MID PENN BANCORP INC
Form 10-Q
August 07, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 1-13677

MID PENN BANCORP, INC.

(Exact Name of Registrant as Specified in its Charter)

Pennsylvania (State or Other Jurisdiction of	25-1666413 (I.R.S. Employer
Incorporation or Organization)	Identification Number)
349 Union Street	
Millersburg, Pennsylvania (Address of Principal Executive Offices)	17061 (Zip Code)

Registrant’s telephone number, including area code 1.866.642.7736

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

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

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

Large accelerated filer	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.

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

As of August 7, 2018, the registrant had 8,450,893 shares of common stock outstanding.

MID PENN BANCORP, INC.

FORM 10-Q

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Unless the context otherwise requires, the terms “Mid Penn”, “we”, “us”, and “our” refer to Mid Penn Bancorp, Inc. and its consolidated subsidiaries.

MID PENN BANCORP, INC.

PART 1 – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands, except share data)	June 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$25,436	$ 19,795
Interest-bearing balances with other financial institutions	4,775	3,028
Federal funds sold	9,196	691
Total cash and cash equivalents	39,407	23,514
Investment securities available for sale, at fair value	111,691	93,465
Investment securities held to maturity, at amortized cost (fair value $150,016 and $100,483)	153,321	101,356
Loans held for sale	1,185	1,040
Loans and leases, net of unearned interest	1,036,479	910,404
Less: Allowance for loan and lease losses	(8,189)	(7,606)
Net loans and leases	1,028,290	902,798
Bank premises and equipment, net	23,905	16,168
Cash surrender value of life insurance	13,171	13,042
Restricted investment in bank stocks	2,765	4,384
Foreclosed assets held for sale	912	189
Accrued interest receivable	5,372	4,564
Deferred income taxes	2,540	1,888
Goodwill	23,107	3,918
Core deposit and other intangibles, net	4,878	434
Other assets	5,103	3,594
Total Assets	$1,415,647	$ 1,170,354
LIABILITIES & SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	$207,013	$ 163,714
Interest-bearing demand	349,109	349,241
Money Market	273,215	246,220
Savings	171,845	62,770
Time	235,336	201,623

Total Deposits	1,236,518	1,023,568
Short-term borrowings	—	34,611
Long-term debt	12,241	12,352
Subordinated debt	17,342	17,338
Accrued interest payable	1,186	645
Other liabilities	6,585	6,137
Total Liabilities	1,273,872	1,094,651
Shareholders' Equity:		
Common stock, par value $1.00; authorized 10,000,000 shares; 6,124,517 and 4,246,216 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	6,125	4,242
Additional paid-in capital	103,498	40,970
Retained earnings	35,386	32,565
Accumulated other comprehensive loss	(3,234)	(2,074)
Total Shareholders' Equity	141,775	75,703
Total Liabilities and Shareholders' Equity	$1,415,647	$1,170,354

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

MID PENN BANCORP, INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in thousands, except per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
INTEREST INCOME				
Interest and fees on loans and leases	$12,073	$9,949	$23,410	$19,651
Interest on interest-bearing balances	17	5	26	7
Interest on federal funds sold	153	23	321	74
Interest and dividends on investment securities:				
U.S. Treasury and government agencies	884	574	1,636	1,019
State and political subdivision obligations, tax-exempt	517	264	1,059	580
Other securities	76	64	248	107
Total Interest Income	13,720	10,879	26,700	21,438
INTEREST EXPENSE				
Interest on deposits	1,997	1,277	3,777	2,481
Interest on short-term borrowings	—	13	12	13
Interest on long-term and subordinated debt	309	179	619	359
Total Interest Expense	2,306	1,469	4,408	2,853
Net Interest Income	11,414	9,410	22,292	18,585
PROVISION FOR LOAN AND LEASE LOSSES	—	100	125	225
Net Interest Income After Provision for Loan and Lease Losses	11,414	9,310	22,167	18,360
NONINTEREST INCOME				
Income from fiduciary activities	286	200	526	396
Service charges on deposits	222	174	425	379
Net gain on sales of investment securities	4	12	102	20
Earnings from cash surrender value of life insurance	65	66	129	131
Mortgage banking income	205	225	361	416
ATM debit card interchange income	326	232	591	456
Merchant services income	93	92	171	166
Net gain on sales of SBA loans	152	157	409	441
Other income	206	204	492	393
Total Noninterest Income	1,559	1,362	3,206	2,798
NONINTEREST EXPENSE				
Salaries and employee benefits	4,542	4,159	9,606	8,389
Occupancy expense, net	870	593	1,667	1,241
Equipment expense	544	370	952	751
Pennsylvania bank shares tax expense	171	160	342	330
FDIC Assessment	93	194	321	388
Legal and professional fees	256	189	480	366
Marketing and advertising expense	230	131	419	238
Software licensing	512	370	1,026	699
Telephone expense	156	133	303	259
Loss on sale or write-down of foreclosed assets	1	6	3	88
Intangible amortization	248	24	496	53

Merger and acquisition expense	222	14	1,916	224
Other expenses	1,897	1,215	3,394	2,334
Total Noninterest Expense	9,742	7,558	20,925	15,360
INCOME BEFORE PROVISION FOR INCOME TAXES	3,231	3,114	4,448	5,798
Provision for income taxes	452	769	665	1,459
NET INCOME	$2,779	$2,345	$3,783	$4,339
PER COMMON SHARE DATA:				
Basic and Diluted Earnings Per Common Share	$0.45	$0.55	$0.63	$1.02
Cash Dividends Paid	$0.15	$0.13	$0.40	$0.36

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

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MID PENN BANCORP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

(Dollars in thousands)	Three Months Ended June 30, 2018	2017
Net income	$2,779	$2,345
Other comprehensive (loss) income:		
Unrealized losses arising during the period on available-for-sale securities, net of income taxes of ($88) and $763, respectively	(333)	1,480
Reclassification adjustment for net gain on sales of available-for-sale securities included in net income, net of income taxes of ($1) and ($4), respectively (a)	(3)	(8)
Change in defined benefit plans, net of income taxes of $277 and ($1), respectively (b)	1,043	(1)
Total other comprehensive income	707	1,471
Total comprehensive income	$3,486	$3,816

