

Annual Disclosure Statement

The attached annual report serves as Bank of Tennessee's 2018 Annual Disclosure Statement as required by the Federal Deposit Insurance Corporation ("FDIC"). The Annual Report has not been reviewed, or confirmed for accuracy or relevance, by the FDIC.

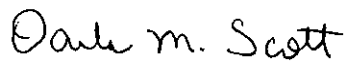
Please contact either Roy L. Harmon, Jr. (Chairman & CEO) or Darla M. Scott (EVP & CFO) for any additional information.

Contact Information

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Darla M. Scott, EVP & CFO
10431 Wallace Alley Street
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Darla M. Scott, CPA



Bank of Tennessee
EVP and CFO

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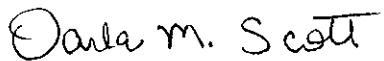
Please contact either Dale Fair (President & CEO) or Darla M. Scott (EVP & CFO) for any additional information.

Contact Information

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Kingsport, TN 37602
423-279-2559 or,
423-262-4337

Darla M. Scott, CPA

A handwritten signature in black ink that reads "Darla M. Scott". The signature is written in a cursive, flowing style.

Bank of Tennessee
EVP and CFO

The logo consists of the letters 'B' and 'T' in a bold, dark blue, sans-serif font. The 'B' is stylized with a thick vertical stroke and a horizontal bar that extends to the right, partially overlapping the 'T'.

ANNUAL REPORT 2018

BancTenn Corp

**BANCTENN CORP.
AND SUBSIDIARY**

CONSOLIDATED FINANCIAL REPORT

DECEMBER 31, 2018

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INDEPENDENT AUDITOR'S REPORT

**To the Stockholders and Board of Directors
BancTenn Corp.
Kingsport, Tennessee**

We have audited the accompanying consolidated financial statements of BancTenn Corp. and its Subsidiary (Company), which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements. We also have audited BancTenn Corp. and Subsidiary's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9SP) as of December 31, 2018, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO).

Management's Responsibility for the Financial Statements and Internal Control over Financial Reporting

The Company's management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of effective internal control over financial reporting relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error. Management is also responsible for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying Management's Assessment on Internal Control over Financial Reporting.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Institution's internal control over financial reporting based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also involves obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

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

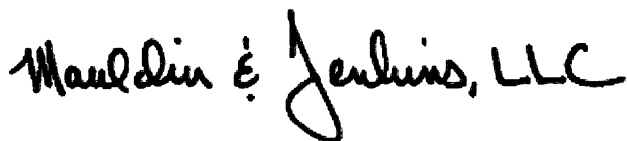
Definition and Inherent Limitations of Internal Control over Financial Reporting

An institution's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of BancTenn Corp. and Subsidiary's internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9SP). An institution's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

In our opinion, the consolidated financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of BancTenn Corp. and its Subsidiary as of December 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America. Also in our opinion, BancTenn Corp. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based upon the criteria *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

A handwritten signature in black ink that reads "Mauldin & Jenkins, LLC". The signature is written in a cursive, flowing style.

Chattanooga, Tennessee
March 21, 2019

BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2018 and 2017
(amounts in thousands, except share data)

ASSETS	2018	2017
Cash and due from banks:		
Noninterest-bearing	\$ 28,591	\$ 23,791
Interest-bearing	<u>586</u>	<u>249</u>
Total cash and due from banks	29,177	24,040
Federal funds sold	-	73
Securities available for sale	196,011	205,527
Securities held to maturity (fair value of \$6,839 in 2018 and \$3,259 in 2017)	6,936	3,275
Other equity investments, at cost	49	49
Restricted equity investments, at cost	7,900	7,717
Loans, net of allowance for loan losses	1,066,029	920,767
Premises and equipment	38,077	33,950
Accrued interest receivable	3,393	2,984
Cash surrender value of life insurance	25,434	24,944
Annuity contracts	16,275	15,898
Other assets	<u>4,676</u>	<u>3,767</u>
Total assets	<u>\$1,393,957</u>	<u>\$ 1,242,991</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	\$ 302,851	\$ 278,237
Interest-bearing	<u>770,498</u>	<u>678,554</u>
Total deposits	1,073,349	956,791
Securities sold under agreements to repurchase	31,882	9,039
Federal Home Loan Bank advances	143,086	122,184
Subordinated debentures	15,465	15,465
Borrowings under line of credit	-	5,000
Accrued interest payable	277	254
Accrued expenses and other liabilities	<u>13,419</u>	<u>11,971</u>
Total liabilities	<u>1,277,478</u>	<u>1,120,704</u>
Stockholders' equity:		
Common stock, \$8 par value, 6,000,000 shares authorized, 2,535,604 and 2,532,089 shares issued and outstanding in 2018 and 2017	20,285	20,257
Additional paid-in capital	8,777	8,778
Retained earnings	78,833	63,870
Accumulated other comprehensive income	<u>8,584</u>	<u>29,382</u>
Total stockholders' equity	<u>116,479</u>	<u>122,287</u>
Total liabilities and stockholders' equity	<u>\$1,393,957</u>	<u>\$ 1,242,991</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2018 and 2017
(amounts in thousands)

	<u>2018</u>	<u>2017</u>
INTEREST INCOME		
Loans, including fees	\$ 50,029	\$ 40,456
Securities	5,243	4,117
Federal funds sold and other	<u>84</u>	<u>4</u>
	55,356	44,577
INTEREST EXPENSE		
Interest on deposits	5,398	2,286
Interest on other borrowed funds	<u>2,900</u>	<u>2,156</u>
	<u>8,298</u>	<u>4,442</u>
Net interest income	47,058	40,135
Provision for loan losses	<u>395</u>	<u>50</u>
Net interest income after provision for loan losses	<u>46,663</u>	<u>40,085</u>
NONINTEREST INCOME		
Customer service fees	2,406	2,415
Service revenue	-	73
Loan origination and settlement fees	2,982	2,799
Gains on sales of foreclosed real estate	-	1,007
Gains on sales of securities	15,883	780
Other	<u>4,122</u>	<u>3,763</u>
	<u>25,393</u>	<u>10,837</u>
NONINTEREST EXPENSES		
Salaries and employee benefits	24,495	23,591
Occupancy expenses	3,594	3,118
Data processing	3,423	2,919
Other operating expenses	<u>13,172</u>	<u>8,853</u>
	<u>44,684</u>	<u>38,481</u>
Income before income taxes	27,372	12,441
Income tax expense	<u>1,156</u>	<u>170</u>
Net income	<u><u>\$ 26,216</u></u>	<u><u>\$ 12,271</u></u>

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BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2018 and 2017
(amounts in thousands)

	<u>2018</u>	<u>2017</u>
Net income	<u>\$26,216</u>	<u>\$12,271</u>
Other comprehensive income (loss) before tax:		
Unrealized gains (losses) on securities -		
Unrealized holding gains (loss) arising during the year, net of tax expense (benefit) of (\$418) and \$551 in 2018 and 2017, respectively	(6,017)	7,912
Reclassification adjustment for gains included in net income, net of tax expense of \$1,033 and \$51 in 2018 and 2017, respectively	(14,850)	(729)
Unrealized gains on derivative contracts -		
Unrealized holding gains arising during the year, net of tax expense of \$5 and \$7 in 2018 and 2017, respectively	<u>69</u>	<u>107</u>
Total comprehensive income (loss)	<u>(20,798)</u>	<u>7,290</u>
Comprehensive income	<u>\$ 5,418</u>	<u>\$19,561</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2018 and 2017
(amounts in thousands, except share data)

	<u>Total Stockholders' Equity</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Unallocated ESOP Shares</u>
BALANCE, December 31, 2016	\$ 110,380	\$ 20,165	\$ 8,220	\$ 60,155	\$ 22,092	\$ (252)
Net income	12,271	-	-	12,271	-	-
Other comprehensive income, net of tax	7,290	-	-	-	7,290	-
Issuance of 18,000 common shares pursuant to stock option plan	870	144	726	-	-	-
Purchase of 6,552 common shares	(424)	(52)	(372)	-	-	-
Employee stock ownership plan: Shares released to participants	456	-	204	-	-	252
Distributions to unallocated shares	26	-	-	26	-	-
Distributions to stockholders	<u>(8,582)</u>	<u>-</u>	<u>-</u>	<u>(8,582)</u>	<u>-</u>	<u>-</u>
BALANCE, December 31, 2017	122,287	20,257	8,778	63,870	29,382	-
Net income	26,216	-	-	26,216	-	-
Other comprehensive loss, net of tax	(20,798)	-	-	-	(20,798)	-
Issuance of 12,000 common shares pursuant to stock option plan	580	96	484	-	-	-
Purchase of 8,485 common shares	(553)	(68)	(485)	-	-	-
Distributions to stockholders	<u>(11,253)</u>	<u>-</u>	<u>-</u>	<u>(11,253)</u>	<u>-</u>	<u>-</u>
BALANCE, December 31, 2018	<u>\$ 116,479</u>	<u>\$ 20,285</u>	<u>\$ 8,777</u>	<u>\$ 78,833</u>	<u>\$ 8,584</u>	<u>\$ -</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2018 and 2017
(amounts in thousands)

