

SI Financial Group, Inc.  
Form 10-Q  
May 07, 2015

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q  
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the Quarterly Period Ended March 31, 2015

OR  
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-54241

SI FINANCIAL GROUP, INC.  
(Exact name of registrant as specified in its charter)

Maryland 80-0643149  
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)  
organization)

803 Main Street, Willimantic, Connecticut 06226  
(Address of principal executive offices) (Zip Code)

(860) 423-4581  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large Accelerated Filer o Accelerated Filer x  
Non-Accelerated Filer o Smaller Reporting Company o

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

As of May 1, 2015, there were 12,495,375 shares of the registrant's common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## SI FINANCIAL GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts / Unaudited)

	March 31, 2015	December 31, 2014
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$17,413	\$18,965
Interest-bearing	35,264	20,286
Total cash and cash equivalents	52,677	39,251
Available for sale securities, at fair value	176,496	173,040
Loans held for sale	562	747
Loans receivable (net of allowance for loan losses of \$8,083 at March 31, 2015 and \$7,797 at December 31, 2014)	1,043,160	1,044,864
Federal Home Loan Bank stock, at cost	10,333	10,333
Bank-owned life insurance	21,468	21,306
Premises and equipment, net	21,915	21,711
Goodwill and other intangibles	18,547	18,697
Accrued interest receivable	3,835	3,853
Deferred tax asset, net	7,521	8,048
Other real estate owned, net	1,324	1,271
Other assets	7,589	7,412
Total assets	\$1,365,427	\$1,350,533
<b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>		
Liabilities:		
Deposits:		
Noninterest-bearing	\$137,639	\$146,062
Interest-bearing	892,008	864,651
Total deposits	1,029,647	1,010,713
Mortgagors' and investors' escrow accounts	2,039	3,600
Federal Home Loan Bank advances	144,006	148,277
Junior subordinated debt owed to unconsolidated trust	8,248	8,248
Accrued expenses and other liabilities	22,459	21,956
Total liabilities	1,206,399	1,192,794
Shareholders' Equity:		
Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)	—	—
Common stock (\$.01 par value; 35,000,000 shares authorized; 12,776,315 shares and 12,776,426 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively)	128	128
Additional paid-in-capital	125,375	125,459
Unallocated common shares held by ESOP	(4,008	) (4,128
Unearned restricted shares	(1,214	) (1,312
Retained earnings	37,925	37,497

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Accumulated other comprehensive income	822	95
Total shareholders' equity	159,028	157,739
Total liabilities and shareholders' equity	\$1,365,427	\$1,350,533

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(In Thousands, Except Per Share Amounts / Unaudited)

	Three Months Ended March 31,	
	2015	2014
Interest and dividend income:		
Loans, including fees	\$ 10,614	\$ 11,087
Securities:		
Taxable interest	733	880
Tax-exempt interest	59	42
Dividends	45	49
Other	19	13
Total interest and dividend income	11,470	12,071
Interest expense:		
Deposits	1,368	1,319
Federal Home Loan Bank advances	596	682
Subordinated debt and other borrowings	83	83
Total interest expense	2,047	2,084
Net interest income	9,423	9,987
Provision for loan losses	335	430
Net interest income after provision for loan losses	9,088	9,557
Noninterest income:		
Service fees	1,648	1,718
Wealth management fees	298	323
Increase in cash surrender value of bank-owned life insurance	162	142
Net gain on sales of securities	—	35
Mortgage banking	147	160
Net gain (loss) on fair value of derivatives	(5	) 17
Other	87	377
Total noninterest income	2,337	2,772
Noninterest expenses:		
Salaries and employee benefits	4,944	5,200
Occupancy and equipment	2,053	2,107
Computer and electronic banking services	1,297	1,352
Outside professional services	466	449
Marketing and advertising	246	226
Supplies	148	168
FDIC deposit insurance and regulatory assessments	245	349
Core deposit intangible amortization	150	164
Other real estate operations	82	169
Other	430	770
Total noninterest expenses	10,061	10,954

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Income before income tax provision	1,364	1,375
Income tax provision	443	469
Net income	\$921	\$906
Earnings per share:		
Basic	\$0.07	\$0.07
Diluted	\$0.07	\$0.07

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (In Thousands / Unaudited)

	Three Months Ended March 31,	
	2015	2014
Net income	\$921	\$906
Other comprehensive income, net of tax:		
Available for sale securities:		
Net unrealized holding gains	702	340
Reclassification adjustment for gains recognized in net income <sup>(1)</sup>	—	(23 )
Net unrealized holding gains on available for sale securities	702	317
Net unrealized gain on interest-rate swap derivative	25	23
Other comprehensive income	727	340
Comprehensive income	\$1,648	\$1,246

<sup>(1)</sup> Amounts are included in net gain on sales of securities in noninterest income on the consolidated statements of income. Income tax expense associated with the reclassification adjustment for the three months ended March 31, 2015 and 2014 was \$0 and \$12,000, respectively.

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2015  
(In Thousands, Except Share Data / Unaudited)

	Common Stock		Additional	Unallocated		Retained	Accumulated	Total
	Shares	Dollars	Paid-in Capital	Common Shares Held by ESOP	Unearned Restricted Shares	Earnings	Other Comprehensive Income	Shareholders' Equity
Balance at December 31, 2014	12,776,426	\$ 128	\$ 125,459	\$(4,128 )	\$(1,312 )	\$ 37,497	\$ 95	\$ 157,739
Comprehensive income	—	—	—	—	—	921	727	1,648
Cash dividends declared (\$0.04 per share)	—	—	—	—	—	(493 )	—	(493 )
Equity incentive plans compensation	—	—	85	—	98	—	—	183
Allocation of 12,159 ESOP shares	—	—	19	120	—	—	—	139
Tax benefit from share-based compensation	—	—	5	—	—	—	—	5
Stock options exercised	193,438	2	2,154	—	—	—	—	2,156
Common shares repurchased	(193,549 )	(2 )	(2,347 )	—	—	—	—	(2,349 )
Balance at March 31, 2015	12,776,315	\$ 128	\$ 125,375	\$(4,008 )	\$(1,214 )	\$ 37,925	\$ 822	\$ 159,028