(Dollars in thousands)	Six Months Ended June 30, 2018	2017
Net income	$3,783	$4,339
Other comprehensive (loss) income:		
Unrealized (losses) gains arising during the period on available-for-sale securities, net of income tax impact of ($564) and $958, respectively	(2,156)	1,859
Reclassification adjustment for net gain on sales of available-for-sale securities included in net income, net of income tax impact of $(21) and $(7), respectively (a)	(81)	(13)
Change in defined benefit plans, net of income tax impact of $277 and ($2), respectively (b)	1,042	(4)
Total other comprehensive (loss) income	(1,195)	1,842
Total comprehensive income	$2,588	$6,181

(a) Amounts are included in net gain on sales of investment securities on the Consolidated Statements of Income as a separate element within total noninterest income.
(b) Amounts are included in the computation of net periodic benefit cost and are included in salaries and employee benefits on the Consolidated Statements of Income as a separate element within total noninterest expense.

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

MID PENN BANCORP, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

For the Six Months Ended June 30, 2018 and 2017

(Dollars in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, January 1, 2018	$ 4,242	$ 40,970	$ 32,565	$ (2,074)	$ 75,703
Impact of adoption of new accounting standard (a)	—	—	(44)	35	(9)
Balance at January 1, 2018, adjusted	4,242	40,970	32,521	(2,039)	75,694
Net income	—	—	3,783	—	3,783
Total other comprehensive loss, net of taxes	—	—	—	(1,195)	(1,195)
Common stock issued to Scottdale shareholders (1,878,827 shares) (b)	1,879	62,302	—	—	64,181
Employee Stock Purchase Plan (1,655 shares)	2	54	—	—	56
Director Stock Purchase Plan (1,819 shares)	2	59	—	—	61
Common stock dividends declared	—	—	(918)	—	(918)
Restricted stock activity	—	113	—	—	113
Balance, June 30, 2018	$ 6,125	$ 103,498	$ 35,386	$ (3,234)	$ 141,775
Balance, January 1, 2017	$ 4,233	$ 40,688	$ 28,399	$ (2,853)	$ 70,467
Net income	—	—	4,339	—	4,339
Total other comprehensive income, net of taxes	—	—	—	1,842	1,842
Employee Stock Purchase Plan (1,940 shares)	2	50	—	—	52
Common stock dividends declared	—	—	(1,101)	—	(1,101)
Restricted stock activity	—	37	—	—	37
Balance, June 30, 2017	$ 4,235	$ 40,775	$ 31,637	$ (1,011)	$ 75,636

(a) Represents the impact of adopting Accounting Standard Update ASU 2016-01. See Note 3 to the consolidated financial statements for more information.
(b) Shares issued on January 8, 2018 as a result of the acquisition of The Scottdale Bank & Trust Company ("Scottdale"). See Note 2 to the consolidated financial statements for more information.

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

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MID PENN BANCORP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands)	Six Months Ended June 30, 2018	2017
Operating Activities:		
Net Income	$3,783	$4,339
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	125	225
Depreciation	1,000	715
Amortization of intangibles	496	53
Net amortization (accretion) of security discounts/premiums	451	(742)
Gain on sales of investment securities	(102)	(20)
Earnings on cash surrender value of life insurance	(129)	(131)
Mortgage loans originated for sale	(22,596)	(23,234)
Proceeds from sales of mortgage loans originated for sale	22,812	23,240
Gain on sale of mortgage loans	(361)	(416)
SBA loans originated for sale	(5,056)	(5,605)
Proceeds from sales of SBA loans originated for sale	5,465	6,046
Gain on sale of SBA loans	(409)	(441)
Loss on disposal of property, plant, and equipment	64	26
Loss on sale or write-down of foreclosed assets	3	88
Stock compensation expense	113	37
Deferred income tax benefit (expense)	1,981	(65)
Decrease (increase) in accrued interest receivable	181	(63)
Increase in other assets	(1,242)	(193)
Increase in accrued interest payable	525	273
(Decrease) increase in other liabilities	(2,186)	381
Net Cash Provided By Operating Activities	4,918	4,513
Investing Activities:		
Proceeds from the sale of available-for-sale securities	102,816	37,667
Proceeds from the maturity or call of available-for-sale securities	5,654	3,579
Purchases of available-for-sale securities	(21,533)	(13,827)
Proceeds from the maturity or call of held-to-maturity securities	11,625	—
Purchases of held-to-maturity securities	(57,850)	(72,684)
Net cash received from acquisition	65,025	—
Redemptions (purchases) of restricted investment in bank stock	1,716	(1,542)
Net increase in loans and leases	(55,732)	(48,078)
Proceeds from the sale of bank premises and equipment held for sale	—	2,201
Purchases of bank premises and equipment	(7,305)	(1,164)
Proceeds from the sale of foreclosed assets	169	136
Net Cash Provided by (Used In) Investing Activities	44,585	(93,712)
Financing Activities:		
Net increase in deposits	2,969	52,095

Net (decrease) increase in short-term borrowings	(34,611)	21,468
Common stock dividends paid	(1,978)	(1,101)
Employee Stock Purchase Plan	56	52
Director Stock Purchase Plan	61	—
Long-term debt repayment	(107)	(109)
Net Cash (Used In) Provided By Financing Activities	(33,610)	72,405
Net increase (decrease) in cash and cash equivalents	15,893	(16,794)
Cash and cash equivalents, beginning of period	23,514	45,973
Cash and cash equivalents, end of period	$39,407	$29,179

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CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (continued)

(Dollars in thousands)	Six Months Ended June 30,	
	2018	2017
Supplemental Disclosures of Cash Flow Information:		
Interest paid	$3,867	$2,580
Income taxes paid	$1,425	$2,190
Supplemental Noncash Disclosures:		
Loan transfers to foreclosed assets held for sale	$884	$—

Assets, Liabilities, and Equity in Connection with Merger:

(Dollars in thousands)	Six Months Ended June 30,	
	2018	2017
Assets Acquired:		
Securities	$114,039	$—
Loans	70,769	—
Restricted stock	97	—
Property and equipment	1,496	—
Foreclosed assets	11	—
Deferred income taxes	1,050	—
Accrued interest receivable	989	—
Core deposit intangible	4,940	—
Other assets	266	—
	$193,657	$—
Liabilities Assumed:		
Deposits	$209,981	$—
Accrued interest payable	16	—
Other liabilities	3,693	—
	$213,690	$—

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

(1) Basis of Presentation

The accompanying consolidated financial statements include the accounts of Mid Penn Bancorp, Inc. (the "Company") and its wholly-owned subsidiary, Mid Penn Bank (the "Bank"). All material intercompany accounts and transactions have been eliminated in consolidation.