	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 26,216	\$ 12,271
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,371	2,268
Provision for loan losses	395	50
Deferred income taxes	504	279
Net amortization on securities	490	522
Other gains, net	(15,870)	(1,795)
Non-Cash contribution	2,011	-
Change in operating assets and liabilities:		
Accrued interest receivable	(409)	(379)
Accrued interest payable	22	77
Other assets and liabilities	1,031	(1,136)
Net cash provided by operating activities	<u>16,761</u>	<u>12,157</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales, maturities, prepayments and calls of securities	46,883	24,978
Purchase of securities	(49,965)	(16,228)
Purchase of restricted stock	(182)	(3,546)
Net (increase) decrease in federal funds sold	73	(73)
Proceeds from sales of foreclosed real estate	144	1,393
Loan originations and principal collections, net	(145,812)	(143,325)
Purchase of premises and equipment	(6,509)	(4,554)
Proceeds from sales of premises and equipment	-	9
Purchase of annuity contracts	(351)	(1,329)
Proceeds from payment of annuity contracts	18	-
Proceeds from sales of repossessions	-	8
Net cash used in investing activities	<u>(155,701)</u>	<u>(142,667)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand deposits and NOW, money market, and savings accounts	85,334	48,584
Net increase in time deposits	31,224	21,199
Net increase in securities sold under agreements to repurchase	22,843	8,053
Net increase in Federal Home Loan Bank advances	20,902	63,903
Proceeds from line of credit	-	5,000
Payment on line of credit	(5,000)	-
Issuance of common shares	580	870
Purchase of common shares	(553)	(424)
Net ESOP transactions	-	482
Distributions to stockholders	(11,253)	(8,582)
Net cash provided by financing activities	<u>144,077</u>	<u>139,085</u>
NET INCREASE IN CASH AND DUE FROM BANKS	5,137	8,575
CASH AND DUE FROM BANKS, beginning of year	<u>24,040</u>	<u>15,465</u>
CASH AND DUE FROM BANKS, end of year	<u>\$ 29,177</u>	<u>\$ 24,040</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for income taxes	\$ 1,409	\$ 121
Cash paid during the year for interest	<u>8,275</u>	<u>4,364</u>
NONCASH INVESTING ACTIVITIES		
Real estate acquired in settlement of loans	<u>\$ 145</u>	<u>\$ 295</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

BancTenn Corp. (Company) is a bank holding company whose principal activity is the ownership and management of its wholly-owned Subsidiary, Bank of Tennessee (Bank). The Bank generates commercial, mortgage and consumer loans and receives deposits from customers located primarily in eastern and middle Tennessee. The Bank's primary deposit products are transaction and savings accounts and certificates of deposit. Its primary lending products are commercial loans, residential real estate loans, and consumer loans.

Basis of Presentation and Accounting Estimates

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. Significant intercompany balances and transactions have been eliminated in consolidation.

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, other-than-temporary impairments of securities, and the fair value of financial instruments.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral.

The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

The Company has evaluated all transactions, events, and circumstances for consideration or disclosure through March 21, 2019, the date these financial statements were available to be issued, and has reflected or disclosed those items within the consolidated financial statements and related footnotes as deemed appropriate.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash, Due from Banks and Cash Flows

For purposes of reporting consolidated cash flows, cash and due from banks includes cash on hand, cash items in process of collection, amounts due from banks, and interest-bearing deposits in banks. Cash flows from loans, federal funds sold, federal funds purchased and securities sold under agreements to repurchase, Federal Home Loan Bank advances, borrowings under line of credit, ESOP transactions and deposits are reported net.

The Bank is required to maintain average balances in cash or on deposit with the Federal Reserve Bank. The total of those reserve balances was approximately \$1,641 and \$1,612 at December 31, 2018 and 2017, respectively.

Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company evaluates investment securities for other-than-temporary impairment using relevant accounting guidance specifying that (a) if the Company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless a credit loss has occurred in the security. If management does not intend to sell the security and it is more likely than not that they will not have to sell the security before recovery of the cost basis, management will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are treated as collateralized financial transactions. These agreements are recorded at the amount at which the securities were acquired or sold plus accrued interest. It is the Company’s policy to take possession of securities purchased under resale agreements. The market value of these securities is monitored, and additional securities are obtained when deemed appropriate to ensure such transactions are adequately collateralized. The Company also monitors its exposure with respect to securities sold under repurchase agreements, and a request for the return of excess securities held by the counterparty is made when deemed appropriate.

Restricted Equity Investments

The Company is required to maintain an investment in capital stock of various entities. Based on redemption provisions of these entities, the stock has no quoted market value and is carried at cost. At their discretion, these entities may declare dividends on the stock. Management reviews for impairment based on the ultimate recoverability of the cost basis in these stocks.

Equity Investments

The Company had equity investments in financial institutions for which it has no substantial influence, generally considered to be an investment of 20% or less. Further, these investments have no readily determinable fair value. These investments have been accounted for at the lower of historical cost or fair market value.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balances less the allowance for loan losses. Interest income is accrued on the outstanding principal balance. The Company does not defer loan fees and related loan origination costs. Based on management's assessment, the difference between deferral and immediate recognition of such fees and related costs is not material.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, or at the time the loan is 90 days past due, unless the loan is well-secured and in the process of collection. Other personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income or charged to the allowance unless management believes that the accrual of interest is recoverable through the liquidation of collateral. Interest income on nonaccrual loans is recognized on the cash basis or cost recovery method, until the loans are returned to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and the loan has been performing according to the contractual terms generally for a period of not less than six months.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to expense. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Confirmed losses are charged off immediately. Subsequent recoveries, if any, are credited to the allowance.

The allowance is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the uncollectibility of loans in light of historical experience, the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, current economic conditions that may affect the borrower's ability to pay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. This evaluation does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For impaired loans, 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 non-impaired loans and is based on historical loss experience adjusted for other qualitative factors. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data. An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans, for which the terms have been modified at the borrower's request, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest when due.

Loans that experience insignificant payment delays and payment shortfalls are not classified as impaired. Impaired loans are measured by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Interest on accruing impaired loans is recognized as long as such loans do not meet the criteria for nonaccrual status. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The Company's homogeneous loan pools include residential real estate loans, commercial real estate loans, construction and land development loans, commercial and industrial loans, and consumer and other loans. The general allocations to these loan pools are based on the historical loss rates for specific loan types and the internal risk grade, if applicable, adjusted for both internal and external qualitative risk factors. The qualitative factors considered by management include, among other factors, (1) changes in local and national economic conditions; (2) changes in asset quality; (3) changes in loan portfolio volume; (4) the composition and concentrations of credit; (5) the impact of competition on loan structuring and pricing; (6) the impact of interest rate changes on portfolio risk and (7) effectiveness of the Company's loan policies, procedures and internal controls. The total allowance established for each homogeneous loan pool represents the product of the historical loss ratio adjusted for both internal and external qualitative risk factors and the total dollar amount of the loans in the pool.

Troubled Debt Restructurings

The Company designates loan modifications as troubled debt restructurings (TDRs) when, for economic or legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. TDRs can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. In circumstances where the TDR involves charging off a portion of the loan balance, the Company typically classifies these restructurings as nonaccrual.

In connection with restructurings, the decision to maintain a loan that has been restructured on accrual status is based on a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation includes consideration of the borrower's current capacity to pay, which among other things may include a review of the borrower's current financial statements, an analysis of global cash flow sufficient to pay all debt obligations, a debt to income analysis, and an evaluation of secondary sources of payment from the borrower and any guarantors. This evaluation also includes an evaluation of the borrower's current willingness to pay, which may include a review of past payment history, an evaluation of the borrower's willingness to provide information on a timely basis, and consideration of offers from the borrower to provide additional collateral or guarantor support. The credit evaluation also reflects consideration of the borrower's future capacity and willingness to pay, which may include evaluation of cash flow projections, consideration of the adequacy of collateral to cover all principal and interest, and trends indicating improving profitability and collectability of receivables.

Restructured nonaccrual loans may be returned to accrual status based on a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation must include consideration of the borrower's sustained historical repayment for a reasonable period, generally a minimum of six months, prior to the date on which the loan is returned to accrual status.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivatives

Derivatives are recognized as assets and liabilities on the consolidated balance sheets and measured at fair value. For exchange-traded contracts, fair value is based on quoted market prices. For non-exchange traded contracts, fair value is based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant management judgment or estimation.

For asset/liability management purposes, the Company and Bank use interest rate swap agreements to hedge various exposures or to modify interest rate characteristics of various balance sheet accounts. Interest rate swaps are contracts in which a series of interest rate cash flows are exchanged over a prescribed period. The notional amount on which the interest payments are based is not exchanged. These swap agreements are derivative instruments and generally convert a portion of the Company's and Bank's variable-rate debt and loans to a fixed rate.

The effective portion of the gain or loss on a derivative designated and qualifying as a cash flow hedging instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized in current earnings.

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a cash flow hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Company and Bank to risk. Those derivative financial instruments that do not meet specified hedging criteria are recorded at fair value with changes in fair value recorded in income. If periodic assessment indicates derivatives no longer provide an effective hedge, the derivative contracts would be closed out and settled, or classified as a trading activity.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company - put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value. Loans held for sale are classified as loans on the consolidated balance sheets and were \$1,492 and \$3,899 for the years ended December 31, 2018 and 2017, respectively.