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In Thousands / Unaudited)

	Three Months Ended March 31,	
	2015	2014
Cash flows from operating activities:		
Net income	\$921	\$906
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	335	430
Employee stock ownership plan expense	139	142
Equity incentive plan expense	183	189
Excess tax benefit from share-based compensation	(5	) (3
Amortization of investment premiums and discounts, net	308	282
Amortization of loan premiums and discounts, net	375	322
Depreciation and amortization of premises and equipment	699	629
Amortization of core deposit intangible	150	164
Amortization of deferred debt issue costs	9	46
Net gain on sales of securities	—	(35
Net loss (gain) on fair value of derivatives	5	(17
Deferred income tax provision (benefit)	151	(6
Loans originated for sale	(3,390	) (4,307
Proceeds from sale of loans held for sale	3,599	5,410
Net gain on sales of loans held for sale	(87	) (94
Net loss (gain) on sales or write-downs of other real estate owned	(1	) 35
Increase in cash surrender value of bank-owned life insurance	(162	) (142
Change in operating assets and liabilities:		
Accrued interest receivable	18	101
Other assets	(114	) 1,899
Accrued expenses and other liabilities	541	3,762
Net cash provided by operating activities	3,674	9,713
Cash flows from investing activities:		
Purchases of available for sale securities	(10,306	) (12,297
Proceeds from sales of available for sale securities	—	81
Proceeds from maturities of and principal repayments on available for sale securities	7,607	12,684
Loan principal collections, net of originations	12,222	5,064
Purchases of loans	(11,280	) (443
Proceeds from sales of other real estate owned	—	357
Purchases of premises and equipment	(903	) (173
Net cash provided by (used in) investing activities	(2,660	) 5,273

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Concluded)  
(In Thousands / Unaudited)

	Three Months Ended March 31,	
	2015	2014
Cash flows from financing activities:		
Net increase in deposits	18,934	19,534
Net decrease in mortgagors' and investors' escrow accounts	(1,561	) (1,597
Proceeds from Federal Home Loan Bank advances	6,000	10,000
Repayments of Federal Home Loan Bank advances	(10,280	) (16,396
Excess tax benefit from share-based compensation	5	3
Cash dividends on common stock	(493	) (368
Stock options exercised	20	297
Common shares repurchased	(213	) (53
Net cash provided by financing activities	12,412	11,420
Net change in cash and cash equivalents	13,426	26,406
Cash and cash equivalents at beginning of period	39,251	27,321
Cash and cash equivalents at end of period	\$52,677	\$53,727
Supplemental cash flow information:		
Interest paid	\$2,031	\$2,075
Income taxes received, net	—	(1,816
Transfer of loans to other real estate owned	52	—
Stock options exercised by net-share settlement	2,136	19

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015 AND 2014 AND DECEMBER 31, 2014

NOTE 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

SI Financial Group, Inc. (the “Company”) is the holding company for Savings Institute Bank and Trust Company (the “Bank”). Established in 1842, the Bank is a community-oriented financial institution headquartered in Willimantic, Connecticut. The Bank provides a variety of financial services to individuals, businesses and municipalities through its 26 offices in eastern Connecticut and Rhode Island. Its primary products include savings, checking and certificate of deposit accounts, residential and commercial mortgage loans, commercial business loans and consumer loans. In addition, wealth management services, which include trust, financial planning, life insurance and investment services, are offered to individuals and businesses through the Bank’s offices. The Company does not conduct any material business other than owning all of the stock of the Bank and making payments on the subordinated debentures held by the Company.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank, and the Bank’s wholly-owned subsidiaries, SI Mortgage Company and SI Realty Company, Inc. All significant intercompany accounts and transactions have been eliminated.

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, with the instructions to Form 10-Q and Rule 10.01 of Regulation S-X of the Securities and Exchange Commission and general practices within the banking industry. Accordingly, certain information and footnote disclosures required by GAAP for complete financial statements have been omitted. Information in the accompanying interim consolidated financial statements and notes to the financial statements of the Company as of March 31, 2015 and for the three months ended March 31, 2015 and 2014 is unaudited. These unaudited interim consolidated financial statements and related notes should be read in conjunction with the audited financial statements of the Company and the accompanying notes for the year ended December 31, 2014 contained in the Company’s Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the periods covered herein. The results of operations for the three months ended March 31, 2015 are not necessarily indicative of the operating results for the year ending December 31, 2015 or for any other period.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities, as of the date of the balance sheets and reported amounts of revenues and expenses for the periods presented. 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 impairment (“OTTI”) of securities, deferred income taxes and the impairment of long-lived assets.

Reclassifications

Amounts in the Company's prior year consolidated financial statements are reclassified to conform to the current year presentation. Such reclassifications have no effect on net income.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Loans Receivable

Loans receivable are stated at current unpaid principal balances, net of the allowance for loan losses and deferred loan origination fees and costs. Management has the ability and intent to hold its loans receivable for the foreseeable future or until maturity or pay-off.

A loan is impaired when, based on current information and events, it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan by loan basis for residential and commercial mortgage loans and commercial business loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not typically identify individual consumer loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring ("TDR") agreement.

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and concessions have been made to the original contractual terms, such as reductions of interest rates or deferral of interest or principal payments due to the borrower's financial condition, the modification is considered a TDR.

Management considers all nonaccrual loans, with the exception of certain consumer loans, to be impaired. Also, all TDRs are initially classified as impaired. In most cases, loan payments less than 90 days past due are considered minor collection delays and the related loans are generally not considered impaired.

Allowance for Loan Losses

The allowance for loan losses, a material estimate which could change significantly in the near-term, is established through a provision for loan losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Loan losses are charged against the allowance for loan losses when management believes the uncollectibility of the principal loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses when received. In the determination of the allowance for loan losses, management may obtain independent appraisals for significant properties, if necessary.