Certain information and disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Mid Penn believes the information presented is not misleading and the disclosures are adequate. For comparative purposes, the June 30, 2017 and December 31, 2017 balances have been reclassified, when, and if necessary, to conform to the 2018 presentation. Such reclassifications had no impact on net income. The results of operations for interim periods are not necessarily indicative of operating results expected for the full year. In the opinion of management, all adjustments necessary for fair presentation of the periods presented have been reflected in the accompanying consolidated financial statements. All such adjustments are of a normal, recurring nature. These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

On January 8, 2018, Mid Penn completed its acquisition of The Scottdale Bank & Trust Company ("Scottdale"), a Pennsylvania bank and trust company, through the merger of Scottdale with and into Mid Penn Bank pursuant to the previously announced Agreement and Plan of Merger, dated as of March 29, 2017, among Mid Penn, Mid Penn Bank and Scottdale. Refer to Note 2, Merger, as well as the Company's Current Report on Form 8-K filed on January 8, 2018, for more information. The comparability of the financial condition and results of operations as of and for the three and six months ended June 30, 2018 and 2017, in general, have been impacted by the acquisition of Scottdale.

On January 16, 2018, Mid Penn entered into an Agreement and Plan of Merger with First Priority Financial Corp. ("First Priority") pursuant to which First Priority would merge with and into Mid Penn (the "Merger"), with Mid Penn being the surviving corporation in the Merger. On July 31, 2018, Mid Penn completed its acquisition of First Priority. Refer to Note 14, Subsequent Events, as well as the Company's Current Report on Form 8-K filed on August 1, 2018, for more information.

Mid Penn has evaluated events and transactions occurring subsequent to the balance sheet date of June 30, 2018, for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

(2) Merger

On January 8, 2018, The Scottdale Bank & Trust Company ("Scottdale") merged with and into Mid Penn Bank, with Mid Penn Bank continuing as the surviving entity.

Pursuant to the Merger Agreement, each share of Scottdale common stock issued and outstanding immediately prior to January 8, 2018 converted into the right to receive (i) $1,166 in cash without interest or (ii) 38.88 shares of Mid

Penn common stock. As a result, Mid Penn issued 1,878,827 shares of Mid Penn common stock with an acquisition date fair value of approximately $64,181,000, based on the closing stock price of Mid Penn's common stock on January 8, 2018 of $34.16, and cash of $2,792,000. Including an insignificant amount of cash paid in lieu of fractional shares, the fair value of total consideration paid was $66,973,000.

The assets and liabilities of Scottdale were recorded on the consolidated balance sheet of the Company at their estimated fair value as of January 8, 2018, and their results of operations have been included in the consolidated income statement of the Company since such date. Scottdale has been fully integrated into Mid Penn, therefore the amount of revenue and earnings of Scottdale included in the consolidated

income statement since the acquisition date is impracticable to provide.

Included in the purchase price was goodwill of $19,189,000 and a core deposit intangible of $4,940,000. The core deposit intangible will be amortized over a ten-year period using a sum of the years' digits basis. The goodwill will not be amortized, but will be measured annually for impairment or more frequently if circumstances require. Core deposit intangible amortization expense related to the Scottdale acquisition for the five years beginning 2018 through 2022 is estimated to be $898,000, $808,000, $719,000, $629,000, and $539,000 per year, respectively, and $1,347,000 in total for the five years after 2022.

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The allocation of the purchase price is as follows:

(Dollars in thousands)	
Assets acquired:	
Cash and cash equivalents	$67,817
Investment securities	114,039
Restricted stock	97
Loans	70,769
Goodwill	19,189
Core deposit intangible	4,940
Premises and equipment	1,496
Foreclosed assets	11
Deferred income taxes	1,050
Accrued interest receivable	989
Other assets	266
Total assets acquired	280,663
Liabilities assumed:	
Deposits	209,981
Accrued interest payable	16
Other liabilities	3,693
Total liabilities assumed	213,690
Consideration paid	$66,973
Cash paid	$2,792
Fair value of common stock issued	64,181

Accounting Standards Codification (“ASC”) Topic 805, Business Combinations, allows for adjustments to goodwill for a period of up to one year after the merger date for information that becomes available that reflects circumstances at the merger date. The goodwill recorded related to the Scottdale acquisition was adjusted in the second quarter of 2018 by $579,000, primarily to reflect updated acquisition date deferred tax asset amounts as a substantial portion of the final tax return preparation for Scottdale was completed by June 30, 2018. The following table summarizes the preliminary estimated fair value of the assets acquired and liabilities and equity assumed.

(Dollars in thousands)	
Total purchase price	$66,973
Net assets acquired:	
Cash and cash equivalents	67,817
Investment securities	114,039
Restricted stock	97

Loans	70,769
Core deposit intangible	4,940
Premises and equipment	1,496
Foreclosed assets	11
Deferred income taxes	1,050
Accrued interest receivable	989
Other assets	266
Deposits	(209,981)
Accrued interest payable	(16)
Other liabilities	(3,693)
	47,784
Goodwill	$19,189

In general, factors contributing to goodwill recognized as a result of the Scottdale acquisition include expected cost savings from combined operations, opportunities to expand into several new markets, and growth and profitability potential from the repositioning of short-term investments into higher-yielding loans. The goodwill acquired as a result of the Scottdale acquisition is not tax deductible.