Loan origination fees and related origination costs are recognized upon sale of loans to third parties. Gains and losses on sale of loans are recognized at the time of the sale. Losses on sales of loans are recognized when management has determined that such loans will be sold at a price less than the carrying value. Gains and losses are determined by the difference between the net sales proceeds and the cost basis of the loans sold.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Premises and Equipment

Land is carried at cost. Other premises and equipment are carried at cost net of accumulated depreciation. Depreciation is computed using the straight-line method based principally on the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in other operating expenses.

	<u>Years</u>
Buildings	15-39
Furniture, fixtures and equipment	3-10

Foreclosed Real Estate

Foreclosed real estate acquired through, or in lieu of, loan foreclosure is held for sale and is initially recorded at fair value less estimated costs to sell. Any write-down to fair value at the time of transfer is charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated costs to sell. Costs of improvements are capitalized, whereas costs related to holding foreclosed real estate and subsequent write-downs to value are expensed. There was no foreclosed real estate at December 31, 2018 and December 31, 2017. The recorded investment in consumer mortgage loans secured by residential real estate properties where formal foreclosure procedures are in process at December 31, 2018 and December 31, 2017 was \$226 and \$275, respectively.

Income Taxes

The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Earnings and losses are included in the personal income tax returns of the stockholders and taxed depending on their personal tax strategies. Accordingly, the Company does not incur federal income tax obligations, and the financial statements do not include a provision for federal income taxes. The Company incurs state income taxes, and the consolidated financial statements include a provision (benefit) for the state tax effect of transactions reported in the consolidated financial statements.

The income tax accounting guidance results in two components of state income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method.

Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. The Company's deferred taxes relate primarily to differences between the tax and book basis of the allowance for loan losses and accumulated depreciation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes (Continued)

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets may be reduced by deferred tax liabilities and a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Advertising Costs

The Company follows the policy of charging the costs of advertising to expense as incurred. Advertising expense charged to operations was \$148 and \$133 for the years ended December 31, 2018 and 2017, respectively.

Stock Compensation Plan

At December 31, 2018 and 2017, the Company had options outstanding under a stock-based compensation plan, which is described in more detail in Note 12. The plan has been accounted for under the accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards and stock grants.

Variable Interest Entities

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in ASC Topic 810, which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb the expected losses or receive the expected returns of the entity. A VIE must be consolidated by the Company if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. The Company has two wholly-owned subsidiary grantor trusts which are deemed to be VIEs. These two VIEs have not been consolidated by the Company as BancTenn Corp. is not the primary beneficiary.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Employee Benefit Plan

Employee benefit plan costs are based on a percentage of individual employee's salary, not to exceed the amount that can be deducted for federal income tax purposes.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and cash flow hedges, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Fair Value of Financial Instruments

Fair values of financial instruments are estimates using relevant market information and other assumptions, as more fully disclosed in Note 16. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

NOTE 2. SECURITIES

The amortized cost and fair value of investment securities at December 31, 2018 and 2017 are as follows:

	2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available for sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 37,385	\$ 126	\$ (549)	\$ 36,962
Obligations of states and political subdivisions	78,682	327	(1,337)	77,672
Mortgage backed securities:				
Government National Mortgage Association guaranteed	13,241	69	(179)	13,131
GSE residential	52,200	113	(743)	51,570
Equity securities	<u>5,316</u>	<u>11,360</u>	<u>-</u>	<u>16,676</u>
	<u>\$186,824</u>	<u>\$11,995</u>	<u>\$(2,808)</u>	<u>\$196,011</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 2. SECURITIES (Continued)

	2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities held to maturity:				
Obligations of states and political subdivisions	\$ 843	\$ -	\$ (25)	\$ 818
Mortgage backed securities:				
GSE residential	<u>6,093</u>	<u>2</u>	<u>(74)</u>	<u>6,021</u>
	<u>\$ 6,936</u>	<u>\$ 2</u>	<u>\$ (99)</u>	<u>\$ 6,839</u>
	2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available for sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 34,137	\$ 96	\$ (421)	\$ 33,812
Obligations of states and political subdivisions	81,847	907	(371)	82,383
Mortgage backed securities:				
Government National Mortgage Association guaranteed	9,167	73	(78)	9,162
GSE residential	38,433	75	(514)	37,994
Equity securities	<u>10,439</u>	<u>31,737</u>	<u>-</u>	<u>42,176</u>
	<u>\$174,023</u>	<u>\$32,888</u>	<u>\$ (1,384)</u>	<u>\$205,527</u>
Debt securities held to maturity:				
Obligations of states and political subdivisions	\$ 926	\$ -	\$ (23)	\$ 903
Mortgage backed securities:				
GSE residential	<u>2,349</u>	<u>18</u>	<u>(11)</u>	<u>2,356</u>
	<u>\$ 3,275</u>	<u>\$ 18</u>	<u>\$ (34)</u>	<u>\$ 3,259</u>

U.S. Government sponsored enterprises include entities such as Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal Home Loan Banks.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 2. SECURITIES (Continued)

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2018, are as follows:

	<u>Securities Available for Sale</u>		<u>Securities Held to Maturity</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due within one year	\$ 11,168	\$ 11,159	\$ 38	\$ 38
Due from one to five years	28,172	28,012	-	-
Due from five to ten years	40,157	39,635	805	780
Due after ten years	36,570	35,828	-	-
Mortgage-backed securities	65,441	64,701	6,093	6,021
Securities with no stated maturity	<u>5,316</u>	<u>16,676</u>	<u>-</u>	<u>-</u>
	<u>\$186,824</u>	<u>\$196,011</u>	<u>\$6,936</u>	<u>\$6,839</u>

During the years ended December 31, 2018 and 2017, proceeds from sales of securities available for sale and other equity investments were \$18,995 and \$3,926, respectively. The Company recognized gross gains of \$15,883 and zero gross losses for 2018, and gross gains of \$792 and gross losses of \$12 for 2017.

Temporarily Impaired Securities

The following tables show the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2018 and 2017.

	<u>Less Than 12 Month</u>		<u>12 Months or More</u>		<u>Total Unrealized Losses</u>
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	
December 31, 2018:					
Available for sale securities:					
U.S. Government-sponsored enterprises (GSEs)	\$ 4,012	\$ (24)	\$ 6,777	\$ (525)	\$ (549)
Obligations of states and political subdivisions	20,904	(496)	23,059	(841)	(1,337)
Mortgage-backed securities- Government National Mortgage Association guaranteed	4,778	(87)	1,902	(92)	(179)
GSE residential	<u>8,729</u>	<u>(39)</u>	<u>44,783</u>	<u>(704)</u>	<u>(743)</u>
	<u>\$38,423</u>	<u>\$(646)</u>	<u>\$76,521</u>	<u>\$(2,162)</u>	<u>\$(2,808)</u>
Debt securities held to maturity:					
Obligations of states and political subdivisions	\$ -	\$ -	\$ 780	\$ (25)	\$ (25)
Mortgage-backed securities- GSE residential	<u>4,174</u>	<u>(37)</u>	<u>1,188</u>	<u>(37)</u>	<u>(74)</u>
	<u>\$ 4,174</u>	<u>\$ (37)</u>	<u>\$ 1,968</u>	<u>\$ (62)</u>	<u>\$ (99)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 2. SECURITIES (Continued)

Temporarily Impaired Securities (Continued)

	<u>Less Than 12 Month</u>		<u>12 Months or More</u>		
	<u>Fair</u>	<u>Gross</u>	<u>Fair</u>	<u>Gross</u>	<u>Total</u>
	<u>Value</u>	<u>Unrealized</u>	<u>Value</u>	<u>Unrealized</u>	<u>Unrealized</u>
		<u>Losses</u>		<u>Losses</u>	<u>Losses</u>
December 31, 2017:					
Available for sale securities:					
U.S. Government-sponsored enterprises (GSEs)	\$12,920	\$(126)	\$13,150	\$(295)	\$ (421)
Obligations of states and political subdivisions	20,922	(184)	5,866	(187)	(371)
Mortgage-backed securities-					
Government National Mortgage Association guaranteed	4,170	(36)	1,775	(42)	(78)
GSE residential	<u>17,950</u>	<u>(148)</u>	<u>14,155</u>	<u>(366)</u>	<u>(514)</u>
	<u>\$55,962</u>	<u>\$(494)</u>	<u>\$34,946</u>	<u>\$(890)</u>	<u>\$(1,384)</u>
Debt securities held to maturity:					
Obligations of states and political subdivisions	\$ -	\$ -	\$ 827	\$ (23)	\$ (23)
Mortgage-backed securities-					
GSE residential	<u>-</u>	<u>-</u>	<u>1,655</u>	<u>(11)</u>	<u>(11)</u>
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,482</u>	<u>\$ (34)</u>	<u>\$ (34)</u>

For U.S. Government-sponsored enterprises and mortgage-backed securities, the unrealized losses on the securities shown above were caused by interest rate increases. For obligations of states and political subdivisions, the unrealized losses were caused by the interest rate environment and reduced desirability for long-duration obligations of states and political subdivisions. It is expected that the securities would not be settled at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2018.

Securities with a carrying value of approximately \$85,505 and \$104,277 at December 31, 2018 and 2017, respectively, were pledged to secure various deposits and borrowings.