Management's judgment in determining the adequacy of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is evaluated on a monthly basis by management and is based on the evaluation of the known and inherent risk characteristics and size and composition of the loan portfolio, the assessment of current economic and real estate market conditions, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, historical loan loss experience, the level and trends of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.

The allowance for loan losses consists of the following key elements:

Specific allowance for identified impaired loans. For loans identified as impaired, an allowance is established when the present value of expected cash flows (or observable market price of the loan or fair value of the collateral if the loan is collateral dependent) of the impaired loan is lower than the carrying value of that loan.

General valuation allowance. The general component represents a valuation allowance on the remainder of the loan portfolio, after excluding impaired loans. For this portion of the allowance, loans are segregated by category and assigned an allowance percentage based on historical loan loss experience



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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015 AND 2014 AND DECEMBER 31, 2014

adjusted for qualitative factors stratified by the following loan segments: residential one- to four-family, multi-family and commercial real estate, construction, commercial business and consumer. Management uses a rolling average of historical losses based on the time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices; changes in international, national, regional and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments; changes in the nature and volume of the loan portfolio and in the terms of the loans; changes in the experience, ability, and depth of lending management and other relevant staff; changes in the volume and severity of past due loans, the volume of nonaccrual loans and the volume and severity of adversely classified or graded loans; changes in the quality of the loan review system; changes in the underlying collateral for collateral-dependent loans; the existence and effect of any concentrations of credit and changes in the level of such concentrations; the effect of other external factors such as competition and legal and regulatory capital requirements on the level of estimated credit losses in the portfolio.

The qualitative factors are determined based on the following various risk characteristics for each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

**Residential – One- to Four-Family –** The Bank primarily originates conventional loans with loan-to-value ratios less than 95% and generally originates loans with loan-to-value ratios in excess of 80% only when secured by first liens on owner-occupied one- to four-family residences. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance or additional collateral. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality of this segment.

**Multi-family and Commercial –** Loans in this segment are originated for the purpose of acquiring, developing, improving or refinancing multi-family and commercial real estate where the property is the primary collateral securing the loan, and the income generated from the property is the primary repayment source. The underlying cash flows generated by the properties can be adversely impacted by the economy as evidenced by increased vacancy rates. Payments on loans secured by income-producing properties often depend on the successful operation and management of the properties. Management continually monitors the cash flows of these loans.

**Construction –** This segment includes loans to individuals, and to a lesser extent builders, to finance the construction of residential dwellings. The Bank also originates construction loans for commercial development projects. Upon the completion of construction, the loan generally converts to a permanent mortgage loan. Credit risk is affected by cost overruns, correct estimates of the sale price of the property, time to sell at an adequate price and market conditions.

**Commercial Business –** Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. The Bank also provides loans to investors in the time share industry, which are secured by consumer receivables, and provides loans for capital improvements to condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners.

Consumer – Loans in this segment primarily include home equity lines of credit (representing both first and second liens), indirect automobile loans and, to a lesser extent, loans secured by marketable securities,

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015 AND 2014 AND DECEMBER 31, 2014

passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

In computing the allowance for loan losses, we do not assign a general valuation allowance to the Small Business Administration ("SBA") and United States Department of Agriculture ("USDA") loans that we purchase as such loans are fully guaranteed. These loans are included in commercial business loans. See Note 4 for details.

The majority of the Company's loans are collateralized by real estate located in eastern Connecticut and Rhode Island. To a lesser extent, certain commercial real estate loans are secured by collateral located outside of our primary market area. Accordingly, the collateral value of a substantial portion of the Company's loan portfolio and real estate acquired through foreclosure is susceptible to changes in local market conditions.

Although management believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and the Company's results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making the determinations. Furthermore, while management believes it has established the allowance for loan losses in conformity with GAAP, our regulators, in reviewing the loan portfolio, may request us to increase our allowance for loan losses based on judgments different from ours. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, the existing allowance for loan losses may not be adequate or increases may be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.

#### Interest and Fees on Loans

Interest on loans is accrued and included in net interest income based on contractual rates applied to principal amounts outstanding. Accrual of interest is discontinued when loan payments are 90 days or more past due, based on contractual terms, or when, in the judgment of management, collectibility of the loan or loan interest becomes uncertain. Subsequent recognition of income occurs only to the extent payment is received subject to management's assessment of the collectibility of the remaining interest and principal. A nonaccrual loan is restored to accrual status when it is no longer delinquent and collectibility of interest and principal is no longer in doubt and the borrower has made regular payments in accordance with the terms of the loan over a period of at least six months. Interest collected on nonaccrual loans is recognized only to the extent cash payments are received, and may be recorded as a reduction to principal if the collectibility of the principal balance of the loan is unlikely.

Loan origination fees, direct loan origination costs and loan purchase premiums are deferred, and the net amount is recognized as an adjustment of the related loan's yield utilizing the interest method over the contractual life of the loan. In addition, discounts related to fair value adjustments for loans receivable acquired in a business combination or asset purchase are accreted into earnings over the contractual term as an adjustment of the loan's yield. The Company periodically evaluates the cash flows expected to be collected for loans acquired with deteriorated credit quality. Changes in the expected cash flows compared to the expected cash flows as of the date of acquisition may impact the accretable yield or result in a charge to the provision for loan losses to the extent of a shortfall.

#### Common Share Repurchases

The Company is chartered in the state of Maryland. Maryland law does not provide for treasury shares, rather shares repurchased by the Company constitute authorized but unissued shares. GAAP states that accounting for treasury stock shall conform to state law. Therefore, the cost of shares repurchased by the Company has been allocated to common stock, additional paid-in capital and retained earnings balances.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015 AND 2014 AND DECEMBER 31, 2014

Recent Accounting Pronouncements

Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. In January 2014, the Financial Accounting Standards Board ("FASB") issued amended guidance that clarifies when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amended guidance clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. In addition, the amended guidance requires interim and annual disclosures of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amended guidance may be applied prospectively or through a modified retrospective approach and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014, with early adoption permitted. The adoption of the amended guidance did not have a material impact on the Company's consolidated financial statements.

Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure - In August 2014, the FASB issued amended guidance that addresses the diversity in practice regarding the classification and measurement of foreclosed loans which were part of a government-sponsored loan guarantee program (e.g. HUD, FHA, VA). The amended guidance outlines certain criteria that, if met, the loan (residential or commercial) should be derecognized and a separate other receivable should be recorded upon foreclosure at the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This amended guidance will be effective for annual reporting periods beginning after December 15, 2014, including interim periods within that reporting period. Early adoption is permitted, provided the entity has adopted Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amended guidance should be adopted either prospectively or on a modified retrospective basis. The adoption of the amended guidance did not have a material impact on the Company's consolidated financial statements.

Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs - In April 2015, the FASB issued guidance, as part of its initiative to reduce complexity in accounting standards, simplifying the presentation of debt issuance costs. The amended guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The amended guidance should be applied on a retrospective basis and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. The adoption of the amended guidance is not expected to have a material impact on the Company's consolidated financial statements.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the net income available to common shareholders by the weighted average number of common shares outstanding during the period. Unvested restricted shares are considered outstanding in the computation of basic earnings per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings per share is computed in a manner similar to basic earnings per share except that the weighted average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's

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common stock equivalents relate solely to stock options. Repurchased common shares and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings per share calculations.

Anti-dilutive shares are common stock equivalents with weighted average exercise prices in excess of the weighted average market value for the periods presented, and are not considered in diluted earnings per share calculations. The Company had anti-dilutive common shares outstanding of 372,936 and 394,497 for the three months ended March 31, 2015 and 2014, respectively.

The computation of earnings per share is as follows:

	Three Months Ended March 31,	
	2015	2014
	(Dollars in Thousands, Except Per Share Amounts)	
Net income	\$921	\$906
Weighted average common shares outstanding:		
Basic	12,315,733	12,295,225
Effect of dilutive stock options	38,641	48,252
Diluted	12,354,374	12,343,477
Earnings per share:		
Basic	\$0.07	\$0.07
Diluted	\$0.07	\$0.07

## NOTE 3. SECURITIES

Available for sale securities:

The amortized cost, gross unrealized gains and losses and fair values of available for sale securities at March 31, 2015 and December 31, 2014 are as follows:

	March 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Debt securities:				
U.S. Government and agency obligations	\$71,996	\$607	\$(185)	) \$72,418
Government-sponsored enterprises	27,372	318	(14)	) 27,676
Mortgage-backed securities: <sup>(1)</sup>				
Agency - residential	63,770	1,031	(707)	) 64,094
Non-agency - residential	248	3	(4)	) 247
Corporate debt securities	1,000	—	—	) 1,000
Collateralized debt obligation	1,156	—	(18)	) 1,138

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Obligations of state and political subdivisions	3,032	180	—	3,212
Tax-exempt securities	6,556	155	—	6,711
Total available for sale securities	\$175,130	\$2,294	\$(928)	) \$176,496

<sup>(1)</sup> Agency securities refer to debt obligations issued or guaranteed by government corporations or government-sponsored enterprises (“GSEs”). Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

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	December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Debt securities:				
U.S. Government and agency obligations	\$66,232	\$385	\$(226)	) \$66,391
Government-sponsored enterprises	27,435	120	(67)	) 27,488
Mortgage-backed securities: <sup>(1)</sup>				
Agency - residential	67,008	907	(1,065)	) 66,850
Non-agency - residential	254	3	(4)	) 253
Corporate debt securities	1,000	—	—	1,000
Collateralized debt obligation	1,188	—	(7)	) 1,181
Obligations of state and political subdivisions	3,039	167	(6)	) 3,200
Tax-exempt securities	6,583	97	(3)	) 6,677
Total available for sale securities	\$172,739	\$1,679	\$(1,378)	) \$173,040

<sup>(1)</sup> Agency securities refer to debt obligations issued or guaranteed by government corporations or GSEs. Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

The amortized cost and fair value of debt securities by contractual maturities at March 31, 2015 are presented below. Maturities are based on the final contractual payment dates and do not reflect the impact of potential prepayments or early redemptions. Because mortgage-backed securities ("MBS") are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

	Amortized Cost	Fair Value
	(In Thousands)	
Within 1 year	\$2,540	\$2,548
After 1 but within 5 years	48,537	49,053
After 5 but within 10 years	15,146	15,350
After 10 years	44,889	45,204
	111,112	112,155
Mortgage-backed securities	64,018	64,341
Total debt securities	\$175,130	\$176,496

The following is a summary of realized gains and losses on the sales of securities for the three months ended March 31, 2015 and 2014:

Three Months Ended March 31,	
2015	2014
(In Thousands)	

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Gross gains on sales	\$—	\$35
Gross losses on sales	—	—
Net gain on sales of securities	\$—	\$35

Proceeds from the sale of available for sale securities were \$81,000 for the three months ended March 31, 2014. There were no sales of available for sale securities for the three months ended March 31, 2015.

