three Months Ended March 31 | |
|--|--|----------|
| | 2018 | 2017 |
| | (In Thousands) | |
| Balance at the beginning of the period | \$2,849 | \$ 1,750 |
| SBA recourse (benefit) provision | (295) | 6 |
| Charge-offs, net | (38) | (91) |
| Balance at the end of the period | \$2,516 | \$ 1,665 |

In the normal course of business, various legal proceedings involving the Corporation are pending. Management, based upon advice from legal counsel, does not anticipate any significant losses as a result of these actions. Management believes that any liability arising from any such proceedings currently existing or threatened will not have a material adverse effect on the Corporation's financial position, results of operations and cash flows.

Note 10 — Fair Value Disclosures

The Corporation determines the fair values of its financial instruments based on the fair value hierarchy established in ASC Topic 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is defined as the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date and is based on exit prices. Fair value includes assumptions about risk, such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 — Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level 2 — Level 2 inputs are inputs, other than quoted prices included with Level 1, that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 — Level 3 inputs are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers

factors specific to the asset or liability.

27

Table of Contents

Assets and liabilities measured at fair value on a recurring basis, segregated by fair value hierarchy level, are summarized below:

| | March 31, 2018 | | | |
|--|----------------|----------|----|-----------|
| | Fair Value | | | |
| | Measurements | | | |
| | Using | | | |
| | Level | Level | | Total |
| | 1 | 2 | 3 | |
| | (In Thousands) | | | |
| Assets: | | | | |
| Securities available-for-sale: | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$ | \$ 990 | \$ | -\$ 990 |
| Municipal obligations | — | 8,181 | — | 8,181 |
| Collateralized mortgage obligations - government issued | — | 22,845 | — | 22,845 |
| Collateralized mortgage obligations - government-sponsored enterprises | — | 93,284 | — | 93,284 |
| Other securities | — | 2,661 | — | 2,661 |
| Interest rate swaps | — | 1,511 | — | 1,511 |
| Liabilities: | | | | |
| Interest rate swaps | — | 961 | — | 961 |
| December 31, 2017 | | | | |
| Fair Value | | | | |
| Measurements | | | | |
| Using | | | | |
| | Level | Level | | Total |
| | 1 | 2 | 3 | |
| | (In Thousands) | | | |
| Assets: | | | | |
| Securities available-for-sale: | | | | |
| U.S. government agency obligations - government-sponsored enterprises | \$ | \$ 1,000 | \$ | -\$ 1,000 |
| Municipal obligations | — | 9,414 | — | 9,414 |
| Asset backed securities | — | — | — | — |
| Collateralized mortgage obligations - government issued | — | 22,249 | — | 22,249 |
| Collateralized mortgage obligations - government-sponsored enterprises | — | 90,305 | — | 90,305 |
| Other securities | — | 3,037 | — | 3,037 |
| Interest rate swaps | — | 942 | — | 942 |
| Liabilities: | | | | |
| Interest rate swaps | — | 1,064 | — | 1,064 |

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the three months ended March 31, 2018 or the year ended December 31, 2017 related to the above measurements.

Table of Contents

Assets and liabilities measured at fair value on a non-recurring basis, segregated by fair value hierarchy are summarized below:

| | March 31, 2018 | | | |
|-----------------------|----------------|---------|----------|-------|
| | Fair Value | | | |
| | Measurements | | | |
| | Using | | | |
| | Level | Level | Level | Total |
| | 1 | 2 | 3 | |
| | (In Thousands) | | | |
| Impaired loans | \$-4,333 | \$6,414 | \$10,747 | |
| Foreclosed properties | -1,484 | — | 1,484 | |

| | December 31, 2017 | | | |
|-----------------------|-------------------|---------|----------|-------|
| | Fair Value | | | |
| | Measurements | | | |
| | Using | | | |
| | Level | Level | Level | Total |
| | 1 | 2 | 3 | |
| | (In Thousands) | | | |
| Impaired loans | \$-10,063 | \$5,084 | \$15,147 | |
| Foreclosed properties | -1,069 | — | 1,069 | |

Impaired loans were written down to the fair value of their underlying collateral less costs to sell of \$10.7 million and \$15.1 million at March 31, 2018 and December 31, 2017, respectively, through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value of the underlying collateral of impaired loans. Valuation techniques consistent with the market approach, income approach or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as current appraisals, recent sales of similar assets or other observable market data, and are reflected within Level 2 of the hierarchy. In cases where an input is unobservable, specifically when discounts are applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. The quantification of unobservable inputs for Level 3 impaired loan values range from 13% - 75% as of the measurement date of March 31, 2018. The weighted average of those unobservable inputs was 16%. The majority of the impaired loans in the Level 3 category are considered collateral dependent loans or are supported by a SBA guaranty.

Foreclosed properties, upon initial recognition, are remeasured and reported at fair value through a charge-off to the allowance for loan and lease losses, if deemed necessary, based upon the fair value of the foreclosed property. The fair value of a foreclosed property, upon initial recognition, is estimated using a market approach or Level 2 inputs based on observable market data, typically a current appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Level 3 inputs typically include unobservable inputs such as management applied discounts used to further reduce values to a net realizable value and may be used in situations when observable inputs become stale. Foreclosed property fair value inputs may transition to Level 1 upon receipt of an accepted offer for the sale of the related foreclosed property.

Table of Contents

Fair Value of Financial Instruments

The Corporation is required to disclose estimated fair values for its financial instruments. Fair value estimates, methods and assumptions, consistent with exit price concepts for fair value measurements, are set forth below:

| | March 31, 2018 | | | | |
|--|----------------|------------|-----------|----------|-----------|
| | Carrying | Fair Value | | | |
| | Amount | Total | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$61,322 | \$61,319 | \$41,622 | \$19,697 | \$ — |
| Securities available-for-sale | 127,961 | 127,961 | — | 127,961 | — |
| Securities held-to-maturity | 41,885 | 41,409 | — | 41,409 | — |
| Loans held for sale | 3,429 | 3,772 | — | 3,772 | — |
| Loans and lease receivables, net | 1,544,852 | 1,541,857 | — | 4,333 | 1,537,524 |
| Federal Home Loan Bank stock | 8,650 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 5,403 | 5,403 | 5,403 | — | — |
| Interest rate swaps | 1,511 | 1,511 | — | 1,511 | — |
| Financial liabilities: | | | | | |
| Deposits | 1,371,158 | 1,367,168 | 1,001,498 | 365,670 | — |
| Federal Home Loan Bank advances and other borrowings | 308,912 | 305,156 | — | 305,156 | — |
| Junior subordinated notes | 10,022 | 8,352 | — | — | 8,352 |
| Accrued interest payable | 2,456 | 2,456 | 2,456 | — | — |
| Interest rate swaps | 961 | 961 | — | 961 | — |
| Off-balance-sheet items: | | | | | |
| Standby letters of credit | 52 | 52 | — | — | 52 |