Restricted equity investments, at cost, consist of the following:

	<u>2018</u>	<u>2017</u>
Federal Home Loan Bank stock	\$7,798	\$7,615
Pacific Coast Bankers Bank stock	<u>102</u>	<u>102</u>
	<u>\$7,900</u>	<u>\$7,717</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 3. OTHER EQUITY INVESTMENTS, AT COST

Other equity investments, at cost consist of the following:

	<u>2018</u>	<u>2017</u>
Providence Bank	\$ 49	\$ 49

Management reviews for impairment based on the ultimate recoverability of the cost basis of these investments. At December 31, 2018 and 2017, management has determined there is no impairment.

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES

Portfolio Segmentation

At December 31, 2018 and 2017, the Company's loans consist of the following:

	<u>2018</u>	<u>2017</u>
Commercial real estate	\$ 362,402	\$317,107
Residential real estate	444,010	411,543
Construction and land development	98,749	56,726
Commercial and industrial	143,786	114,859
Consumer and other	<u>24,559</u>	<u>28,185</u>
Total loans	1,073,506	928,420
Less - Allowance for loan losses	<u>(7,477)</u>	<u>(7,653)</u>
Net loans	<u>\$1,066,029</u>	<u>\$920,767</u>

For purposes of the disclosures required by ASC 310, the loan portfolio was disaggregated into segments. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. There are five loan portfolio segments that include commercial real estate, residential real estate, construction and land development, commercial and industrial, and consumer and other.

The following describe risk characteristics relevant to each of the portfolio segments:

Commercial Real Estate: Include owner-occupied commercial real estate loans and loans secured by income producing properties. Owner-occupied commercial real estate loans to operating businesses are long-term financing of land and buildings. These loans are repaid by cash flow generated from the business operation. Real estate loans for income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers are repaid from rent income derived from the properties. Loans within this segment are particularly sensitive to the valuation of real estate collateral.

Residential Real Estate: Include 1-4 family residential real estate loans, second liens, or open end real estate loans, such as home equity lines and up to four unit multifamily residential loans. These are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property. These loans are sensitive to the valuation of real estate collateral, unemployment and other key economic measures.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Portfolio Segmentation (Continued)

Construction and Land Development: Loans for real estate construction and land development are repaid through cash flow related to the operations, sale or refinance of the underlying property. This portfolio segment includes extensions of credit to real estate developers or investors where repayment is dependent on the sale of the real estate or income generated from the real estate collateral. These loans are particularly sensitive to the valuation of real estate.

Commercial and Industrial: Include commercial, financial and agricultural loans. These loans include those loans to commercial customers for use in normal business operations to finance working capital needs, equipment purchases, or expansion projects. Loans are repaid by business cash flows. Collection risk in this portfolio is driven by the creditworthiness of the underlying borrower, particularly cash flows from the customers' business operations.

Consumer and Other: The consumer loan portfolio segment includes direct consumer installment loans, overdrafts and other revolving credit loans, and loans secured by farmland. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

Credit Risk Management

The Company employs a credit risk management process with defined policies, accountability and routine reporting to manage credit risk in the loan portfolio segments. Credit risk management is guided by credit policies that provide for a consistent and prudent approach to underwriting and approvals of credits. Within the Credit Policy, procedures exist that elevate the approval requirements as credits become larger and more complex. All loans are individually underwritten, risk-rated, approved, and monitored.

Responsibility and accountability for adherence to underwriting policies and accurate risk ratings lies in each portfolio segment. For the residential real estate and consumer and other portfolio segments, the risk management process focuses on managing customers who become delinquent in their payments. For the commercial and industrial, commercial real estate and construction and land development portfolio segments, the risk management process focuses on underwriting new business and, on an ongoing basis, monitoring the credit of the portfolios, including a third party review of the largest credits on an annual basis or more frequently as needed. To ensure problem credits are identified on a timely basis, several specific portfolio reviews occur periodically to assess the larger adversely rated credits for proper risk rating and accrual status.

Credit quality and trends in the loan portfolio segments are measured and monitored regularly. Detailed reports, by product, collateral, accrual status, etc., are reviewed by the Senior Credit Officer and the Directors Loan Committee.

The allowance for loan losses is a valuation reserve allowance established through provisions for loan losses charged against income. The allowance for loan losses, which is evaluated monthly, is maintained at a level that management deems sufficient to absorb probable losses inherent in the loan portfolio.

Loans deemed to be uncollectible are charged against the allowance for loan losses, while recoveries of previously charged-off amounts are credited to the allowance for loan losses. The allowance for loan losses is comprised of specific valuation allowances for loans evaluated individually for impairment, general allocations for pools of homogeneous loans with similar risk characteristics and trends, and an unallocated component that reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Risk Management (Continued)

The allowance for loan losses related to specific loans is based on management's estimate of potential losses on impaired loans as determined by (1) the present value of expected future cash flows; (2) the fair value of collateral if the loan is determined to be collateral dependent or (3) the loan's observable market price. The Company's homogeneous loan pools include commercial real estate loans, residential real estate loans, construction and land development loans, commercial and industrial loans, and consumer and other loans.

The general allocations to these loan pools are based on the historical loss rates for specific loan types and the internal risk grade, if applicable, adjusted for both internal and external qualitative risk factors. The qualitative factors considered by management include, among other factors, (1) changes in local and national economic conditions; (2) changes in asset quality; (3) changes in loan portfolio volume; (4) the composition and concentrations of credit; (5) the impact of competition on loan structuring and pricing; (6) the impact of interest rate changes on portfolio risk and (7) effectiveness of the Company's loan policies, procedures and internal controls. The total allowance established for each homogeneous loan pool represents the product of the historical loss ratio adjusted for both internal and external qualitative risk factors and the total dollar amount of the loans in the pool.

The following tables detail activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2018 and 2017. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Year Ended December 31, 2018						Total
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	
Balance, beginning of year	\$3,011	\$2,434	\$488	\$612	\$ 315	\$ 793	\$ 7,653
Provision for (reallocation of) loan losses	118	19	47	195	(256)	272	395
Recoveries of loans charged off	4	55	47	7	517	-	630
Loans charged off	(665)	(168)	-	(54)	(314)	-	(1,201)
Balance, end of year	<u>\$2,468</u>	<u>\$2,340</u>	<u>\$582</u>	<u>\$760</u>	<u>\$ 262</u>	<u>\$1,065</u>	<u>\$ 7,477</u>

	Year Ended December 31, 2017						Total
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	
Balance, beginning of year	\$2,785	\$2,601	\$ 995	\$499	\$ 440	\$ 81	\$7,401
Provision for (reallocation of) loan losses	222	(59)	(621)	92	(296)	712	50
Recoveries of loans charged off	4	209	114	63	595	-	985
Loans charged off	-	(317)	-	(42)	(424)	-	(783)
Balance, end of year	<u>\$3,011</u>	<u>\$2,434</u>	<u>\$ 488</u>	<u>\$612</u>	<u>\$ 315</u>	<u>\$793</u>	<u>\$7,653</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Risk Management (Continued)

The composition of loans by primary loan classification as well as impaired and performing loan status at December 31, 2018 and 2017, is summarized in the tables below:

	December 31, 2018					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$359,541	\$442,915	\$98,741	\$143,571	\$24,555	\$1,069,323
Impaired loans	<u>2,861</u>	<u>1,095</u>	<u>8</u>	<u>215</u>	<u>4</u>	<u>4,183</u>
Total loans	<u>\$362,402</u>	<u>\$444,010</u>	<u>\$98,749</u>	<u>\$143,786</u>	<u>\$24,559</u>	<u>\$1,073,506</u>

	December 31, 2017					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$308,550	\$409,875	\$56,623	\$114,624	\$27,631	\$917,303
Impaired loans	<u>8,557</u>	<u>1,668</u>	<u>103</u>	<u>235</u>	<u>554</u>	<u>11,117</u>
Total loans	<u>\$317,107</u>	<u>\$411,543</u>	<u>\$56,726</u>	<u>\$114,859</u>	<u>\$28,185</u>	<u>\$928,420</u>

The following tables show the allowance for loan losses allocation by loan classification for impaired and performing loans as of December 31, 2018 and 2017:

	December 31, 2018						
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	Total
Allowance related to:							
Performing loans	\$2,219	\$2,314	\$582	\$760	\$260	\$1,065	\$7,200
Impaired loans	<u>249</u>	<u>26</u>	<u>-</u>	<u>-</u>	<u>2</u>	<u>-</u>	<u>277</u>
Total allowance	<u>\$2,468</u>	<u>\$2,340</u>	<u>\$582</u>	<u>\$760</u>	<u>\$262</u>	<u>\$1,065</u>	<u>\$7,477</u>

	December 31, 2017						
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	Total
Allowance related to:							
Performing loans	\$1,780	\$2,391	\$488	\$612	\$312	\$793	\$6,376
Impaired loans	<u>1,231</u>	<u>43</u>	<u>-</u>	<u>-</u>	<u>3</u>	<u>-</u>	<u>1,277</u>
Total allowance	<u>\$3,011</u>	<u>\$2,434</u>	<u>\$488</u>	<u>\$612</u>	<u>\$315</u>	<u>\$793</u>	<u>\$7,653</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Risk Management (Continued)

A description of the general characteristics of the risk grades used by the Company is as follows:

Pass: Loans in this risk category involve borrowers of acceptable-to-strong credit quality and risk who have the apparent ability to satisfy their loan obligations. Loans in this risk grade would possess sufficient mitigating factors, such as adequate collateral or strong guarantors possessing the capacity to repay the debt if required, for any weakness that may exist.