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The following tables present information pertaining to securities with gross unrealized losses at March 31, 2015 and December 31, 2014, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

March 31, 2015	Less Than 12 Months		12 Months Or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
U.S. Government and agency obligations	\$9,147	\$32	\$13,556	\$153	\$22,703	\$185
Government sponsored enterprises	997	1	3,026	13	4,023	14
Mortgage-backed securities:						
Agency - residential	1,662	1	31,596	706	33,258	707
Non-agency - residential	—	—	123	4	123	4
Collateralized debt obligation	1,138	18	—	—	1,138	18
Total	\$12,944	\$52	\$48,301	\$876	\$61,245	\$928
December 31, 2014	Less Than 12 Months		12 Months Or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
U.S. Government and agency obligations	\$9,273	\$15	\$16,655	\$211	\$25,928	\$226
Government-sponsored enterprises	6,974	4	3,973	63	10,947	67
Mortgage-backed securities:						
Agency - residential	4,251	122	32,127	943	36,378	1,065
Non-agency - residential	—	—	127	4	127	4
Collateralized debt obligation	1,181	7	—	—	1,181	7
Obligations of state and political subdivisions	—	—	668	6	668	6
Tax-exempt securities	1,141	3	—	—	1,141	3
Total	\$22,820	\$151	\$53,550	\$1,227	\$76,370	\$1,378

At March 31, 2015, twenty-seven debt securities with gross unrealized losses had aggregate depreciation of approximately 1.49% of the Company's amortized cost basis. The majority of the unrealized losses are related to the Company's agency MBS. There were no investments deemed other-than-temporarily impaired for the three months ended March 31, 2015 or 2014. The following summarizes, by security type, the basis for management's determination during the preparation of the financial statements that the applicable investments within the Company's securities portfolio were not other-than-temporarily impaired at March 31, 2015.

U.S. Government and Agency Obligations. The unrealized losses on the Company's U.S. Government and agency obligations related primarily to a widening of the rate spread to comparable treasury securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not

intend to sell these securities and it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at March 31, 2015.

Government Sponsored Enterprises. The unrealized losses on the Company's government sponsored enterprises were also caused by interest rate movement. The contractual cash flows of these investments are guaranteed by a government sponsored agency. Accordingly, it is expected that the securities would not be settled at a price less

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than the amortized cost of our investment. As a result of (1) the decline in market value being attributable to changes in interest rates and not credit quality, (2) the Company's position that it does not intend to sell these securities and (3) it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at March 31, 2015.

**Mortgage-backed Securities - Agency - Residential.** The unrealized losses on the Company's agency-residential mortgage-backed securities were caused by increases in the rate spread to comparable treasury securities. The Company does not expect these securities to settle at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before the recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired at March 31, 2015.

**Mortgage-backed Securities - Non-agency - Residential.** The unrealized losses on the Company's non-agency - residential mortgage-backed securities relate to one investment which has been evaluated by management and no potential credit losses were identified. Because the Company does not intend to sell this security and it is not more likely than not that the Company will be required to sell this security before the recovery of its amortized cost basis, which may be maturity, the Company did not consider this investment to be other-than-temporarily impaired at March 31, 2015.

**Collateralized Debt Obligations.** The unrealized losses on the Company's collateralized debt obligations relate to one investment in a pooled trust preferred security ("PTPS"). The PTPS market has stabilized at depressed market values as a result of market saturation. Transactions for PTPS have been limited and have occurred primarily as a result of distressed or forced liquidation sales. The securities were widely held by hedge funds and European banks and used to offset interest rate exposure tied to LIBOR. As positions unwound, an excess supply of these securities have saturated the market.

Management evaluated current credit ratings, credit support and stress testing for future defaults related to the Company's PTPS. Management also reviewed analytics provided by the trustee and independent OTTI reviews and associated cash flow analyses performed by an independent third party. The unrealized losses on the Company's PTPS investment were caused by a lack of liquidity, credit downgrades and decreasing credit support. The increased number of bank and insurance company failures has decreased the level of credit support for this investment. A number of lower tranches have foregone payments or have received payment in kind through increased principal allocations. However, the number of deferring securities has been decreasing and a number of reinstatements have occurred recently. The Company's PTPS was upgraded to investment grade and based on its senior credit profile, management does not believe this investment will suffer from any further credit-related losses. Because the Company does not intend to sell the investment and it is not more likely than not the Company will be required to sell the investment before recovery of its amortized cost basis, which may be at maturity, the Company did not record impairment losses as of March 31, 2015.



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## NOTE 4. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

## Loan Portfolio

The composition of the Company's loan portfolio at March 31, 2015 and December 31, 2014 is as follows:

	March 31, 2015 (In Thousands)	December 31, 2014
Real estate loans:		
Residential - 1 to 4 family	\$430,676	\$430,575
Multi-family and commercial	295,029	298,320
Construction	15,395	13,579
Total real estate loans	741,100	742,474
Commercial business loans:		
SBA and USDA guaranteed	115,892	118,466
Time share	46,452	45,669
Condominium association	22,709	21,386
Other	67,590	66,446
Total commercial business loans	252,643	251,967
Consumer loans:		
Home equity	51,059	51,093
Indirect automobile	3,192	3,692
Other	1,691	1,864
Total consumer loans	55,942	56,649
Total loans	1,049,685	1,051,090
Deferred loan origination costs, net of fees	1,558	1,571
Allowance for loan losses	(8,083	) (7,797
Loans receivable, net	\$1,043,160	\$1,044,864

The Company purchased commercial business loans totaling \$11.3 million during the three months months ended March 31, 2015. For the twelve months ended December 31, 2014, the Company purchased commercial business loans totaling \$59.9 million.

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## Allowance for Loan Losses

Changes in the allowance for loan losses for the three months ended March 31, 2015 and 2014 are as follows:

Three Months Ended March 31, 2015	Residential - 1 to 4 Family	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total	
	(In Thousands)						
Balance at beginning of period	\$955	\$3,607	\$254	\$2,382	\$599	\$7,797	
Provision for loan losses	24	59	38	209	5	335	
Loans charged-off	(35	) (20	) —	(25	) (1	) (81	)
Recoveries of loans previously charged-off	32	—	—	—	—	32	
Balance at end of period	\$976	\$3,646	\$292	\$2,566	\$603	\$8,083	
Three Months Ended March 31, 2014	Residential - 1 to 4 Family	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total	
	(In Thousands)						
Balance at beginning of period	\$975	\$3,395	\$169	\$1,875	\$502	\$6,916	
Provision for loan losses	33	207	15	130	45	430	
Loans charged-off	(74	) —	—	(13	) (29	) (116	)
Recoveries of loans previously charged-off	14	—	—	3	5	22	
Balance at end of period	\$948	\$3,602	\$184	\$1,995	\$523	\$7,252	