The fair value of the financial assets acquired included loans receivable with a net amortized cost basis of $70,769,000. The table below illustrates the fair value adjustments made to the amortized cost basis in order to present a fair value of the loans acquired.

(Dollars in thousands)	
Gross amortized cost basis at January 8, 2018	$71,809
Market rate adjustment	601
Credit fair value adjustment on pools of homogeneous loans	(995)
Credit fair value adjustment on impaired loans	(646)
Fair value of purchased loans at January 8, 2018	$70,769

The market rate adjustment represents the movement in market interest rates, irrespective of credit adjustments, compared to the contractual rates of the acquired loans. The credit adjustment made on pools of homogeneous loans represents the changes in credit quality of the underlying borrowers from loan inception to the acquisition date. The credit adjustment on impaired loans is derived in accordance with ASC 310-30-30 and represents the portion of the loan balance that has been deemed uncollectible based on our expectations of future cash flows for each respective loan.

The information about the acquired Scottdale impaired loan portfolio as of January 8, 2018 is as follows:

(Dollars in thousands)	
Contractually required principal and interest at acquisition	$2,586
Contractual cash flows not expected to be collected (nonaccretable discount)	(1,010)
Expected cash flows at acquisition	1,576
Interest component of expected cash flows (accretable discount)	(305)
Fair value of acquired loans	$1,271

The following table presents pro forma information as if the merger between Mid Penn Bank and Scottdale had been completed on January 1, 2017. The pro forma information does not necessarily reflect the results of operations that would have occurred had Mid Penn Bank merged with Scottdale at the beginning of 2017. The supplemental pro forma earnings for six months ended June 30, 2018 exclude both (i) adjustments to estimate the eight day impact of Scottdale due to immateriality and impracticality and (ii) $1,262,000 of merger related costs incurred in 2018 related to the Scottdale acquisition, which included approximately $518,000 of severance and retention bonus expenses. The results for the six months ended June 30, 2017 were adjusted to include $1,262,000 of merger related costs which would have been incurred if the merger had been completed January 1, 2017. The pro forma financial information does not include the impact of possible business model changes, nor does it consider any potential impacts of current market conditions or revenues, expense efficiencies, or other factors.

(Dollars in thousands, except per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net interest income after loan loss provision	$11,414	$10,883	$22,167	$1,448
Noninterest income	1,559	1,486	3,206	1,585
Noninterest expense	9,753	10,275	19,663	2,544
Net income	2,768	1,529	4,831	357
Net income per common share	0.45	0.25	0.79	0.06

(3) Investment Securities
Securities to be held for indefinite periods, but not intended to be held to maturity, are classified as available-for-sale and carried at fair value. Securities held for indefinite periods include securities that management intends to use as part of its asset and liability management strategy and that may be sold in response to liquidity needs, changes in interest rates, resultant prepayment risk, pledging requirements, and other factors related to effective portfolio management. Securities to be held to maturity are carried at amortized cost.

For available-for-sale debt securities, realized gains and losses on dispositions are based on the net proceeds and the amortized cost of the securities sold, using the specific identification method. Unrealized gains and losses on debt securities are based on the difference between the amortized cost and fair value of each security as of the respective reporting date. Unrealized gains and losses are credited or charged to other comprehensive income, whereas realized gains and losses flow through Mid Penn’s consolidated statements of income for the respective period.

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ASC Topic 320, Investments – Debt and Equity Securities, clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess, in addition to the credit condition of the underlying issuer, whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment.

In instances when a determination is made that other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, this guidance changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Mid Penn had no securities considered by management to be other-than-temporarily impaired as of June 30, 2018, December 31, 2017, or June 30, 2017, and did not record any securities impairment charges in the respective periods ended on these dates. Mid Penn does not consider the securities with unrealized losses on the respective dates to be other-than-temporarily impaired as the unrealized losses were deemed to relate to changes in interest rates, and not erosion of credit quality.

Beginning January 1, 2018, upon adoption of ASU 2016-01, equity securities with readily determinable fair values are stated at fair value within other assets on the balance sheet, with realized and unrealized gains and losses reported in other expense on the income statement. For periods prior to January 1, 2018, equity securities were classified as available-for-sale and stated at fair value within investment securities available-for-sale on the balance sheet, with unrealized gains and losses reported as a separate component of accumulated other comprehensive loss, net of tax. Equity securities without readily determinable fair values are recorded at cost less any impairment.

The amortized cost, fair value, and unrealized gains and losses on investment securities at June 30, 2018 and December 31, 2017 are as follows:

(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2018				
Available-for-sale debt securities:				
U.S. Treasury and U.S. government agencies	$ 40,597	$ —	$ 2,257	$ 38,340
Mortgage-backed U.S. government agencies	43,713	1	1,288	42,426
State and political subdivision obligations	31,551	3	1,980	29,574
Corporate debt securities	1,350	1	—	1,351
Total available-for-sale debt securities	117,211	5	5,525	111,691
Held-to-maturity debt securities:				
U.S. Treasury and U.S. government agencies	10,985	—	201	10,784
Mortgage-backed U.S. government agencies	66,512	4	1,649	64,867
State and political subdivision obligations	75,824	57	1,516	74,365

Total held-to-maturity debt securities	153,321	61	3,366	150,016
Total	$ 270,532	$ 66	$ 8,891	$ 261,707

(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2017				
Available-for-sale debt securities:				
U.S. Treasury and U.S. government agencies	$ 40,125	$ —	$ 1,395	$ 38,730
Mortgage-backed U.S. government agencies	26,398	2	569	25,831
State and political subdivision obligations	27,775	7	739	27,043
Corporate debt securities	1,350	5	—	1,355
Total available-for-sale debt securities	95,648	14	2,703	92,959
Available-for-sale equity securities:				
Equity securities	550	—	44	506
Total available-for-sale equity securities	550	—	44	506
Held-to-maturity debt securities:				
U.S. Treasury and U.S. government agencies	10,984	—	90	10,894
Mortgage-backed U.S. government agencies	53,472	—	523	52,949
State and political subdivision obligations	36,900	41	301	36,640
Total held-to-maturity debt securities	101,356	41	914	100,483
Total	$ 197,554	$ 55	$ 3,661	$ 193,948

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Estimated fair values of debt securities are based on quoted market prices, where applicable. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, adjusted for differences between the quoted instruments and the instruments being valued. Please refer to Note 5, Fair Value Measurement, for more information on the fair value of investment securities.