Special Mention: Loans in this risk grade are the equivalent of the regulatory definition of “Other Assets Especially Mentioned” classification. Loans in this category possess some credit deficiency or potential weakness, which requires a high level of management attention. Potential weaknesses include declining trends in operating earnings and cash flows and /or reliance on the secondary source of repayment. If left uncorrected, these potential weaknesses may result in noticeable deterioration of the repayment prospects for the asset or in the Company’s credit position.

Substandard: Loans in this risk grade are inadequately protected by the borrower’s current financial condition and payment capability or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the orderly repayment of debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans in this risk grade have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or orderly repayment in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimated loss is deferred until its more exact status may be determined.

Uncollectable: Loans in this risk grade are considered to be non-collectible and of such little value that their continuance as bankable assets is not warranted. This does not mean the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future. Charge-offs against the allowance for loan losses are taken in the period in which the loan becomes uncollectible. Consequently, the Company typically does not maintain a recorded investment in loans within this category.

The following tables outline the amount of each loan classification and the amount categorized into each risk rating as of December 31, 2018 and 2017:

	December 31, 2018					Total
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	
Pass	\$359,661	\$439,232	\$98,400	\$143,494	\$24,381	\$1,065,168
Special mention	-	100	-	-	-	100
Substandard	2,741	4,678	349	292	178	8,238
Doubtful	-	-	-	-	-	-
Total	<u>\$362,402</u>	<u>\$444,010</u>	<u>\$98,749</u>	<u>\$143,786</u>	<u>\$24,559</u>	<u>\$1,073,506</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Risk Management (Continued)

	December 31, 2017					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$308,613	\$405,006	\$55,561	\$114,537	\$28,091	\$911,808
Special mention	-	104	-	-	-	104
Substandard	8,494	6,433	1,165	322	94	16,508
Doubtful	-	-	-	-	-	-
Total	<u>\$317,107</u>	<u>\$411,543</u>	<u>\$56,726</u>	<u>\$114,859</u>	<u>\$28,185</u>	<u>\$928,420</u>

Past Due Loans

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. Generally, management places loans on non-accrual when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. The following tables present the aging of the recorded investment in loans and leases as of December 31, 2018 and 2017:

	December 31, 2018					
	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	Current Loans	Total Loans
Commercial real estate	\$ 461	\$ -	\$ 353	\$ 814	\$ 361,588	\$ 362,402
Residential real estate	4,163	-	2,431	6,594	437,416	444,010
Construction and land development	-	-	215	215	98,534	98,749
Commercial and industrial	186	-	23	209	143,577	143,786
Consumer and other	96	-	151	247	24,312	24,559
Total	<u>\$4,906</u>	<u>\$ -</u>	<u>\$3,173</u>	<u>\$8,079</u>	<u>\$1,065,427</u>	<u>\$1,073,506</u>

	December 31, 2017					
	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	Current Loans	Total Loans
Commercial real estate	\$ 167	\$ -	\$1,678	\$ 1,845	\$315,262	\$317,107
Residential real estate	2,871	-	4,506	7,377	404,166	411,543
Construction and land development	19	-	1,021	1,040	55,686	56,726
Commercial and industrial	109	-	1	110	114,749	114,859
Consumer and other	323	-	50	373	27,812	28,185
Total	<u>\$3,489</u>	<u>\$ -</u>	<u>\$7,256</u>	<u>\$10,745</u>	<u>\$917,675</u>	<u>\$928,420</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired Loans

A loan held for investment is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement. The following tables detail impaired loans, by portfolio segment as of December 31, 2018 and 2017:

	As of December 31, 2018			For the Year Ended December 31, 2018	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate	\$1,682	\$1,682	\$ -	\$2,014	\$338
Residential real estate	961	961	-	1,101	346
Construction and land development	8	8	-	56	47
Commercial and industrial	215	215	-	225	22
Consumer and other	<u>2</u>	<u>2</u>	<u>-</u>	<u>274</u>	<u>28</u>
Total	<u>2,868</u>	<u>2,868</u>	<u>-</u>	<u>3,670</u>	<u>781</u>
Impaired loans with a valuation allowance:					
Commercial real estate	1,179	1,179	249	3,695	60
Residential real estate	134	134	26	283	9
Construction and land development	-	-	-	-	-
Commercial and industrial	-	-	-	-	-
Consumer and other	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>-</u>
Total	<u>1,315</u>	<u>1,315</u>	<u>277</u>	<u>3,980</u>	<u>69</u>
Total impaired loans	<u>\$4,183</u>	<u>\$4,183</u>	<u>\$277</u>	<u>\$7,650</u>	<u>\$850</u>

	As of December 31, 2017			For the Year Ended December 31, 2017	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate	\$ 2,345	\$ 2,345	\$ -	\$ 2,877	\$201
Residential real estate	1,237	1,237	-	1,318	389
Construction and land development	103	103	-	522	64
Commercial and industrial	235	235	-	141	16
Consumer and other	<u>551</u>	<u>551</u>	<u>-</u>	<u>442</u>	<u>31</u>
Total	<u>4,471</u>	<u>4,471</u>	<u>-</u>	<u>5,300</u>	<u>701</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired Loans (Continued)

	As of December 31, 2017			For the Year Ended December 31, 2017	
	Recorded <u>Investment</u>	Unpaid Principal <u>Balance</u>	Related <u>Allowance</u>	Average Recorded <u>Investment</u>	Interest Income <u>Recognized</u>
Impaired loans with a valuation allowance:					
Commercial real estate	6,212	6,212	1,231	4,841	119
Residential real estate	431	431	43	545	30
Construction and land development	-	-	-	-	-
Commercial and industrial	-	-	-	-	-
Consumer and other	<u>3</u>	<u>3</u>	<u>3</u>	<u>187</u>	<u>-</u>
Total	<u>6,646</u>	<u>6,646</u>	<u>1,277</u>	<u>5,573</u>	<u>149</u>
Total impaired loans	<u>\$11,117</u>	<u>\$11,117</u>	<u>\$1,277</u>	<u>\$10,873</u>	<u>\$850</u>

Troubled Debt Restructurings

At December 31, 2018 and 2017, impaired loans included loans that were classified as Troubled Debt Restructurings "TDRs". The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession.

In assessing whether or not a borrower is experiencing financial difficulties, the Company considers information currently available regarding the financial condition of the borrower. This information includes, but is not limited to, whether (i) the debtor is currently in payment default on any of its debt; (ii) a payment default is probable in the foreseeable future without the modification; (iii) the debtor has declared or is in the process of declaring bankruptcy and (iv) the debtor's projected cash flow is sufficient to satisfy contractual payments due under the original terms of the loan without a modification.

The Company considers all aspects of the modification to loan terms to determine whether or not a concession has been granted to the borrower. Key factors considered by the Company include the debtor's ability to access funds at a market rate for debt with similar risk characteristics, the significance of the modification relative to unpaid principal balance or collateral value of the debt, and the significance of a delay in the timing of payments relative to the original contractual terms of the loan.

The most common concessions granted by the Company generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt, (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (iii) a temporary period of interest-only payments, and (iv) a reduction in the contractual payment amount for either a short period or remaining term of the loan. As of December 31, 2018 and 2017, management had \$2,469 and \$2,742, respectively, in loans considered restructured that are not on nonaccrual. Of the nonaccrual loans at December 31, 2018 and 2017, \$460 and \$511, respectively met the criteria for restructured. A loan is placed back on accrual status when both principal and interest are current and it is probable that management will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

There were no loans modified as troubled debt restructurings during the years ended December 31, 2018 or 2017.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Related Party Loans

In the ordinary course of business, the Company has granted loans to certain related parties, including directors, executive officers, and their affiliates. The interest rates on these loans were substantially the same as rates prevailing at the time of the transaction and repayment terms are customary for the type of loan. The total of these loans was approximately \$9,280 and \$5,245 at December 31, 2018 and 2017, respectively.

NOTE 5. PREMISES AND EQUIPMENT

A summary of premises and equipment at December 31, 2018 and 2017, is as follows:

	<u>2018</u>	<u>2017</u>
Land	\$ 7,465	\$ 7,465
Buildings and leasehold improvements	38,271	37,991
Furniture and equipment	17,657	17,394
Transportation equipment	1,254	1,209
Construction in progress	<u>2,784</u>	<u>607</u>
	67,431	64,666
Accumulated depreciation	<u>(29,354)</u>	<u>(30,716)</u>
	<u>\$ 38,077</u>	<u>\$ 33,950</u>

At December 31, 2018, management estimates the costs necessary to complete the construction in progress will be approximately \$2,287.

NOTE 6. DEPOSITS

The composition of deposits at December 31, 2018 and 2017, is as follows:

	<u>2018</u>	<u>2017</u>
Demand deposits, noninterest bearing	\$ 302,851	\$278,237
NOW accounts	216,919	198,208
Money market accounts	277,604	239,371
Savings accounts	130,781	127,005
Time deposits	<u>145,194</u>	<u>113,970</u>
	<u>\$1,073,349</u>	<u>\$956,791</u>

The aggregate amount of time deposits in denominations of \$250 or more at December 31, 2018 and December 31, 2017 were approximately \$31,205 and \$18,665, respectively. At December 31, 2018 and 2017, the scheduled maturities of time deposits are as follows:

	<u>2018</u>	<u>2017</u>
Less than one year	\$ 90,063	\$ 87,712
One through three years	35,838	18,816
Three through five years	<u>19,293</u>	<u>7,442</u>
	<u>\$145,194</u>	<u>\$113,970</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 7. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase represent the purchase of interest in securities by commercial checking customers. The Company may also enter into structured repurchase agreements with other financial institutions. Repurchase agreements with commercial checking customers generally settle the following business day, while structured repurchase agreements with other financial institutions will have varying terms.