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Further information pertaining to the allowance for loan losses at March 31, 2015 and December 31, 2014 is as follows:

March 31, 2015	Residential - 1 to 4 Family (In Thousands)	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
Allowance for loans individually evaluated and deemed to be impaired	\$279	\$108	\$—	\$137	\$—	\$524
Allowance for loans individually or collectively evaluated and not deemed to be impaired	697	3,538	292	2,429	603	7,559
Allowance for loans acquired with deteriorated credit quality	—	—	—	—	—	—
Total loan loss allowance	\$976	\$3,646	\$292	\$2,566	\$603	\$8,083
Loans individually evaluated and deemed to be impaired	\$5,092	\$2,053	\$—	\$742	\$24	\$7,911
Loans individually or collectively evaluated and not deemed to be impaired	425,214	289,294	15,395	251,552	55,918	1,037,373
Amount of loans acquired with deteriorated credit quality	370	3,682	—	349	—	4,401
Total loans	\$430,676	\$295,029	\$15,395	\$252,643	\$55,942	\$1,049,685
December 31, 2014	Residential - 1 to 4 Family (In Thousands)	Multi-family and Commercial	Construction	Commercial Business	Consumer	Total
Allowance for loans individually evaluated and deemed to be impaired	\$287	\$52	\$—	\$20	\$—	\$359
Allowance for loans individually or collectively evaluated and not deemed to be impaired	668	3,555	254	2,362	599	7,438
Allowance for loans acquired with deteriorated credit quality	—	—	—	—	—	—
Total loan loss allowance	\$955	\$3,607	\$254	\$2,382	\$599	\$7,797

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Loans individually evaluated and deemed to be impaired	\$5,318	\$1,872	\$—	\$470	\$—	\$7,660
Loans individually or collectively evaluated and not deemed to be impaired	424,885	292,215	13,579	251,140	56,649	1,038,468
Amount of loans acquired with deteriorated credit quality	372	4,233	—	357	—	4,962
Total loans	\$430,575	\$298,320	\$13,579	\$251,967	\$56,649	\$1,051,090

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## Past Due Loans

The following represents an aging of loans at March 31, 2015 and December 31, 2014:

March 31, 2015	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total 30 Days or More Past Due	Current	Total Loans	
	(In Thousands)						
Real Estate:							
Residential - 1 to 4 family	\$4,375	\$477	\$1,210	\$6,062	\$424,614	\$430,676	
Multi-family and commercial	4,338	241	721	5,300	289,729	295,029	
Construction	—	—	—	—	15,395	15,395	
Commercial Business:							
SBA and USDA guaranteed	1,726	899	—	2,625	113,267	115,892	
Time share	—	—	—	—	46,452	46,452	
Condominium association	—	—	—	—	22,709	22,709	
Other	300	171	246	717	66,873	67,590	
Consumer:							
Home equity	134	43	23	200	50,859	51,059	
Indirect automobile	29	—	—	29	3,163	3,192	
Other	2	—	—	2	1,689	1,691	
Total	\$10,904	\$1,831	\$2,200	\$14,935	\$1,034,750	\$1,049,685	
December 31, 2014	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total 30 Days or More Past Due	Current	Total Loans	Past Due 90 Days or More and Accruing
	(In Thousands)						
Real Estate:							
Residential - 1 to 4 family	\$4,194	\$258	\$1,602	\$6,054	\$424,521	\$430,575	\$—
Multi-family and commercial	768	794	775	2,337	295,983	298,320	—
Construction	—	—	—	—	13,579	13,579	—
Commercial Business:							
SBA and USDA guaranteed	1,536	—	459	1,995	116,471	118,466	459
Time share	—	—	—	—	45,669	45,669	—
Condominium association	—	—	—	—	21,386	21,386	—
Other	50	—	446	496	65,950	66,446	—
Consumer:							
Home equity	20	158	23	201	50,892	51,093	—
Indirect automobile	103	10	—	113	3,579	3,692	—
Other	—	—	—	—	1,864	1,864	—
Total	\$6,671	\$1,220	\$3,305	\$11,196	\$1,039,894	\$1,051,090	\$459

The Company did not have any loans that were past due 90 days or more and still accruing interest at March 31, 2015.

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## Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at March 31, 2015 and December 31, 2014:

March 31, 2015	Impaired Loans <sup>(1)</sup>			
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Nonaccrual Loans
	(In Thousands)			
Impaired loans without valuation allowance:				
Real Estate:				
Residential - 1 to 4 family	\$3,200	\$3,200	\$—	\$2,713
Multi-family and commercial	4,393	4,590	—	899
Commercial business - Other	643	643	—	245
Consumer - Home equity	24	24	—	24
Total impaired loans without valuation allowance	8,260	8,457	—	3,881
Impaired loans with valuation allowance:				
Real Estate:				
Residential - 1 to 4 family	2,262	2,290	279	241
Multi-family and commercial	1,342	1,452	108	190
Commercial business - Other	448	448	137	448
Total impaired loans with valuation allowance	4,052	4,190	524	879
Total impaired loans	\$12,312	\$12,647	\$524	\$4,760

<sup>(1)</sup> Includes loans acquired with deteriorated credit quality, performing TDRs, and from the acquisition of Newport Federal Savings Bank ("Newport").

December 31, 2014	Impaired Loans <sup>(1)</sup>			
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Nonaccrual Loans
	(In Thousands)			
Impaired loans without valuation allowance:				
Real Estate:				
Residential - 1 to 4 family	\$3,414	\$3,485	\$—	\$2,923
Multi-family and commercial	4,815	5,102	—	775
Commercial business - Other	645	645	—	264
Consumer - Home equity	—	—	—	23
Total impaired loans without valuation allowance	8,874	9,232	—	3,985
Impaired loans with valuation allowance:				
Real Estate:				
Residential - 1 to 4 family	2,276	2,304	287	244
Multi-family and commercial	1,290	1,290	52	132
Commercial business - Other	182	182	20	182

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Total impaired loans with valuation allowance	3,748	3,776	359	558
Total impaired loans	\$12,622	\$13,008	\$359	\$4,543

<sup>(1)</sup> Includes loans acquired with deteriorated credit quality, performing TDRs, and from the acquisition of Newport.

