

**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 June 30, 2022

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

53719

Madison

Wisconsin

(Address of Principal Executive Offices)

(Zip Code)

(608) 238-8008

Registrant's telephone number, including area code

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, \$0.01 par value	FBIZ	The Nasdaq Stock Market LLC

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

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

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☒ Emerging growth company ☐

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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 July 24, 2022 was 8,475,953 shares.

FIRST BUSINESS FINANCIAL SERVICES, INC.
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PART I. Financial Information

Item 1. Financial Statements

First Business Financial Services, Inc. Consolidated Balance Sheets

	June 30, 2022	December 31, 2021
	(Unaudited)	
	(In Thousands, Except Share Data)	
Assets		
Cash and due from banks	\$ 39,251	\$ 9,697
Short-term investments	56,233	47,413
Cash and cash equivalents	95,484	57,110
Securities available-for-sale, at fair value	208,643	205,702
Securities held-to-maturity, at amortized cost	13,968	19,746
Loans held for sale	2,256	3,570
Loans and leases receivable, net of allowance for loan and lease losses of \$24,104 and \$24,336, respectively	2,265,996	2,215,072
Premises and equipment, net	1,899	1,694
Foreclosed properties	124	164
Right-of-use assets, net	5,772	4,910
Bank-owned life insurance	54,324	53,600
Federal Home Loan Bank stock, at cost	22,959	13,336
Goodwill and other intangible assets	12,262	12,268
Derivatives	44,461	26,343
Accrued interest receivable and other assets	48,868	39,390
Total assets	<u>\$ 2,777,016</u>	<u>\$ 2,652,905</u>
Liabilities and Stockholders' Equity		
Deposits	\$ 1,869,331	\$ 1,957,923
Federal Home Loan Bank advances and other borrowings	596,642	403,451
Junior subordinated notes	—	10,076
Lease liabilities	7,207	5,406
Derivatives	40,357	28,283
Accrued interest payable and other liabilities	13,556	15,344
Total liabilities	<u>2,527,093</u>	<u>2,420,483</u>
Stockholders' equity:		
Preferred stock, Series A; \$0.01 par value, 7% non-cumulative perpetual preferred stock liquidation preference \$1,000 per share, 2,500,000 shares authorized, 12,500 and no shares issued and outstanding at June 30, 2022 and December 31, 2021, respectively	11,992	—
Common stock, \$0.01 par value, 25,000,000 shares authorized, 9,367,337 and 9,326,361 shares issued, 8,474,699 and 8,457,564 shares outstanding at June 30, 2022 and December 31, 2021, respectively	94	93
Additional paid-in capital	86,123	85,797
Retained earnings	186,302	170,020
Accumulated other comprehensive loss	(11,588)	(1,457)
Treasury stock, 892,638 and 868,797 shares at June 30, 2022 and December 31, 2021, respectively, at cost	(23,000)	(22,031)
Total stockholders' equity	<u>249,923</u>	<u>232,422</u>
Total liabilities and stockholders' equity	<u>\$ 2,777,016</u>	<u>\$ 2,652,905</u>

See accompanying Notes to Unaudited Consolidated Financial Statements.

First Business Financial Services, Inc.
Consolidated Statements of Income (Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2022	2021	2022	2021
(In Thousands, Except Per Share Data)				
Interest income				
Loans and leases	\$ 25,687	\$ 23,591	\$ 48,759	\$ 46,386
Securities	1,064	816	2,039	1,669
Short-term investments	280	192	468	351
Total interest income	27,031	24,599	51,266	48,406
Interest expense				
Deposits	1,058	943	1,824	1,962
Federal Home Loan Bank advances and other borrowings	2,313	1,727	3,851	3,377
Junior subordinated notes	—	277	504	552
Total interest expense	3,371	2,947	6,179	5,891
Net interest income	23,660	21,652	45,087	42,515
Provision for loan and lease losses	(3,727)	(958)	(4,582)	(3,026)
Net interest income after provision for loan and lease losses	27,387	22,610	49,669	45,541
Non-interest income				
Private wealth management service fees	2,852	2,744	5,693	5,151
Gain on sale of Small Business Administration loans	951	1,203	1,537	2,281
Service charges on deposits	1,041	941	2,040	1,859
Loan fees	697	569	1,349	1,114
Increase in cash surrender value of bank-owned life insurance	350	350	698	699
Net gain on sale of securities	—	29	—	29
Swap fees	471	—	697	684
Other non-interest income	510	485	2,244	1,699
Total non-interest income	6,872	6,321	14,258	13,516
Non-interest expense				
Compensation	14,020	13,255	27,658	25,912
Occupancy	568	533	1,123	1,085
Professional fees	1,298	913	2,468	1,778
Data processing	892	798	1,673	1,569
Marketing	670	511	1,170	902
Equipment	235	261	479	506
Computer software	1,117	1,129	2,199	2,244
FDIC insurance	296	280	610	642
Other non-interest expense	360	504	900	876
Total non-interest expense	19,456	18,184	38,280	35,514
Income before income tax expense	14,803	10,747	25,647	23,543
Income tax expense	3,599	2,512	5,771	5,577
Net income	11,204	8,235	19,876	17,966
Preferred stock dividend	246	—	246	—
Net income available to common shareholders	\$ 10,958	\$ 8,235	\$ 19,630	\$ 17,966
Earnings per common share				
Basic	\$ 1.29	\$ 0.95	\$ 2.31	\$ 2.08
Diluted	1.29	0.95	2.31	2.08
Dividends declared per share	0.1975	0.18	0.395	0.36

See accompanying Notes to Unaudited Consolidated Financial Statements.

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2022	2021	2022	2021
	(In Thousands)			
Net income	\$ 11,204	\$ 8,235	\$ 19,876	\$ 17,966
Other comprehensive (loss) income				
Securities available-for-sale:				
Unrealized securities (losses) gains arising during the period	(7,184)	662	(19,665)	(1,576)
Reclassification adjustment for net gain realized in net income	—	(29)	—	(29)
Securities held-to-maturity:				
Amortization of net unrealized losses transferred from available-for-sale	3	7	8	15
Interest rate swaps:				
Unrealized gains (losses) on interest rate swaps arising during the period	2,175	(271)	6,044	1,818
Income tax benefit (expense)	1,281	(94)	3,482	(58)
Total other comprehensive (loss) income	(3,725)	275	(10,131)	170
Comprehensive income	<u>\$ 7,479</u>	<u>\$ 8,510</u>	<u>\$ 9,745</u>	<u>\$ 18,136</u>

See accompanying Notes to Unaudited Consolidated Financial Statements.

First Business Financial Services, Inc.
Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

	Common Shares Outstanding	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
(In Thousands, Except Share Data)								
Balance at January 1, 2021	8,566,960	\$ —	\$ 92	\$ 83,125	\$ 140,431	\$ (933)	\$ (16,553)	\$ 206,162
Net income	—	—	—	—	9,731	—	—	9,731
Other comprehensive loss	—	—	—	—	—	(105)	—	(105)
Share-based compensation - restricted shares and employee stock purchase plan	84,255	—	1	530	—	—	—	531
Issuance of common stock under the employee stock purchase plan	1,775	—	—	39	—	—	—	39
Cash dividends (\$0.18 per share)	—	—	—	—	(1,541)	—	—	(1,541)
Treasury stock purchased	(14,795)	—	—	—	—	—	(326)	(326)
Balance at March 31, 2021	8,638,195	\$ —	\$ 93	\$ 83,694	\$ 148,621	\$ (1,038)	\$ (16,879)	\$ 214,491
Net income	—	—	—	—	8,235	—	—	8,235
Other comprehensive loss	—	—	—	—	—	275	—	275
Share-based compensation - restricted shares and employee stock purchase plan	1,421	—	—	607	—	—	—	607
Issuance of common stock under the employee stock purchase plan	1,694	—	—	42	—	—	—	42
Cash dividends (\$0.18 per share)	—	—	—	—	(1,556)	—	—	(1,556)
Treasury stock purchased	(23,549)	—	—	—	—	—	(642)	(642)
Balance at June 30, 2021	8,617,761	\$ —	\$ 93	\$ 84,343	\$ 155,300	\$ (763)	\$ (17,521)	\$ 221,452

	Common Shares Outstanding	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
(In Thousands, Except Share Data)								
Balance at January 1, 2022	8,457,564	\$ —	\$ 93	\$ 85,797	\$ 170,020	\$ (1,457)	\$ (22,031)	\$ 232,422
Net income	—	—	—	—	8,672	—	—	8,672
Other comprehensive loss	—	—	—	—	—	(6,406)	—	(6,406)
Issuance of preferred stock, net of issuance costs	—	11,992	—	—	—	—	—	11,992
Share-based compensation - restricted shares and employee stock purchase plan	47,864	—	1	608	—	—	—	609
Issuance of common stock under the employee stock purchase plan	1,380	—	—	40	—	—	—	40
Treasury stock re-issued	—	—	—	(1,002)	—	—	1,002	—
Cash dividends (\$0.1975 per share)	—	—	—	—	(1,670)	—	—	(1,670)
Treasury stock purchased	(18,223)	—	—	—	—	—	(608)	(608)
Balance at March 31, 2022	<u>8,488,585</u>	<u>\$ 11,992</u>	<u>\$ 94</u>	<u>\$ 85,443</u>	<u>\$ 177,022</u>	<u>\$ (7,863)</u>	<u>\$ (21,637)</u>	<u>\$ 245,051</u>
Net income	—	—	—	—	11,204	—	—	11,204
Other comprehensive income	—	—	—	—	—	(3,725)	—	(3,725)
Share-based compensation - restricted shares and employee stock purchase plan	25,860	—	—	645	—	—	—	645
Issuance of common stock under the employee stock purchase plan	1,254	—	—	35	—	—	—	35
Preferred stock dividends	—	—	—	—	(246)	—	—	(246)
Cash dividends (\$0.1975 per share)	—	—	—	—	(1,678)	—	—	(1,678)
Treasury stock purchased	(41,000)	—	—	—	—	—	(1,363)	(1,363)
Balance at June 30, 2022	<u>8,474,699</u>	<u>\$ 11,992</u>	<u>\$ 94</u>	<u>\$ 86,123</u>	<u>\$ 186,302</u>	<u>\$ (11,588)</u>	<u>\$ (23,000)</u>	<u>\$ 249,923</u>

See accompanying Notes to Unaudited Consolidated Financial Statements.

First Business Financial Services, Inc.
Consolidated Statements of Cash Flows (Unaudited)

	For the Six Months Ended June 30,	
	2022	2021
	(In Thousands)	
Operating activities		
Net income	\$ 19,876	\$ 17,966
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes, net	(1,695)	(1,359)
Impairment of tax credit investments	(351)	—
Provision for loan and lease losses	(4,582)	(3,026)
Derivative credit valuation adjustment	—	(376)
Depreciation, amortization and accretion, net	2,025	1,845
Loss on disposal of equipment	—	56
Share-based compensation	1,254	1,138
Net gain on sale of securities	—	(29)
Increase in bank-owned life insurance policies	(698)	(699)
Origination of loans for sale	(61,278)	(48,137)
Sale of SBA loans originated for sale	64,129	53,054
Gain on sale of loans originated for sale	(1,537)	(2,281)
Net loss on foreclosed properties, including impairment valuation	20	1
Loan servicing right impairment valuation	—	(78)
Excess tax benefit (expense) from share-based compensation	183	(16)
Returns on investments in limited partnerships	314	—
Payments on operating lease liabilities	(817)	(788)
Payments received on operating leases	90	82
Net increase in accrued interest receivable and other assets	(13,814)	(1,152)
Net increase (decrease) in accrued interest payable and other liabilities	13,658	(1,230)
Net cash provided by operating activities	16,777	14,971
Investing activities		
Proceeds from maturities, redemptions, and paydowns of available-for-sale securities	20,185	31,315
Proceeds from maturities, redemptions, and paydowns of held-to-maturity securities	5,761	3,969
Proceeds from sale of available-for-sale securities	—	14,955
Purchases of available-for-sale securities	(43,231)	(35,559)
Proceeds from sale of foreclosed properties	37	—
Net (increase) decrease in loans and leases	(46,359)	2,444
Investments in limited partnerships	(363)	—
Returns of investments in limited partnerships	—	60
Distribution from historic development entities	282	57
Investment in low-income housing entities	(5,937)	(1,307)
Investment in Federal Home Loan Bank stock	(23,370)	(6,314)
Proceeds from the sale of Federal Home Loan Bank stock	13,746	6,440
Purchases of leasehold improvements and equipment, net	(469)	(135)
Proceeds from sale of leasehold improvements and equipment	—	12
Premium payment on bank owned life insurance policies	(25)	—
Proceeds from redemption of Trust II stock	315	—
Net cash used in investing activities	(79,428)	15,937
Financing activities		
Net (decrease) increase in deposits	(88,592)	305,191
Proceeds from Federal Home Loan Bank advances	1,413,844	510,300

Repayment of Federal Home Loan Bank advances	(1,228,543)	(517,000)
Repayment of subordinated notes payable	(9,090)	—
Proceeds from issuance of subordinated notes payable	20,000	—
Repayment of junior subordinated notes payable	(10,076)	—
Net (decrease) increase in long-term borrowed funds	(3,020)	7,653
Cash dividends paid	(3,348)	(3,097)
Preferred stock dividends paid	(246)	—
Proceeds from issuance of common stock under ESPP	75	81
Proceeds from issuance of preferred stock	11,992	—
Purchase of treasury stock	(1,971)	(968)
Net cash provided by financing activities	101,025	302,160
Net increase in cash and cash equivalents	38,374	333,068
Cash and cash equivalents at the beginning of the period	57,110	56,909
Cash and cash equivalents at the end of the period	\$ 95,484	\$ 389,977
Supplementary cash flow information		
Cash paid during the period for:		
Interest paid on deposits and borrowings	\$ 5,707	\$ 7,469
Income taxes paid	(31)	7,658
Non-cash investing and financing activities:		
Right-of-use assets obtained in exchange for operating lease liabilities	—	316
Transfer from loans and leases to foreclosed properties	17	149

See accompany Notes to Unaudited Consolidated Financial Statements

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. (“FBFS” or the “Corporation”), through our wholly-owned subsidiary, First Business Bank (“FBB” or the “Bank”), have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). FBB operates as a commercial banking institution primarily in Wisconsin and the greater Kansas City metropolitan area. The Bank provides a full range of financial services to businesses, business owners, executives, professionals, and high net worth individuals. FBB also offers bank consulting services to community banks. The Bank is subject to competition from other financial institutions and service providers, and is also subject to state and federal regulations. As of June 30, 2022, FBB had the following wholly-owned subsidiaries: First Business Specialty Finance, LLC (“FBSF”), First Madison Investment Corp. (“FMIC”), ABKC Real Estate, LLC (“ABKC”), FBB Real Estate 2, LLC (“FBB RE 2”), BOC Investment, LLC (“BOC”), Mitchell Street Apartments Investment, LLC (“Mitchell Street”), and FBB Tax Credit Investment, LLC (“FBB Tax Credit”).

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, 2021. 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”) was not consolidated into the financial statements. As of March 30, 2022, the Bank’s trust preferred securities were redeemed and Trust II was subsequently dissolved.

Management of the Corporation is required to make estimates and assumptions which 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, and income taxes. The results of operations for the three and six months ended June 30, 2022, are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2022. 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, 2021.

Recent Accounting Pronouncements

In June 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) No. 2016-13, “*Financial Instruments- Credit Losses (Topic 326)*,” which is often referred to as Current Expected Credit Losses (“CECL”). 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 under which the Corporation has 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. In November 2019, the FASB issued ASU No. 2019-10, “*Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842)*.” The ASU delays the effective date for the credit losses standard from January 1, 2020 to January 1, 2023 for certain entities, including certain Securities and Exchange Commission filers, public business entities, and private companies. As a smaller reporting company, the Corporation is eligible for the delay and has deferred adoption. The Corporation has established a cross-functional committee and has implemented a third-party software solution to assist with the adoption of the standard. Management has gathered all necessary data and reviewed potential methods to calculate the expected

credit losses. Management is currently calculating sample expected loss computations and developing the allowance methodology and assumptions that will be used under the new standard. Management will continue to progress on its implementation project plan and improve the Corporation's approach throughout the deferral period.

In March 2020, the FASB issued ASU No. 2020-04 "Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting." These amendments provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference the London Interbank Offered Rate ("LIBOR") or another reference rate expected to be discontinued. It is intended to help stakeholders during the global market-wide reference rate transition period. In January 2021, the FASB issued ASU 2021-01 which clarifies that certain optional expedients and exceptions in Topic 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022. The Corporation continues to implement its transition plan toward cessation of LIBOR and the modification of its loans and other financial instruments with attributes that are either directly or indirectly influenced by LIBOR. The Corporation expects to utilize the LIBOR transition relief allowed under ASU 2020-04 and ASU 2020-01, and does not expect such adoption to have a material impact on its accounting and disclosures.

In August 2021, the FASB issued ASU No. 2021-06 "Presentation of Financial Statements (Topic 205), Financial Services-Depository and Lending (Topic 942), and Financial Services-Investment Companies (Topic 946): Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10786, Amendments to Financial Disclosures about Acquired and Disposed Businesses, and No. 33-10835, Update of Statistical Disclosures for Bank and Savings and Loan Registrants." This ASU amends the SEC sections of the Codification related to Final Rule Releases No. 33-10786, Amendments to Financial Disclosures about Acquired and Disposed Businesses, and No. 33-10835, Update to Statistical Disclosures for Bank and Savings and Loan Registrants. The guidance is effective upon its addition to the FASB codification. The Corporation is assessing the impact of ASU 2021-06 and its impact on its disclosures.

In March 2022, the FASB issued ASU 2022-02 "Financial Instruments-Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures." The amendments in this update eliminate the accounting guidance for troubled debt restructurings ("TDRs") by creditors in Subtopic 310-40, Receivables-Troubled Debt Restructurings by Creditors, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Specifically, rather than applying the recognition and measurement guidance for TDRs, an entity must apply the loan refinancing and restructuring guidance in paragraphs 310-20-35-9 through 35-11 to determine whether a modification results in a new loan or a continuation of an existing loan. Additionally, for public business entities, the amendments in this Update require that an entity disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of Subtopic 326-20, Financial Instruments-Credit Losses-Measured at Amortized Cost in the vintage disclosures required by paragraph 326-20-50-6. The guidance is effective for the Corporation upon the adoption of ASU 2016-13, January 1, 2023. The Corporation is currently assessing the impact of ASU 2022-02 on its disclosures and control structure; however, the Corporation does not expect the adoption of this standard to have a material impact on the consolidated financial statements.