Equity securities consist of Community Reinvestment Act funds and, as of June 30, 2018 and December 31, 2017, Mid Penn had $492,000 and $506,000, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive loss, net of tax. At December 31, 2017, net unrealized gains of $44,000 had been recognized in accumulated other comprehensive loss. On January 1, 2018, with the adoption of ASU 2016-01, these unrealized gains and losses were reclassified out of accumulated other comprehensive loss and into retained earnings and subsequent changes in fair value are now recognized in net income and the fair value of securities is presented in other assets. No equity securities were sold during the three and six months ended June 30, 2018.

Investment securities having a fair value of $158,363,000 at June 30, 2018 and $141,465,000 at December 31, 2017 were pledged to secure public deposits, some trust account holdings, and certain other borrowings.

Gross realized gains and losses on sales of available-for-sale debt securities for the three and six months ended June 30, 2018 and 2017 are shown in the table below.

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Realized gains	$11	$77	$111	$200
Realized losses	(7)	(65)	(9)	(180)
Net gains	$4	$12	$102	$20

The following tables present gross unrealized losses and fair value of debt security investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	Less Than 12 Months			12 Months or More			Total		
June 30, 2018	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Available-for-sale debt securities:									

U.S. Treasury and U.S. government agencies	3	$4,453	$ 231	19	$33,887	$ 2,026	22	$38,340	$ 2,257
Mortgage-backed U.S. government agencies	15	23,474	407	15	18,916	881	30	42,390	1,288
State and political subdivision obligations	15	8,094	356	41	18,486	1,624	56	26,580	1,980
Total temporarily impaired available-for-sale debt securities	33	36,021	994	75	71,289	4,531	108	107,310	5,525
Held-to-maturity debt securities:									
U.S. Treasury and U.S. government agencies	3	8,793	191	1	1,991	10	4	10,784	201
Mortgage-backed U.S. government agencies	37	54,276	1,324	7	8,825	325	44	63,101	1,649
State and political subdivision obligations	134	53,362	1,461	3	1,486	55	137	54,848	1,516
Total temporarily impaired held-to-maturity debt securities	174	116,431	2,976	11	12,302	390	185	128,733	3,366
Total	207	$152,452	$ 3,970	86	$83,591	$ 4,921	293	$236,043	$ 8,891

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(Dollars in thousands)	Less Than 12 Months			12 Months or More			Total		
December 31, 2017	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Available-for-sale securities:									
U.S. Treasury and U.S. government agencies	3	$5,008	$ 184	18	$33,722	$1,211	21	$38,730	$1,395
Mortgage-backed U.S. government agencies	4	5,267	75	15	20,497	494	19	25,764	569
State and political subdivision obligations	11	6,144	102	40	19,091	637	51	25,235	739
Equity securities	0	—	—	1	506	44	1	506	44
Total temporarily impaired available-for-sale securities	18	$16,419	$ 361	74	$73,816	$2,386	92	$90,235	$2,747
Held-to-maturity securities:									
U.S. Treasury and U.S. government agencies	0	—	—	4	10,894	90	4	10,894	90
Mortgage-backed U.S. government agencies	0	—	—	35	52,949	523	35	52,949	523
State and political subdivision obligations	0	—	—	77	29,976	301	77	29,976	301
Total temporarily impaired held to maturity securities	0	—	—	116	93,819	914	116	93,819	914
Total	18	$16,419	$ 361	190	$167,635	$3,300	208	$184,054	$3,661

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such additional evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than amortized cost and the financial condition and near term prospects of the issuer. In addition, for debt securities, Mid Penn considers (a) whether management has the intent to sell the security, (b) it is more likely than not that management will be required to sell the security prior to its anticipated recovery, and (c) whether management expects to recover the entire amortized cost basis. For equity securities, management considers the intent and ability to hold securities until recovery of unrealized losses.

The majority of the investment portfolio is comprised of securities issued by U.S. government agencies and state and political subdivision obligations. For the investment securities with an unrealized loss, Mid Penn has concluded that,

based on its analysis, the unrealized losses were primarily caused by the movement of interest rates and not due to an erosion of credit quality of the underlying issuers.

At both June 30, 2018 and December 31, 2017, the majority of available-for-sale securities and held-to-maturity securities in an unrealized loss position were obligations of state and political subdivisions, U.S. Treasury and agency securities, and mortgage-backed U.S. government agencies.

The table below illustrates the maturity distribution of investment securities at amortized cost and fair value as of June 30, 2018.

(Dollars in thousands)	Available-for-sale		Held-to-maturity	
	Amortized	Fair	Amortized	Fair
June 30, 2018	Cost	Value	Cost	Value
Due in 1 year or less	$1,460	$1,460	$2,001	$1,991
Due after 1 year but within 5 years	18,711	18,050	11,705	11,494
Due after 5 years but within 10 years	43,730	41,041	71,195	69,796
Due after 10 years	9,597	8,714	1,909	1,868
	73,498	69,265	86,810	85,149
Mortgage-backed securities	43,713	42,426	66,511	64,867
	$117,211	$111,691	$153,321	$150,016

(4) Loans and Allowance for Loan and Lease Losses

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the

unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans, generally being amortized over the contractual life of the loan. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

The loan portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following classes: commercial and industrial, commercial real estate, commercial real estate-construction and lease financing. Consumer loans consist of the following classes: residential mortgage loans, home equity loans and other consumer loans.