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The Company reviews and establishes, if necessary, an allowance for certain impaired loans for the amount by which the present value of expected cash flows (or observable market price of loan or fair value of the collateral if the loan is collateral dependent) are lower than the carrying value of the loan. At March 31, 2015 and December 31, 2014, the Company concluded that certain impaired loans required no valuation allowance as a result of management's measurement of impairment. No additional funds are committed to be advanced to those borrowers whose loans are deemed impaired.

Additional information related to impaired loans is as follows:

	Three Months Ended March 31, 2015			Three Months Ended March 31, 2014		
	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
	(In Thousands)					
Real Estate:						
Residential - 1 to 4 family	\$5,576	\$26	\$1	\$6,143	\$22	\$1
Multi-family and commercial	5,920	79	—	7,716	163	72
Commercial business - Other	959	6	—	1,102	17	10
Consumer - Home equity	24	—	—	59	—	—
Total	\$12,479	\$111	\$1	\$15,020	\$202	\$83

**Credit Quality Information**

The Company utilizes an eight-grade internal loan rating system for all loans in the portfolio, with the exception of its purchased SBA and USDA commercial business loans that are fully guaranteed by the U.S. government, as follows:

- o Pass (Ratings 1-4): Loans in these categories are considered low to average risk.
- o Special Mention (Rating 5): Loans in this category are starting to show signs of potential weakness and are being closely monitored by management.
- o Substandard (Rating 6): Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.
- o Doubtful (Rating 7): Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.
- o Loss (Rating 8): Loans in this category are considered uncollectible and of such little value that their continuance as assets is not warranted.

Management periodically reviews the ratings described above and the Company's internal audit function reviews components of the credit files, including the assigned risk ratings, of certain commercial loans as part of its loan review.





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The following tables present the Company's loans by risk rating at March 31, 2015 and December 31, 2014:

March 31, 2015	Not Rated	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(In Thousands)						
Real Estate:							
Residential - 1 to 4 family	\$—	\$423,202	\$1,715	\$5,759	\$—	\$—	\$430,676
Multi-family and commercial	—	268,068	15,479	11,482	—	—	295,029
Construction	—	15,395	—	—	—	—	15,395
Total real estate loans	—	706,665	17,194	17,241	—	—	741,100
Commercial Business:							
SBA and USDA guaranteed	115,892	—	—	—	—	—	115,892
Time share	—	46,452	—	—	—	—	46,452
Condominium association	—	22,709	—	—	—	—	22,709
Other	—	62,733	2,626	2,231	—	—	67,590
Total commercial business loans	115,892	131,894	2,626	2,231	—	—	252,643
Consumer:							
Home equity	—	50,915	73	71	—	—	51,059
Indirect automobile	—	3,192	—	—	—	—	3,192
Other	—	1,691	—	—	—	—	1,691
Total consumer loans	—	55,798	73	71	—	—	55,942
Total loans	\$115,892	\$894,357	\$19,893	\$19,543	\$—	\$—	\$1,049,685

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December 31, 2014	Not Rated	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(In Thousands)						
Real Estate:							
Residential - 1 to 4 family	\$—	\$423,134	\$1,430	\$6,011	\$—	\$—	\$430,575
Multi-family and commercial	—	269,680	17,058	11,582	—	—	298,320
Construction	—	13,579	—	—	—	—	13,579
Total real estate loans	—	706,393	18,488	17,593	—	—	742,474
Commercial Business:							
SBA and USDA guaranteed	118,466	—	—	—	—	—	118,466
Time share	—	45,669	—	—	—	—	45,669
Condominium association	—	21,386	—	—	—	—	21,386
Other	—	61,835	2,709	1,902	—	—	66,446
Total commercial business loans	118,466	128,890	2,709	1,902	—	—	251,967
Consumer:							
Home equity	—	50,965	57	71	—	—	51,093
Indirect automobile	—	3,692	—	—	—	—	3,692
Other	—	1,864	—	—	—	—	1,864
Total consumer loans	—	56,521	57	71	—	—	56,649
Total loans	\$118,466	\$891,804	\$21,254	\$19,566	\$—	\$—	\$1,051,090

**Troubled Debt Restructurings**

A modified loan is considered a TDR when two conditions are met: 1) the borrower is experiencing documented financial difficulty and 2) concessions are made by the Company that would not otherwise be considered for a borrower with similar risk characteristics. The most common types of modifications include below market interest rate reductions, deferrals of principal and maturity extensions. Modified terms are dependent upon the financial position and needs of the individual borrower. If the modification agreement is violated, the loan is handled by the Company's Collections Department for resolution, which may result in foreclosure. The Company's determination of whether a loan modification is a TDR considers the individual facts and circumstances surrounding each modification.

The Company's nonaccrual policy is followed for TDRs. If the loan was current prior to modification, nonaccrual status would not be required. If the loan was on nonaccrual prior to modification or if the payment amount significantly increases, the loan will remain on nonaccrual for a period of at least six months. Loans qualify for return to accrual status once the borrower has demonstrated the willingness and the ability to perform in accordance with the restructured terms of the loan agreement for a period of not less than six consecutive months.

All TDRs are initially reported as impaired. Impaired classification may be removed after a year following the restructure if the borrower demonstrates compliance with the modified terms and the restructuring agreement specifies an interest rate equal to that which would be provided to a borrower with similar risk characteristics at the time of restructuring.



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The following table provides information on loans modified as TDRs during the three months ended March 31, 2015 and 2014. During the modification process, there were no loan charge-offs or principal reductions for the loans included in the table below.