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 June 30,		For the Six Months Ended June 30,	
	2022	2021	2022	2021
(Dollars in Thousands, Except Share Data)				
<i>Basic earnings per common share</i>				
Net income	\$ 11,204	\$ 8,235	\$ 19,876	\$ 17,966
Less: preferred stock dividends	246	—	246	—
Less: earnings allocated to participating securities	310	238	547	493
Basic earnings allocated to common shareholders	<u>\$ 10,648</u>	<u>\$ 7,997</u>	<u>\$ 19,083</u>	<u>\$ 17,473</u>
Weighted-average common shares outstanding, excluding participating securities	8,225,838	8,385,069	8,245,317	8,381,868
Basic earnings per common share	\$ 1.29	\$ 0.95	\$ 2.31	\$ 2.08
<i>Diluted earnings per common share</i>				
Earnings allocated to common shareholders, diluted	\$ 10,648	\$ 7,997	\$ 19,083	\$ 17,473
Weighted-average diluted common shares outstanding, excluding participating securities	8,225,838	8,385,069	8,245,317	8,381,868
Diluted earnings per common share	\$ 1.29	\$ 0.95	\$ 2.31	\$ 2.08

Note 3 — Share-Based Compensation

The Corporation adopted the 2019 Equity Incentive Plan (the "Plan") during the quarter ended June 30, 2019. The Plan is administered by the Compensation Committee of the Board of Directors (the "Board") of the Corporation and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options ("Stock Options"), restricted stock, restricted stock units, dividend equivalent units, and any other type of award permitted by the Plan. As of June 30, 2022, 154,002 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.

Restricted Stock

Under the Plan, the Corporation may grant restricted stock awards ("RSA"), restricted stock units ("RSU"), and other stock-based awards 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 award 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 for restricted stock is recognized over the requisite service period of generally three or 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.

The Corporation may issue a combination of performance-based restricted stock units ("PRSU") and time-based restricted stock awards to its plan participants. Vesting of the performance-based restricted stock units will be measured on the relative Total Shareholder Return ("TSR") and relative Return on Equity ("ROE") and will cliff-vest after a three-year measurement period based on the Corporation's TSR performance and ROE performance compared to a broad peer group of over 100 banks. At the end of the performance period, the number of actual shares to be awarded varies between 0% and 200% of target amounts. The

restricted stock awards issued to executive officers will vest ratably over a three-year period. Compensation expense is recognized for PRSU over the requisite service and performance period of generally three years for the entire expected award on a straight-line basis. The compensation expense for the awards expected to vest for the percentage of performance-based restricted stock units subject to the ROE metric will be adjusted if there is a change in the expectation of ROE. The compensation expense for the awards expected to vest for the percentage of performance based restricted stock units subject to the TSR metric are never adjusted, and are amortized utilizing the accounting fair value provided using a Monte Carlo pricing model.

Restricted stock activity for the year ended December 31, 2021 and the six months ended June 30, 2022 was as follows:

	RSA	Weighted Average Grant Price	PRSU	Weighted Average Grant Price	RSU	Weighted Average Grant Price	Total	Weighted Average Grant Price
Nonvested balance as of January 1, 2021	143,246	\$ 23.04	39,570	\$ 28.85	4,988	\$ 24.08	187,804	\$ 24.29
Granted ⁽¹⁾	67,515	22.39	23,550	27.12	2,065	21.68	93,130	23.57
Vested	(61,384)	22.26	—	—	(2,001)	22.91	(63,385)	22.28
Forfeited	(7,760)	23.24	—	—	—	—	(7,760)	23.24
Nonvested balance as of December 31, 2021	141,617	23.06	63,120	28.20	5,052	23.56	209,789	24.62
Granted ⁽¹⁾	55,275	33.59	37,335	24.71	335	33.60	92,945	30.02
Vested	(46,367)	23.38	(43,020)	18.91	(1,552)	24.17	(90,939)	21.28
Forfeited	(1,807)	25.60	—	—	—	—	(1,807)	25.60
Nonvested balance as of June 30, 2022	148,718	\$ 26.84	57,435	\$ 32.89	3,835	\$ 24.19	209,988	\$ 28.45
Unrecognized compensation cost (in thousands)	\$ 3,222		\$ 1,239		\$ 70		\$ 4,531	
Weighted average remaining recognition period (in years)	2.67		2.00		1.97		2.47	

(1) The number of restricted shares/units shown includes the shares that would be granted if the target level of performance is achieved plus related to the performance based restricted stock units. The number of shares actually issued may vary. During the six months ended June 30, 2022, an additional 21,510 were issued related to actual performance results of previously granted awards.

Employee Stock Purchase Plan

During 2020, an employee stock purchase plan ("ESPP") was approved by the Corporation's shareholders and is offered to all qualifying employees. The Corporation is authorized to issue up to 250,000 shares of common stock under the ESPP. The plan qualifies as an employee stock purchase plan under section 423 of the Internal Revenue Code of 1986. Under the ESPP, eligible employees may enroll in a three month offer period that begins January, April, July, and October of each year. Employees may elect to purchase a limited number of shares on the Corporation's common stock at 90% of the fair market value on the last day of the offering period. The ESPP is treated as a compensatory item for purposes of share-based compensation expense.

During the six months ended June 30, 2022, the Corporation issued 2,634 shares of common stock under the ESPP. As of June 30, 2022, 238,122 shares remained available for issuance under the ESPP.

Share-based compensation expense related to restricted stock and ESPP included in the unaudited Consolidated Statements of Income was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2022	2021	2022	2021
	(In Thousands)			
Share-based compensation expense	\$ 645	\$ 607	\$ 1,254	\$ 1,138

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 June 30, 2022				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale:				
U.S. treasuries	\$ 4,974	\$ —	\$ (401)	4,573
U.S. government agency securities - government-sponsored enterprises	17,059	248	(393)	16,914
Municipal securities	43,995	7	(5,228)	38,774
Residential mortgage-backed securities - government issued	17,148	2	(1,284)	15,866
Residential mortgage-backed securities - government-sponsored enterprises	104,040	3	(8,085)	95,958
Commercial mortgage-backed securities - government issued	3,834	—	(337)	3,497
Commercial mortgage-backed securities - government-sponsored enterprises	36,275	—	(4,195)	32,080
Other securities	980	1	—	981
	<u>\$ 228,305</u>	<u>\$ 261</u>	<u>\$ (19,923)</u>	<u>\$ 208,643</u>

As of December 31, 2021				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale:				
U.S. treasuries	\$ 4,971	\$ —	\$ (57)	4,914
U.S. government agency securities - government-sponsored enterprises	19,797	248	(110)	19,935
Municipal securities	30,828	473	(344)	30,957
Residential mortgage-backed securities - government issued	19,563	238	(140)	19,661
Residential mortgage-backed securities - government-sponsored enterprises	85,748	741	(784)	85,705
Commercial mortgage-backed securities - government issued	5,801	36	(66)	5,771
Commercial mortgage-backed securities - government-sponsored enterprises	36,786	313	(568)	36,531
Other securities	2,205	23	—	2,228
	<u>\$ 205,699</u>	<u>\$ 2,072</u>	<u>\$ (2,069)</u>	<u>\$ 205,702</u>

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 June 30, 2022				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)				
Held-to-maturity:				
Municipal securities	\$ 8,291	\$ 23	\$ (26)	\$ 8,288
Residential mortgage-backed securities - government issued	1,878	—	(57)	1,821
Residential mortgage-backed securities - government-sponsored enterprises	1,792	—	(48)	1,744
Commercial mortgage-backed securities - government-sponsored enterprises	2,007	—	(11)	1,996
	<u>\$ 13,968</u>	<u>\$ 23</u>	<u>\$ (142)</u>	<u>\$ 13,849</u>
As of December 31, 2021				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)				
Held-to-maturity:				
Municipal securities	\$ 13,009	\$ 222	\$ (3)	\$ 13,228
Residential mortgage-backed securities - government issued	2,226	40	—	2,266
Residential mortgage-backed securities - government-sponsored enterprises	2,502	76	—	2,578
Commercial mortgage-backed securities - government-sponsored enterprises	2,009	195	—	2,204
	<u>\$ 19,746</u>	<u>\$ 533</u>	<u>\$ (3)</u>	<u>\$ 20,276</u>

U.S. Treasuries contains treasury bonds issued by the United States Treasury. U.S. government agency securities - government-sponsored enterprises represent securities issued by Federal National Mortgage Association (“FNMA”) and the SBA. Municipal securities include securities issued by various municipalities located primarily within Wisconsin and are primarily general obligation bonds that are tax-exempt in nature. Residential and commercial mortgage-backed securities - government issued represent securities guaranteed by the Government National Mortgage Association. Residential and commercial mortgage-backed securities - government-sponsored enterprises include securities guaranteed by the Federal Home Loan Mortgage Corporation, FNMA, and the FHLB. Other securities represent certificates of deposit of insured banks and savings institutions with an original maturity greater than three months. There were no sales of available-for-sale securities that occurred during the three and six months ended June 30, 2022 and there were seven sales of available-for-sale securities that occurred during the three and six months ended June 30, 2021.

At June 30, 2022 and December 31, 2021, securities with a fair value of \$39.7 million and \$70.3 million, respectively, were pledged to secure various obligations, including interest rate swap contracts and municipal deposits.

The amortized cost and fair value of securities by contractual maturity at June 30, 2022 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	\$ 2,757	\$ 2,755	\$ 3,962	\$ 3,973
Due in one year through five years	12,882	12,115	4,130	4,109
Due in five through ten years	58,532	53,524	4,940	4,862
Due in over ten years	154,134	140,249	936	905
	<u>\$ 228,305</u>	<u>\$ 208,643</u>	<u>\$ 13,968</u>	<u>\$ 13,849</u>

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 June 30, 2022 and December 31, 2021. At June 30, 2022, the Corporation held 164 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 June 30, 2022, the Corporation held 11 available-for-sale securities that have 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 and six months ended June 30, 2022 and 2021.

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 June 30, 2022					
	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. treasuries	\$ 4,573	\$ 401	\$ —	\$ —	\$ 4,573	\$ 401
U.S. government agency securities - government-sponsored enterprises	926	73	2,181	320	3,107	393
Municipal securities	33,074	3,895	3,517	1,333	36,591	5,228
Residential mortgage-backed securities - government issued	14,826	1,284	—	—	14,826	1,284
Residential mortgage-backed securities - government-sponsored enterprises	83,381	6,556	11,394	1,529	94,775	8,085
Commercial mortgage-backed securities - government issued	3,497	337	—	—	3,497	337
Commercial mortgage-backed securities - government-sponsored enterprises	26,080	3,048	6,000	1,147	32,080	4,195
	<u>\$ 166,357</u>	<u>\$ 15,594</u>	<u>\$ 23,092</u>	<u>\$ 4,329</u>	<u>\$ 189,449</u>	<u>\$ 19,923</u>

	As of December 31, 2021					
	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. treasuries	\$ 4,914	\$ 57	\$ —	\$ —	\$ 4,914	\$ 57
U.S. government agency securities - government-sponsored enterprises	978	22	2,412	88	3,390	110
Municipal securities	12,568	344	—	—	12,568	344
Residential mortgage-backed securities - government issued	12,745	140	—	—	12,745	140
Residential mortgage-backed securities - government-sponsored enterprises	41,276	629	4,250	155	45,526	784
Commercial mortgage-backed securities - government issued	2,193	66	—	—	2,193	66
Commercial mortgage-backed securities - government-sponsored enterprises	25,906	568	—	—	25,906	568
	<u>\$ 100,580</u>	<u>\$ 1,826</u>	<u>\$ 6,662</u>	<u>\$ 243</u>	<u>\$ 107,242</u>	<u>\$ 2,069</u>

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 June 30, 2022 and December 31, 2021. At June 30, 2022, the Corporation held 23 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. At June 30, 2022, the Corporation held one held-to-maturity security that had been in a

continuous unrealized loss position for twelve months or greater. 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 and six months ended June 30, 2022 and 2021.

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 June 30, 2022					
	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:						
Municipal securities	\$ 1,742	\$ 8	\$ 268	\$ 18	\$ 2,010	\$ 26
Residential mortgage-backed securities - government issued	1,821	57	—	—	1,821	57
Residential mortgage-backed securities - government-sponsored enterprises	3,364	48	—	—	3,364	48
Commercial mortgage-backed securities - government-sponsored enterprises	376	11	—	—	376	11
	<u>\$ 7,303</u>	<u>\$ 124</u>	<u>\$ 268</u>	<u>\$ 18</u>	<u>\$ 7,571</u>	<u>\$ 142</u>
	As of December 31, 2021					
	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:						
Municipal securities	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 284</u>	<u>\$ 3</u>	<u>\$ 284</u>	<u>\$ 3</u>

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:

	June 30, 2022	December 31, 2021
	(In Thousands)	
Commercial real estate:		
Commercial real estate — owner occupied	\$ 258,375	\$ 235,589
Commercial real estate — non-owner occupied	651,920	661,423
Land development	42,545	42,792
Construction	203,913	179,841
Multi-family	314,392	320,072
1-4 family	17,335	14,911
Total commercial real estate	1,488,480	1,454,628
Commercial and industrial	741,363	730,819
Direct financing leases, net	13,718	15,743
Consumer and other:		
Home equity and second mortgages	5,132	4,223
Other	42,387	35,518
Total consumer and other	47,519	39,741
Total gross loans and leases receivable	2,291,080	2,240,931
Less:		
Allowance for loan and lease losses	24,104	24,336
Deferred loan fees	980	1,523
Loans and leases receivable, net	\$ 2,265,996	\$ 2,215,072

As of June 30, 2022 and December 31, 2021, the Corporation had \$8.3 million and \$27.9 million, respectively, in gross PPP loans outstanding included in the commercial and industrial loan category and deferred processing fees outstanding of \$113,000 and \$557,000, respectively, included in deferred loan fees. The processing fees are deferred and recognized over the contractual life of the loan, or accelerated at forgiveness, as an adjustment of yield using the interest method. The SBA provides a guaranty to the lender of 100% of principal and interest, unless the lender violated an obligation under the agreement. As loan losses are expected to be immaterial, if any at all, due to the guaranty, management excluded the PPP loans from the allowance for loan and lease losses calculation. Management funded these short-term loans primarily through a combination of excess cash held at the Federal Reserve and from an increase in in-market deposits.

The total amount of the Corporation's ownership of SBA loans on-balance sheet is comprised of the following:

	June 30, 2022	December 31, 2021
	(In Thousands)	
SBA 7(a) loans	\$ 32,927	\$ 33,223
SBA 504 loans	38,569	41,394
SBA Express loans and lines of credit	233	387
SBA PPP loans	8,285	27,854
Total SBA loans	\$ 80,014	\$ 102,858

As of June 30, 2022 and December 31, 2021, \$944,000 and \$1.7 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 and participation interests in other, non-SBA originated loans. The total principal amount of the guaranteed portions of SBA loans sold during the three months ended June 30, 2022, and 2021, was \$11.9 million and \$9.0 million, respectively. The total principal amount of the guaranteed portions of SBA loans sold during the six months ended June 30, 2022, and 2021, was

\$17.4 million and \$19.6 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 June 30, 2022, and 2021, 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 June 30, 2022, and December 31, 2021, was \$95.9 million and \$93.0 million, respectively.

The total principal amount of transferred participation interests in other, non-SBA originated loans during the three months ended June 30, 2022, and 2021, was \$23.0 million and \$11.8 million, respectively. The total principal amount of transferred participation interests in other, non-SBA originated loans during the six months ended June 30, 2022, and 2021, was \$45.2 million and \$16.9 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, non-SBA 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 June 30, 2022, and December 31, 2021, was \$199.0 million and \$195.2 million, respectively. As of June 30, 2022, and December 31, 2021, the total amount of the Corporation's partial ownership of these transferred loans on the unaudited Consolidated Balance Sheets was \$320.2 million and \$314.5 million, respectively. As of June 30, 2022 and December 31, 2021, the non-SBA originated participation portfolio contained no impaired loans. The Corporation does not share in the participant's portion of any potential charge-offs. There were no loan participations purchased on the unaudited Consolidated Balance Sheets as of June 30, 2022 and December 31, 2021.

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:

	June 30, 2022				
	Category				
	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	\$ 203,127	\$ 36,688	\$ 18,447	\$ 113	\$ 258,375
Commercial real estate — non-owner occupied	540,971	92,025	18,924	—	651,920
Land development	42,221	324	—	—	42,545
Construction	162,066	17,475	24,372	—	203,913
Multi-family	280,188	23,018	11,186	—	314,392
1-4 family	13,470	3,832	—	33	17,335
Total commercial real estate	1,242,043	173,362	72,929	146	1,488,480
Commercial and industrial	576,320	119,543	39,922	5,578	741,363
Direct financing leases, net	9,136	320	4,213	49	13,718
Consumer and other:					
Home equity and second mortgages	3,047	1,822	263	—	5,132
Other	42,153	234	—	—	42,387
Total consumer and other	45,200	2,056	263	—	47,519
Total gross loans and leases receivable	\$ 1,872,699	\$ 295,281	\$ 117,327	\$ 5,773	\$ 2,291,080
Category as a % of total portfolio	81.74 %	12.89 %	5.12 %	0.25 %	100.00 %

	December 31, 2021				
	Category				
	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	\$ 192,849	\$ 31,611	\$ 10,781	\$ 348	\$ 235,589
Commercial real estate — non-owner occupied	540,572	88,880	31,971	—	661,423
Land development	41,745	1,047	—	—	42,792
Construction	130,285	18,973	30,583	—	179,841
Multi-family	280,183	28,623	11,266	—	320,072
1-4 family	12,057	2,113	402	339	14,911
Total commercial real estate	1,197,691	171,247	85,003	687	1,454,628
Commercial and industrial	594,388	97,678	32,964	5,789	730,819
Direct financing leases, net	10,829	168	4,647	99	15,743
Consumer and other:					
Home equity and second mortgages	2,473	1,683	67	—	4,223
Other	35,249	269	—	—	35,518
Total consumer and other	37,722	1,952	67	—	39,741
Total gross loans and leases receivable	\$ 1,840,630	\$ 271,045	\$ 122,681	\$ 6,575	\$ 2,240,931
Category as a % of total portfolio	82.14 %	12.10 %	5.47 %	0.29 %	100.00 %

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 primarily 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 asset quality review committees.

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 asset quality review committees on a monthly basis.

Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases, with the exception of performing TDRs, 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 asset quality review committees on a monthly basis.