For all classes of loans, the accrual of interest generally is discontinued when the contractual payment of principal or interest has become 90 days or more past due, or management has serious doubts about further collectability of principal or interest even though the loan is currently performing. A loan past due 90 days or more may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest is credited to income. Interest received on nonaccrual loans, including impaired loans, is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Nonaccrual loans may be restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally, at least nine consecutive months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

Commercial and Industrial

Mid Penn originates commercial and industrial loans. Most of the Bank's commercial and industrial loans have been extended to finance local and regional businesses and include short-term loans to finance machinery and equipment purchases, inventory, and accounts receivable. Commercial loans also involve the extension of revolving credit for a combination of equipment acquisitions and working capital in expanding companies.

The maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Generally, the maximum term on non-mortgage lines of credit is one year. The loan-to-value ratio on such loans and lines of credit generally may not exceed 80 percent of the value of the collateral securing the loan. The Bank's commercial business lending policy includes credit file documentation and analysis of the borrower's character, capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as an evaluation of conditions affecting the borrower. Analysis of the borrower's past, present, and future cash flows is also an important aspect of the Bank's current credit analysis. Nonetheless, such loans are believed to carry higher credit risk than other extensions of credit.

Commercial and industrial loans typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself, which, in turn, is likely to be dependent upon the general economic environment. Mid Penn's commercial and industrial loans are usually, but not always, secured by business assets and personal guarantees. However, the collateral securing the loans may depreciate over time, may be difficult to appraise, and may fluctuate in value based on the success of the business.

Commercial Real Estate and Commercial Real Estate - Construction

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

Residential Mortgage

Mid Penn offers a wide array of residential mortgage loans for both permanent structures and those under construction. The Bank’s residential mortgage originations are secured primarily by properties located in its primary market and surrounding areas. Residential mortgage loans have terms up to a maximum of 30 years and with loan-to-value ratios up to 100 percent of the lesser of the appraised value of the security property or the contract price. Private mortgage insurance is generally required in an amount sufficient to reduce the Bank’s exposure to at or below the 85 percent loan to value level. Residential mortgage loans generally do not include prepayment penalties.

In underwriting residential mortgage loans, the Bank evaluates both the borrower’s ability to make monthly payments and the value of the property securing the loan. Most properties securing real estate loans made by Mid Penn are appraised by independent fee appraisers. The Bank generally requires borrowers to obtain title insurance and fire and property insurance (including flood insurance, if necessary) in an amount not less than the amount of the loan. Real estate loans originated by the Bank generally contain a “due on sale” clause allowing the Bank to declare the unpaid principal balance due and payable upon the sale of the security property.

The Bank underwrites residential mortgage loans to the standards established by the secondary mortgage market, i.e., Fannie Mae, Ginnie Mae, Freddie Mac, or Pennsylvania Housing Finance Agency standards, with the intention of selling the majority of residential mortgages originated into the secondary market. In the event that the facts and circumstances surrounding a residential mortgage application do not meet all underwriting conditions of the secondary mortgage market, the Bank will evaluate the failed conditions and evaluate the potential

risk of holding the residential mortgage in the Bank's portfolio rather than rejecting the loan request. In the event that the loan is held in the Bank's portfolio, the interest rate on the residential mortgage would be increased to compensate for the added portfolio risk.

Consumer, Including Home Equity

Mid Penn offers a variety of secured consumer loans, including home equity, automobile, and deposit secured loans. In addition, the Bank offers other secured and unsecured consumer loans. Most consumer loans are originated in Mid Penn's primary market and surrounding areas.

The largest component of Mid Penn's consumer loan portfolio consists of fixed rate home equity loans and variable rate home equity lines of credit. Substantially all home equity loans and lines of credit are secured by junior lien mortgages on principal residences. The Bank will lend amounts, which, together with all prior liens, typically may be up to 85 percent of the appraised value of the property securing the loan. Home equity term loans may have maximum terms up to 20 years, while home equity lines of credit generally have maximum terms of five years.

Consumer loan terms vary according to the type and value of collateral, length of contract and creditworthiness of the borrower. The underwriting standards employed by the Bank for consumer loans include an application, a determination of the applicant's payment history on other debts, and an assessment of ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, in relation to the proposed loan amount.

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

Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a higher security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market weakens and property values deteriorate.

Allowance for Loan and Lease Losses

The allowance for credit losses ("allowance") consists of (i) the allowance for loan and lease losses, and (ii) the reserve for unfunded lending commitments. The allowance for loan and lease losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated balance sheet. The reserve for unfunded lending commitments was $108,000 at June 30, 2018 and $105,000 at December 31, 2017. The allowance is increased by the provision for loan and lease losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential consumer loans are generally charged off no later than 120 days past due on a contractual basis, earlier in the event of bankruptcy, or if there is an amount deemed

uncollectible. Because all identified losses are immediately charged off, no portion of the allowance is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

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

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

The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include changes in economic conditions, fluctuations in loan quality measures, changes in collateral values, changes in the experience of the lending staff and loan review systems, changes in lending policies and procedures (including underwriting standards), changes in the mix and volume of loans originated, the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing loan portfolio, shifting industry or portfolio concentrations, and other relevant factors.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

The unallocated component of the allowance for loan and lease losses covers several considerations that are not specifically measureable through either the specific and general components. For example, we believe that we could face increasing credit risks and uncertainties, not yet reflected in recent historical losses or qualitative factor assessments, associated with unpredictable changes in economic growth or business conditions in our markets or for certain industries in which we have commercial loan borrowers, or unanticipated stresses to the values of real estate held as collateral. Any or all of these additional issues can adversely affect our borrowers' ability to timely repay their loans. Additionally, we have experienced continued strong commercial loan growth, including growth in newer markets where we have less of a loss history. Also, the unallocated component allocation recognizes the inherent imprecision in our allowance for loan and lease loss methodology, or any alternative methodology, for estimating specific and general loan losses, including the unpredictable timing and amounts of charge-offs, the fact that historical loss averages don't necessarily correlate to future loss trends, and unexpected changes to specific-credit or general portfolio future cash flows and collateral values which could negatively impact unimpaired portfolio loss factors.