N/A = The fair value is not applicable due to restrictions placed on transferability

Table of Contents

| | December 31, 2017 | | | | |
|--|--------------------|------------|-----------|----------|-----------|
| | Carrying Amount | Fair Value | | | |
| | | Total | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$52,539 | \$52,539 | \$ 35,114 | \$17,425 | \$ — |
| Securities available-for-sale | 126,005 | 126,005 | — | 126,005 | — |
| Securities held-to-maturity | 37,778 | 37,696 | — | 37,696 | — |
| Loans held for sale | 2,194 | 2,413 | — | 2,413 | — |
| Loans and lease receivables, net | 1,482,832 | 1,482,664 | — | 10,063 | 1,472,601 |
| Federal Home Loan Bank stock | 5,670 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 5,019 | 5,019 | 5,019 | — | — |
| Interest rate swaps | 942 | 942 | — | 942 | — |
| Financial liabilities: | | | | | |
| Deposits | 1,394,331 | 1,391,801 | 1,010,147 | 381,654 | — |
| Federal Home Loan Bank advances and other borrowings | 207,898 | 206,441 | — | 206,441 | — |
| Junior subordinated notes | 10,019 | 8,836 | — | — | 8,836 |
| Accrued interest payable | 2,095 | 2,095 | 2,095 | — | — |
| Interest rate swaps | 1,064 | 1,064 | — | 1,064 | — |
| Off-balance-sheet items: | | | | | |
| Standby letters of credit | 75 | 75 | — | — | 75 |

N/A = The fair value is not applicable due to restrictions placed on transferability

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the unaudited Consolidated Balance Sheets. 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 the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Corporation.

Securities: The fair value measurements of investment securities are determined by a third-party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, credit information and the securities' terms and conditions, among other things. The fair value measurements are subject to independent verification by another pricing source on a quarterly basis to review for reasonableness. Any significant differences in pricing are reviewed with appropriate members of management who have the relevant technical expertise to assess the results. The Corporation has determined that these valuations are classified in Level 2 of the fair value hierarchy. When the independent pricing service does not provide a fair value measurement for a particular security, the Corporation will estimate the fair value based on specific information about each security. Fair values derived in this manner are classified in Level 3 of the fair value hierarchy.

Loans Held for Sale: Loans held for sale, which consist of the guaranteed portions of SBA loans, are carried at the lower of cost or estimated fair value. The estimated fair value is based on what secondary markets are currently offering for portfolios with similar characteristics.

Interest Rate Swaps: The carrying amount and fair value of existing derivative financial instruments are based upon independent valuation models, which use widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative contract. This analysis reflects the contractual terms of the

derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The

31

Table of Contents

Corporation incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Corporation considers the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees.

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

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and are not considered in the estimates.

Note 11 — Derivative Financial Instruments

The Corporation offers interest rate swap products directly to qualified commercial borrowers. The Corporation economically hedges client derivative transactions by entering into offsetting interest rate swap contracts executed with a third party. Derivative transactions executed as part of this program are not considered hedging instruments and are marked- to-market through earnings each period. The derivative contracts have mirror-image terms, which results in the positions' changes in fair value primarily offsetting through earnings each period. The credit risk and risk of non-performance embedded in the fair value calculations is different between the dealer counterparties and the commercial borrowers which may result in a difference in the changes in the fair value of the mirror-image swaps. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty's risk in the fair value measurements. When evaluating the fair value of its derivative contracts for the effects of non-performance and credit risk, the Corporation considered the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At March 31, 2018, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was \$91.0 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. These interest rate swaps mature between September 2018 and July 2034. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. These commercial borrower swaps were reported on the unaudited Consolidated Balance Sheet as a derivative assets of \$961,000, included in accrued interest receivable and other assets, and as a derivative liability of \$265,000, included in accrued interest payable and other liabilities. As of March 31, 2018, no interest rate swaps were in default and therefore all values for the commercial borrower swaps were recorded on a gross basis on the unaudited Consolidated Balance Sheets.

At March 31, 2018, the aggregate amortizing notional value of interest rate swaps with dealer counterparties was also \$91.0 million. The Corporation pays fixed rates and receives floating rates based upon LIBOR on the swaps with dealer counterparties. These interest rate swaps mature in September 2018 through July 2034. Dealer counterparty swaps are subject to master netting agreements among the contracts within our Bank and are reported on the unaudited Consolidated Balance Sheet as a net derivative liability of \$696,000, included in accrued interest payable and other liabilities. The gross amount of dealer counterparty swaps, without regard to the enforceable master netting agreement, was a gross derivative liability of 961,000 and gross derivative assets of 265,000. No right of offset existed with dealer counterparty swaps as of March 31, 2018.

All changes in the fair value of these instruments are recorded in other non-interest income. Given the mirror-image terms of the outstanding derivative portfolio, the change in fair value for the three months ended March 31, 2018 and

2017 had an insignificant impact on the unaudited Consolidated Statements of Income.

The Corporation also enters into interest rate swaps to manage interest rate risk and reduce the cost of match-funding certain long-term fixed rate loans. These derivative contracts involve the receipt of floating rate interest from a counterparty in exchange for the Corporation making fixed-rate payments over the life of the agreement, without the exchange of the underlying notional value. The instruments are designated as cash flow hedges as the receipt of floating rate interest from the counterparty is used to manage interest rate risk associated with forecasted issuances of short-term FHLB advances. The change in the fair value of these hedging instruments is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged transactions affects earnings.

32

Table of Contents

As of March 31, 2018, the aggregate notional value of interest rate swaps designated as cash flow hedges was \$30.0 million. These interest rate swaps matures between June 2027 and December 2027. A pre-tax unrealized gain of \$672,000 was recognized in other comprehensive income for the three months ended March 31, 2018 and there was no ineffective portion of these hedge. No interest rate swaps designated as cash flow hedges were outstanding as of March 31, 2017.