The delinquency aging of the loan and lease portfolio by class of receivable was as follows:

June 30, 2022						
	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	\$ —	\$ —	\$ —	\$ —	\$ 258,262	\$ 258,262
Non-owner occupied	—	—	—	—	651,920	651,920
Land development	—	—	—	—	42,545	42,545
Construction	13,400	—	—	13,400	190,513	203,913
Multi-family	—	—	—	—	314,392	314,392
1-4 family	—	—	—	—	17,302	17,302
Commercial and industrial	3,685	437	—	4,122	731,851	735,973
Direct financing leases, net	2,827	59	—	2,886	10,783	13,669
Consumer and other:						
Home equity and second mortgages	—	—	—	—	5,132	5,132
Other	—	—	—	—	42,387	42,387
Total	19,912	496	—	20,408	2,265,087	2,285,495
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	—	—	113	113	—	113
Non-owner occupied	—	—	—	—	—	—
Land development	—	—	—	—	—	—
Construction	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—
1-4 family	—	—	—	—	33	33
Commercial and industrial	77	79	1,377	1,533	3,857	5,390
Direct financing leases, net	—	—	49	49	—	49
Consumer and other:						
Home equity and second mortgages	—	—	—	—	—	—
Other	—	—	—	—	—	—
Total	77	79	1,539	1,695	3,890	5,585
Total loans and leases						
Commercial real estate:						
Owner occupied	—	—	113	113	258,262	258,375
Non-owner occupied	—	—	—	—	651,920	651,920
Land development	—	—	—	—	42,545	42,545
Construction	13,400	—	—	13,400	190,513	203,913
Multi-family	—	—	—	—	314,392	314,392
1-4 family	—	—	—	—	17,335	17,335
Commercial and industrial	3,762	516	1,377	5,655	735,708	741,363
Direct financing leases, net	2,827	59	49	2,935	10,783	13,718
Consumer and other:						
Home equity and second mortgages	—	—	—	—	5,132	5,132
Other	—	—	—	—	42,387	42,387
Total	\$ 19,989	\$ 575	\$ 1,539	\$ 22,103	\$ 2,268,977	\$ 2,291,080
Percent of portfolio	0.87 %	0.03 %	0.07 %	0.97 %	99.03 %	100.00 %

December 31, 2021						
	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	\$ 420	\$ —	\$ —	\$ 420	\$ 234,821	\$ 235,241
Non-owner occupied	—	—	—	—	661,423	661,423
Land development	—	—	—	—	42,792	42,792
Construction	394	—	—	394	179,447	179,841
Multi-family	—	—	—	—	320,072	320,072
1-4 family	100	—	—	100	14,472	14,572
Commercial and industrial	907	536	—	1,443	723,804	725,247
Direct financing leases, net	281	14	—	295	15,349	15,644
Consumer and other:						
Home equity and second mortgages	—	—	—	—	4,223	4,223
Other	—	—	—	—	35,518	35,518
Total	2,102	550	—	2,652	2,231,921	2,234,573
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	—	—	113	113	235	348
Non-owner occupied	—	—	—	—	—	—
Land development	—	—	—	—	—	—
Construction	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—
1-4 family	—	—	—	—	339	339
Commercial and industrial	23	36	1,445	1,504	4,068	5,572
Direct financing leases, net	—	—	84	84	15	99
Consumer and other:						
Home equity and second mortgages	—	—	—	—	—	—
Other	—	—	—	—	—	—
Total	23	36	1,642	1,701	4,657	6,358
Total loans and leases						
Commercial real estate:						
Owner occupied	420	—	113	533	235,056	235,589
Non-owner occupied	—	—	—	—	661,423	661,423
Land development	—	—	—	—	42,792	42,792
Construction	394	—	—	394	179,447	179,841
Multi-family	—	—	—	—	320,072	320,072
1-4 family	100	—	—	100	14,811	14,911
Commercial and industrial	930	572	1,445	2,947	727,872	730,819
Direct financing leases, net	281	14	84	379	15,364	15,743
Consumer and other:						
Home equity and second mortgages	—	—	—	—	4,223	4,223
Other	—	—	—	—	35,518	35,518
Total	\$ 2,125	\$ 586	\$ 1,642	\$ 4,353	\$ 2,236,578	\$ 2,240,931
Percent of portfolio	0.09 %	0.03 %	0.07 %	0.19 %	99.81 %	100.00 %

The Corporation's total impaired assets consisted of the following:

	June 30, 2022	December 31, 2021
	(In Thousands)	
Non-accrual loans and leases		
Commercial real estate:		
Commercial real estate — owner occupied	\$ 113	\$ 348
Commercial real estate — non-owner occupied	—	—
Land development	—	—
Construction	—	—
Multi-family	—	—
1-4 family	33	339
Total non-accrual commercial real estate	146	687
Commercial and industrial	5,390	5,572
Direct financing leases, net	49	99
Consumer and other:		
Home equity and second mortgages	—	—
Other	—	—
Total non-accrual consumer and other loans	—	—
Total non-accrual loans and leases	5,585	6,358
Foreclosed properties, net	124	164
Total non-performing assets	5,709	6,522
Performing troubled debt restructurings	188	217
Total impaired assets	\$ 5,897	\$ 6,739
	June 30, 2022	December 31, 2021
Total non-accrual loans and leases to gross loans and leases	0.24 %	0.28 %
Total non-performing assets to total gross loans and leases plus foreclosed properties, net	0.25	0.29
Total non-performing assets to total assets	0.21	0.25
Allowance for loan and lease losses to gross loans and leases	1.05	1.09
Allowance for loan and lease losses to non-accrual loans and leases	431.58	382.76

As of June 30, 2022 and December 31, 2021, \$615,000 and \$627,000 of the non-accrual loans and leases were considered TDRs, respectively. The Corporation has allocated \$138,000 and \$134,000 of specific reserves to TDRs as of June 30, 2022 and December 31, 2021, respectively. There were no unfunded commitments associated with TDR loans and leases as of June 30, 2022.

All loans and leases modified as TDRs 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.

The following table provides the number of loans modified as a TDR and the pre- and post-modification recorded investment by class of receivable for the three and six months ended June 30, 2021:

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2021			2021		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
	(Dollars in Thousands)					
Commercial and industrial	—	—	—	1	\$ 56	\$ 43

During the three and six months ended June 30, 2022, no loans were modified as a TDR.

Restructured loan modifications may include payment schedule modifications, interest rate concessions, maturity date extensions, principal reduction, or some combination of these concessions. During the six months ended June 30, 2021, the modification of terms primarily consisted of payment schedule modifications.

There were no loans modified as a TDR during the 12 months ended June 30, 2022 which subsequently defaulted during the three and six months ended June 30, 2022 and one with a recorded investment of \$269,000 that defaulted during the three and six months ended June 30, 2021.

Additionally, the Corporation worked with borrowers impacted by COVID-19 and provided modifications to include interest only deferrals and principal and interest deferrals. These modifications were excluded from TDR classification under Section 4013 of the CARES Act or under applicable interagency guidance of the federal banking regulators. As of June 30, 2022, the Corporation had no deferrals outstanding. As of December 31, 2021, the Corporation had three deferrals outstanding, representing \$293,000 in total loans.

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

As of and for the Six Months Ended June 30, 2022								
	Recorded Investment ⁽¹⁾	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment ⁽²⁾	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income	
(In Thousands)								
With no impairment reserve recorded:								
Commercial real estate:								
Owner occupied	\$ 113	\$ 151	\$ —	\$ 343	\$ 13	\$ 735	\$ (722)	
Non-owner occupied	—	—	—	—	—	1	(1)	
Land development	—	—	—	—	—	—	—	
Construction	—	—	—	—	—	—	—	
Multi-family	—	—	—	—	—	—	—	
1-4 family	33	38	—	193	6	29	(23)	
Commercial and industrial	3,998	4,099	—	4,256	135	45	90	
Direct financing leases, net	—	—	—	26	—	2	(2)	
Consumer and other:								
Home equity and second mortgages	—	—	—	—	—	—	—	
Other	—	—	—	—	—	—	—	
Total	4,144	4,288	—	4,818	154	812	(658)	
With impairment reserve recorded:								
Commercial real estate:								
Owner occupied	—	—	—	—	—	—	—	
Non-owner occupied	—	—	—	—	—	—	—	
Land development	—	—	—	—	—	—	—	
Construction	—	—	—	—	—	—	—	
Multi-family	—	—	—	—	—	—	—	
1-4 family	—	—	—	—	—	—	—	
Commercial and industrial	1,580	1,580	1,205	1,142	51	1	50	
Direct financing leases, net	49	49	49	49	1	—	1	
Consumer and other:								
Home equity and second mortgages	—	—	—	—	—	—	—	
Other	—	—	—	—	—	—	—	
Total	1,629	1,629	1,254	1,191	52	1	51	
Total:								
Commercial real estate:								
Owner occupied	113	151	—	343	13	735	(722)	
Non-owner occupied	—	—	—	—	—	1	(1)	
Land development	—	—	—	—	—	—	—	
Construction	—	—	—	—	—	—	—	
Multi-family	—	—	—	—	—	—	—	
1-4 family	33	38	—	193	6	29	(23)	
Commercial and industrial	5,578	5,679	1,205	5,398	186	46	140	
Direct financing leases, net	49	49	49	75	1	2	(1)	
Consumer and other:								
Home equity and second mortgages	—	—	—	—	—	—	—	
Other	—	—	—	—	—	—	—	
Grand total	\$ 5,773	\$ 5,917	\$ 1,254	\$ 6,009	\$ 206	\$ 813	\$ (607)	

(1) The recorded investment represents the unpaid principal balance net of any partial charge-offs.

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

As of and for the Year Ended December 31, 2021

	Recorded Investment ⁽¹⁾	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment ⁽²⁾	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income
(In Thousands)							
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	\$ 348	\$ 386	\$ —	\$ 2,217	\$ 145	\$ 218	\$ (73)
Non-owner occupied	—	—	—	2,281	233	16	217
Land development	—	—	—	7	—	—	—
Construction	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	339	344	—	285	60	24	36
Commercial and industrial	3,717	3,819	—	7,914	522	179	343
Direct financing leases, net	15	15	—	2	1	—	1
Consumer and other:							
Home equity and second mortgages	—	—	—	40	7	9	(2)
Other	—	—	—	8	23	—	23
Total	4,419	4,564	—	12,754	991	446	545
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	—	—	—	—	—	—	—
Non-owner occupied	—	—	—	—	—	—	—
Land development	—	—	—	—	—	—	—
Construction	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	—	—	—	—	—	—	—
Commercial and industrial	2,072	2,072	1,439	1,456	109	8	101
Direct financing leases, net	84	84	66	50	4	—	4
Consumer and other:							
Home equity and second mortgages	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Total	2,156	2,156	1,505	1,506	113	8	105
Total:							
Commercial real estate:							
Owner occupied	348	386	—	2,217	145	218	(73)
Non-owner occupied	—	—	—	2,281	233	16	217
Land development	—	—	—	7	—	—	—
Construction	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	339	344	—	285	60	24	36
Commercial and industrial	5,789	5,891	1,439	9,370	631	187	444
Direct financing leases, net	99	99	66	52	5	—	5
Consumer and other:							
Home equity and second mortgages	—	—	—	40	7	9	(2)
Other	—	—	—	8	23	—	23
Grand total	\$ 6,575	\$ 6,720	\$ 1,505	\$ 14,260	\$ 1,104	\$ 454	\$ 650

(1) The recorded investment represents the unpaid principal balance net of any partial charge-offs.

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

The difference between the recorded investment of loans and leases and the unpaid principal balance of \$144,000 and \$145,000 as of June 30, 2022, and December 31, 2021, 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 \$188,000 and \$217,000 of loans as of June 30, 2022, and December 31, 2021, respectively, that were performing TDRs, 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 June 30, 2022			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Beginning balance	\$ 13,765	\$ 8,912	\$ 992	\$ 23,669
Charge-offs	—	(85)	—	(85)
Recoveries	4,121	117	9	4,247
Net recoveries (charge-offs)	4,121	32	9	4,162
Provision for loan and lease losses	(4,476)	922	(173)	(3,727)
Ending balance	<u>\$ 13,410</u>	<u>\$ 9,866</u>	<u>\$ 828</u>	<u>\$ 24,104</u>

	As of and for the Three Months Ended June 30, 2021			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(In Thousands)			
Beginning balance	\$ 18,445	\$ 9,544	\$ 993	\$ 28,982
Charge-offs	(249)	(2,621)	(24)	(2,894)
Recoveries	84	460	1	545
Net (charge-offs) recoveries	(165)	(2,161)	(23)	(2,349)
Provision for loan and lease losses	(1,404)	498	(52)	(958)
Ending balance	<u>\$ 16,876</u>	<u>\$ 7,881</u>	<u>\$ 918</u>	<u>\$ 25,675</u>

As of and for the Six Months Ended June 30, 2022				
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
(In Thousands)				
Beginning balance	\$ 15,110	\$ 8,413	\$ 813	\$ 24,336
Charge-offs	—	(107)	—	(107)
Recoveries	4,237	201	19	4,457
Net recoveries (charge-offs)	4,237	94	19	4,350
Provision for loan and lease losses	(5,937)	1,359	(4)	(4,582)
Ending balance	<u>\$ 13,410</u>	<u>\$ 9,866</u>	<u>\$ 828</u>	<u>\$ 24,104</u>

As of and for the Six Months Ended June 30, 2021				
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
(In Thousands)				
Beginning balance	\$ 17,157	\$ 10,593	\$ 771	\$ 28,521
Charge-offs	(249)	(2,765)	(24)	(3,038)
Recoveries	2,303	913	2	3,218
Net (charge-offs) recoveries	2,054	(1,852)	(22)	180
Provision for loan and lease losses	(2,335)	(860)	169	(3,026)
Ending balance	<u>\$ 16,876</u>	<u>\$ 7,881</u>	<u>\$ 918</u>	<u>\$ 25,675</u>

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

As of June 30, 2022				
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
(In Thousands)				
Allowance for loan and lease losses:				
Collectively evaluated for impairment	\$ 13,410	\$ 8,612	\$ 828	\$ 22,850
Individually evaluated for impairment	—	1,254	—	1,254
Total	<u>\$ 13,410</u>	<u>\$ 9,866</u>	<u>\$ 828</u>	<u>\$ 24,104</u>
Loans and lease receivables:				
Collectively evaluated for impairment	\$ 1,488,334	\$ 749,454	\$ 47,519	\$ 2,285,307
Individually evaluated for impairment	146	5,627	—	5,773
Total	<u>\$ 1,488,480</u>	<u>\$ 755,081</u>	<u>\$ 47,519</u>	<u>\$ 2,291,080</u>
As of December 31, 2021				
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
(In Thousands)				
Allowance for loan and lease losses:				
Collectively evaluated for impairment	\$ 15,110	\$ 6,908	\$ 813	\$ 22,831
Individually evaluated for impairment	—	1,505	—	1,505
Total	<u>\$ 15,110</u>	<u>\$ 8,413</u>	<u>\$ 813</u>	<u>\$ 24,336</u>
Loans and lease receivables:				
Collectively evaluated for impairment	\$ 1,453,941	\$ 740,674	\$ 39,741	\$ 2,234,356
Individually evaluated for impairment	687	5,888	—	6,575
Total	<u>\$ 1,454,628</u>	<u>\$ 746,562</u>	<u>\$ 39,741</u>	<u>\$ 2,240,931</u>

Note 6 — Leases

The Corporation leases various office spaces and specialized lending production offices under non-cancellable operating leases which expire on various dates through 2033. The Corporation also leases office equipment. The Corporation recognizes a right-of-use asset and an operating lease liability for all leases, with the exception of short-term leases. Right-of-use assets represent the right to use an underlying asset for the lease term and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term. Lease expense for operating leases and short-term leases is recognized on a straight-line basis over the lease term. During 2022, the Corporation entered into a new lease in the Southeast Wisconsin market resulting in a \$1.6 million right-of-use asset. In addition, the Corporation received a \$991,000 tenant improvement allowance which is recognized as a lease incentive and deducted from the right-of-use asset.

In 2019, the Corporation entered into a sublease for office space it vacated in its Kansas City metropolitan area which expires in 2023. During the first quarter 2022, the Corporation amended the sublease agreement and the amendment did not result in any impairment.

The components of total lease expense were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2022	2021	2022	2021
	(In Thousands)			
Operating lease cost	\$ 382	\$ 374	\$ 765	\$ 749
Short-term lease cost	37	49	74	88
Variable lease cost	140	111	266	239
Less: sublease income	(45)	(43)	(90)	(82)
Total lease cost, net	<u>\$ 514</u>	<u>\$ 491</u>	<u>\$ 1,015</u>	<u>\$ 994</u>

Quantitative information regarding the Corporation's operating leases was as follows:

	June 30, 2022	December 31, 2021
Weighted-average remaining lease term (in years)	6.84	5.05
Weighted-average discount rate	2.72 %	2.51 %

The following maturity analysis shows the undiscounted cash flows due on the Corporation's operating lease liabilities:

(In Thousands)

2022	\$ 832
2023	1,248
2024	1,073
2025	949
2026	935
Thereafter	3,003
Total undiscounted cash flows	<u>8,040</u>
Discount on cash flows	(833)
Total lease liability	<u>\$ 7,207</u>

Note 7 — Other Assets

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

	June 30, 2022	December 31, 2021
	(In Thousands)	
Accrued interest receivable	\$ 6,433	\$ 5,497
Net deferred tax asset	7,870	6,175
Investment in historic development entities	2,369	2,299
Investment in low-income housing development entity	8,901	2,964
Investment in limited partnerships	11,435	9,874
Investment in Trust II	—	315
Prepaid expenses	3,760	2,689
Other assets	8,100	9,577
Total accrued interest receivable and other assets	<u>\$ 48,868</u>	<u>\$ 39,390</u>

As of March 30, 2022, the Corporation surrendered its common shares for no gain or loss and exited the Trust II entity, which was subsequently dissolved. Previously, the Corporation was the sole owner of \$315,000 of common securities issued by Trust II. The purpose of Trust II was to complete the sale of \$10.0 million of 10.50% fixed rate preferred securities. Trust II, a wholly owned subsidiary of the Corporation, is not consolidated into the financial statements of the Corporation. The investment in Trust II of \$315,000 as of December 31, 2021 is included in accrued interest receivable and other assets.

Note 8 — Deposits

The composition of deposits is shown below. Average balances represent year to date averages.

	June 30, 2022			December 31, 2021		
	Balance	Average Balance	Average Rate	Balance	Average Balance	Average Rate
(Dollars in Thousands)						
Non-interest-bearing transaction accounts	\$ 544,507	\$ 559,793	— %	\$ 589,559	\$ 536,981	— %
Interest-bearing transaction accounts	466,785	517,923	0.23	530,225	506,693	0.19
Money market accounts	731,718	775,808	0.22	754,410	693,608	0.17
Certificates of deposit	114,000	63,098	0.54	54,091	47,020	0.84
Wholesale deposits	12,321	14,282	2.94	29,638	119,831	0.82
Total deposits	<u>\$ 1,869,331</u>	<u>\$ 1,930,904</u>	0.19	<u>\$ 1,957,923</u>	<u>\$ 1,904,133</u>	0.19

A summary of annual maturities of in-market and wholesale certificates of deposit at June 30, 2022 is as follows:

(In Thousands)

Maturities during the year ended December 31,	
2022	\$ 90,092
2023	16,724
2024	16,541
2025	402
2026	490
Thereafter	2,072
	<u>\$ 126,321</u>

Wholesale deposits include \$12.3 million of wholesale certificates of deposit and no non-reciprocal interest-bearing transaction accounts at June 30, 2022, compared to \$19.6 million and \$10.0 million of wholesale certificates of deposit and non-reciprocal interest-bearing transaction accounts, respectively, at December 31, 2021.