Mid Penn generally considers a commercial loan (consisting of commercial and industrial, commercial real estate, commercial real estate-construction, and lease financing loan classes) to be impaired when it becomes 90 days or more past due and not in the process of collection or sooner when it is probable that Mid Penn will be unable to collect all contractual principal and interest due. This methodology assumes the borrower cannot or will not continue to make additional payments. At that time the loan would generally be considered collateral dependent as the discounted cash flow method would generally indicate no operating income available for evaluating the collateral position; therefore, most impaired loans are deemed to be collateral dependent.

In addition, Mid Penn's rating system assumes any loans classified as nonaccrual, included in the substandard rating, to be impaired, and most of these loans are considered collateral dependent; therefore, most of Mid Penn's impaired loans, whether reporting a specific allocation or not, are considered collateral dependent.

Mid Penn evaluates loans for charge-off on a monthly basis. Policies that govern the recommendation for charge-off are unique to the type of loan being considered. Commercial loans rated as substandard nonaccrual or lower will first have a collateral evaluation completed in accordance with the guidance on impaired loans. Once the collateral evaluation has been completed, a specific allocation of allowance is made based upon the results of the evaluation. The remaining balance remains a nonperforming loan with the original terms and interest rate intact (not restructured). In the event the loan is unsecured, the loan would have been charged-off at the recognition of impairment. Commercial real estate loans rated as impaired will also have an initial collateral evaluation completed in accordance with the guidance on impaired loans. An updated real estate valuation is ordered and the collateral evaluation is modified to reflect any variations in value. A specific allocation of allowance is made for any anticipated collateral shortfall. The remaining balance remains a nonperforming loan with the original terms and interest rate intact (not restructured). The process of charging off a residential mortgage loan begins when a loan becomes delinquent for 90 days and is not in the process of collection. The existing appraisal is reviewed and a lien search is obtained to determine lien position and any instances of intervening liens. A new appraisal of the property will be ordered if deemed necessary by management and a collateral evaluation is completed. The loan will then be charged down to the value indicated in the evaluation. Consumer loans (including home equity loans and other consumer loans) are recommended for charge-off after reaching delinquency of 90 days and the loan is not well-secured or otherwise not probable for collection. The collateral shortfall of the consumer loan is recommended

for charge-off at this point.

As noted above, Mid Penn assesses a specific allocation for commercial loans and commercial real estate loans. The remaining balance remains a nonperforming loan with the original terms and interest rate intact (not restructured). In addition, Mid Penn takes a preemptive step when any commercial loan becomes classified under its internal classification system. A preliminary collateral evaluation, in accordance with the guidance on impaired loans, is prepared using the existing collateral information in the loan file. This process allows Mid Penn to review both the credit and documentation files to determine the status of the information needed to make a collateral evaluation. This collateral evaluation is preliminary, but allows Mid Penn to determine if any potential collateral shortfalls exist.

It is Mid Penn's policy to obtain updated third party valuations on all impaired loans collateralized by real estate as soon as practically possible following the credit being classified as substandard nonaccrual. Prior to receipt of the updated real estate valuation, Mid Penn will use any existing real estate valuation to determine any potential allowance issues; however, no allowance recommendation will be made until such time Mid Penn is in receipt of the updated valuation. The Asset Recovery department employs an electronic tracking system to monitor the receipt of and need for updated appraisals. To date, there have been no material time lapses noted with the above processes.

In some instances Mid Penn is not holding real estate as collateral and is relying on business assets (personal property) for repayment. In these circumstances a collateral inspection is performed by Mid Penn personnel to determine an estimated value. The value is based on net book value, as provided by the financial statements, and discounted accordingly based on determinations made by management. Occasionally, Mid Penn will employ an outside service to provide a fair estimate of value based on auction sales or private sales. Management reviews the estimates of these third parties and discounts them accordingly based on management's judgment, if deemed necessary.

For impaired loans with no valuation allowance required, Mid Penn's practice of obtaining independent third party market valuations on the subject property as soon as practically possible following the credit being placed on nonaccrual status sometimes indicates that the loan

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to value ratio is sufficient to obviate the need for a specific allocation in spite of significant deterioration in real estate values in Mid Penn's primary market area. These circumstances are determined on a case by case analysis of the impaired loans.

Mid Penn actively monitors the values of collateral on impaired loans. This monitoring may require the modification of collateral values over time or changing circumstances by some factor, either positive or negative, from the original values. All collateral values will be assessed by management at least every 12 months for possible revaluation by an independent third party.

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

Loans whose terms are modified are classified as troubled debt restructurings if the borrowers have been granted concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for nine consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

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

In addition, Federal and State regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance and may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

Acquired Loans

Loans that Mid Penn acquires in connection with business combinations are recorded at fair value with no carryover of the existing related allowance for loan losses. Fair value of the loans involves estimating the amount and timing of principal and interest cash flows expected to be collected on the loans and discounting those cash flows at a market rate of interest.

The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loan. The difference between contractually

required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable discount. These loans are accounted for under the ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. The nonaccretable discount includes estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows will require Mid Penn to evaluate the need for an additional allowance. Subsequent improvement in expected cash flows will result in the reversal of a corresponding amount of the nonaccretable discount which Mid Penn will then reclassify as accretable discount that will be recognized into interest income over the remaining life of the loan.

Loans acquired through business combinations that meet the specific criteria of ASC 310-30 are individually evaluated each period to analyze expected cash flows. To the extent that the expected cash flows of a loan have decreased due to credit deterioration, Mid Penn establishes an allowance.

Loans acquired through business combinations that do not meet the specific criteria of ASC 310-30 are accounted for under ASC 310-20. These loans are initially recorded at fair value, and include credit and interest rate marks associated with acquisition accounting adjustments. Purchase premiums or discounts are subsequently amortized as an adjustment to yield over the estimated contractual lives of the loans. There is no allowance for loan losses established at the acquisition date for acquired performing loans. An allowance for loan losses is recorded for any credit deterioration in these loans subsequent to acquisition.