The table below provides information about the balance sheet location and fair value of the Corporation's derivative instruments as of March 31, 2018 and December 31, 2017:

| | Interest Rate Swap Contracts | | Fair Value | Interest Rate Swap Contracts | | Fair Value |
|---|---|--------|------------|---|--|------------|
| | Balance Sheet Location | | | Balance Sheet Location | | |
| | (In Thousands) | | | | | |
| Derivatives not designated as hedging instruments | | | | | | |
| March 31, 2018 | Accrued interest receivable and other assets | \$ 961 | | Accrued interest payable and other liabilities | | \$ 961 |
| December 31, 2017 | Accrued interest receivable and other assets | \$ 942 | | Accrued interest payable and other liabilities | | \$ 942 |
| Derivatives designated as hedging instruments | | | | | | |
| March 31, 2018 | Accrued interest receivable and other assets | \$ 550 | | Accumulated other comprehensive income ⁽¹⁾ | | \$ 550 |
| December 31, 2017 | Accumulated other comprehensive income ⁽¹⁾ | \$ 122 | | Accrued interest payable and other liabilities | | \$ 122 |

(1) The fair value of derivatives designated as hedging instruments included in accumulated other comprehensive income represent pre-tax amounts, which are reported net of tax on the unaudited Consolidated Balance Sheets.

Note 12 — Regulatory Capital

The Corporation and the Bank are subject to various regulatory capital requirements administered by Federal and the State of Wisconsin banking agencies. Failure to meet minimum capital requirements can result in certain mandatory, and possibly additional discretionary actions on the part of regulators, that if undertaken, could have a direct material effect on the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory practices. The Corporation's and the Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. The Corporation regularly reviews and updates, when appropriate, its Capital and Liquidity Action Plan, which is designed to help ensure appropriate capital adequacy, to plan for future capital needs and to ensure that the Corporation serves as a source of financial strength to the Bank. The Corporation's and the Bank's Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their respective capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

As a bank holding company, the Corporation's ability to pay dividends is affected by the policies and enforcement powers of the Board of Governors of the Federal Reserve system (the "Federal Reserve"). Federal Reserve guidance urges financial institutions to strongly consider eliminating, deferring or significantly reducing dividends if: (i) net income available to common stockholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividend; (ii) the prospective rate of earnings retention is not consistent with the bank holding company's capital needs and overall current and prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital ratios. Management

intends, when appropriate under regulatory guidelines, to consult with the Federal Reserve Bank of Chicago and provide it with information on the Corporation's then-current and prospective earnings and capital position in advance of declaring any cash dividends. As a Wisconsin corporation, the Corporation is

Table of Contents

subject to the limitations of the Wisconsin Business Corporation Law, which prohibit the Corporation from paying dividends if such payment would: (i) render the Corporation unable to pay its debts as they become due in the usual course of business, or (ii) result in the Corporation's assets being less than the sum of its total liabilities plus the amount needed to satisfy the preferential rights upon dissolution of any stockholders with preferential rights superior to those stockholders receiving the dividend.

The Bank is also subject to certain legal, regulatory and other restrictions on their ability to pay dividends to the Corporation. As a bank holding company, the payment of dividends by the Bank to the Corporation is one of the sources of funds the Corporation could use to pay dividends, if any, in the future and to make other payments. Future dividend decisions by the Bank and the Corporation will continue to be subject to compliance with various legal, regulatory and other restrictions as defined from time to time.

Qualitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios of Total Common Equity Tier 1 and Tier 1 capital to risk-weighted assets and of Tier 1 capital to adjusted total assets. These risk-based capital requirements presently address credit risk related to both recorded and off-balance-sheet commitments and obligations.

In July 2013, the FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks. These rules are applicable to all financial institutions that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as bank and savings and loan holding companies other than "small bank holding companies" (generally non-publicly traded bank holding companies with consolidated assets of less than \$1 billion). Under the final rules, minimum requirements increased for both the quantity and quality of capital held by the Corporation. The rules include a new Common Equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. The rules also permit banking organizations with less than \$15 billion in assets to retain, through a one-time election, the past treatment for accumulated other comprehensive income, which did not affect regulatory capital. The Corporation elected to retain this treatment, which reduces the volatility of regulatory capital ratios. A new capital conservation buffer, comprised of Common Equity Tier 1 capital, was also established above the regulatory minimum capital requirements. This capital conservation buffer will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019.

Table of Contents

As of March 31, 2018, the Corporation's capital levels exceeded the regulatory minimums and Bank's capital levels remained characterized as well capitalized under the regulatory framework. The following table summarizes both the Corporation's and Bank's capital ratios and the ratios required by their federal regulators at March 31, 2018 and December 31, 2017:

| | Actual | | Minimum Required for Capital Adequacy Purposes | | For Capital Adequacy Purposes Plus Capital Conservation Buffer | | Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements | |
|---|-----------|---------|--|--------|--|---------|---|---------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| (Dollars in Thousands) | | | | | | | | |
| As of March 31, 2018 | | | | | | | | |
| Total capital (to risk-weighted assets) | | | | | | | | |
| Consolidated | \$216,519 | 11.78 % | \$147,099 | 8.00 % | \$181,575 | 9.875 % | N/A | N/A |
| First Business Bank | 209,579 | 11.45 | 146,437 | 8.00 | 180,758 | 9.875 | \$183,046 | 10.00 % |
| Tier 1 capital (to risk-weighted assets) | | | | | | | | |
| Consolidated | \$171,638 | 9.33 % | \$110,324 | 6.00 % | \$144,801 | 7.875 % | N/A | N/A |
| First Business Bank | 188,425 | 10.29 | 109,828 | 6.00 | 144,149 | 7.875 | \$146,437 | 8.00 % |
| Common equity tier 1 capital (to risk-weighted assets) | | | | | | | | |
| Consolidated | \$161,616 | 8.79 % | \$82,743 | 4.50 % | \$117,219 | 6.375 % | N/A | N/A |
| First Business Bank | 188,425 | 10.29 | 82,371 | 4.50 | 116,692 | 6.375 | \$118,980 | 6.50 % |
| Tier 1 leverage capital (to adjusted assets) | | | | | | | | |
| Consolidated | \$171,638 | 9.26 % | \$74,127 | 4.00 % | \$74,127 | 4.00 % | N/A | N/A |
| First Business Bank | 188,425 | 10.19 | 73,929 | 4.00 | 73,929 | 4.00 | \$92,412 | 5.00 % |