At December 31, 2018 and 2017, the Company had securities sold under agreements to repurchase of \$31,882 and \$9,039, respectively, with commercial checking customers.

NOTE 8. FEDERAL HOME LOAN BANK ADVANCES

The Bank has an agreement with the Federal Home Loan Bank (FHLB) that can provide short-term and long-term funding to the Bank in an amount up to \$421,689. The Bank has pledged its loans secured by one to four single-family mortgages, second mortgages and home equity lines, multi-family, commercial real estate, and agricultural real estate properties. The collateral to loan ratio ranges from 49% to 83%.

At December 31, 2018 and 2017, FHLB advances consist of the following:

	<u>2018</u>	<u>2017</u>
Long-term advance requiring monthly interest payments, fixed at 2.99%, principal due September 2018, callable	\$ -	\$ 5,000
Long-term advance requiring monthly interest payments, fixed at 1.52%, principal due January 2019	5,000	5,000
Long-term advance requiring monthly interest payments, fixed at 1.55%, principal due April 2019	5,000	5,000
Long-term advance requiring monthly interest payments, fixed at 1.61%, principal due July 2019	5,000	5,000
Long-term advance requiring monthly interest payments, fixed at 1.64%, principal due October 2019	5,000	5,000
Long-term advance requiring monthly interest payments, fixed at 1.69%, principal due January 2020	5,000	5,000
Long-term advance requiring monthly interest payments, fixed at 1.72%, principal due April 2020	5,000	5,000
Long-term advance requiring monthly interest payments, fixed at 1.76%, principal due July 2020	5,000	5,000
Long-term amortizing advance requiring monthly principal and interest payments, fixed at 2.30%, matures February 2023	1,709	1,779

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 8. FEDERAL HOME LOAN BANK ADVANCES (Continued)

	<u>2018</u>	<u>2017</u>
Long-term amortizing advance requiring monthly principal and interest payments, fixed at 2.00%, matures July 2030	\$ 377	\$ 405
CMA advance, principal and interest due at maturity, fixed at 1.43%, matures January 12, 2018	-	10,000
CMA advance, principal and interest due at maturity, fixed at 1.45%, matures January 17, 2018	-	10,000
CMA advance, principal and interest due at maturity, fixed at 2.52%, matures January 17, 2019	20,000	-
Repo based advance, principal and interest due at maturity, fixed at 1.45%, matures January 19, 2018	-	15,000
Overnight advance, principal and interest due at maturity, fixed at 1.42%, matures January 2, 2018	-	45,000
Overnight advance, principal and interest due at maturity, fixed at 2.45%, matures January 2, 2019 (January 3, 2018 for 2017)	<u>86,000</u>	<u>-</u>
	<u>\$143,086</u>	<u>\$122,184</u>

The long-term advances may be prepaid subject to a prepayment penalty as defined in the agreements. The FHLB has the right to exercise a put on certain of these advances as defined in the agreements.

Aggregate principal payments required on FHLB borrowings at December 31, 2018, are as follows:

2019	\$126,109
2020	15,103
2021	106
2022	108
2023	1,437
Thereafter	<u>223</u>
	<u>\$143,086</u>

NOTE 9. SUBORDINATED DEBENTURES

Effective June 22, 2004 and December 4, 2006, two wholly-owned subsidiary grantor trusts were established by the Company, BancTenn Capital Trust II and BancTenn Capital Trust III, respectively. These subsidiaries issued \$6,000 and \$9,000 of pooled Trust Preferred Securities ("trust preferred securities"), respectively. Trust preferred securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The trust used the net proceeds from the offering to purchase a like amount of Junior Subordinated Debentures (the "Debentures") of the Company. The Debentures are the sole assets of the trust. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 9. SUBORDINATED DEBENTURES (Continued)

The Company has the right to redeem the Debentures in whole or in part after specific dates, at a redemption price specified in the indenture plus any accrued but unpaid interest to the redemption date. The trust preferred securities have a maturity of 30 years and are redeemable at the Company's option with certain exceptions. At December 31, 2018, the floating-rate securities in BancTenn Capital Trust II had a 5.13% interest rate which resets quarterly at the three-month LIBOR rate plus 2.65% and BancTenn Capital Trust III had a 4.44% interest rate which resets quarterly at the three-month LIBOR rate plus 1.65%.

For regulatory capital purposes, these trust-preferred securities qualify as a component of Tier I capital, subject to certain limitations.

ASC Topic 810 resulted in the Company's investment in the common equity of the trust being included in the consolidated balance sheets as other assets, totaling \$465 at December 31, 2018 and 2017. The outstanding balance of the subordinated debentures was \$15,465 at December 31, 2018 and 2017.

NOTE 10. BORROWINGS UNDER LINE OF CREDIT

The Company has a \$10,000 line of credit with another financial institution at December 31, 2018. The line matures on March 21, 2019. The line is secured by 100% of the stock of Bank of Tennessee. Interest on the line is Wall Street Journal Prime less 15 basis points, with a floor of 2.5%. There were no outstanding borrowings under the line of credit at December 31, 2018. Outstanding borrowings under the line of credit at December 31, 2017, were \$5,000.

The line of credit requires the Bank to meet certain covenants, which include: (i) the Bank shall be well capitalized, (ii) the Bank shall maintain a Tier I leverage ratio of not less than 8%, (iii) the Bank shall maintain a nonperforming asset ratio of not more than 40%, and (iv) the Bank shall maintain a return on asset ratio not less than 0.35%. At December 31, 2018, the Bank was in compliance with all covenants.

NOTE 11. DERIVATIVE INSTRUMENTS – INTEREST RATE CONTRACTS

Cash Flow Hedges

At December 31, 2018, the Company has an interest rate swap derivative instrument, used to minimize interest rate volatility on trust preferred securities, which is designated and qualify as a cash flow hedge.

In December 2008, the Company, relating to the Company's subordinated debentures, entered into an interest rate swap agreement with Compass Bank to pay a fixed rate of 5.48% while receiving a variable rate of the three-month LIBOR plus 265 basis points. This swap has a \$6 million notional value and the termination date is January 2019.

At December 31, 2018 and 2017, the estimated fair value of the cash flow hedge derivative instrument recorded in other liabilities was \$5 and \$79, respectively. Changes in the fair value of the derivative instrument are reported in accumulated other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the subordinated debentures affects earnings. Included in interest expense is \$40 and \$100 which resulted from the reclassification of accumulated other comprehensive income into earnings during 2018 and 2017, respectively. Hedge ineffectiveness recognized into income during 2018 and 2017 was insignificant.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 12. EMPLOYEE BENEFIT PLANS

Employee Retirement Plans

The Company has a salary reduction/profit-sharing plan under the provisions of Section 401(k) of the Internal Revenue Code. All employees are eligible to participate immediately upon hire. The Plan provides for contributions by the Company in such amounts as determined by the Board of Directors not to exceed 6 percent of the participant's annual compensation. In addition, the Plan provides for the Company to match employee contributions to the Plan equal to 50 percent of the first 6 percent of the participant's annual compensation. The Company contributed \$434 and \$410 to the Plan for the years ended December 31, 2018 and 2017, respectively.

The Company and the Bank provide deferred compensation agreements for the benefit of executive and other key officers. The Bank records the estimated amount of future payments to be made over the active service periods of the officers. Deferred compensation expense under these agreements was \$929 and \$889 for the years ended December 31, 2018 and 2017, respectively. Accrued deferred compensation of approximately \$8,087 and \$7,249 is included in other liabilities at December 31, 2018 and 2017 respectively.

Employee Stock Ownership Plan

Effective January 1, 2004, the Company established an Employee Stock Ownership Plan (the "Plan"), within the guidelines as defined by the Internal Revenue Code, for the purpose of enabling participants to acquire an ownership interest in the Company. All employees are eligible to participate in the Plan after completing one year of service with a minimum of 1,000 hours. Initial funding for the purchase of the Company's common stock was provided by Security Acquisition Loans from the Company to the Plan. The Security Acquisition Loans call for principal and interest to be repaid in ten equal annual installments of principal and interest. Shares obtained in connection with Security Acquisition Loans are held in a suspense account and are classified as unallocated shares.

Contributions are made to the Plan as determined by the Company's Board of Directors, generally commensurate with the debt service requirements set forth in the loan agreements. Unallocated shares held in suspense by the Plan are released based on the ratio of principal payments made in the current year to total required future principal payments. Shares of the Company's common stock owned by the Plan are allocated as of each year end to each participant based on the ratio of individual compensation to total covered compensation, as defined by the agreement. Contributions can be in the form of cash, shares of Company stock, or other property as determined by the Board.

S Corporation distributions related to unallocated shares are used to fund the debt service requirements defined in the Security Acquisition Loans. Any remaining distributions are allocated proportionately to the participant, as defined by the plan agreement. At the Board's discretion, S Corporation distributions related to allocated shares may be used to make payments on Securities Acquisition Loans or shall be allocated to the participants, in accordance with the plan agreement.