Deposits include \$25.3 million and \$7.9 million of certificates of deposit and wholesale deposits which are denominated in amounts greater than \$250,000 at June 30, 2022 and December 31, 2021, respectively.

Note 9 — FHLB Advances, Other Borrowings and Junior Subordinated Notes

The composition of borrowed funds is shown below. Average balances represent year to date averages.

	June 30, 2022			December 31, 2021		
	Balance	Weighted Average Balance	Weighted Average Rate	Balance	Weighted Average Balance	Weighted Average Rate
(Dollars in Thousands)						
Federal funds purchased	\$ —	\$ 22	2.01 %	\$ —	\$ —	— %
FHLB advances	554,100	417,518	1.29 %	368,800	376,781	1.30 %
Line of credit	—	171	2.76	500	78	2.90
Other borrowings	8,267	9,600	4.05	10,363	8,090	4.11
Subordinated notes payable	34,275	35,901	5.27	23,788	23,766	5.94
Junior subordinated notes ⁽¹⁾	—	4,898	20.58	10,076	10,068	11.05
	<u>\$ 596,642</u>	<u>\$ 468,110</u>	1.86	<u>\$ 413,527</u>	<u>\$ 418,783</u>	1.86

- (1) Weighted average rate of junior subordinated notes reflects the accelerated amortization of subordinated debt issuance costs as a result of the early redemption of the junior subordinated notes during the first quarter of 2022.

A summary of annual maturities of borrowings at June 30, 2022 is as follows:

(In Thousands)

Maturities during the year ended December 31,		
2022	\$	338,300
2023		42,300
2024		35,500
2025		48,000
2026		60,000
Thereafter		72,542
	\$	<u>596,642</u>

In September 2008, Trust II completed the sale of \$10.0 million of 10.50% fixed rate trust preferred securities (“Trust Preferred Securities”). Trust II also issued common securities of \$315,000. Trust II used the proceeds from the offering to purchase \$10.3 million of 10.50% junior subordinated notes of the Corporation. The Trust Preferred Securities are mandatorily redeemable upon the maturity of the junior subordinated notes on September 26, 2038. As of March 30, 2022 the junior subordinated notes were redeemed and the remaining unamortized debt issuance cost was accelerated due to the early redemption. As of December 31, 2021 the unamortized debt issuance cost included in junior subordinated notes on the Consolidated Balance Sheets was \$239,000.

The Corporation issued a new subordinated note payable as of March 4, 2022. The principal amount of the newly issued subordinated note payable was \$20.0 million which qualified as Tier 2 capital. The subordinated note bears a fixed interest rate of 3.50% with a maturity date of March 15, 2032. The subordinated note payable has certain performance debt covenants of which the Corporation was in compliance. The Corporation may, at its option, redeem the note, in whole or part, at any time after the fifth anniversary of issuance. As of June 16, 2022, the \$9.1 million subordinated notes payable that bore a fixed interest rate of 6.00% were redeemed, and the remaining unamortized debt issuance cost was accelerated due to the early redemption. As of June 30, 2022, \$725,000 of debt issuance costs remain in the subordinated note payable balance, of which \$456,000 is related to the recently issued subordinated note.

As of June 30, 2022, the Corporation had other borrowings of \$8.2 million, which consisted of sold loans accounted for as secured borrowings because they did not qualify for true sale accounting.

As of June 30, 2022 and December 31, 2021, 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, 2022, the Corporation pays a fee on this line of credit. During both the six months ended June 30, 2022 and 2021, the Corporation incurred interest expense of \$6,600 due to this fee.

Note 10 — Preferred Stock

On March 4, 2022, the Corporation issued 12,500 shares, or \$12.5 million in aggregate liquidation preference, of 7.0% Fixed-to-Floating Rate Non-Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share, with a liquidation preference of \$1,000 per share (the “Series A Preferred Stock”) in a private placement to institutional investors. The net proceeds received from the issuance of the Series A Preferred Stock were \$12.0 million.

The Corporation expects to pay dividends on the Series A Preferred Stock when and if declared by the Board, at a fixed rate of 7.0% per annum, payable quarterly, in arrears, on March 15, June 15, September 15 and December 15 of each year up to, but excluding, March 15, 2027. For each dividend period from and including March 15, 2027, dividends will be paid at a floating rate of Three-Month Term Secured Overnight Financing Rate (“SOFR”) plus a spread of 539 basis points per annum. During the three and six months ended June 30, 2022, the Board of Directors declared a cash preferred stock dividend of \$246,000. The Series A Preferred Stock is perpetual and has no stated maturity. The Corporation may redeem the Series A Preferred Stock at its option at a redemption price equal to \$1,000 per share, plus any declared and unpaid dividends (without regard to any undeclared dividends), subject to regulatory approval, on or after March 15, 2027 or within 90 days following a regulatory capital treatment event, in accordance with the terms of the Series A Preferred Stock.

Note 11 — Commitments and Contingencies

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.

The Corporation sells the guaranteed portions of SBA 7(a) and 504 loans, as well as participation interests in other, non-SBA 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 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 \$673,000 at June 30, 2022, 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 June 30,		As of and for the Six Months Ended June 30,	
	2022	2021	2022	2021
	(In Thousands)			
Balance at the beginning of the period	\$ 559	\$ 593	\$ 635	\$ 723
SBA recourse provision	114	245	38	115
Charge-offs, net	—	(8)	—	(8)
Balance at the end of the period	<u>\$ 673</u>	<u>\$ 830</u>	<u>\$ 673</u>	<u>\$ 830</u>

Note 12 — 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.

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

June 30, 2022				
Fair Value Measurements Using				
Level 1	Level 2	Level 3	Total	
(In Thousands)				
Assets:				
Securities available-for-sale:				
U.S. treasuries	\$ —	\$ 4,573	\$ —	\$ 4,573
U.S. government agency securities - government-sponsored enterprises	—	16,914	—	16,914
Municipal securities	—	38,774	—	38,774
Residential mortgage-backed securities - government issued	—	15,866	—	15,866
Residential mortgage-backed securities - government-sponsored enterprises	—	95,958	—	95,958
Commercial mortgage-backed securities - government issued	—	3,497	—	3,497
Commercial mortgage-backed securities - government-sponsored enterprises	—	32,080	—	32,080
Other securities	—	981	—	981
Interest rate swaps	—	44,461	—	44,461
Liabilities:				
Interest rate swaps	—	40,357	—	40,357
December 31, 2021				
Fair Value Measurements Using				
Level 1	Level 2	Level 3	Total	
(In Thousands)				
Assets:				
Securities available-for-sale:				
U.S. treasuries	\$ —	\$ 4,914	\$ —	\$ 4,914
U.S. government agency securities - government-sponsored enterprises	—	19,935	—	19,935
Municipal securities	—	30,957	—	30,957
Residential mortgage-backed securities - government issued	—	19,661	—	19,661
Residential mortgage-backed securities - government-sponsored enterprises	—	85,705	—	85,705
Commercial mortgage-backed securities - government issued	—	5,771	—	5,771
Commercial mortgage-backed securities - government-sponsored enterprises	—	36,531	—	36,531
Other securities	—	2,228	—	2,228
Interest rate swaps	—	26,343	—	26,343
Liabilities:				
Interest rate swaps	—	28,283	—	28,283

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the three and six months ended June 30, 2022 or the year ended December 31, 2021 related to the above measurements.

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

	June 30, 2022			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Impaired loans	\$ —	\$ —	\$ 720	\$ 720
Foreclosed properties	—	—	124	124
Loan servicing rights	—	—	1,594	1,594
	December 31, 2021			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Impaired loans	\$ —	\$ —	\$ 1,000	\$ 1,000
Foreclosed properties	—	—	164	164
Loan servicing rights	—	—	1,601	1,601

Impaired loans were written down to the fair value of their underlying collateral less costs to sell of \$720,000 and \$1.0 million at June 30, 2022 and December 31, 2021, 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. These techniques 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 unobservable inputs, typically when discounts are applied to appraisal values to adjust such values to current market conditions or to reflect net realizable values. The quantification of unobservable inputs for Level 3 impaired loan values range from 8% - 100% as of the measurement date of June 30, 2022. The weighted average of those unobservable inputs was 32%. The majority of the impaired loans are considered collateral dependent loans or are supported by an 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 based on observable market data, typically a current appraisal, or based upon assumptions specific to the individual property or equipment, such as management applied discounts used to further reduce values to a net realizable value when observable inputs become stale.

Loan servicing rights represent the asset retained upon sale of the guaranteed portion of certain SBA loans. When SBA loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. The servicing rights are subsequently measured using the amortization method, which requires amortization into interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

The Corporation periodically reviews this portfolio for impairment and engages a third-party valuation firm to assess the fair value of the overall servicing rights portfolio. Loan servicing rights do not trade in an active, open market with readily observable prices. While sales of loan servicing rights do occur, the precise terms and conditions typically are not readily available to allow for a “quoted price for similar assets” comparison. Accordingly, the Corporation utilizes an independent valuation from a third party which uses a discounted cash flow model to estimate the fair value of its loan servicing rights. The valuation model incorporates prepayment assumptions to project loan servicing rights cash flows based on the current interest rate scenario, which is then discounted to estimate an expected fair value of the loan servicing rights. The valuation model considers portfolio characteristics of the underlying serviced portion of the SBA loans and uses the following significant unobservable inputs: (1) constant prepayment rate (“CPR”) assumptions based on the SBA sold pools historical CPR as quoted in Bloomberg and (2) a discount rate. Due to the nature of the valuation inputs, loan servicing rights are classified in Level 3 of the fair value hierarchy.

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:

	June 30, 2022				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
		(In Thousands)			
Financial assets:					
Cash and cash equivalents	\$ 95,484	\$ 95,484	\$ 95,484	\$ —	\$ —
Securities available-for-sale	208,643	208,643	—	208,643	—
Securities held-to-maturity	13,968	13,849	—	13,849	—
Loans held for sale	2,256	2,437	—	2,437	—
Loans and lease receivables, net	2,265,996	2,258,728	—	—	2,258,728
Federal Home Loan Bank stock	22,959	N/A	N/A	N/A	N/A
Accrued interest receivable	6,433	6,433	6,433	—	—
Interest rate swaps	44,461	44,461	—	44,461	—
Financial liabilities:					
Deposits	1,869,331	1,869,191	1,743,010	126,181	—
Federal Home Loan Bank advances and other borrowings	596,642	587,308	—	587,308	—
Accrued interest payable	1,708	1,708	1,708	—	—
Interest rate swaps	40,357	40,357	—	40,357	—
Off-balance sheet items:					
Standby letters of credit	116	116	—	—	116

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

	December 31, 2021				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
		(In Thousands)			
Financial assets:					
Cash and cash equivalents	\$ 57,110	\$ 57,110	\$ 57,110	\$ —	\$ —
Securities available-for-sale	205,702	205,702	—	205,702	—
Securities held-to-maturity	19,746	20,276	—	20,276	—
Loans held for sale	3,570	3,927	—	3,927	—
Loans and lease receivables, net	2,215,072	2,241,093	—	—	2,241,093
Federal Home Loan Bank stock	13,336	N/A	N/A	N/A	N/A
Accrued interest receivable	5,497	5,497	5,497	—	—
Interest rate swaps	26,343	26,343	—	26,343	—
Financial liabilities:					
Deposits	1,957,923	1,968,195	1,894,273	73,922	—
Federal Home Loan Bank advances and other borrowings	403,451	409,894	—	409,894	—
Junior subordinated notes	10,076	8,844	—	—	8,844
Accrued interest payable	1,008	1,008	1,008	—	—
Interest rate swaps	28,283	28,283	—	28,283	—
Off-balance sheet items:					
Standby letters of credit	203	203	—	—	203

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 7(a) 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 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 13 — 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 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. As of June 30, 2022 and December 31, 2021, the credit valuation allowance was \$191,000.

The Corporation receives fixed rates and pays floating rates based upon designated benchmark interest rates used on the swaps with commercial borrowers. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. The Corporation pays fixed rates and receives floating rates based upon designated benchmark interest rates used on the swaps with dealer counterparties. Dealer counterparty swaps are subject to master netting agreements among the contracts within our Bank and are reported on the unaudited Consolidated Balance Sheet. The gross amount of dealer counterparty swaps, without regard to the enforceable master netting agreement, was a gross derivative liability of \$3.2 million and \$40.3 million gross derivative asset. No right of offset existed with the dealer counterparty swaps as of June 30, 2022.

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 and six months ended June 30, 2022 and 2021 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. A pre-tax unrealized gain of \$1.7 million and \$5.7 million was recognized in other comprehensive income for the three and six months ended June 30, 2022, and there were no ineffective portions of these hedges.

The Corporation also enters into interest rate swaps to mitigate market value volatility on certain long-term fixed securities. The objective of the hedge is to protect the Corporation against changes in fair value due to changes in benchmark interest rates. The instruments are designated as fair value hedges as the changes in the fair value of the interest rate swap are expected to offset changes in the fair value of the hedged item attributable to changes in the SOFR swap rate, the designated benchmark interest rate. 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 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. A pre-tax unrealized gain of \$426,000 and \$376,000 was recognized in other comprehensive income for the three and six months ended June 30, 2022 and there was no ineffective portion of these hedges.

As of June 30, 2022				
	Number of Instruments	Notional Amount	Weighted Average Maturity (In Years)	Fair Value
(Dollars in Thousands)				
Included in Derivative assets				
Derivatives not designated as hedging instruments				
Interest rate swap agreements on loans with commercial loan customers	12	\$ 131,393	8.91	\$ 3,215
Interest rate swap agreements on loans with third-party counter parties	81	646,078	8.12	37,142
Derivatives designated as hedging instruments				
Interest rate swap related to AFS securities	11	\$ 12,500	9.78	\$ 377
Interest rate swap related to FHLB borrowings	12	\$ 124,400	3.19	\$ 3,727
Included in Derivative liabilities				
Derivatives not designated as hedging instruments				
Interest rate swap agreements on loans with commercial loan customers	69	\$ 514,685	7.92	\$ 40,357
As of December 31, 2021				
	Number of Instruments	Notional Amount	Weighted Average Maturity (In Years)	Fair Value
(Dollars in Thousands)				
Included in Derivative assets				
Derivatives not designated as hedging instruments				
Interest rate swap agreements on loans with commercial loan customers	41	\$ 411,913	8.18	\$ 26,343
Included in Derivative liabilities				
Derivatives not designated as hedging instruments				
Interest rate swap agreements on loans with commercial loan customers	39	\$ 228,676	8.70	\$ 6,595
Interest rate swap agreements on loans with third-party counter parties	80	640,589	8.37	19,748
Derivatives designated as hedging instruments				
Interest rate swap related to FHLB borrowings	10	\$ 106,000	3.17	\$ 1,940

Note 14 — Regulatory Capital

The Corporation and the Bank are subject to various regulatory capital requirements administered by Federal and 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 Board 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 shareholders 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 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 shareholders with preferential rights superior to those shareholders 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.

Quantitative 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.

As of June 30, 2022, the Corporation's capital levels exceeded the regulatory minimums and the Bank's capital levels remained characterized as well capitalized under the regulatory framework. The following tables summarize both the Corporation's and the Bank's capital ratios and the ratios required by their federal regulators:

As of June 30, 2022								
	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)								
Total capital (to risk-weighted assets)								
Consolidated	\$ 309,573	11.56 %	\$ 214,312	8.00 %	\$ 281,285	10.50 %	N/A	N/A
First Business Bank	301,151	11.25	214,190	8.00	281,125	10.50	\$ 267,738	10.00 %
Tier 1 capital (to risk-weighted assets)								
Consolidated	\$ 250,331	9.34 %	\$ 160,734	6.00 %	\$ 227,707	8.50 %	N/A	N/A
First Business Bank	276,184	10.32	160,643	6.00	227,577	8.50	\$ 214,190	8.00 %
Common equity tier 1 capital (to risk-weighted assets)								
Consolidated	\$ 238,339	8.90 %	\$ 120,551	4.50 %	\$ 187,523	7.00 %	N/A	N/A
First Business Bank	276,184	10.32	120,482	4.50	187,417	7.00	\$ 174,030	6.50 %
Tier 1 leverage capital (to adjusted assets)								
Consolidated	\$ 250,331	9.19 %	\$ 108,923	4.00 %	\$ 108,923	4.00 %	N/A	N/A
First Business Bank	276,184	10.15	108,823	4.00	108,823	4.00	\$ 136,029	5.00 %
As of December 31, 2021								
	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)								
Total capital (to risk-weighted assets)								
Consolidated	\$ 281,745	10.82 %	\$ 208,337	8.00 %	\$ 273,443	10.50 %	N/A	N/A
First Business Bank	280,448	10.78	208,142	8.00	273,187	10.50	\$ 260,178	10.00 %
Tier 1 capital (to risk-weighted assets)								
Consolidated	\$ 232,795	8.94 %	\$ 156,253	6.00 %	\$ 221,358	8.50 %	N/A	N/A
First Business Bank	255,286	9.81	156,107	6.00	221,151	8.50	\$ 208,142	8.00 %
Common equity tier 1 capital (to risk-weighted assets)								
Consolidated	\$ 222,719	8.55 %	\$ 117,190	4.50 %	\$ 182,295	7.00 %	N/A	N/A
First Business Bank	255,286	9.81	117,080	4.50	182,124	7.00	\$ 169,116	6.50 %
Tier 1 leverage capital (to adjusted assets)								
Consolidated	\$ 232,795	8.94 %	\$ 104,145	4.00 %	\$ 104,145	4.00 %	N/A	N/A
First Business Bank	255,286	9.81	104,045	4.00	104,045	4.00	\$ 130,056	5.00 %

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:

- Adverse changes in the economy or business conditions, either nationally or in our markets, including, without limitation, inflation, supply chain issues, labor shortages, wage pressures, and the adverse effects of the COVID-19 pandemic on the global, national, and local economy.
- Competitive pressures among depository and other financial institutions nationally and 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.
- Changes in legislative or regulatory requirements applicable to us and our subsidiaries.
- 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 portions 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, 2021 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, such expectation or belief is expressed in good faith and 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.

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 FBB and First Business Specialty Finance, LLC (“FBSF”), a wholly-owned subsidiary of FBB. 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 and medium-sized businesses, business owners, executives, professionals, and high net worth individuals. Our products and services include those for business banking, private wealth, and bank consulting. Within business banking, we offer commercial lending, asset-based lending, accounts receivable financing, equipment financing, floorplan financing, vendor financing, SBA lending and servicing, treasury management services, and company retirement plans. Our private wealth services for executives and individuals include trust and estate administration, financial planning, investment management, consumer lending, and private banking. For other financial institutions, our bank consulting experts provide investment portfolio administrative services, asset liability management services, and asset liability management process validation. We do not utilize a branch network to attract retail clients. Our operating philosophy is predicated on deep client relationships within our commercial bank markets and extensive expertise within our nationwide specialized lending business lines, combined with the efficiency of centralized administrative functions, such as information technology, loan and deposit operations, finance and accounting, credit administration, compliance, marketing, 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.