Table of Contents

| | Actual | | Minimum Required for Capital Adequacy Purposes | | For Capital Adequacy Purposes Plus Capital Conservation Buffer | | Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements | |
|------------------------------|-----------|---------|--|--------|--|---------|---|---------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| (Dollars in Thousands) | | | | | | | | |
| As of December 31, 2017 | | | | | | | | |
| Total capital | | | | | | | | |
| (to risk-weighted assets) | | | | | | | | |
| Consolidated | \$214,501 | 11.98 % | \$143,219 | 8.00 % | \$165,597 | 9.250 % | N/A | N/A |
| First Business Bank | 207,986 | 11.66 | 142,736 | 8.00 | 165,038 | 9.250 | \$178,420 | 10.00 % |
| Tier 1 capital | | | | | | | | |
| (to risk-weighted assets) | | | | | | | | |
| Consolidated | \$169,176 | 9.45 % | \$107,414 | 6.00 % | \$129,792 | 7.250 % | N/A | N/A |
| First Business Bank | 186,374 | 10.45 | 107,052 | 6.00 | 129,354 | 7.250 | \$142,736 | 8.00 % |
| Common equity tier 1 capital | | | | | | | | |
| (to risk-weighted assets) | | | | | | | | |
| Consolidated | \$159,157 | 8.89 % | \$80,561 | 4.50 % | \$102,939 | 5.750 % | N/A | N/A |
| First Business Bank | 186,374 | 10.45 | 80,289 | 4.50 | 102,591 | 5.750 | \$115,973 | 6.50 % |
| Tier 1 leverage capital | | | | | | | | |
| (to adjusted assets) | | | | | | | | |
| Consolidated | \$169,176 | 9.54 % | \$70,920 | 4.00 % | \$70,920 | 4.00 % | N/A | N/A |
| First Business Bank | 186,374 | 10.56 | 70,617 | 4.00 | 70,617 | 4.00 | \$88,272 | 5.00 % |

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

General

Unless otherwise indicated or unless the context requires otherwise, all references in this Report to the "Corporation," "we," "us," "our," or similar references mean First Business Financial Services, Inc. together with our subsidiary. "FBB" or the "Bank" refers to our subsidiary, First Business Bank.

Forward-Looking Statements

This report may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, which reflect our current views with respect to future events and financial performance. Forward-looking statements are not based on historical information, but rather are related to future operations, strategies, financial results or other developments. Forward-looking statements are based on management's expectations as well as certain assumptions and estimates made by, and information available to, management at the time the statements are made. Such statements are subject to risks and uncertainties, including among other things:

• Competitive pressures among depository and other financial institutions nationally and in our markets.

• Adverse changes in the economy or business conditions, either nationally or in our markets.

• Increases in defaults by borrowers and other delinquencies.

• Our ability to manage growth effectively, including the successful expansion of our client support, administrative infrastructure and internal management systems.

• Fluctuations in interest rates and market prices.

• The consequences of continued bank acquisitions and mergers in our markets, resulting in fewer but much larger and financially stronger competitors.

• Changes in legislative or regulatory requirements applicable to us and our subsidiary.

• Changes in tax requirements, including tax rate changes, new tax laws and revised tax law interpretations.

• Fraud, including client and system failure or breaches of our network security, including our internet banking activities.

• Failure to comply with the applicable SBA regulations in order to maintain the eligibility of the guaranteed portion of SBA loans.

These risks could cause actual results to differ materially from what we have anticipated or projected. These risk factors and uncertainties should be carefully considered by our stockholders and potential investors. See Part I, Item 1A — Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2017 for discussion relating to risk factors impacting us. Investors should not place undue reliance on any such forward-looking statements, which speak only as of the date made. The factors described within this Form 10-Q could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods.

Where any such forward-looking statement includes a statement of the assumptions or bases underlying such forward-looking statement, we caution that, while our management believes such assumptions or bases are reasonable and are made in good faith, assumed facts or bases can vary from actual results, and the differences between assumed facts or bases and actual results can be material, depending on the circumstances. Where, in any forward-looking statement, an expectation or belief is expressed as to future results is believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will be achieved or accomplished.

We do not intend to, and specifically disclaim any obligation to, update any forward-looking statements.

The following discussion and analysis is intended as a review of significant events and factors affecting our financial condition and results of operations for the periods indicated. The discussion should be read in conjunction with the unaudited Consolidated Financial Statements and the Notes thereto presented in this Form 10-Q.

Table of Contents

Overview

We are a registered bank holding company incorporated under the laws of the State of Wisconsin and are engaged in the commercial banking business through our wholly-owned banking subsidiary, FBB. All of our operations are conducted through the Bank and certain of its subsidiaries. We operate as a business bank focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small- to medium-sized businesses, business owners, executives, professionals and high net worth individuals. Our products and services include commercial lending, SBA lending and servicing, asset-based lending, equipment financing, factoring, trust and investment services, investment portfolio administrative services, asset/liability management services, treasury management services and a broad range of deposit products. We do not utilize a branch network to attract retail clients. Our operating philosophy is predicated on deep client relationships fostered by local expertise, combined with the efficiency of centralized administrative functions such as information technology, loan and deposit operations, finance and accounting, credit administration, compliance and human resources. Our focused model allows experienced staff to provide the level of financial expertise needed to develop and maintain long-term relationships with our clients.

Operational Summary

Results for the three months ended March 31, 2018 include:

Total assets increased to \$1.878 billion as of March 31, 2018 compared to \$1.794 billion as of December 31, 2017.

Net income for the three months ended March 31, 2018 was \$3.6 million compared to net income of \$3.4 million for the three months ended March 31, 2017.

Diluted earnings per common share for the three months ended March 31, 2018 were \$0.42 compared to diluted earnings per common share of \$0.39 for the three months ended March 31, 2017.

Annualized return on average assets ("ROAA") and annualized return on average equity ("ROAE") were 0.78% and 8.88%, respectively, for the three month period ended March 31, 2018, compared to 0.77% and 8.31%, respectively, for the same time period in 2017.

Trust and investment services fee income increased 16.5% to \$1.9 million for the three months ended March 31, 2018 compared to \$1.6 million for the three months ended March 31, 2017.

Top line revenue, the sum of net interest income and non-interest income, increased 10.1% to \$20.9 million for the three months ended March 31, 2018 compared to \$19.0 million for the three months ended March 31, 2017.

Net interest margin increased 14 basis points to 3.65% for the three months ended March 31, 2018 compared to 3.51% for the three months ended March 31, 2017.