The Company recognizes compensation expense for contributions and for allocated shares that were previously unallocated. The fair value, as determined by an independent appraisal, is used to calculate the compensation expense. Compensation expense recognized in association with the Plan for 2018 and 2017 totaled \$255 and \$476, respectively.

When a participant retires or otherwise terminates from the Plan, the Company is required to offer the participant the fair value for any allocated, vested shares of company stock. If the participant declines this option, the Company retains the right of first refusal of such shares. At December 31, 2018 and 2017, there were no repurchase obligations outstanding.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 12. EMPLOYEE BENEFIT PLANS (Continued)

Employee Stock Ownership Plan (Continued)

The fair value of allocated shares at December 31, 2018 and 2017, was \$63.00 and \$59.00, respectively, per share as determined by the most recent stock valuations performed as of December 31, 2018 and 2017. The number of shares allocated, unallocated and committed to be released totaled 80,447, zero and zero, respectively, as of December 31, 2018 and 2017.

Stock Option Plan

The Company has a stock option plan, which is administered by the Board of Directors that provides for both incentive stock options and nonqualified stock options. The Company also grants non-qualified stock options to the Board of Directors. The maximum number of common shares that can be sold or optioned under the plan is 670,000 shares. Under the plan, the exercise price of each option shall not be less than 100 percent of the fair market value of the common stock on the date of grant, those options awards generally vest based on five years of continuous service and have a ten-year contractual term.

A summary of stock option activity for the years ended December 31, 2018 and 2017 is as follows:

	2018		2017	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of period	13,000	\$48.19	31,000	\$48.28
Options granted	-	-	-	-
Options exercised	(12,000)	48.35	(18,000)	48.35
Options forfeited	-	-	-	-
Outstanding at end of period	<u>1,000</u>	46.20	<u>13,000</u>	48.19

Information pertaining to options outstanding at December 31, 2018, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$46.20	<u>1,000</u>	0.3	\$46.20	<u>1,000</u>	\$46.20
Outstanding at end of year	<u>1,000</u>	0.3	46.20	<u>1,000</u>	46.20

There were 12,000 options exercised during 2018 and 18,000 options exercised during 2017. There were no options vested during the years ended December 31, 2018 and 2017. There was no stock-based compensation expense and no income tax benefits recognized during 2018 or 2017.

Cash received from option exercises under all share-based payment arrangements for the year ended December 31, 2018 and 2017, was \$580 and \$870, respectively. The intrinsic value related to stock options exercised in 2018 is \$176 and in 2017 is \$192. There was no actual tax benefit realized for the tax deductions from option exercises of the share-based payment arrangements for the years ended December 31, 2018 and 2017.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 13. INCOME TAXES

The Company files consolidated income tax returns with its subsidiary, Bank of Tennessee. Under the terms of a tax-sharing agreement, the subsidiary's allocated portion of the consolidated tax liability is computed as if it were reporting its income and expenses as a separate entity.

The income tax expense in the consolidated statements of income for the years ended December 31, 2018 and 2017, includes the following:

	<u>2018</u>	<u>2017</u>
Current tax expense (benefit):		
State	\$ 652	\$(109)
Deferred income taxes related to:		
Provision for loan losses	11	(16)
Depreciation	406	(13)
Deferred compensation retirement plans	(55)	(50)
Cash method of accounting	(99)	49
Other	<u>241</u>	<u>309</u>
Income tax expense	<u>\$1,156</u>	<u>\$ 170</u>

Deferred tax assets recognized for deductible temporary differences totaled \$1,119 and \$1,002 at December 31, 2018 and 2017, respectively. Deferred tax liabilities for taxable temporary differences totaled \$741 and \$364 at December 31, 2018 and 2017, respectively.

The income tax returns of the Company for 2017, 2016, and 2015 are subject to examination by the IRS, generally for three years after they were filed.

NOTE 14. COMMITMENTS AND CONTINGENCIES

Loan Commitments

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized in the balance sheets. The majority of all commitments to extend credit and standby letters of credit are variable rate instruments.

The Company's exposure to credit loss is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments. A summary of the Company's commitments is as follows:

	<u>2018</u>	<u>2017</u>
Commitments to extend credit	\$173,785	\$143,905
Financial standby letters of credit	1,775	1,906
Other standby letters of credit	<u>713</u>	<u>119</u>
	<u>\$176,273</u>	<u>\$145,930</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 14. COMMITMENTS AND CONTINGENCIES (Continued)

Loan Commitments (Continued)

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Collateral held varies and is required in instances which the Company deems necessary.

At December 31, 2018 and 2017, the carrying amount of liabilities related to the Company's obligation to perform under standby letters of credit was insignificant. The Company was not required to perform on any standby letters of credit during 2018 or 2017.

Contingencies

During the normal course of business, the Company is subject to various lawsuits and claims. As of December 31, 2018, management believes that there are no current proceedings that would materially impact the consolidated financial statements of the Company.

NOTE 15. CONCENTRATIONS OF CREDIT RISK

The Company originates primarily commercial, residential, and consumer loans to customers in eastern and middle Tennessee and western North Carolina. The ability of the majority of the Company's customers to honor their contractual loan obligations is dependent on the economy in these areas.

At December 31, 2018, seventy-five percent of the Company's loan portfolio is concentrated in loans secured by real estate, of which a substantial portion is secured by real estate in the Company's primary market area. Additionally, forty-one percent of the Company's loan portfolio is concentrated in residential real estate loans. Accordingly, the ultimate collectability of the loan portfolio and recovery of the carrying amount of foreclosed real estate is susceptible to changes in real estate conditions in the Company's primary market area. The other concentrations of credit by type of loan are set forth in Note 4.

The Company, as a matter of policy, does not generally extend credit to any single borrower or group of related borrowers in excess of 25% of statutory capital, or approximately \$29,930.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(amounts in thousands, except share data)

NOTE 16. FAIR VALUE OF ASSETS AND LIABILITIES

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the *Fair Value Measurements and Disclosures* topic (FASB ASC 820), the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. 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. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 - Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on 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 asset or liability.

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

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 16. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value Hierarchy (Continued)

Securities: Where quoted prices are available in an active market, management classifies the securities within Level 1 of the valuation hierarchy. Level 1 securities include exchange-traded equities. If quoted market prices are not available, management estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include GSE obligations and other securities. Mortgage-backed securities are included in Level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, management classifies those securities in Level 3.

Interest Rate Swaps: Substantially all interest rate swaps held or issued by the Company for risk management are traded in over-the-counter markets where quoted market prices are not readily available. For these derivatives, the Company measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty risk. The Company classifies interest rate swaps held or issued for risk management activities as Level 2 inputs.

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Securities available for sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 36,962	\$ -	\$ 36,962	\$ -
Obligations of states and political subdivisions	77,672	-	77,672	-
Mortgage-backed securities:				
Government National Mortgage Association guaranteed	13,131	-	13,131	-
GSE residential	51,570	-	51,570	-
Equity securities	<u>16,676</u>	<u>16,676</u>	<u>-</u>	<u>-</u>
Total securities available for sale	<u>\$196,011</u>	<u>\$16,676</u>	<u>\$179,335</u>	<u>\$ -</u>
Liabilities				
Interest rate swaps	<u>\$ 5</u>	<u>\$ -</u>	<u>\$ 5</u>	<u>\$ -</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 16. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value Hierarchy (Continued)

	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Securities available for sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 33,812	\$ -	\$ 33,812	\$ -
Obligations of states and political subdivisions	82,383	-	82,383	-
Mortgage-backed securities:				
Government National Mortgage Association guaranteed	9,162	-	9,162	-
GSE residential	37,994	-	37,994	-
Equity securities	<u>42,176</u>	<u>42,176</u>	<u>-</u>	<u>-</u>
Total securities available for sale	<u>\$205,527</u>	<u>\$42,176</u>	<u>\$163,351</u>	<u>\$ -</u>
Liabilities				
Interest rate swaps	<u>\$ 79</u>	<u>\$ -</u>	<u>\$ 79</u>	<u>\$ -</u>

Assets Measured at Fair Value on a Nonrecurring Basis: Under certain circumstances management makes adjustments to fair value for assets and liabilities although they are not measured at fair value on an ongoing basis. The following tables present the financial instruments carried on the consolidated balance sheets by caption and by level in the fair value hierarchy, for which a nonrecurring change in fair value has been recorded:

	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$1,038	\$ -	\$ -	\$1,038

	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$5,369	\$ -	\$ -	\$5,369

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 16. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value Hierarchy (Continued)

Impaired Loans: Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent.

The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Foreclosed Real Estate: Foreclosed real estate, consisting of properties obtained through foreclosure or in satisfaction of loans, is initially recorded at fair value less estimated costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell.

Fair values are generally based on third party appraisals of the property and if unadjusted, are classified within Level 2 of the fair value hierarchy. The appraisals are sometimes discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value and are classified within Level 3 of the fair value hierarchy. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, a loss is recognized in noninterest expense.

Quantitative Disclosures for Level 3 Fair Value Measurements: The Company had no Level 3 assets measured at fair value on a recurring basis at December 31, 2018 and 2017.

For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2018 and 2017, the significant unobservable inputs used in the fair value measurements are presented below.