Acquired loans that met the criteria for impaired or nonaccrual of interest prior to the acquisition may be considered performing upon acquisition, regardless of whether the customer is contractually delinquent, if Mid Penn expects to fully collect the new carrying value (i.e. fair value) of the loans. As such, Mid Penn may no longer consider the loan to be nonaccrual or nonperforming and may accrue interest on these loans, including the impact of any accretable discount. In addition, charge-offs on such loans would be first applied to the nonaccretable difference portion of the fair value adjustment.

The classes of the loan portfolio, summarized by the pass rating (net of deferred fees and costs of $479,000 as of June 30, 2018 and $464,000 as of December 31, 2017), and the classified ratings of special mention and substandard within Mid Penn's internal risk rating system as of June 30, 2018 and December 31, 2017, are as follows:

(Dollars in thousands) June 30, 2018	Pass	Special Mention	Substandard	Total
Commercial and industrial	$197,102	$2,420	$ 5,202	$204,724
Commercial real estate	565,517	1,807	8,632	575,956
Commercial real estate - construction	82,323	—	367	82,690
Lease financing	153	—	—	153
Residential mortgage	118,779	262	1,219	120,260
Home equity	47,732	4	79	47,815
Consumer	4,881	—	—	4,881
	$1,016,487	$4,493	$ 15,499	$1,036,479

(Dollars in thousands) December 31, 2017	Pass	Special Mention	Substandard	Total
Commercial and industrial	$182,168	$453	$ 5,412	$188,033
Commercial real estate	505,397	1,435	8,180	515,012
Commercial real estate - construction	61,667	182	487	62,336
Lease financing	229	—	—	229
Residential mortgage	97,814	157	1,062	99,033
Home equity	41,479	105	309	41,893
Consumer	3,868	—	—	3,868
	$892,622	$2,332	$ 15,450	$910,404

Mid Penn had no loans classified as doubtful as of June 30, 2018 and December 31, 2017.

MID PENN BANCORP, INC.

Impaired loans by loan portfolio class as of June 30, 2018 and December 31, 2017 are summarized as follows:

(Dollars in thousands)	June 30, 2018			December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial and industrial	$—	$ —	$ —	$—	$ 13	$ —
Commercial real estate	1,711	2,357	—	3,424	4,056	—
Commercial real estate - construction	—	—	—	—	—	—
Lease financing	—	—	—	—	—	—
Residential mortgage	728	852	—	760	877	—
Home equity	8	107	—	260	295	—
Consumer	—	—	—	—	—	—
With no related allowance recorded and acquired with credit deterioration:						
Commercial and industrial	$23	$ 23	$ —	$—	$ —	$ —
Commercial real estate	1,466	1,466	—	555	555	—
Commercial real estate - construction	—	—	—	—	—	—
Lease financing	—	—	—	—	—	—
Residential mortgage	493	493	—	306	306	—
Home equity	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
With an allowance recorded:						
Commercial and industrial	$4,324	$ 4,410	$ 282	$4,434	$ 4,460	$ 136
Commercial real estate	550	602	238	1,423	1,589	293
Commercial real estate - construction	367	370	54	487	492	100
Lease financing	—	—	—	—	—	—
Residential mortgage	—	—	—	—	—	—
Home equity	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
Total Impaired Loans:						
Commercial and industrial	$4,347	$ 4,433	$ 282	$4,434	$ 4,473	$ 136
Commercial real estate	3,727	4,425	238	5,402	6,200	293
Commercial real estate - construction	367	370	54	487	492	100
Lease financing	—	—	—	—	—	—
Residential mortgage	1,221	1,345	—	1,066	1,183	—
Home equity	8	107	—	260	295	—
Consumer	—	—	—	—	—	—

MID PENN BANCORP, INC.

The average recorded investment of impaired loans and related interest income recognized for the three and six months ended June 30, 2018 and 2017 are summarized as follows:

	Three Months Ended			
	June 30, 2018		June 30, 2017	
(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and industrial	$—	$ —	$36	$ —
Commercial real estate	2,650	3	644	110
Commercial real estate - construction	—	—	473	—
Lease financing	—	—	—	—
Residential mortgage	699	7	860	7
Home equity	95	—	90	—
Consumer	—	—	—	—
With no related allowance recorded and acquired with credit deterioration:				
Commercial and industrial	$23	$ —	$—	$ —
Commercial real estate	1,455	7	644	110
Commercial real estate - construction	—	—	326	2
Lease financing	—	—	—	—
Residential mortgage	639	—	—	—
Home equity	—	—	—	—
Consumer	—	—	—	—
With an allowance recorded:				
Commercial and industrial	$4,349	$ —	$—	$ —
Commercial real estate	1,029	—	2,792	—
Commercial real estate - construction	367	—	240	—
Lease financing	—	—	—	—
Residential mortgage	—	—	66	—
Home equity	—	—	—	—
Consumer	—	—	—	—
Total Impaired Loans:				
Commercial and industrial	$4,372	$ —	$36	$ —
Commercial real estate	5,134	10	4,080	220
Commercial real estate - construction	367	—	1,039	2
Lease financing	—	—	—	—
Residential mortgage	1,338	7	926	7
Home equity	95	—	90	—
Consumer	—	—	—	—

MID PENN BANCORP, INC.

(Dollars in thousands)	Six Months Ended June 30, 2018 Average Recorded Investment	Interest Income Recognized	June 30, 2017 Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and industrial	$—	$ —	$18	$ —
Commercial real estate	2,306	3	524	279
Commercial real estate - construction	17	—	313	—
Lease financing	—	—	—	—
Residential mortgage	796	14	843	18
Home equity	208	—	101	2
Consumer	—	—	—	—
With no related allowance recorded and acquired with credit deterioration:				
Commercial and industrial	$20	$ —	$—	$ —
Commercial real estate	2,001	14	738	110
Commercial real estate - construction	—	—	—	—
Lease financing	—	—	—	—
Residential mortgage	1,086	—	350	—
Home equity	—	—		