Efficiency ratio was 67.45% for the three months ended March 31, 2018, compared to 70.85% for the three months ended March 31, 2017.

Provision for loan and lease losses was \$2.5 million for the three months ended March 31, 2018 compared to \$572,000 for the same period in the prior year.

SBA recourse provision was a benefit of \$295,000 for the three months ended March 31, 2018, compared to a \$6,000 expense for the three months ended March 31, 2017.

Net charge-offs of \$2.6 million represented an annualized 0.67% of average loans and leases for the three months ended March 31, 2018 compared to annualized net recoveries of 0.05% for the three months ended March 31, 2017.

Gross loans and leases receivable increased \$61.9 million, or 16.5% annualized, to \$1.563 billion at March 31, 2018 from \$1.502 billion at December 31, 2017.

Allowance for loan and lease losses as a percentage of gross loans and leases was 1.19% at March 31, 2018 compared to 1.25% at December 31, 2017.

Non-performing assets as a percentage of total assets was 1.15% at March 31, 2018 compared to 1.53% at December 31, 2017.

Non-accrual loans decreased by \$6.4 million, or 24.1%, to \$20.0 million at March 31, 2018 from \$26.4 million at December 31, 2017.

Table of Contents

Results of Operations

Top Line Revenue

Top line revenue is comprised of net interest income and non-interest income. For the three months ended March 31, 2018, top line revenue increased 10.1% compared to the same period in the prior year primarily due to loan growth combined with higher loan yields, as well as an increase in commercial loan swap fees and trust and investment fee income. This increase was partially offset by higher rates paid on interest-bearing liabilities amid a rising rate environment and a moderate decline in the gain on sale of SBA loans.

The components of top line revenue were as follows:

| | For the Three Months Ended March 31, | | |
|------------------------|---|-----------|--------|
| | 2018 | 2017 | Change |
| | (Dollars in Thousands) | | |
| Net interest income | \$ 16,202 | \$ 14,888 | 8.8 % |
| Non-interest income | 4,667 | 4,063 | 14.9 |
| Total top line revenue | \$ 20,869 | \$ 18,951 | 10.1 |

Annualized Return on Average Assets and Annualized Return on Average Equity

ROAA for the three months ended March 31, 2018 increased to 0.78% compared to 0.77% for the three months ended March 31, 2017. The increase in ROAA for the three months ended March 31, 2018 was primarily due to an increase in net interest income, trust and investment fee income, commercial loan swap fee income and a decrease in the corporate federal income tax rate from 35% to 21% effective January 1, 2018. This improvement in profitability was partially offset by an increase in the provision for loan and leases losses. ROAA is a critical metric used by us to measure the profitability of our organization and how efficiently our assets are deployed. It is a measurement that allows us to better benchmark our profitability to our peers without the need to consider different degrees of leverage that can ultimately influence return on equity measures.

ROAE for the three months ended March 31, 2018 was 8.88% compared to 8.31% for the three months ended March 31, 2017. The reasons for the increase in ROAE are consistent with the explanations discussed above with respect to ROAA for the three months ended March 31, 2018. We view ROAE to be an important measure of profitability and we continue to focus on improving the return to our stockholders by enhancing the overall profitability of our client relationships, controlling expenses and seeking to minimize credit costs.

Efficiency Ratio

Efficiency ratio is a non-GAAP measure representing non-interest expense excluding the effects of the SBA recourse provision, impairment of tax credit investments, losses or gains on foreclosed properties, amortization of other intangible assets and other discrete items, if any, divided by operating revenue, which is equal to net interest income plus non-interest income less realized gains or losses on securities, if any.

The efficiency ratio was 67.45% for the three months ended March 31, 2018, compared to 70.85% for the three months ended March 31, 2017. We continue to progress towards enhancing the Corporation's long-term efficiency ratio, building on the strategic changes we have made to date and laying the foundation to generate sustainable and high-quality revenue growth. After significant investments in 2016 and 2017, we believe we now have a solid SBA infrastructure, with the people and processes in place to allow us to build production levels which achieve our profitability goals. At the same time, we expect our charter consolidation and core system conversions to create capacity within our existing workforce to accommodate future growth in a highly efficient manner. We believe these strategic initiatives will continue to act as catalysts for earnings growth in 2018 and beyond. Management will continue to take proactive measures to drive positive operating leverage with the objective of moving the efficiency ratio back within the Corporation's long-term operating goal of 58-62%.

We believe the efficiency ratio allows investors and analysts to better assess the Corporation's operating expenses in relation to its operating revenue by removing the volatility that is associated with certain non-recurring or discrete items. The efficiency ratio also allows management to benchmark performance of our model to our peers without the influence of the loan loss provision and tax considerations, which will ultimately influence other traditional financial measurements, including ROAA and ROAE. The information provided below reconciles the efficiency ratio to its

most comparable GAAP measure.

39

Table of Contents

Please refer to both the Non-Interest Income and Non-Interest Expense sections below for discussion on the primary drivers of the year-over-year improvement in the efficiency ratio.

| | For the Three Months Ended March 31, | | | |
|---|--------------------------------------|----------|---------|--------|
| | 2018 | 2017 | \$ | % |
| | | | Change | Change |
| | (Dollars in Thousands) | | | |
| Total non-interest expense | \$13,907 | \$13,560 | \$347 | 2.6 % |
| Less: | | | | |
| Amortization of other intangible assets | 12 | 14 | (2) | (14.3) |
| SBA recourse (benefit) provision | (295) | 6 | (301) | N/M |
| Impairment of tax credit investments | 113 | 113 | — | — |
| Total adjusted operating expense | \$14,077 | \$13,427 | \$650 | 4.8 |
| Net interest income | \$16,202 | \$14,888 | \$1,314 | 8.8 |
| Total non-interest income | 4,667 | 4,063 | 604 | 14.9 |
| Total operating revenue | \$20,869 | \$18,951 | \$1,918 | 10.1 |
| Efficiency ratio | 67.45 % | 70.85 % | | |

N/M = Not meaningful

Table of Contents

Net Interest Income

Net interest income levels depend on the amount of and yield on interest-earning assets as compared to the amount of and rate paid on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the asset/liability management processes to prepare for and respond to such changes.