Financial Performance Summary

Results as of and for the three and six months ended June 30, 2022 include:

- Net income available to common shareholders totaled \$11.0 million, or diluted earnings per share of \$1.29, for the three months ended June 30, 2022, compared to \$8.2 million, or diluted earnings per share of \$0.95, for the same period in 2021. Net income available to common shareholders totaled \$19.6 million, or diluted earnings per share of \$2.31, for the six months ended June 30, 2022, compared to \$18.0 million, or diluted earnings per share of \$2.08, for the same period in 2021.
- Annualized return on average assets (“ROA”) and annualized return on average common equity (“ROCE”) for the three months ended June 30, 2022 measured 1.61% and 18.79%, respectively, compared to 1.26% and 15.09% for the same period in 2021. Annualized ROA and annualized ROCE for the six months ended June 30, 2022 measured 1.46% and 16.74%, respectively, compared to 1.38% and 16.75% for the same period in 2021.
- Pre-tax, pre-provision adjusted earnings, which excludes certain one-time and discrete items, totaled \$10.8 million for the three months ended June 30, 2022, increasing \$835,000, or 8.3%, from the same period in 2021. Pre-tax, pre-provision adjusted ROA was 1.60% for the three months ended June 30, 2022, compared to 1.53% for the same period in 2021. Excluding PPP interest and fee income, pre-tax, pre-provision adjusted earnings totaled \$10.6 million for the three months ended June 30, 2022, up \$3.7 million, or 53.8%, from the same period in 2021. Pre-tax, pre-provision adjusted ROA, excluding the impact of PPP, was 1.57% for the three months ended June 30, 2022, compared to 1.15% for the same period in 2021.
- Pre-tax, pre-provision adjusted earnings totaled \$20.8 million for the six months ended June 30, 2022, up \$153,000, or 0.7%, from the same period in 2021. Pre-tax, pre-provision adjusted ROA was 1.54% for the six months ended June 30, 2022, compared to 1.59% for the same period in 2021. Excluding PPP interest and fee income, pre-tax, pre-provision adjusted earnings totaled \$20.2 million for the six months ended June 30, 2022, up \$5.6 million, or 37.8%, from the same period in 2021. Pre-tax, pre-provision adjusted ROA, excluding the impact of PPP, was 1.51% for the six months ended June 30, 2022, compared to 1.24% for the same period in 2021.
- Fees in lieu of interest, defined as prepayment fees, asset-based loan fees, non-accrual interest, and loan fee amortization, totaled \$1.9 million for the three months ended June 30, 2022 compared to \$3.5 million for the three months ended June 30, 2021. PPP fee income, included in loan fee amortization, was \$196,000 for the three months ended June 30, 2022 compared to \$2.5 million for the same period in 2021.
- Fees in lieu of interest totaled \$3.2 million for the six months ended June 30, 2022, compared to \$6.6 million for the six months ended June 30, 2021. PPP fee income, included in loan fee amortization, was \$445,000 for the six months ended June 30, 2022 compared to \$4.8 million for the same period in 2021.
- Net interest margin was 3.71% for the three months ended June 30, 2022 compared to 3.49% for the same period in 2021. Adjusted net interest margin, which excludes certain one-time and volatile items, was 3.45% for the three months ended June 30, 2022 up from 3.20% for the same period in 2021. Net interest margin was 3.55% for the six months ended June 30, 2022 compared to 3.46% for the same period in 2021. Adjusted net interest margin, which excludes certain one-time and volatile items, was 3.35% for the six months ended June 30, 2022 up from 3.20% for the same period in 2021.

- Top line revenue, defined as net interest income plus non-interest income, totaled \$30.5 million for the three months ended June 30, 2022, up \$2.6 million, or 9.1% from the same period in 2021. Excluding PPP interest income and fees, top line revenue increased \$5.4 million, up 21.9% from the same period in 2021. Top line revenue totaled \$59.3 million for the six months ended June 30, 2022, up \$3.3 million, or 5.9% from the same period in 2021. Excluding PPP interest income and fees, top line revenue increased \$8.7 million, up 17.4% from the same period in 2021.
- Provision for loan and lease losses was a benefit of \$3.7 million for the three months ended June 30, 2022 compared to a benefit of \$958,000 for the same period in 2021. Provision for loan and lease losses was a benefit of \$4.6 million for the six months ended June 30, 2022 compared to a benefit of \$3.0 million for the same period in 2021.
- Total assets at June 30, 2022 increased \$124.1 million, or 9.4% annualized, to \$2.777 billion from \$2.653 billion at December 31, 2021.
- Period-end gross loans and leases receivable increased \$50.1 million, or 4.5% annualized, to \$2.291 billion as of June 30, 2022 compared to \$2.241 billion as of December 31, 2021. Average gross loans and leases of \$2.259 billion increased \$55.6 million, or 2.5%, for the six months ended June 30, 2022, compared to \$2.203 billion for the same period in 2021.
- Period-end gross loans and leases receivable, excluding PPP loans, at June 30, 2022 increased \$69.7 million, or 6.3% annualized, to \$2.283 billion from \$2.213 billion as of December 31, 2021. Average gross loans and leases, excluding net PPP loans, of \$2.243 billion increased \$275.0 million, or 14.0%, for the six months ended June 30, 2022, compared to \$1.968 billion for the same period in 2021.
- Period-end gross PPP loans and PPP deferred processing fees were \$8.3 million and \$113,000, respectively, at June 30, 2022 compared to \$27.9 million and \$557,000 at December 31, 2021. Average PPP loans, net of deferred processing fees, were \$16.3 million for the six months ended June 30, 2022 compared to \$235.7 million for the same period in 2021.
- Non-performing assets were \$5.7 million and 0.21% of total assets as of June 30, 2022, compared to \$6.5 million and 0.25% of total assets as of December 31, 2021.
- The allowance for loan and lease losses decreased \$232,000, or 1.0%, compared to December 31, 2021. The allowance for loan and lease losses decreased to 1.05% of total loans, compared to 1.09% at December 31, 2021. Excluding net PPP loans, the allowance for loan and lease losses decreased to 1.06% of total loans as of June 30, 2022, compared to 1.10% as of December 31, 2021.
- Period-end in-market deposits at June 30, 2022 decreased \$71.3 million, or 3.7%, to \$1.857 billion from \$1.928 billion as of December 31, 2021. Average in-market deposits of \$1.917 billion increased \$187.8 million, or 10.9%, for the six months ended June 30, 2022, compared to \$1.729 billion for the same period in 2021.
- Private wealth and trust assets under management and administration decreased by \$280.3 million, or 9.9%, to \$2.554 billion at June 30, 2022, compared to \$2.921 billion at December 31, 2021. Private wealth management service fees increased \$108,000, or 3.9%, and \$542,000, or 10.5%, for the three and six months ended June 30, 2022, compared to the three and six months ended June 30, 2021.

Results of Operations

Top Line Revenue

Top line revenue, comprised of net interest income and non-interest income, increased \$2.6 million, or 9.1%, for the three months ended June 30, 2022, compared to the same period in 2021, due to a 9% increase in net interest income and non-interest income. The increase in net interest income, driven by an increase in average loans and leases outstanding, was partially offset by a decrease in PPP interest and fees of \$2.9 million. Excluding PPP interest and fees, top line revenue grew 21.9%. The increase in non-interest income was due to an increase in commercial loan swap fee income, private wealth fee income, loan fee income, and services charges on deposits, partially offset by a reduction in gains on the sale of SBA loans. Top line revenue increased \$3.3 million, or 5.9%, for the six months ended June 30, 2022, compared to the same period in 2021, due to a 6% increase in net interest income and non-interest income, combined with a benefit from above-average returns from the Corporation's investments in mezzanine funds. Excluding PPP interest and fees, top line revenue grew 17.4%.

The components of top line revenue were as follows:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2022	2021	\$ Change	% Change	2022	2021	\$ Change	% Change
(Dollars in Thousands)								
Net interest income	\$ 23,660	\$ 21,652	\$ 2,008	9.3%	\$ 45,087	\$ 42,515	\$ 2,572	6.0%
Non-interest income	6,872	6,321	551	8.7	14,258	13,516	742	5.5
Top line revenue	<u>\$ 30,532</u>	<u>\$ 27,973</u>	<u>\$ 2,559</u>	<u>9.1</u>	<u>\$ 59,345</u>	<u>\$ 56,031</u>	<u>\$ 3,314</u>	<u>5.9</u>

Annualized Return on Average Assets and Annualized Return on Average Common Equity

ROA for the three and six months ended June 30, 2022 increased to 1.61% and 1.46%, respectively, compared to 1.26% and 1.38% for the three and six months ended June 30, 2021, respectively. The increase in ROA was due to an increase in top line revenue and increase in loan loss provision benefit, partially offset by an increase in operating expenses. Please refer to the operating results analysis below for further discussion on the reasons driving the increase in profitability. We consider ROA a critical metric to measure the profitability of our organization and how efficiently our assets are deployed. ROA also allows us to better benchmark our profitability to our peers without the need to consider different degrees of leverage which can ultimately influence return on equity measures.

ROCE for the three and six months ended June 30, 2022 was 18.79% and 16.74%, respectively, compared to 15.09% and 16.75% for the three and six months ended June 30, 2021, respectively. The primary reason for the change in ROCE is consistent with the net income variance explanation as discussed under **Return on Average Assets** above. We view ROCE as an important measurement for monitoring profitability and continue to focus on improving our return to our shareholders by enhancing the overall profitability of our client relationships, controlling our expenses, and minimizing our costs of credit.

Efficiency Ratio and Pre-Tax, Pre-Provision Adjusted Earnings

Efficiency ratio is a non-GAAP measure representing operating expense, which is non-interest expense excluding the effects of the SBA recourse benefit or provision, impairment of tax credit investments, net gains or losses 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 net gains or losses on securities, if any. Pre-tax, pre-provision adjusted earnings is defined as operating revenue less operating expense. In the judgment of the Corporation's management, the adjustments made to non-interest expense and non-interest income allow investors and analysts to better assess the Corporation's operating expenses in relation to its core operating revenue by removing the volatility associated with certain one-time items and other discrete items. The pre-tax, pre-provision adjusted earnings 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 ROA and ROCE. The information provided below reconciles the efficiency ratio to its most comparable GAAP measure.

Please refer to the **Non-Interest Income** and **Non-Interest Expense** sections below for discussion on additional drivers of the year-over-year change in the efficiency ratio and pre-tax, pre-provision adjusted earnings.

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2022	2021	\$ Change	% Change	2022	2021	\$ Change	% Change
(Dollars in Thousands)								
Total non-interest expense	\$ 19,456	\$ 18,184	\$ 1,272	7.0%	\$ 38,280	\$ 35,514	\$ 2,766	7.8%
Less:								
Net loss (gain) on foreclosed properties	8	(1)	9	NM	20	1	19	NM
Amortization of other intangible assets	—	8	(8)	NM	—	15	(15)	NM
SBA recourse provision	114	245	(131)	(53.5)	38	115	(77)	(67.0)
Tax credit investment impairment recovery	(351)	—	(351)	NM	(351)	—	(351)	NM
Total operating expense	\$ 19,685	\$ 17,932	\$ 1,753	9.8	\$ 38,573	\$ 35,383	\$ 3,190	9.0
Net interest income	\$ 23,660	\$ 21,652	\$ 2,008	9.3	\$ 45,087	\$ 42,515	\$ 2,572	6.0
Total non-interest income	6,872	6,321	551	8.7	14,258	13,516	742	5.5
Less:								
Net gain on sale of securities	—	29	(29)	NM	—	29	(29)	NM
Adjusted non-interest income	6,872	6,292	580	9.2	\$ 14,258	\$ 13,487	\$ 771	5.7
Total operating revenue	\$ 30,532	\$ 27,944	\$ 2,588	9.3	\$ 59,345	\$ 56,002	\$ 3,343	6.0
Efficiency ratio	64.47 %	64.17 %			65.00 %	63.18 %		
Pre-tax, pre-provision adjusted earnings	\$ 10,847	\$ 10,012	\$ 835	8.3	\$ 20,772	\$ 20,619	\$ 153	0.7
Average total assets	\$ 2,716,707	\$ 2,621,340	\$ 95,367	3.6	2,691,613	2,599,373	92,240	3.5
Pre-tax, pre-provision adjusted return on average assets	1.60 %	1.53 %			1.54 %	1.59 %		

NM = Not Meaningful

PPP loans, related fees, and interest income had a material impact on the prior period comparisons in the table above. As this economic stimulus was non-recurring, we believe these key performance indicators are a better indicator of current operating performance of the Corporation, excluding PPP loans and related fee and interest income. The table below includes the efficiency ratio, and pre-tax, pre-provision adjusted earnings and return on average assets, excluding average net PPP loans, fee income, and interest income.

The improvement in efficiency and pre-tax, pre-provision profitability, excluding the impact of PPP loans, was primarily due to the aforementioned increase in net interest income driven by an increase in average loans and leases receivable.

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2022	2021	\$ Change	% Change	2022	2021	\$ Change	% Change
(Dollars in Thousands)								
Total non-interest expense	\$ 19,456	\$ 18,184	\$ 1,272	7.0%	\$ 38,280	\$ 35,514	\$ 2,766	7.8%
Less:								
Net loss on foreclosed properties	8	(1)	9	NM	20	1	19	NM
Amortization of other intangible assets	—	8	(8)	NM	—	15	(15)	NM
SBA recourse provision	114	245	(131)	(53.5)	38	115	(77)	(67.0)
Tax credit investment impairment recovery	(351)	—	(351)	NM	(351)	—	(351)	NM
Total operating expense	\$ 19,685	\$ 17,932	\$ 1,753	9.8	\$ 38,573	\$ 35,383	\$ 3,190	9.0
Net interest income	\$ 23,660	\$ 21,652	\$ 2,008	9.3	\$ 45,087	\$ 42,515	\$ 2,572	6.0
Less:								
PPP interest income	29	566	(537)	(94.9)	81	1,169	(1,088)	(93.1)
PPP loan fee amortization	196	2,541	(2,345)	(92.3)	445	4,754	(4,309)	(90.6)
Adjusted net interest income	23,435	18,545	4,890	26.4	44,561	36,592	7,969	21.8
Total non-interest income	6,872	6,321	551	8.7	14,258	13,516	742	5.5
Less:								
Net gain on sale of securities	—	29	(29)	NM	—	29	(29)	NM
Adjusted non-interest income	6,872	6,292	580	9.2	14,258	13,487	771	5.7
Adjusted operating revenue	\$ 30,307	\$ 24,837	\$ 5,470	22.0	\$ 58,819	\$ 50,079	\$ 8,740	17.5
Efficiency ratio	64.95 %	72.20 %			65.58 %	70.65 %		
Pre-tax, pre-provision adjusted earnings	\$ 10,622	\$ 6,905	\$ 3,717	53.8	\$ 20,246	\$ 14,696	\$ 5,550	37.8
Average total assets	\$ 2,716,707	\$ 2,621,340	\$ 95,367	3.6	\$ 2,691,613	\$ 2,599,373	\$ 92,240	3.5
Average PPP loans, net	11,650	229,165	(217,515)	(94.9)	16,266	235,668	(219,402)	(93.1)
Adjusted average total assets	\$ 2,705,057	\$ 2,392,175	\$ 312,882	13.1	\$ 2,675,347	\$ 2,363,705	\$ 311,642	13.2
Pre-tax, pre-provision adjusted return on average assets	1.57 %	1.15 %			1.51 %	1.24 %		

NM = Not Meaningful

Excluding the impact of PPP in periods of comparison, we believe the Corporation will generate positive operating leverage on an annual basis and progress towards enhancing the long-term efficiency ratio at a measured pace as we focus on strategic initiatives directed toward revenue growth, process improvement, and automation. These initiatives include efforts to grow our existing specialized lending revenues, increase our commercial banking market share, and scale our private wealth management business.

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 and six months ended June 30, 2022 compared to the same period in 2021. 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 June 30,			Increase (Decrease) for the Six Months Ended June 30,		
	2022 Compared to 2021			2022 Compared to 2021		
	Rate	Volume	Net	Rate	Volume	Net
(In Thousands)						
Interest-earning assets						
Commercial real estate and other mortgage loans ⁽¹⁾	\$ 1,414	\$ 842	\$ 2,256	\$ 1,264	\$ 1,810	\$ 3,074
Commercial and industrial loans ⁽¹⁾	330	(495)	(165)	310	(999)	(689)
Direct financing leases ⁽¹⁾	3	(49)	(46)	14	(115)	(101)
Consumer and other loans ⁽¹⁾	(3)	54	51	(2)	91	89
Total loans and leases receivable	1,744	352	2,096	1,586	787	2,373
Mortgage-related securities	51	122	173	56	211	267
Other investment securities	14	61	75	6	97	103
FHLB and FRB Stock	9	41	50	9	60	69
Short-term investments	48	(10)	38	54	(6)	48
Total net change in income on interest-earning assets	1,866	566	2,432	1,711	1,149	2,860
Interest-bearing liabilities						
Transaction accounts	93	2	95	91	8	99
Money market accounts	178	49	227	183	108	291
Certificates of deposit	(50)	52	2	(173)	54	(119)
Wholesale deposits	266	(475)	(209)	549	(958)	(409)
Total deposits	487	(372)	115	650	(788)	(138)
FHLB advances	231	151	382	(33)	202	169
Other borrowings	(34)	238	204	(101)	406	305
Junior subordinated notes ⁽²⁾	—	(277)	(277)	327	(375)	(48)
Total net change in expense on interest-bearing liabilities	684	(260)	424	843	(555)	288
Net change in net interest income	\$ 1,182	\$ 826	\$ 2,008	\$ 868	\$ 1,704	\$ 2,572

(1) The average balances of loans and leases include non-accrual loans and leases and loans held for sale.

(2) The rate column for the three and six months ended June 30, 2022 includes \$12,000 and \$248,000 in accelerated amortization of debt issuance costs, respectively.

The tables below show 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 and six months ended June 30, 2022 and 2021. The average balances are derived from average daily balances.