	<u>Carrying Amount</u>	<u>Valuation Technique</u>	<u>Significant Unobservable Input</u>	<u>Weighted Average of Input</u>
Nonrecurring - 2018:				
Impaired loans	\$1,038	Appraisal	Appraisal discounts	57%
Nonrecurring - 2017:				
Impaired loans	\$5,369	Appraisal	Appraisal discounts	38%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 17. REGULATORY MATTERS

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines, and additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under Basel III rules, the Company must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in at the rate of 0.625% per year from 0.0% in 2015 to 2.50% on January 1, 2019. The capital conservation buffer for 2018 is 1.875% and for 2017 is 1.25%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2018, the Company and Bank meet all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At December 31, 2018, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are not conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts and ratios as of December 31, 2018, and the Company's and the Bank's actual capital amounts and ratios as of 2017, are presented in the following table. The Company was exempt from consolidated capital requirements as those requirements did not apply to certain small savings bank holding companies with assets under \$3 billion in 2018.

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2018:						
Total capital (to risk-weighted assets)						
Bank	\$127,197	11.6%	\$88,057	8.0%	\$110,071	10.0%
Tier I capital (to risk-weighted assets)						
Bank	119,720	10.9%	66,042	6.0%	88,057	8.0%
Common equity Tier I capital (to risk-weighted assets)						
Bank	119,720	10.9%	49,532	4.5%	71,546	6.5%
Tier I capital (to average assets)						
Bank	119,720	8.9%	53,667	4.0%	67,084	5.0%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data)

NOTE 17. REGULATORY MATTERS (Continued)

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2017:						
Total capital (to risk-weighted assets)						
Company	\$114,640	10.9%	\$84,225	8.0%	N/A	N/A
Bank	110,573	11.9%	74,080	8.0%	\$92,600	10.0%
Tier I capital (to risk-weighted assets)						
Company	106,987	10.2%	63,169	6.0%	N/A	N/A
Bank	102,920	11.1%	55,560	6.0%	74,080	8.0%
Common equity Tier I capital (to risk-weighted assets)						
Company	91,987	8.7%	47,377	4.5%	N/A	N/A
Bank	102,920	11.1%	41,670	4.5%	60,190	6.5%
Tier I capital (to average assets)						
Company	106,987	8.8%	48,391	4.0%	N/A	N/A
Bank	102,920	8.8%	46,655	4.0%	58,319	5.0%

NOTE 18. CONCENTRATIONS IN DEPOSITS

The Company had a concentration in its deposits to two customers totaling approximately \$89 and \$76 at December 31, 2018 and 2017, respectively.



**INDEPENDENT AUDITOR'S REPORT
ON CONSOLIDATING INFORMATION**

**To the Stockholders and Board of Directors
BancTenn Corp.
Kingsport, Tennessee**

We have audited the consolidated financial statements of BancTenn Corp. and its Subsidiary as of and for the year ended December 31, 2018, and have issued our report thereon dated March 21, 2019, which contains an unmodified opinion on those consolidated financial statements. See page 1.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual companies, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

A handwritten signature in black ink that reads "Mauldin & Jenkins, LLC". The signature is written in a cursive, flowing style.

Chattanooga, Tennessee
March 21, 2019

BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATING BALANCE SHEET
December 31, 2018
(amounts in thousands, except share data)

	Bank of Tennessee	BancTenn Corp.	Eliminations	Consolidated
ASSETS				
Cash and due from banks:				
Noninterest-bearing	\$ 28,591	\$ 120	\$ 120	\$ 28,591
Interest-bearing	292	294	-	586
Total cash and due from banks	28,883	414	120	29,177
Securities available for sale	179,335	16,676	-	196,011
Securities held to maturity	6,936	-	-	6,936
Other equity investments, at cost	-	49	-	49
Restricted equity investments, at cost	7,900	-	-	7,900
Loans, net of allowance for loan losses	1,066,029	-	-	1,066,029
Premises and equipment	37,589	488	-	38,077
Accrued interest receivable	3,393	-	-	3,393
Cash surrender value of life insurance	25,434	-	-	25,434
Annuity contracts	16,275	-	-	16,275
Other assets	3,840	1,003	167	4,676
Investment in subsidiary	-	117,687	117,687	-
Total assets	<u>\$ 1,375,614</u>	<u>\$ 136,317</u>	<u>\$ 117,974</u>	<u>\$ 1,393,957</u>
LIABILITIES AND STOCKHOLDERS' EQUITY				
Deposits:				
Noninterest-bearing	\$ 302,971	\$ -	\$ 120	\$ 302,851
Interest-bearing	770,498	-	-	770,498
Total deposits	1,073,469	-	120	1,073,349
Securities sold under agreements to repurchase	31,882	-	-	31,882
Federal Home Loan Bank advances	143,086	-	-	143,086
Subordinated debentures	-	15,465	-	15,465
Accrued interest payable	196	81	-	277
Accrued expenses and other liabilities	9,294	4,292	167	13,419
Total liabilities	<u>1,257,927</u>	<u>19,838</u>	<u>287</u>	<u>1,277,478</u>
Stockholders' equity:				
Common stock, no par value; 250,000 shares authorized; 209,148 shares outstanding	2,269	-	2,269	-
Common stock, \$8 par value; 6,000,000 shares authorized; 2,535,604 shares outstanding	-	20,285	-	20,285
Additional paid-in capital	26,142	8,777	26,142	8,777
Retained earnings	91,308	78,833	91,308	78,833
Accumulated other comprehensive income (loss)	(2,032)	8,584	(2,032)	8,584
Total stockholders' equity	<u>117,687</u>	<u>116,479</u>	<u>117,687</u>	<u>116,479</u>
Total liabilities and stockholders' equity	<u>\$ 1,375,614</u>	<u>\$ 136,317</u>	<u>\$ 117,974</u>	<u>\$ 1,393,957</u>

BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATING STATEMENT OF INCOME
Year Ended December 31, 2018
(Amounts in thousands)

	<u>Bank of Tennessee</u>	<u>BancTenn Corp.</u>	<u>Eliminations</u>	<u>Consolidated</u>
INTEREST INCOME				
Loans, including fees	\$ 50,029	\$ -	\$ -	\$ 50,029
Securities	4,717	526	-	5,243
Federal funds sold and other	<u>7</u>	<u>77</u>	<u>-</u>	<u>84</u>
	54,753	603	-	55,356
INTEREST EXPENSE				
Interest on deposits	5,398	-	-	5,398
Interest on other borrowed funds	<u>2,119</u>	<u>781</u>	<u>-</u>	<u>2,900</u>
	7,517	781	-	8,298
Net interest income (expense)	47,236	(178)	-	47,058
Provision for loan losses	<u>395</u>	<u>-</u>	<u>-</u>	<u>395</u>
Net interest income (expense) after provision for loan losses	<u>46,841</u>	<u>(178)</u>	<u>-</u>	<u>46,663</u>
NONINTEREST INCOME				
Customer service fees	2,406	-	-	2,406
Loan origination and settlement fees	2,982	-	-	2,982
Gains on sale of securities	-	15,883	-	15,883
Equity in subsidiary's earnings	-	16,875	16,875	-
Other	<u>4,245</u>	<u>281</u>	<u>404</u>	<u>4,122</u>
	<u>9,633</u>	<u>33,039</u>	<u>17,279</u>	<u>25,393</u>
NONINTEREST EXPENSES				
Salaries and employee benefits	22,679	1,816	-	24,495
Occupancy expenses	3,594	-	-	3,594
Data processing	3,423	-	-	3,423
Other operating expenses	<u>9,481</u>	<u>4,095</u>	<u>404</u>	<u>13,172</u>
	<u>39,177</u>	<u>5,911</u>	<u>404</u>	<u>44,684</u>
Income before income taxes	17,297	26,950	16,875	27,372
Income tax expense	<u>422</u>	<u>734</u>	<u>-</u>	<u>1,156</u>
Net income	<u>\$ 16,875</u>	<u>\$ 26,216</u>	<u>\$ 16,875</u>	<u>\$ 26,216</u>

Management's Assessment Of Internal Control over Financial Reporting

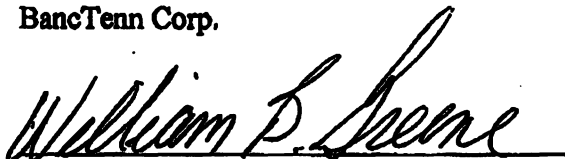
BancTenn Corp's (the "Company") internal control over financial reporting is a process designed and effected by those charged with governance, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes (FRY-9SP). The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management is responsible for establishing and maintaining effective internal control over financial reporting including controls over the preparation of regulatory financial statements. Management assessed the effectiveness of the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the FRY-9SP, as of December 31, 2018, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework. Based on that assessment, management concluded that, as of December 31, 2018, the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the FRY-9SP, is effective based on the criteria established in Internal Control - Integrated Framework. The following subsidiary institution of the Company that is subject to Part 363 is included in this assessment of the effectiveness of internal control over financial reporting: Bank of Tennessee.

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the FRY-9SP, as of December 31, 2018, has been audited by Mauldin & Jenkins, LLC, an independent public accounting firm, as stated in their report dated March 21, 2019.

BancTenn Corp.

A handwritten signature in cursive script, reading "William B. Greene, Jr.", written over a horizontal line.

William B. Greene, Jr.

Chief Executive Officer

March 21, 2019

A handwritten signature in cursive script, reading "Darla M. Scott", written over a horizontal line.

Darla M. Scott

Chief Financial Officer

March 21, 2019