The following table provides information with respect to (1) the change in net interest income attributable to changes in rate (changes in rate multiplied by prior volume) and (2) the change in net interest income attributable to changes in volume (changes in volume multiplied by prior rate) for the three months ended March 31, 2018 compared to the same periods in 2017. The change in net interest income attributable to changes in rate and volume (changes in rate multiplied by changes in volume) has been allocated to the rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each.

| | Increase (Decrease) for the Three Months Ended March 31, 2018 Compared to 2017 | | |
|--|---|---------|---------|
| | Rate | Volume | Net |
| | (In Thousands) | | |
| Interest-earning assets | | | |
| Commercial real estate and other mortgage loans ⁽¹⁾ | \$874 | \$1,149 | \$2,023 |
| Commercial and industrial loans ⁽¹⁾ | 286 | (179) | 107 |
| Direct financing leases ⁽¹⁾ | (17) | (3) | (20) |
| Consumer and other loans ⁽¹⁾ | 17 | 12 | 29 |
| Total loans and leases receivable | 1,160 | 979 | 2,139 |
| Mortgage-related securities | 150 | (81) | 69 |
| Other investment securities | 17 | (9) | 8 |
| FHLB and FRB Stock | (7) | 32 | 25 |
| Short-term investments | 18 | 16 | 34 |
| Total net change in income on interest-earning assets | 1,338 | 937 | 2,275 |
| Interest-bearing liabilities | | | |
| Transaction accounts | 35 | 141 | 176 |
| Money market accounts | 325 | (134) | 191 |
| Certificates of deposit | 37 | 70 | 107 |
| Wholesale deposits | 118 | (435) | (317) |
| Total deposits | 515 | (358) | 157 |
| FHLB advances | 204 | 645 | 849 |
| Other borrowings | (19) | (26) | (45) |
| Junior subordinated notes | — | — | — |
| Total net change in expense on interest-bearing liabilities | 700 | 261 | 961 |
| Net change in net interest income | \$638 | \$676 | \$1,314 |

(1) Includes non-performing loans and leases and loans held for sale.

Table of Contents

The table below shows our average balances, interest, average yields/rates, net interest margin and the spread between the combined average yields earned on interest-earning assets and average rates on interest-bearing liabilities for the three months ended March 31, 2018 and 2017. The average balances are derived from average daily balances.

| | For the Three Months Ended March 31, | | | | | | | |
|---|--------------------------------------|-----------|---------------------------|---------------------------|--------------|-----------|---------------------------|---------------------------|
| | 2018 | 2017 | Average | Average | Interest | Average | Interest | Average |
| | Average | Average | Yield/Rate ⁽⁴⁾ | Yield/Rate ⁽⁴⁾ | Balance | Balance | Yield/Rate ⁽⁴⁾ | Yield/Rate ⁽⁴⁾ |
| | Balance | Balance | | | | | | |
| | (Dollars in Thousands) | | | | | | | |
| Interest-earning assets | | | | | | | | |
| Commercial real estate and other mortgage loans ⁽¹⁾ | \$ 1,046,751 | \$ 12,341 | 4.72 | % | \$ 946,110 | \$ 10,318 | 4.36 | % |
| Commercial and industrial loans ⁽¹⁾ | 439,491 | 6,702 | 6.10 | | 451,552 | 6,595 | 5.84 | |
| Direct financing leases ⁽¹⁾ | 29,871 | 303 | 4.06 | | 30,123 | 323 | 4.29 | |
| Consumer and other loans ⁽¹⁾ | 29,361 | 315 | 4.29 | | 28,202 | 286 | 4.06 | |
| Total loans and leases receivable ⁽¹⁾ | 1,545,474 | 19,661 | 5.09 | | 1,455,987 | 17,522 | 4.81 | |
| Mortgage-related securities ⁽²⁾ | 128,061 | 687 | 2.15 | | 145,804 | 618 | 1.70 | |
| Other investment securities ⁽³⁾ | 36,392 | 169 | 1.86 | | 38,554 | 161 | 1.67 | |
| FHLB and FRB stock | 6,717 | 49 | 2.92 | | 3,150 | 24 | 3.05 | |
| Short-term investments | 57,291 | 156 | 1.09 | | 51,136 | 122 | 0.95 | |
| Total interest-earning assets | 1,773,935 | 20,722 | 4.67 | | 1,694,631 | 18,447 | 4.35 | |
| Non-interest-earning assets | 88,750 | | | | 80,254 | | | |
| Total assets | \$ 1,862,685 | | | | \$ 1,774,885 | | | |
| Interest-bearing liabilities | | | | | | | | |
| Transaction accounts | \$ 297,730 | 408 | 0.55 | | \$ 192,297 | 232 | 0.48 | |
| Money market accounts | 514,837 | 851 | 0.66 | | 627,188 | 660 | 0.42 | |
| Certificates of deposit | 80,904 | 239 | 1.18 | | 55,393 | 132 | 0.95 | |
| Wholesale deposits | 300,855 | 1,332 | 1.77 | | 400,672 | 1,649 | 1.65 | |
| Total interest-bearing deposits | 1,194,326 | 2,830 | 0.95 | | 1,275,550 | 2,673 | 0.84 | |
| FHLB advances | 217,517 | 1,003 | 1.84 | | 60,703 | 154 | 1.01 | |
| Other borrowings | 24,403 | 413 | 6.77 | | 25,921 | 458 | 7.07 | |
| Junior subordinated notes | 10,020 | 274 | 10.94 | | 10,006 | 274 | 10.97 | |
| Total interest-bearing liabilities | 1,446,266 | 4,520 | 1.25 | | 1,372,180 | 3,559 | 1.04 | |
| Non-interest-bearing demand deposit accounts | 228,557 | | | | 228,015 | | | |
| Other non-interest-bearing liabilities | 23,553 | | | | 11,223 | | | |
| Total liabilities | 1,698,376 | | | | 1,611,418 | | | |
| Stockholders' equity | 164,309 | | | | 163,467 | | | |
| Total liabilities and stockholders' equity | \$ 1,862,685 | | | | \$ 1,774,885 | | | |
| Net interest income | | \$ 16,202 | | | | \$ 14,888 | | |
| Interest rate spread | | | 3.42 | % | | | 3.31 | % |
| Net interest-earning assets | \$ 327,669 | | | | \$ 322,451 | | | |
| Net interest margin | | | 3.65 | % | | | 3.51 | % |
| Average interest-earning assets to average interest-bearing liabilities | 122.66 | % | | | 123.50 | % | | |
| Return on average assets ⁽⁴⁾ | 0.78 | | | | 0.77 | | | |
| Return on average equity ⁽⁴⁾ | 8.88 | | | | 8.31 | | | |
| Average equity to average assets | 8.82 | | | | 9.21 | | | |
| Non-interest expense to average assets ⁽⁴⁾ | 2.99 | | | | 3.06 | | | |

(1)

The average balances of loans and leases include non-performing loans and leases and loans held for sale. Interest income related to non-performing loans and leases is recognized when collected. Interest income includes net loan fees collected in lieu of interest.