	For the Three Months Ended June 30,					
	2022			2021		
	Average Balance	Interest	Average Yield/Rate ⁽⁴⁾	Average Balance	Interest	Average Yield/Rate ⁽⁴⁾
(Dollars in Thousands)						
Interest-earning assets						
Commercial real estate and other mortgage loans ⁽¹⁾	\$ 1,472,075	\$ 15,343	4.17 %	\$ 1,386,187	\$ 13,087	3.78 %
Commercial and industrial loans ⁽¹⁾	734,299	9,710	5.29	772,257	9,875	5.11
Direct financing leases ⁽¹⁾	15,527	176	4.53	19,883	222	4.47
Consumer and other loans ⁽¹⁾	51,045	458	3.59	45,026	407	3.62
Total loans and leases receivable ⁽¹⁾	2,272,946	25,687	4.52	2,223,353	23,591	4.24
Mortgage-related securities ⁽²⁾	176,747	804	1.82	149,253	631	1.69
Other investment securities ⁽³⁾	54,591	260	1.91	41,569	185	1.78
FHLB and FRB stock	17,355	226	5.21	14,172	176	4.97
Short-term investments	29,541	54	0.73	55,100	16	0.12
Total interest-earning assets	2,551,180	27,031	4.24	2,483,447	24,599	3.96
Non-interest-earning assets	165,527			137,893		
Total assets	\$ 2,716,707			\$ 2,621,340		
Interest-bearing liabilities						
Transaction accounts	\$ 502,763	343	0.27	\$ 499,040	248	0.20
Money market accounts	767,433	509	0.27	662,919	282	0.17
Certificates of deposit	73,560	114	0.62	45,993	112	0.97
Wholesale deposits	12,350	92	2.98	162,580	301	0.74
Total interest-bearing deposits	1,356,106	1,058	0.31	1,370,532	943	0.28
FHLB advances	449,599	1,666	1.48	405,855	1,284	1.27
Other borrowings	51,018	647	5.07	32,447	443	5.46
Junior subordinated notes ⁽⁵⁾	—	—	—	10,066	277	11.01
Total interest-bearing liabilities	1,856,723	3,371	0.73	1,818,900	2,947	0.65
Non-interest-bearing demand deposit accounts	557,086			527,441		
Other non-interest-bearing liabilities	57,615			56,691		
Total liabilities	2,471,424			2,403,032		
Stockholders' equity	245,283			218,308		
Total liabilities and stockholders' equity	\$ 2,716,707			\$ 2,621,340		
Net interest income		\$ 23,660			\$ 21,652	
Interest rate spread			3.51 %			3.31 %
Net interest-earning assets	\$ 694,457			\$ 664,547		
Net interest margin			3.71 %			3.49 %
Average interest-earning assets to average interest-bearing liabilities	137.40 %			136.54 %		
Return on average assets ⁽⁴⁾	1.61			1.26		
Return on average common equity ⁽⁴⁾	18.79			15.09		
Average equity to average assets	9.03			8.33		
Non-interest expense to average assets ⁽⁴⁾	2.86			2.77		

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

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

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

(4) Represents annualized yields/rates.

(5) The calculation for the three months ended June 30, 2022 includes \$12,000 in accelerated amortization of debt issuance costs.

For the Six Months Ended June 30,						
2022			2021			
	Average Balance	Interest	Average Yield/Rate ⁽⁴⁾	Average Balance	Interest	Average Yield/Rate ⁽⁴⁾
(Dollars in Thousands)						
Interest-earning assets						
Commercial real estate and other mortgage loans ⁽¹⁾	\$ 1,466,017	\$ 28,689	3.91 %	\$ 1,371,744	\$ 25,615	3.73 %
Commercial and industrial loans ⁽¹⁾	726,376	18,811	5.18	765,117	19,500	5.10
Direct financing leases ⁽¹⁾	16,030	365	4.55	21,071	466	4.42
Consumer and other loans ⁽¹⁾	50,449	894	3.54	45,335	805	3.55
Total loans and leases receivable ⁽¹⁾	2,258,872	48,759	4.32	2,203,267	46,386	4.21
Mortgage-related securities ⁽²⁾	180,832	1,564	1.73	156,249	1,297	1.66
Other investment securities ⁽³⁾	52,584	475	1.81	41,871	372	1.78
FHLB and FRB stock	15,688	398	5.07	13,323	329	4.94
Short-term investments	30,321	70	0.46	39,922	22	0.11
Total interest-earning assets	2,538,297	51,266	4.04	2,454,632	48,406	3.94
Non-interest-earning assets	153,316			144,741		
Total assets	\$ 2,691,613			\$ 2,599,373		
Interest-bearing liabilities						
Transaction accounts	\$ 517,923	597	0.23	\$ 510,024	498	0.20
Money market accounts	775,808	848	0.22	660,319	557	0.17
Certificates of deposit	63,098	169	0.54	51,677	288	1.11
Wholesale deposits	14,282	210	2.94	164,654	619	0.75
Total interest-bearing deposits	1,371,111	1,824	0.27	1,386,674	1,962	0.28
FHLB advances	417,518	2,702	1.29	386,371	2,533	1.31
Other borrowings	45,694	1,149	5.03	29,886	844	5.65
Junior subordinated notes ⁽⁵⁾	4,898	504	20.58	10,064	552	10.97
Total interest-bearing liabilities	1,839,221	6,179	0.67	1,812,995	5,891	0.65
Non-interest-bearing demand deposit accounts	559,793			506,767		
Other non-interest-bearing liabilities	50,117			65,146		
Total liabilities	2,449,131			2,384,908		
Stockholders' equity	242,482			214,465		
Total liabilities and stockholders' equity	\$ 2,691,613			\$ 2,599,373		
Net interest income		\$ 45,087			\$ 42,515	
Interest rate spread			3.37 %			3.29 %
Net interest-earning assets	\$ 699,076			\$ 641,637		
Net interest margin			3.55 %			3.46 %
Average interest-earning assets to average interest-bearing liabilities	138.01 %			135.39 %		
Return on average assets ⁽⁴⁾	1.46			1.38		
Return on average common equity ⁽⁴⁾	16.74			16.75		
Average equity to average assets	9.01			8.25		
Non-interest expense to average assets ⁽⁴⁾	2.84			2.73		

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

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

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

(4) Represents annualized yields/rates.

(5) The calculation for the six months ended June 30, 2022 includes \$248,000 in accelerated amortization of debt issuance costs.

Comparison of Net Interest Income for the Three and Six Months Ended June 30, 2022 and 2021

Net interest income increased \$2.0 million, or 9.3%, and \$2.6 million, or 6.0%, during the three and six months ended June 30, 2022, respectively, compared to the three and six months ended June 30, 2021. The increase in net interest income reflected an increase in average gross loans and leases and an increase in net interest margin, partially offset by a reduction in fees in lieu of interest. Fees in lieu of interest, which can vary from quarter to quarter, totaled \$1.9 million and \$3.2 million for the three and six months ended June 30, 2022, respectively, compared to \$3.5 million and \$6.6 million for the same periods in 2021. Excluding fees in lieu of interest and interest income from PPP loans, net interest income for the three and six months ended June 30, 2022 increased \$4.2 million, or 24.0%, and \$7.1 million, or 20.5%, respectively. Average gross loans and leases for the three and six months ended June 30, 2022 increased \$49.6 million, or 2.2%, and \$55.6 million, or 2.5%, respectively, compared to the three and six months ended June 30, 2021. Excluding net PPP loans, average gross loans and leases for the three and six months ended June 30, 2022 increased \$267.1 million, or 13.4%, and \$275.0 million, or 14.0%, respectively, compared to the three and six months ended June 30, 2021.

Net interest margin increased to 3.71% and 3.55% for the three and six months ended June 30, 2022, respectively, compared to 3.49% and 3.46% for the three and six months ended June 30, 2021. The primary driver of improved net interest margin was a low deposit beta and higher earning asset yields in the current rising rate environment. The change in the rate paid on interest-bearing liabilities compared to the change in short-term market rates is commonly referred to as a beta. The Corporation uses the daily average effective federal funds rate for purposes of estimating interest-bearing liability betas. Adjusted net interest margin measured 3.45% and 3.35% for the three and six months ended June 30, 2022, respectively, compared to 3.20% for both the three and six months ended June 30, 2021. Adjusted net interest margin is a non-GAAP measure representing net interest income excluding the fees in lieu of interest and other recurring, but volatile, components of net interest margin divided by average interest-earning assets less average net PPP loans, if any, and other recurring, but volatile, components of average interest-earning assets.

The yield on average loans and leases for the three and six months ended June 30, 2022 was 4.52% and 4.32%, respectively, compared to 4.24% and 4.21% for the three and six months ended June 30, 2021. Excluding the impact of loan fees in lieu of interest and PPP loan interest income, the yield on average loans and leases excluding net PPP loans for the three and six months ended June 30, 2022 was 4.21% and 4.06%, respectively, compared to 3.91% and 3.92% for the three and six months ended June 30, 2021. Similarly, the yield on average interest-earning assets for the three and six months ended June 30, 2022 measured 4.24% and 4.04%, respectively, compared to 3.96% and 3.94% for the three and six months ended June 30, 2021. Excluding loan fees in lieu of interest and the impact of PPP loans, the yield on average interest-earning assets for the three and six months ended June 30, 2022 was 3.96% and 3.81%, respectively, compared to 3.64% and 3.66% for the three and six months ended June 30, 2021. The increase in yields was primarily due to rising rates on variable-rate loans, following the Federal Open Market Committee's ("FOMC") decision to raise the target Fed Funds rate 150 basis points during the first half of 2022, as well as the reinvestment of cash flows from the securities and fixed-rate loan portfolios in a rising rate environment.

The rate paid on average interest-bearing in-market deposits for the three and six months ended June 30, 2022 increased to 0.29% and 0.24%, respectively, from 0.21% and 0.22% for the three and six months ended June 30, 2021. The average rate paid on total interest-bearing liabilities for the three and six months ended June 30, 2022 increased to 0.73% and 0.67%, respectively, from 0.65% for both the three and six months ended June 30, 2021. Total interest-bearing liabilities include interest-bearing deposits, federal funds purchased, FHLB advances, subordinated and junior subordinated notes payable, and other borrowings. The average rates paid increased commensurate with the increase in short-term market rates and the renewal of maturing FHLB advances at higher fixed rates. The daily average effective federal funds rate for the three and six months ended June 30, 2022 increased 70 and 38 basis points, respectively, compared to the same periods in 2021. This equates to a beta of 11% and 5% for the three and six months ended June 30, 2022, respectively, on interest-bearing in-market deposits.

Management believes its success in growing in-market deposit relationships, disciplined loan pricing, and increased production in existing higher-yielding specialized lending lines of business will allow the Corporation to maintain a net interest margin of at least 3.50%, on average, over the long-term; 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. 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. The Corporation continues to maintain an asset-sensitive balance sheet and ended the quarter appropriately positioned for net interest income to benefit from rising short-term interest rates.

Provision for Loan and Lease Losses

We determine our provision for loan and lease losses pursuant to our allowance for loan and lease loss methodology, which is based on the magnitude of current and historical net charge-offs recorded throughout the established look-back period, the evaluation of several qualitative factors for each portfolio category, and the amount of specific reserves established for impaired loans that present collateral shortfall positions. Refer to **Allowance for Loan and Lease Losses**, below, for further information regarding our allowance for loan and lease loss methodology.

The Corporation recognized a \$3.7 million and \$4.6 million provision benefit for the three and six months ended June 30, 2022, respectively, compared to a benefit of \$1.0 million and \$3.0 million for the three and six months ended June 30, 2021. The provision benefit for the three months ended June 30, 2022 was primarily due to a net recovery of \$4.2 million and a \$185,000 reduction due to qualitative risk factor improvements, partially offset by a \$527,000 increase in the general reserve due to loan growth. The provision benefit for the six months ended June 30, 2022 was primarily due to a net recovery of \$4.4 million, a \$601,000 reduction due to qualitative risk factor improvements, and a \$251,000 net decrease in specific reserves, partially offset by a \$762,000 increase in the general reserve due to loan growth. The net recovery for the three and six months ended June 30, 2022 included a \$4.1 million principal recovery relating to a legacy SBA relationship originated in May 2016 and fully charged-off in December 2020.

The following table shows the components of the provision for loan and lease losses for the three and six months ended June 30, 2022 compared to the three months ended June 30, 2021.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2022	2021	2022	2021
(In Thousands)				
Change in general reserve due to subjective factor changes	\$ (185)	\$ (652)	\$ (601)	\$ 430
Change in general reserve due to historical loss factor changes	64	(1,687)	(142)	(2,671)
Charge-offs	85	2,894	107	3,038
Recoveries	(4,247)	(545)	(4,457)	(3,218)
Change in specific reserves on impaired loans, net	29	(1,466)	(251)	(1,660)
Change due to loan growth, net	527	498	762	1,055
Total provision for loan and lease losses	<u>\$ (3,727)</u>	<u>\$ (958)</u>	<u>\$ (4,582)</u>	<u>\$ (3,026)</u>

The addition of specific reserves on impaired loans represents new specific reserves established when collateral shortfalls or government guaranty deficiencies are present, while 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. This amount is net of the release of any specific reserve that may have already been provided. 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 loss rate. Refer to **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 and Six Months Ended June 30, 2022 and 2021

Non-Interest Income

Non-interest income increased \$551,000, or 8.7%, to \$6.9 million for the three months ended June 30, 2022 compared to \$6.3 million for the same period in 2021. The increase in total non-interest income for the three months ended June 30, 2022 was due to increases in private wealth management services fee income, loan fee income, service charges on deposits, and commercial loan swap fee income. These favorable variances were partially offset by a decrease in gains on the sale of SBA loans. Non-interest income for the six months ended June 30, 2022 increased \$742,000, or 5.5%, to \$14.3 million compared to \$13.5 million for the same period in 2021. The increase in total non-interest income for the six months ended June 30, 2022 reflected strong private wealth management services fee income, an increase in other non-interest income, led by mezzanine fund investment income, and an increase in commercial loan swap fee income, loan fee income, and service charges on deposits. These favorable variances were partially offset by a decrease in gains on the sale of SBA loans.

Management continues to focus on revenue growth from multiple non-interest income sources in order to maintain a diversified revenue stream through greater contributions from fee-based revenues. Total non-interest income accounted for 22.5% and 24.0% of total revenues for the three and six months ended June 30, 2022, respectively, compared to 22.6% and 24.1% for the three and six months ended June 30, 2021.

The components of non-interest income were as follows:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2022	2021	\$ Change	% Change	2022	2021	\$ Change	% Change
(Dollars in Thousands)								
Private wealth management services fee income	\$ 2,852	\$ 2,744	\$ 108	3.9%	\$ 5,693	\$ 5,151	\$ 542	10.5%
Gain on sale of SBA loans	951	1,203	(252)	(20.9)	1,537	2,281	(744)	(32.6)
Service charges on deposits	1,041	941	100	10.6	2,040	1,859	181	9.7
Loan fees	697	569	128	22.5	1,349	1,114	235	21.1
Increase in cash surrender value of bank-owned life insurance	350	350	—	NM	698	699	(1)	(0.1)
Net gain (loss) on sale of securities	—	29	(29)	NM	—	29	(29)	NM
Swap fees	471	—	471	NM	697	684	13	1.9
Other non-interest income	510	485	25	5.2	2,244	1,699	545	32.1
Total non-interest income	<u>\$ 6,872</u>	<u>\$ 6,321</u>	<u>\$ 551</u>	<u>8.7</u>	<u>\$ 14,258</u>	<u>\$ 13,516</u>	<u>\$ 742</u>	<u>5.5</u>
Fee income ratio ⁽¹⁾	22.5 %	22.6 %			24.0 %	24.1 %		

(1) Fee income ratio is fee income, per the above table, divided by top line revenue (defined as net interest income plus non-interest income).

Private wealth management service fees increased \$108,000, or 3.9%, and \$542,000, or 10.5%, for the three and six months ended June 30, 2022, compared to the three and six months ended June 30, 2021. Private wealth management fee income is primarily driven by the amount of assets under management and administration, as well as the mix of business at different fee structures, and can be positively or negatively influenced by the timing and magnitude of volatility within the capital markets. As of June 30, 2022, private wealth and trust assets under management and administration totaled \$2.554 billion, decreasing \$10.6 million, or 0.4%, compared to \$2.564 billion as of June 30, 2021, as new client relationships and new money from existing clients was more than offset by the decline in market values.

Commercial loan interest rate swap fee income was \$471,000 and \$697,000 for the three and six months ended June 30, 2022, respectively, compared to no activity for the three months ended June 30, 2021 and \$684,000 for the six months ended June 30, 2021. We originate commercial real estate loans in which we offer clients a floating rate and an interest rate swap. The client's swap is then offset with a counter-party dealer. The execution of these transactions generates swap fee income. The aggregate amortizing notional value of interest rate swaps with various borrowers was \$646.1 million as of June 30, 2022, compared to \$637.0 million as of June 30, 2021. Interest rate swaps can be an attractive product for our commercial borrowers, although associated fee income can be variable from period to period based on loan activity and the interest rate environment in any given quarter.

Loan fees increased \$128,000, or 22.5%, and \$235,000, or 21.1%, for the three and six months ended June 30, 2022, respectively, compared to same periods in 2021. The increase was due to an increase in conventional, SBA, and floorplan financing activity generating additional service fee income.

Service charges on deposits increased \$100,000, or 10.6%, and \$181,000, or 9.7%, for the three and six months ended June 30, 2022, respectively, compared to same periods in 2021. The increase was due to an increase in new client relationships and the addition of new services to existing client relationships.

Other non-interest income increased \$25,000, or 5.2%, and \$545,000, or 32.1% for the three and six months ended June 30, 2022, respectively, compared to the same periods in 2021. The increase for the six months ended June 30, 2022 was primarily due to above average returns from the Corporation's investments in mezzanine funds.

Gain on sale of SBA loans for the three and six months ended June 30, 2022 decreased \$252,000, or 20.9%, and \$744,000, or 32.6%, respectively, compared to the same periods in 2021.

Comparison of Non-Interest Expense for the Three and Six Months Ended June 30, 2022 and 2021

Non-Interest Expense

Non-interest expense for the three and six months ended June 30, 2022 increased by \$1.3 million, or 7.0%, and \$2.8 million, or 7.8%, respectively, compared to the same periods in 2021. Operating expense, which excludes certain one-time and discrete items as defined in the Efficiency Ratio table above, increased \$1.8 million, or 9.8%, and \$3.2 million, or 9.0%, for the three and six months ended June 30, 2022, respectively, compared to the same periods in 2021. The increase in operating expense was primarily due to an increase in compensation, professional fees, and marketing expenses.

The components of non-interest expense were as follows:

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2022	2021	\$ Change	% Change	2022	2021	\$ Change	% Change
(Dollars in Thousands)								
Compensation	\$ 14,020	\$ 13,255	\$ 765	5.8 %	\$ 27,658	\$ 25,912	\$ 1,746	6.7 %
Occupancy	568	533	35	6.6	1,123	1,085	38	3.5
Professional fees	1,298	913	385	42.2	2,468	1,778	690	38.8
Data processing	892	798	94	11.8	1,673	1,569	104	6.6
Marketing	670	511	159	31.1	1,170	902	268	29.7
Equipment	235	261	(26)	(10.0)	479	506	(27)	(5.3)
Computer software	1,117	1,129	(12)	(1.1)	2,199	2,244	(45)	(2.0)
FDIC insurance	296	280	16	5.7	610	642	(32)	(5.0)
Other non-interest expense	360	504	(144)	(28.6)	900	876	24	2.7
Total non-interest expense	\$ 19,456	\$ 18,184	\$ 1,272	7.0	\$ 38,280	\$ 35,514	\$ 2,766	7.8
Total operating expense ⁽¹⁾	\$ 19,685	\$ 17,932	\$ 1,753	9.8	\$ 38,573	\$ 35,383	\$ 3,190	9.0
Full-time equivalent employees	333	319			333	319		

(1) Total operating expense represents total non-interest expense, adjusted to exclude the impact of discrete items as previously defined in the non-GAAP efficiency ratio calculation, above.