(2) Includes amortized cost basis of assets available-for-sale and held-to-maturity.

(3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.

(4) Represents annualized yields/rates.

Table of Contents

Comparison of Net Interest Income for the Three Months Ended March 31, 2018 and 2017

Net interest income increased \$1.3 million, or 8.8%, during the three months ended March 31, 2018, compared to the same period in 2017. The increase in net interest income was attributable to both positive interest-earning asset volume and rate variances. Interest-earning asset growth was primarily driven by an \$89.5 million, or 6.1%, increase in average loans and leases, while yields on variable-rate loans benefited from the FOMC's decision to raise the targeted federal funds rate throughout 2017 and 2018. The increase was partially offset by an increase in both average volume and average rate paid on interest-bearing liabilities.

The yield on average earning assets for the three months ended March 31, 2018 increased 32 basis points to 4.67%, compared to 4.35% for the three months ended March 31, 2017. The increase was due to increased rates on variable-rate loans following the FOMC's decision to raise the targeted federal funds rate and, to a lesser extent, a higher yielding securities portfolio.

The weighted average rate paid on our interest-bearing deposits for the three months ended March 31, 2018 increased 11 basis points to 0.95%, compared to 0.84% for the three months ended March 31, 2017. The rate increase is primarily attributable to a moderate increase in rates across all in-market deposit types. This increase in interest-bearing deposit costs was partially offset by a \$99.8 million decrease in wholesale deposits. Excluding wholesale deposits, the weighted average rate paid on interest-bearing deposits for the three months ended March 31, 2018 increased 20 basis points to 0.67%, compared to 0.47% for the three months ended March 31, 2017. The average effective federal funds rate during this same time period increased 75 basis points, resulting in an estimated deposit beta of approximately 27%. Deposit beta is defined as the basis point change in the average rate paid on in-market interest-bearing deposits divided by the basis point change in the average effective federal funds rate.

The rising rate environment has resulted in modest increases in deposit pricing as necessary to serve the Corporation's client relationships. Management believes an increase in average total interest-bearing deposit costs may continue as the Corporation looks to effectively manage deposit relationships amid intense competition and continued expectation of a rising rate environment.

The overall weighted average rate paid on interest-bearing liabilities was 1.25% for the three months ended March 31, 2018, compared to 1.04% for the three months ended March 31, 2017. The primary reason for the increase in rate paid was a moderate increase in rates across all in-market deposit types combined with higher wholesale funding rates resulting from a rising rate environment. The weighted average rate paid on interest-bearing liabilities continued to benefit from a relatively stable level of in-market interest-bearing deposits which increased \$18.6 million, or 2.1%, for the three months ended March 31, 2018, compared to the same period in 2017. Consistent with the Corporation's longstanding funding strategy to manage risk and use the most efficient and cost effective source of wholesale funds, fixed rate FHLB advances were used at various maturity terms commensurate with the Bank's funding needs. Average FHLB advances for the three months ended March 31, 2018 increased \$156.8 million to \$217.5 million at a weighted average rate paid of 1.84%. As of March 31, 2018, the weighted average original maturity of our FHLB term advances was 3.6 years.

We believe we effectively manage the Corporation's liability structure in both term and rate to deliver a net interest margin at or above our target of 3.50%. Further, we expect continued success in attracting in-market deposit relationships in our Wisconsin and Kansas markets which we believe will contribute to our ability to maintain an appropriate cost of funds. Average in-market client deposits - comprised of all transaction accounts, money market accounts and non-wholesale deposits - were \$1.122 billion for the three months ended March 31, 2018, compared to \$1.103 billion for the three months ended March 31, 2017.

Net interest margin increased 14 basis points to 3.65% for the three months ended March 31, 2018, compared to 3.51% for the three months ended March 31, 2017 primarily due to the aforementioned increase in rates on variable-rate loans and a higher yielding securities portfolio. The resulting increase in earning asset yields benefited net interest margin by 32 basis points. This benefit was partially offset by an increase in average rate paid on in-market deposits, reducing net interest margin by 10 basis points, and by both rate and volume increases in Bank wholesale funds, reducing net interest margin by an additional 10 basis points.

During the first quarter of 2018, management continued to replace wholesale deposits with FHLB advances consistent with our funding philosophy to manage risk and utilize the most efficient and cost effective sources of wholesale funds. This shift in wholesale funds also reduced our FDIC assessment rate resulting in an \$81,000, or 21.3%, decrease in FDIC insurance expense, compared to the same period in 2017.

Table of Contents

Management believes the successful efforts to optimize funding costs and profitably expand loan balances will allow the Corporation to continue to maintain a net interest margin of 3.50% or better. However, the collection of loan fees in lieu of interest is an expected source of volatility to quarterly net interest income and net interest margin, given the nature of the Corporation's asset-based lending business. Net interest margin may also experience volatility due to events such as the collection of interest on loans previously in non-accrual status or the accumulation of significant short-term deposit inflows.

Provision for Loan and Lease Losses

We determine our provision for loan and lease losses based upon credit risk and other subjective factors pursuant to our allowance for loan and lease loss methodology, the magnitude of current and historical net charge-offs recorded in the period and the amount of reserves established for impaired loans that present collateral shortfall positions. Refer to the section in this MD&A entitled Allowance for Loan and Lease Losses, below, for further information regarding our allowance for loan and lease loss methodology.

We recorded provision expense of \$2.5 million for the three months ended March 31, 2018 compared to \$572,000 for the same time period in 2017. Provision for the three months ended March 31, 2018 primarily reflected net charge-offs in excess of previously established specific reserves and an increase to the general reserve commensurate with loan growth. Net charge-offs of \$2.6 million for the three months ended March 31, 2018 were primarily related to three legacy SBA loan relationships that were previously identified as impaired.

The addition of specific reserves on impaired loans represents new specific reserves established when collateral shortfalls are present, while conversely the release of specific reserves represents the reduction of previously established reserves that are no longer required. Changes in the allowance for loan and lease losses due to subjective factor changes reflect management's evaluation of the level of risk within the portfolio based upon several factors for each portfolio segment. Charge-offs in excess of previously established specific reserves require an additional provision for loan and lease losses to maintain the allowance for loan and lease losses at a level deemed appropriate by management. Change in the inherent risk of the portfolio is primarily influenced by the overall growth in gross loans and leases and an analysis of loans previously charged off, as well as, movement of existing loans and leases in and out of an impaired loan classification where a specific evaluation of a particular credit may be required rather than the application of a general reserve ratio. Refer to the section in this MD&A entitled Asset Quality, below, for further information regarding the overall credit quality of our loan and lease portfolio.

Comparison of Non-Interest Income for the Three Months Ended March 31, 2018 and 2017

Non-Interest Income

Non-interest income consists primarily of fees earned for trust and investment services, gains on sale of SBA loans, service charges on deposits, loan fee income and commercial loan swap fee income. For the three months ended March 31, 2018 non-interest income increased by \$604,000, or 14.9%, to \$4.7 million from \$4.1 million for the same period in 2017.

Management continues to focus on revenue growth from multiple non-interest income sources in order to maintain a diversified revenue stream through greater contribution from fee-based revenues. Total non-interest income accounted for 22.4% of our total revenues for the three months ended March 31, 2018, compared to 21.4% and for the three months ended March 31, 2017. Management believes the expected steady and gradual expansion of our rebuilt SBA lending program will drive our fee income ratio towards our current strategic target of 25%.

Table of Contents

The components of non-interest income were as follows for the three months ended March 31, 2018 and 2017:

| | For the Three Months Ended March 31, | | | |
|---|--------------------------------------|---------|--------------|-------------|
| | 2018 | 2017 | \$ Change | % Change |
| | (Dollars in Thousands) | | | |
| Trust and investment services fee income | \$1,898 | \$1,629 | \$ 269 | 16.5 % |
| Gain on sale of SBA loans | 269 | 360 | (91) | (25.3) |
| Service charges on deposits | 784 | 765 | 19 | 2.5 |
| Loan fees | 527 | 458 | 69 | 15.1 |
| Increase in cash surrender value of bank-owned life insurance | 292 | 311 | (19) | (6.1) |
| Commercial loan swap fees | 633 | 199 | 434 | 218.1 |
| Other non-interest income | 264 | 341 | (77) | (22.6) |
| Total non-interest income | \$4,667 | \$4,063 | \$ 604 | 14.9 |
| Fee income ratio ⁽¹⁾ | 22.4 % | 21.4 % | | |

(1) Fee income ratio is non-interest income divided by top line revenue (defined as net interest income plus non-interest income).

Trust and investment services fee income increased \$269,000, or 16.5%, to a record \$1.9 million for the three months ended March 31, 2018, compared to \$1.6 million for the three months ended March 31, 2017. This increase was driven by growth in assets under management and administration attributable to both new client relationships and increased equity market values throughout 2017. At March 31, 2018, there were a record \$1.394 billion of trust assets under management compared to \$1.127 billion at March 31, 2017. Assets under administration were \$185.5 million at March 31, 2018 compared to \$177.0 million at March 31, 2017.

Gains on sale of SBA loans for the three months ended March 31, 2018 totaled \$269,000, a decrease of \$91,000, or 25.3%, compared to the three months ended March 31, 2017. After significant investments in 2016 and 2017, management believes a solid SBA infrastructure is now in place, with the people and processes necessary to build production and achieve our profitability goals throughout 2018 and beyond. The Corporation recently hired three more SBA business development officers in Wisconsin, and now, with the production talent already added in 2017, management anticipates production to grow at a moderate pace.

Commercial loan swap fee income for the three months ended March 31, 2018 increased \$434,000 to \$633,000, compared to \$199,000, from the same period in 2017. We believe due to the market's assumption of a rising interest rate environment throughout 2018 we could see additional loan demand for these types of relationship-based opportunities.

Table of Contents

Comparison of Non-Interest Expense for the Three Months Ended March 31, 2018 and 2017

Non-Interest Expense

The components of non-interest expense were as follows for the three months ended March 31, 2018 and 2017:

| | For the Three Months Ended March 31, | | | |
|--|--------------------------------------|----------|--------|--------|
| | 2018 | 2017 | \$ | % |
| | | | Change | Change |
| | (Dollars in Thousands) | | | |
| Compensation | \$9,071 | \$8,683 | \$ 388 | 4.5 % |
| Occupancy | 529 | 475 | 54 | 11.4 |
| Professional fees | 1,035 | 1,010 | 25 | 2.5 |
| Data processing | 611 | 584 | 27 | 4.6 |
| Marketing | 333 | 370 | (37) | (10.0) |
| Equipment | 343 | 283 | 60 | 21.2 |
| Computer software | 742 | 683 | 59 | 8.6 |
| FDIC insurance | 299 | 380 | (81) | (21.3) |
| Collateral liquidation costs | 1 | 92 | (91) | (98.9) |
| Impairment on tax credit investments | 113 | 113 | — | — |
| SBA recourse (benefit) provision | (295) | 6 | (301) | N/M |
| Other non-interest expense | 1,125 | 881 | 244 | 27.7 |
| Total non-interest expense | \$13,907 | \$13,560 | \$ 347 | 2.6 |
| Total adjusted operating expense ⁽¹⁾ | \$14,077 | \$13,427 | | |
| Compensation expense to total adjusted operating expense | 64.44 % | 64.67 % | | |
| Full-time equivalent employees | 256 | 258 | | |

N/M = Not meaningful

(1) Total adjusted operating expense excludes the impact of discrete items as previously defined in the non-GAAP efficiency ratio calculation.

Non-interest expense for the three months ended March 31, 2018 increased by \$347,000, or 2.6%, to \$13.9 million compared to \$13.6 million for the same period in 2017. The increase in non-interest expense was primarily due to an increase in compensation and other non-interest expense, partially offset by a decrease in SBA recourse provision.

Compensation expense increased by \$388,000, or 4.5%, to \$9.1 million for the three months ended March 31, 2018 from \$8.7 million for the three months ended March 31, 2017. The overall increase reflected growth related to annual merit increases. We expect to continue to opportunistically invest in talent to support our strategic growth efforts, both in the form of additional production and operational staff.

The Corporation recorded a net benefit of \$295,000 in SBA recourse provision for estimated losses in the outstanding guaranteed portion of SBA loans sold for the three months ended March 31, 2018, down from a net expense of \$6,000