Compensation expense for the three and six months ended June 30, 2022 increased \$765,000, or 5.8%, and \$1.7 million, or 6.7%, respectively, compared to the three and six months ended June 30, 2021. The increase reflects above average

annual merit and market increases, reflecting the competitive job market, as well as an increase in the annual cash incentive compensation bonus accrual related to performance and hiring to support the Bank's growth plans. Management believes there will be upward pressure on compensation throughout the remainder of the year as the Bank continues to opportunistically invest in new talent and retain existing talent in the competitive market. Average full-time equivalent employees for the three months ended June 30, 2022 increased to 321, up 2.89%, compared to 312 for the three months ended June 30, 2021.

Professional fees increased \$385,000, or 42.2%, and \$690,000, or 38.8%, for the three and six months ended June 30, 2022, respectively, compared to the three and six months ended June 30, 2021. The increase was primarily due to an increase in recruiting expense, audit expenses, and a general increase in other professional consulting services for various projects.

Marketing expense increased \$159,000, or 31.1%, and \$268,000, or 29.7%, for the three and six months ended June 30, 2022, respectively, compared to the three and six months ended June 30, 2021. The increase was primarily due to an increase in business development efforts as the Corporation returns to pre-pandemic spending levels.

Income Taxes

Income tax expense totaled \$5.8 million for the six months ended June 30, 2022 compared to an income tax expense of \$5.6 million for the six months ended June 30, 2021. The effective tax rate for the six months ended June 30, 2022 was 23.7% compared to 23.6% for the six months ended June 30, 2021. For 2022, the Corporation expects to report an effective tax rate of approximately 23% as management intends to continue actively pursuing tax credit opportunities.

Generally, the provision for income taxes is determined by applying an estimated annual effective income tax rate to income before taxes and adjusting for discrete items. The rate is based on the most recent annualized forecast of pre-tax income, book versus tax differences and tax credits, if any. If we conclude that a reliable estimated annual effective tax rate cannot be determined, the actual effective tax rate for the year-to-date period may be used. We re-evaluate the income tax rates each quarter. Therefore, the current projected effective tax rate for the entire year may change.

Financial Condition

General

Total assets increased by \$124.1 million, or 4.7%, to \$2.777 billion as of June 30, 2022 compared to \$2.653 billion at December 31, 2021. The increase in total assets was primarily driven by an increase in cash and loans and leases receivable. Total liabilities increased by \$106.6 million, or 4.4%, to \$2.527 billion at June 30, 2022 compared to \$2.420 billion at December 31, 2021. The increase in total liabilities was principally due to an increase in FHLB advances and subordinated debentures, partially offset by a decrease in deposits and payoff of junior subordinated debentures. Total stockholders' equity increased by \$17.5 million, or 7.5%, to \$249.9 million at June 30, 2022 compared to \$232.4 million at December 31, 2021. The increase in total stockholders' equity was due to retention of earnings and issuance of preferred stock, partially offset by unrealized losses on available-for-sale securities and dividends paid to common stockholders.

Cash and Cash Equivalents

Cash and cash equivalents include short-term investments and cash and due from banks. Cash and due from banks increased \$29.6 million to \$39.3 million at June 30, 2022 principally due to a routine temporary increase in cash related to client funds in-transit. Short-term investments increased by \$8.8 million to \$56.2 million at June 30, 2022 from \$47.4 million at December 31, 2021. Our short-term investments primarily consist of interest-bearing deposits held at the FRB. We value the safety and soundness provided by the FRB, and therefore, we incorporate short-term investments in our on-balance sheet liquidity program. As of June 30, 2022 and December 31, 2021, interest-bearing deposits held at the FRB were \$55.5 million and \$47.0 million, respectively. In general, the level of our cash and short-term investments will be influenced by the timing of deposit gathering, scheduled maturities of wholesale deposits, funding of loan and lease growth, and the level of our securities portfolio. Please refer to the section entitled **Liquidity and Capital Resources** for further discussion.

Securities

Total securities, including available-for-sale and held-to-maturity, decreased by \$2.8 million, or 1.3%, to \$222.6 million, or 8.0% of total assets at June 30, 2022 compared to \$225.4 million, or 8.5% of total assets at December 31, 2021. During the six months ended June 30, 2022 the Corporation recognized unrealized losses of \$19.7 million before income taxes through other comprehensive income, compared to unrealized losses of \$1.6 million for the same period in 2021. These unrealized losses are solely driven by the recent shift in interest rates. As of June 30, 2022 and December 31, 2021, our overall securities portfolio, including available-for-sale securities and held-to-maturity securities, had an estimated weighted-average expected maturity of 6.3 years and 5.7 years, respectively. Our investment philosophy remains as stated in our most recent Annual Report on Form 10-K.

We use a third-party pricing service as our primary source of market prices for our securities portfolio. On a quarterly basis, we validate the reasonableness of prices received from this source through independent verification, data integrity validation primarily through comparison of current price to an expectation-based analysis of movement in prices based upon the changes in the related yield curves, and other market factors. No securities within our portfolio were deemed to be other-than-temporarily impaired as of June 30, 2022.

Loans and Leases Receivable

Loans and leases receivable, net of allowance for loan and lease losses, increased by \$50.9 million, or to \$2.266 billion at June 30, 2022 from \$2.215 billion at December 31, 2021 which was driven by commercial loan growth, partially offset by PPP loan forgiveness. Loans and leases receivable, net of allowance for loan and lease losses and excluding net PPP loans, increased by \$70.0 million to \$2.258 billion at June 30, 2022 from \$2.188 billion at December 31, 2021.

Total commercial real estate (“CRE”) loans increased \$33.9 million to \$1.488 billion, up from \$1.455 billion at December 31, 2021. Owner occupied CRE and construction financing drove CRE loan growth as of June 30, 2022, increasing \$22.8 million, and \$24.1 million, respectively, from December 31, 2021, partially offset by a \$5.7 million and \$9.5 million decline in multi-family and non-owner occupied CRE loans, respectively.

There continues to be a concentration in CRE loans which represented 65.2% and 65.8% of our total loans, excluding net PPP loans, as of June 30, 2022 and December 31, 2021, respectively. As of June 30, 2022, 17.4% of the CRE loans were owner-occupied CRE, compared to 16.2% as of December 31, 2021. We consider owner-occupied CRE more characteristic of the Corporation’s C&I portfolio as, in general, the client’s primary source of repayment is the cash flow from the operating entity occupying the commercial real estate property.

Excluding PPP loans, C&I loans increased \$30.1 million, to \$733.1 million from \$703.0 million at December 31, 2021. Despite elevated payoffs during the first quarter of 2022, management believes timely prior-period investments in conventional and specialized commercial lending has positioned C&I lending for strong and sustainable growth in 2022 and beyond. Including PPP loans, our C&I portfolio increased \$10.5 million to \$741.4 million from \$730.8 million at December 31, 2021.

We will continue to actively pursue C&I loans across the Corporation as this segment of our loan and lease portfolio provides an attractive yield commensurate with an appropriate level of credit risk and creates opportunities for in-market deposit, treasury management, and private wealth management relationships which generate additional fee revenue.

Underwriting of new credit is primarily through approval from a serial sign-off or committee process and is a key component of our operating philosophy. Business development officers have no individual lending authority limits. We make every reasonable effort to ensure that there is appropriate collateral or a government guarantee at the time of origination to protect our interest in the related loan or lease. To monitor the ongoing credit quality of our loans and leases, each credit is evaluated for proper risk rating using a nine grade risk rating system at the time of origination, subsequent renewal, evaluation of updated financial information from our borrowers, or as other circumstances dictate.

While we continue to experience significant competition from banks operating in our primary geographic areas, we remain committed to our underwriting standards and will not deviate from those standards for the sole purpose of growing our loan and lease portfolio. We continue to expect our new loan and lease activity to be adequate to replace normal amortization, allowing us to continue growing in future years. The types of loans and leases we originate and the various risks associated with these originations remain consistent with information previously outlined in our most recent Annual Report on Form 10-K.

Deposits

As of June 30, 2022, deposits decreased by \$88.6 million to \$1.869 billion from \$1.958 billion at December 31, 2021, primarily due to a \$108.5 million and \$22.7 million decrease in transaction accounts and money market accounts, respectively, partially offset by a \$59.9 million increase in certificates of deposit. The decline in balances was due to movement of client deposits to investment alternatives, seasonality within the Bank's municipality clients, tax payments, and normal course of business for continuing client relationships. Management believes the Bank's deposit-centric sales strategy, led by treasury management sales, will contribute to a net increase in deposits annually; however, period-end deposit balances associated with in-market relationships will fluctuate based upon maturity of time deposits, client demands for the use of their cash, and our ability to maintain existing and new client relationships.

Our strategic efforts remain focused on adding in-market deposit relationships. We measure the success of in-market deposit gathering efforts based on the number and average balances of our deposit accounts as compared to ending balances due to the volatility of some of our larger relationships. The Bank's average in-market deposits, consisting of all transaction accounts, money market accounts, and certificates of deposit, were \$1.917 billion for the six months ended June 30, 2022 compared to \$1.729 billion for the six months ended June 30, 2021.

FHLB Advances and Other Borrowings

As of June 30, 2022, FHLB advances and other borrowings increased by \$193.2 million, or 47.9%, to \$596.6 million from \$403.5 million at December 31, 2021. The FHLB advances were used to fund the seasonal decline of in-market deposits and to match-fund existing and new fixed-rate loan growth to mitigate interest risk.

As of June 30, 2022 and December 31, 2021, the Corporation had other borrowings of \$8.3 million and \$10.4 million respectively, which consisted of sold loans which were accounted for as a secured borrowing, because they did not qualify for true sale accounting, and borrowings associated with our investment in a community development entity.

On March 4, 2022, the Corporation completed a private placement of \$20.0 million in new subordinated debt to one institutional investor. Management used a portion of the proceeds during the second quarter of 2022 to redeem \$9.1 million of subordinated notes bearing a fixed interest rate of 6.00%. The remainder of the proceeds will be used for general corporate purposes, including to support the Bank's growth strategy, and to fund the Corporation's previously announced \$5 million share repurchase plan. The subordinated note bears a fixed interest rate of 3.50% with a maturity date of March 15, 2032 and has certain performance debt covenants of which the Corporation was in compliance as of June 30, 2022. The Corporation may, at its option, redeem the note, in whole or part, at any time after the fifth anniversary of issuance.

Consistent with our funding philosophy to manage interest rate risk, we will use the most efficient and cost effective source of wholesale funds. We will utilize FHLB advances to the extent we maintain an adequate level of excess borrowing capacity for liquidity and contingency funding purposes and pricing remains favorable in comparison to the wholesale deposit alternative. We will use FHLB advances and/or brokered certificates of deposit in specific maturity periods needed, typically three to five years, to match-fund fixed rate loans and effectively mitigate the interest rate risk measured through our asset/liability management process and to support asset growth initiatives while taking into consideration our operating goals and desired level of usage of wholesale funds. Please refer to the section entitled **Liquidity and Capital Resources**, below, for further information regarding our use and monitoring of wholesale funds.

Preferred Stock

On March 4, 2022, the Corporation issued 12,500 shares, or \$12.5 million in aggregate liquidation preference, of its 7.0% Fixed-to-Floating Rate Non-Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share, with a liquidation preference of \$1,000 per share (the "Series A Preferred Stock") in a private placement to institutional investors. The net proceeds received from the issuance of the Series A Preferred Stock were \$12.0 million. The proceeds were used to redeem \$10.1 million of junior subordinated notes in the first quarter of 2022.

The Corporation expects to pay dividends on the Series A Preferred Stock when and if declared by its Board, at a fixed rate of 7.0% per annum, payable quarterly, in arrears, on March 15, June 15, September 15 and December 15 of each year up to, but excluding, March 15, 2027. For each dividend period from and including March 15, 2027, dividends will be paid at a floating rate of Three-Month Term SOFR plus a spread of 539 basis points per annum. During the three months ended June 30, 2022, the Corporation paid \$246,000 in preferred cash dividends. The Series A Preferred Stock is perpetual and has no stated maturity. The Corporation may redeem the Series A Preferred Stock at its option at a redemption price equal to \$1,000 per share, plus any declared and unpaid dividends (without regard to any undeclared dividends), subject to regulatory approval, on or after March 15, 2027 or within 90 days following a regulatory capital treatment event, in accordance with the terms of the Series A Preferred Stock.

Derivatives

The Board approved Bank policies allow the Bank to participate in hedging strategies or to use financial futures, options, forward commitments, or interest rate swaps. The Bank utilizes, from time to time, derivative instruments in the course of its asset/liability management. The Corporation's derivative financial instruments, under which the Corporation is required to either receive cash from or pay cash to counterparties depending on changes in interest rates applied to notional amounts, are carried at fair value on the consolidated balance sheets.

As of June 30, 2022, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was approximately \$646.1 million, compared to \$640.6 million as of December 31, 2021. We receive fixed rates and pay floating rates based upon designated benchmark interest rates on the swaps with commercial borrowers. These swaps mature between May 2024 and March 2038. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. As of June 30, 2022, the commercial borrower swaps were reported on the Consolidated Balance Sheet as a derivative asset of \$3.2 million and as a derivative liability of \$40.4 million compared to a derivative asset and liability of \$26.3 million and \$6.6 million, respectively, as of December 31, 2021. On the offsetting swap contracts with dealer counterparties, we pay fixed rates and receive floating rates based upon designated benchmark interest rates. These interest rate swaps also have maturity dates between May 2024 and March 2038. Dealer counterparty swaps are subject to master netting agreements among the contracts within our Bank and were reported on the Consolidated Balance Sheet as a net derivative asset of \$37.1 million as of June 30, 2022, compared to a net derivative liability of \$19.7 million as of December 31, 2021. The gross amount of dealer counterparty swaps as of June 30, 2022, without regard to the enforceable master netting agreement, was a gross derivative liability of \$3.2 million and a gross derivative asset of \$40.4 million, compared to a gross derivative liability of \$26.3 million and gross derivative asset of \$6.6 million as of December 31, 2021.

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. As of June 30, 2022, the aggregate notional value of interest rate swaps designated as cash flow hedges was \$124.4 million. These interest rate swaps mature between December 2022 and March 2034. A pre-tax unrealized gain of \$1.7 million and \$5.7 million was recognized in other comprehensive income for the three and six months ended June 30, 2022, respectively, and there was no ineffective portion of these hedges.

The Corporation also enters into interest rate swaps to mitigate market value volatility on certain long-term fixed securities. The objective of the hedge is to protect the Corporation against changes in fair value due to changes in benchmark interest rates. The instruments are designated as fair value hedges as the changes in the fair value of the interest rate swap are expected to offset changes in the fair value of the hedged item attributable to changes in the SOFR swap rate, the designated benchmark interest rate. 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 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. As of June 30, 2022, the aggregate notional value of interest rate swaps designated as fair value hedges was \$12.5 million. These interest rate swaps mature between February 2031 and October 2034. A pre-tax unrealized loss of \$376,000 was recognized in other comprehensive income for the six months ended June 30, 2022 and there was no ineffective portion of these hedges.

For further information and discussion of our derivatives, see **Note 13 — Derivative Financial Instruments** of the Consolidated Financial Statements.

Asset Quality

Impaired Assets

Total impaired assets consisted of the following at June 30, 2022 and December 31, 2021, respectively:

	June 30, 2022	December 31, 2021
	(Dollars in Thousands)	
Non-accrual loans and leases		
Commercial real estate:		
Commercial real estate - owner occupied	\$ 113	\$ 348
Commercial real estate - non-owner occupied	—	—
Land development	—	—
Construction	—	—
Multi-family	—	—
1-4 family	33	339
Total non-accrual commercial real estate	146	687
Commercial and industrial	5,390	5,572
Direct financing leases, net	49	99
Consumer and other:		
Home equity and second mortgages	—	—
Other	—	—
Total non-accrual consumer and other loans	—	—
Total non-accrual loans and leases	5,585	6,358
Foreclosed properties, net	124	164
Total non-performing assets	5,709	6,522
Performing troubled debt restructurings	188	217
Total impaired assets	\$ 5,897	\$ 6,739
Total non-accrual loans and leases to gross loans and leases	0.24 %	0.28 %
Total non-performing assets to gross loans and leases plus foreclosed properties, net	0.25	0.29
Total non-performing assets to total assets	0.21	0.25
Allowance for loan and lease losses to gross loans and leases	1.05	1.09
Allowance for loan and lease losses to non-accrual loans and leases	431.58	382.76

Net PPP loans outstanding as of June 30, 2022 and December 31, 2021, were \$8.2 million and \$27.3 million, respectively. The following asset quality ratios exclude net PPP loans as they are fully guaranteed by the SBA:

	June 30, 2022	December 31, 2021
Total non-accrual loans and leases to gross loans and leases	0.24 %	0.29 %
Total non-performing assets to gross loans and leases plus foreclosed properties, net	0.25	0.29
Total non-performing assets to total assets	0.21	0.25
Allowance for loan and lease losses to gross loans and leases	1.06	1.10

Non-accrual loans decreased \$773,000, or 12.2%, to \$5.6 million at June 30, 2022, compared to \$6.4 million at December 31, 2021. The decrease in non-accrual loans was principally due to loan payoffs, loans returning to accrual status, and \$85,000 of charge-offs. The Corporation's non-accrual loans as a percentage of total gross loans and leases measured 0.24% and 0.28% at June 30, 2022 and December 31, 2021, respectively. Non-accrual loans as a percentage of total gross loans and leases, excluding net PPP loans, was 0.24% and 0.29% at June 30, 2022 and December 31, 2021, respectively. As of

June 30, 2022 and December 31, 2021, \$615,000 and \$627,000 of non-accrual loans and leases were considered TDRs, respectively.

We use a wide variety of available metrics to assess the overall asset quality of the portfolio and no one metric is used independently to make a final conclusion as to the asset quality of the portfolio. Non-performing assets as a percentage of total assets was 0.21% and 0.25% at June 30, 2022 and December 31, 2021, respectively. As of June 30, 2022, the payment performance of our loans and leases did not point to any new areas of concern, as approximately 99.0% of the total portfolio was in a current payment status, compared to 99.8% as of December 31, 2021. We also monitor asset quality through our established categories as defined in **Note 5 – Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses** of the Consolidated Financial Statements. As we continue to actively monitor the credit quality of our loan and lease portfolios, we may identify additional loans and leases for which the borrowers or lessees are having difficulties making the required principal and interest payments based upon factors including, but not limited to, the inability to sell the underlying collateral, inadequate cash flow from the operations of the underlying businesses, liquidation events, or bankruptcy filings. We are proactively working with our impaired loan borrowers to find meaningful solutions to difficult situations that are in the best interests of the Bank.

As of June 30, 2022, as well as in all previous reporting periods, there were no loans over 90 days past due and still accruing interest. Loans and leases greater than 90 days past due are considered impaired and are placed on non-accrual status. Cash received while a loan or a lease is on non-accrual status is generally applied solely against the outstanding principal. If collectability of the contractual principal and interest is not in doubt, payments received may be applied to both interest due on a cash basis and principal.

The following represents additional information regarding our impaired loans and leases:

	As of and for the Six Months Ended June 30,		As of and for the Year Ended December
	2022	2021	31, 2021
	(In Thousands)		
Impaired loans and leases with no impairment reserves required	\$ 4,144	\$ 7,948	\$ 4,419
Impaired loans and leases with impairment reserves required	1,629	3,530	2,156
Total impaired loans and leases	5,773	11,478	6,575
Less: Impairment reserve (included in allowance for loan and lease losses)	1,254	2,021	1,505
Net impaired loans and leases	\$ 4,519	\$ 9,457	\$ 5,070
Average impaired loans and leases	\$ 6,009	\$ 19,420	\$ 14,260
Foregone interest income attributable to impaired loans and leases	\$ 206	\$ 1,081	\$ 1,104
Less: Interest income recognized on impaired loans and leases	813	153	454
Net foregone interest income on impaired loans and leases	\$ (607)	\$ 928	\$ 650

Allowance for Loan and Lease Losses

The allowance for loan and lease losses decreased \$232,000, or 1.0%, to \$24.1 million as of June 30, 2022 from \$24.3 million as of December 31, 2021. The allowance for loan and lease losses as a percentage of gross loans and leases decreased to 1.05% as of June 30, 2022 from 1.09% as of December 31, 2021. The allowance for loan and lease losses as a percentage of gross loans and leases, excluding net PPP loans, was 1.06% as of June 30, 2022 compared to 1.10% as of December 31, 2021. The decrease in allowance for loan and lease losses as a percent of gross loans and leases was principally due to the net decrease in specific reserves and qualitative risk factor improvements. These general and specific reserve releases were partially offset by an increase in general reserve commensurate with loan growth. The majority of loan segments experienced a reduction in historical loss factors as the look-back period continued to roll off the Corporation's higher loss rates from the Great Recession.

There have been no substantive changes to our methodology for estimating the appropriate level of allowance for loan and lease loss reserves from what was previously outlined in our most recent Annual Report on Form 10-K.

During the six months ended June 30, 2022, we recorded net recoveries on impaired loans and leases of \$4.4 million, comprised of \$107,000 of charge-offs and \$4.5 million of recoveries. While we likely will continue to experience some level of periodic charge-offs in the future as exit strategies are considered and executed, based on current economic conditions, management believes net charge-offs will remain at low levels in the near term. Loans and leases with previously established specific reserves, however, may ultimately result in a charge-off under a variety of scenarios.

As of June 30, 2022 and December 31, 2021, our ratio of allowance for loan and lease losses to total non-accrual loans and leases was 431.58% and 382.76%, respectively. This ratio increased primarily due to the substantial decrease in non-accrual loans and leases discussed above, in comparison to the decrease in the allowance for loan and lease losses. Impaired loans and leases exhibit weaknesses that inhibit repayment in compliance with the original terms of the note or lease; however, the measurement of impairment on loans and leases may not always result in a specific reserve included in the allowance for loan and lease losses. As part of the underwriting process, as well as our ongoing monitoring efforts, we try to ensure that we have sufficient collateral to protect our interest in the related loan or lease. As a result of this practice, a significant portion of our outstanding balance of non-performing loans or leases may not require additional specific reserves or require only a minimal amount of required specific reserve. Management is proactive in recording charge-offs to bring loans to their net realizable value in situations where it is determined with certainty that we will not recover the entire amount of our principal. This practice may lead to a lower allowance for loan and lease loss to non-accrual loans and leases ratio as compared to our peers or industry expectations. As asset quality strengthens, our allowance for loan and lease losses is measured more through general characteristics, including historical loss experience, of our portfolio rather than through specific identification and we would therefore expect this ratio to rise. Conversely, if we identify further impaired loans, this ratio could fall if the impaired loans are adequately collateralized and therefore require no specific or general reserve. Given our business practices and evaluation of our existing loan and lease portfolio, we believe this coverage ratio is appropriate for the probable losses inherent in our loan and lease portfolio as of June 30, 2022.

To determine the level and composition of the allowance for loan and lease losses, we break out the portfolio by segments with similar risk characteristics. First, we evaluate loans and leases for potential impairment classification. We analyze each loan and lease identified as 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. For each segment of loans and leases that has not been individually evaluated, management segregates the Bank's loss factors into a quantitative general reserve component based on historical loss rates throughout the defined look back period. The quantitative general reserve component also considers an estimate of the historical loss emergence period, which is the period of time between the event that triggers the loss to the charge-off of that loss. The methodology also focuses on evaluation of several qualitative factors for each portfolio category, including but not limited to: management's ongoing review and grading of the loan and lease portfolios, consideration of delinquency experience, changes in the size of the loan and lease portfolios, existing economic conditions, level of loans and leases subject to more frequent review by management, changes in underlying collateral, concentrations of loans to specific industries, and other qualitative factors that could affect credit losses.

When it is determined that we will not receive our entire contractual principal or the loss is confirmed, we record a charge against the allowance for loan and lease loss reserve to bring the loan or lease to its net realizable value. Many of the impaired loans as of June 30, 2022 are collateral dependent. It is typically part of our process to obtain appraisals on impaired loans and leases that are primarily secured by real estate or equipment at least annually, or more frequently as circumstances warrant. As we have completed new appraisals and/or market evaluations, in specific situations current fair values collateralizing certain impaired loans were inadequate to support the entire amount of the outstanding debt. Foreclosure actions may have been initiated on certain of these commercial real estate and other mortgage loans.

As a result of our review process, we have concluded an appropriate allowance for loan and lease losses for the existing loan and lease portfolio was \$24.1 million, or 1.05% of gross loans and leases, at June 30, 2022. However, given ongoing complexities with current workout situations and the uncertainty surrounding future economic conditions, further charge-offs, and increased provisions for loan and lease losses may be recorded if additional facts and circumstances lead us to a different conclusion. In addition, various federal and state regulatory agencies review the allowance for loan and lease losses. These agencies could require certain loan and lease balances to be classified differently or charged off when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination.

A summary of the activity in the allowance for loan and lease losses follows:

	As of and for the Three Months Ended June 30,		As of and for the Six Months Ended June 30,	
	2022	2021	2022	2021
	(Dollars in Thousands)			
Allowance at beginning of period	\$ 23,669	\$ 28,982	\$ 24,336	\$ 28,521
Charge-offs:				
Commercial real estate:				
Commercial real estate — owner occupied	—	(4)	—	(4)
Commercial real estate — non-owner occupied	—	—	—	—
Construction and land development	—	—	—	—
Multi-family	—	—	—	—
1-4 family	—	(245)	—	(245)
Commercial and industrial	(85)	(2,621)	(107)	(2,765)
Direct financing leases	—	—	—	—
Consumer and other:				
Home equity and second mortgages	—	—	—	—
Other	—	(24)	—	(24)
Total charge-offs	(85)	(2,894)	(107)	(3,038)
Recoveries:				
Commercial real estate:				
Commercial real estate — owner occupied	4,121	84	4,236	225
Commercial real estate — non-owner occupied	—	—	1	—
Construction and land development	—	—	—	2,078
Multi-family	—	—	—	—
1-4 family	—	—	—	—
Commercial and industrial	117	460	201	913
Direct financing leases	—	—	—	—
Consumer and other:				
Home equity and second mortgages	—	—	—	1
Other	9	1	19	1
Total recoveries	4,247	545	4,457	3,218
Net recoveries	4,162	(2,349)	4,350	180
Provision for loan and lease losses	(3,727)	(958)	(4,582)	(3,026)
Allowance at end of period	\$ 24,104	\$ 25,675	\$ 24,104	\$ 25,675
Annualized net (recoveries) charge-offs as a percent of average gross loans and leases	(0.73)%	0.42 %	(0.39)%	(0.02)%
Annualized net (recoveries) charge-offs as a percent of average gross loans and leases, excluding average net PPP loans	(0.74)%	0.47 %	(0.39)%	(0.02)%

Liquidity and Capital Resources

The Corporation expects to meet its liquidity needs through existing cash on hand, established cash flow sources, its third party senior line of credit, and dividends received from the Bank. While the Bank is subject to certain generally applicable regulatory limitations regarding its ability to pay dividends to the Corporation, we do not believe that the Corporation will be adversely affected by these dividend limitations. The Corporation's principal liquidity requirements at June 30, 2022 were the interest payments due on subordinated notes and cash dividends payable to both common and preferred stockholders. The capital ratios of the Bank met all applicable regulatory capital adequacy requirements in effect on June 30, 2022, and continue to meet the heightened requirements imposed by Basel III, including the capital conservation buffer. The Corporation's Board and management teams adhere to the appropriate regulatory guidelines on decisions which affect their capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

The Bank maintains liquidity by obtaining funds from several sources. The Bank's primary source of funds are principal and interest payments on loans receivable and mortgage-related securities, deposits, and other borrowings, such as federal funds, and FHLB advances. The scheduled payments of loans and mortgage-related securities are generally a predictable source of funds. Deposit flows and loan prepayments, however, are greatly influenced by general interest rates, economic conditions, and competition.

We view on-balance sheet liquidity as a critical element to maintaining adequate liquidity to meet our cash and collateral obligations. We define our on-balance sheet liquidity as the total of our short-term investments, our unencumbered securities available-for-sale, and our unencumbered pledged loans. As of June 30, 2022 and December 31, 2021, our immediate on-balance sheet liquidity was \$413.0 million and \$529.5 million, respectively. At June 30, 2022 and December 31, 2021, the Bank had \$55.5 million and \$47.0 million on deposit with the FRB recorded in short-term investments, respectively. Any excess funds not used for loan funding or satisfying other cash obligations were maintained as part of our on-balance sheet liquidity in our interest-bearing accounts with the FRB, as we value the safety and soundness provided by the FRB. We plan to utilize excess liquidity to fund loan and lease portfolio growth, pay down maturing debt, allow run off of maturing wholesale certificates of deposit or invest in securities to maintain adequate liquidity at an improved margin.

We had \$566.4 million of outstanding wholesale funds at June 30, 2022, compared to \$398.4 million of wholesale funds as of December 31, 2021, which represented 23.4% and 17.1%, respectively, of ending balance total bank funding. Wholesale funds include FHLB advances, brokered certificates of deposit, and deposits gathered from internet listing services. Total bank funding is defined as total deposits plus FHLB advances. We are committed to raising in-market deposits while utilizing wholesale funds to mitigate interest rate risk. Wholesale funds continue to be an efficient and cost effective source of funding for the Bank and allows it to gather funds across a larger geographic base at price levels and maturities that are more attractive than local time deposits when required to raise a similar level of in-market deposits within a short time period. Access to such deposits and borrowings allows us the flexibility to refrain from pursuing single service deposit relationships in markets that have experienced unfavorable pricing levels. In addition, the administrative costs associated with wholesale funds are considerably lower than those that would be incurred to administer a similar level of local deposits with a similar maturity structure. During the time frames necessary to accumulate wholesale funds in an orderly manner, we will use short-term FHLB advances to meet our temporary funding needs. The short-term FHLB advances will typically have terms of one week to one month to cover the overall expected funding demands.

Period-end in-market deposits decreased \$71.3 million, or 3.7%, to \$1.857 billion at June 30, 2022 from \$1.928 billion at December 31, 2021. The decline was due to movement of deposits to investment alternatives and to pay taxes, seasonality within the Bank's municipality clients, and normal course of business for continuing client relationships. The decline in in-market deposits was not the result of the loss of any significant client relationships, and we expect to continue to establish new client relationships and increase deposit balances with existing clients' accounts. Nonetheless, we will continue to use wholesale funds in specific maturity periods, typically three to five years, needed to effectively mitigate the interest rate risk measured through our asset/liability management process or in shorter time periods if in-market deposit balances decline. In order to provide for ongoing liquidity and funding, none of our wholesale certificates of deposit allow for withdrawal at the option of the depositor before the stated maturity (with the exception of deposits accumulated through the internet listing service which have the same early withdrawal privileges and fees as do our other in-market deposits) and FHLB advances with contractual maturity terms. The Bank limits the percentage of wholesale funds to total bank funds in accordance with liquidity policies approved by its Board. The Bank was in compliance with its policy limits as of June 30, 2022.

The Bank was able to access the wholesale funding market as needed at rates and terms comparable to market standards during the year ended June 30, 2022. In the event that there is a disruption in the availability of wholesale funds at maturity, the Bank has managed the maturity structure, in compliance with our approved liquidity policy, so at least one year of maturities could be funded through on-balance sheet liquidity. These potential funding sources include deposits maintained at the FRB or Federal Reserve Discount Window utilizing currently unencumbered securities and acceptable loans as collateral.

As of June 30, 2022, the available liquidity was in excess of the stated policy minimum. We believe the Bank will also have access to the unused federal funds lines, cash flows from borrower repayments, and cash flows from security maturities. The Bank also has the ability to raise local market deposits by offering attractive rates to generate the level required to fulfill its liquidity needs.

The Corporation has filed a shelf registration with the Securities and Exchange Commission that would allow the Corporation to offer and sell, from time to time and in one or more offerings, up to \$75.0 million in aggregate initial offering price of common and preferred stock, debt securities, warrants, subscription rights, units, or depository shares, or any combination thereof.

The Bank is required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe that the Bank has sufficient liquidity to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows.

During the six months ended June 30, 2022, operating activities resulted in a net cash inflow of \$16.8 million, which included net income of \$19.9 million, partially offset by a \$4.6 million provision for loan and lease loss benefit. Net cash used by investing activities for the six months ended June 30, 2022 was \$79.4 million primarily due to investments made in securities available for sale, net loan disbursements, and a net increase in FHLB stock. Net cash provided by financing activities was \$101.0 million for the six months ended June 30, 2022 primarily due to a net increase in FHLB advances, partially offset by a net decrease in deposits. Please refer to the **Consolidated Statements of Cash Flows** included in PART I, Item 1 for further details regarding significant sources of cash flow for the Corporation.

Contractual Obligations and Off-Balance Sheet Arrangements

As of June 30, 2022, there were no material changes to our contractual obligations and off-balance sheet arrangements disclosed in our Annual Report on Form 10-K for the year ended December 31, 2021. We continue to believe that we have adequate capital and liquidity available from various sources to fund projected contractual obligations and commitments.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Corporation's management, with the participation of the Corporation's Chief Executive Officer and Chief Financial Officer, has evaluated the Corporation's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based upon that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of June 30, 2022.

Changes in Internal Control over Financial Reporting

There was no change in the Corporation's internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) that occurred during the quarter ended June 30, 2022 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

From time to time, the Corporation and its subsidiaries are engaged in legal proceedings in the ordinary course of their respective businesses. 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, or cash flows.

Item 1A. Risk Factors

There were no material changes to the risk factors previously disclosed in Item 1A. to Part I of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2021.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Securities

On March 4, 2022, the Corporation's Board approved a new share repurchase program. The program authorized the repurchase by the Corporation of up to \$5 million of its total outstanding shares of common stock over a period of approximately twelve months, ending March 4, 2023. As of June 30, 2022, the Corporation had repurchased a total of 30,600 shares for approximately \$1.0 million at an average cost of \$33.28 per share.

Under the share repurchase program, the Corporation is authorized to repurchase shares from time to time in the open market or negotiated transactions at prevailing market rates, or by other means in accordance with federal securities laws. In connection with the share repurchase program, the Corporation implemented a 10b5-1 trading plan. The trading plan allows the Corporation to repurchase shares of its common stock at times when it otherwise might be prevented from doing so under insider trading laws by requiring that an agent selected by the Corporation repurchase shares of common stock on the Corporation's behalf on pre-determined terms.

The following table sets forth information about the Corporation's purchases of its common stock during the three months ended June 30, 2022.

Period	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Total Number of Shares that May Yet Be Purchased Under the Plans or Programs
April 1, 2022 - April 30, 2022	22,797	\$ 33.15	7,809	—
May 1, 2022 - May 31, 2022	10,557	33.74	9,743	—
June 1, 2022 - June 30, 2022	7,646	32.78	8,546	—
Total	41,000	33.24	26,098	124,075

- (1) During the second quarter of 2022, the Corporation repurchased an aggregate 41,000 shares of the Corporation's common stock in open-market transactions, of which 26,098 shares were purchased pursuant to the repurchase program publicly announced on March 4, 2022, and of which 14,902 shares were surrendered to us to satisfy income tax withholding obligations in connection with the vesting of restricted awards.

Item 6. Exhibits

- 31.1 [Certification of the Chief Executive Officer](#)
- 31.2 [Certification of the Chief Financial Officer](#)
- 32 [Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350](#)
- 101 The following financial information from First Business Financial Services, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2022, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of June 30, 2022 and December 31, 2021, (ii) Consolidated Statements of Income for the three and six months ended June 30, 2022 and 2021, (iii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2022 and 2021, (iv) Consolidated Statements of Changes in Stockholders' Equity for the three and six months ended June 30, 2022 and 2021, (v) Consolidated Statements of Cash Flows for the six months ended June 30, 2022 and 2021, and (vi) the Notes to Unaudited Consolidated Financial Statements
- 104 The cover page from First Business Financial Services, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2022 has been formatted in Inline XBRL and contained in Exhibit 101.

Signatures

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

FIRST BUSINESS FINANCIAL SERVICES, INC.

July 29, 2022

/s/ Corey A. Chambas
Corey A. Chambas
Chief Executive Officer

July 29, 2022

/s/ Edward G. Sloane, Jr.
Edward G. Sloane, Jr.
Chief Financial Officer
(principal financial officer)

Certifications

I, Corey A. Chambas, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Business Financial Services, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. Any significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Corey A. Chambas

Corey A. Chambas
Chief Executive Officer
July 29, 2022

Certifications

I, Edward G. Sloane, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Business Financial Services, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. Any significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Edward G. Sloane, Jr.

Edward G. Sloane, Jr.
Chief Financial Officer
July 29, 2022

Certification of the Chief Executive Officer and the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

Solely for the purposes of complying with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, we, the undersigned Chief Executive Officer and Chief Financial Officer, of First Business Financial Services, Inc., a Wisconsin Corporation (the “Corporation”), hereby certify, based on our knowledge that the Quarterly Report on Form 10-Q of the Corporation for the quarter ended June 30, 2022 (the “Report”) fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended, and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

/s/ Corey A. Chambas

Corey A. Chambas
Chief Executive Officer
July 29, 2022

/s/ Edward G. Sloane, Jr.

Edward G. Sloane, Jr.
Chief Financial Officer
July 29, 2022