	Three Months Ended March 31, 2015			2014		
	Number of Loans (Dollars in Thousands)	Recorded Investment	Allowance for Loan Losses (End of Period)	Number of Loans	Recorded Investment	Allowance for Loan Losses (End of Period)
Multi-family and commercial	—	\$—	\$—	1	\$1,173	\$55
Commercial business - other	1	25	—	—	—	—
Total	1	\$25	\$—	1	\$1,173	\$55

The following table provides the recorded investment, by type of modification, during the three months ended March 31, 2015 and 2014 for modified loans identified as TDRs.

	Three Months Ended March 31,	
	2015	2014
	(In Thousands)	
Combination of rate and maturity <sup>(1)</sup>	\$25	\$1,173
Total	\$25	\$1,173

<sup>(1)</sup> Terms include combination of interest rate adjustments and extensions of maturity.

There were no TDRs in payment default (defined as 90 days or more past due) within twelve months of restructure for the three months ended March 31, 2015 and 2014.

As of March 31, 2015, the Company held \$1.8 million in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction.

**Loans Acquired with Deteriorated Credit Quality**

The following is a summary of loans acquired with evidence of credit deterioration from Newport as of March 31, 2015 and December 31, 2014.

	Contractual Required Payments Receivable (In Thousands)	Cash Expected To Be Collected	Non-Accrutable Discount	Accrutable Yield	Loans Receivable
Balance at December 31, 2014	\$5,799	\$4,962	\$837	\$—	\$4,962
Collections	(43 )	(41 )	(1 )	—	(41 )
Dispositions	(579 )	(520 )	(59 )	—	(520 )

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Balance at March 31, 2015	\$5,177	\$4,401	\$777	\$—	\$4,401
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## NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at March 31, 2015 and December 31, 2014 are summarized as follows:

	March 31, 2015 (In Thousands)	December 31, 2014
Land	\$4,746	\$4,746
Buildings	13,196	11,879
Leasehold improvements	10,514	10,802
Furniture and equipment	13,099	12,741
Construction in process	309	1,233
	41,864	41,401
Accumulated depreciation and amortization	(19,949	) (19,690
Premises and equipment, net	\$21,915	\$21,711

At December 31, 2014, construction in process related to design and site costs associated with a new branch location. At March 31, 2015, construction in process primarily related to the renovation of an existing branch. Outstanding commitments related to the renovation of the existing branch totaled \$563,000 at March 31, 2015.

## NOTE 6. OTHER COMPREHENSIVE INCOME

Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of shareholders' equity on the balance sheet, such items, along with net income are components of comprehensive income.

Components of other comprehensive income and related tax effects are as follows:

	Three Months Ended March 31, 2015		
	Before Tax Amount	Tax Effects	Net of Tax Amount
Securities:	(In Thousands)		
Unrealized holding gains on available for sale securities	\$1,065	\$(363	) \$702
Reclassification adjustment for gains recognized in net income	—	—	—
Unrealized holding gains on available for sale securities, net of taxes	1,065	(363	) 702
Derivative instrument:			
Change in fair value of effective cash flow hedging derivative	38	(13	) 25
Other comprehensive income	\$1,103	\$(376	) \$727

The components of accumulated other comprehensive income included in shareholders' equity are as follows:

	March 31, 2015		
	Before Tax Amount	Tax Effects	Net of Tax Amount
Net unrealized gains on available for sale securities	\$1,366	\$(465	) \$901

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Net unrealized loss on effective cash flow hedging derivative	(119	) 40	(79	)
Accumulated other comprehensive income	\$1,247	\$(425	) \$822	

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	December 31, 2014		Net of Tax Amount
	Before Tax Amount	Tax Effects	
	(In Thousands)		
Net unrealized gains on available for sale securities	\$301	\$(102)	) \$199
Net unrealized loss on effective cash flow hedging derivative	(157)	) 53	(104)
Accumulated other comprehensive income	\$144	\$(49)	) \$95

## NOTE 7. REGULATORY CAPITAL

The Company and the Bank are subject to regulatory capital adequacy requirements promulgated by federal bank regulatory agencies. Failure by the Company or the Bank to meet minimum capital requirements could result in certain mandatory and discretionary actions by regulators that could have a material adverse effect on our consolidated financial statements. The following tables present regulatory capital information for the Company and the Bank. Information presented for March 31, 2015 reflects the Basel III capital requirements that became effective January 1, 2015 for both the Company and the Bank and changed the inputs and methodology for computing capital. Prior to January 1, 2015, the Bank was subject to capital requirements under Basel I and there were no capital requirements for the Company. Under these capital requirements, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors.

Quantitative measures established by regulation require the Company and the Bank to maintain certain minimum capital amounts and ratios. Federal bank regulators require the Company and the Bank to maintain minimum ratios of core capital to adjusted average assets of 4.0%, common equity tier 1 capital to risk-weighted assets of 4.5%, tier 1 capital to risk-weighted assets of 6.0% and total risk-based capital to risk-weighted assets of 8.0%. At March 31, 2015, the Company and the Bank met all the capital adequacy requirements to which they were subject and were "well capitalized" under the regulatory requirements. To be "well capitalized," the Company and the Bank must maintain minimum leverage, common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios of at least 5.0%, 6.5%, 8.0% and 10.0%, respectively. Management believes that no conditions or events have occurred since March 31, 2015 that would materially adversely change the Company's and the Bank's capital classifications.



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March 31, 2015	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized			
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
(Dollars in Thousands)								
Tier 1 Capital to Average Assets:								
Company	\$ 143,761	10.67	% \$ 53,869	4.00	% \$ 67,336	5.00	%	
Bank	131,130	9.84	53,291	4.00	66,614	5.00		
Tier 1 Capital to Risk Weighted Assets:								
Company	143,761	17.14	50,315	6.00	67,086	8.00		
Bank	131,130	15.66	50,240	6.00	66,986	8.00		
Total Capital to Risk Weighted Assets:								
Company	152,440	18.18	67,086	8.00	83,858	10.00		
Bank	139,809	16.70	66,986	8.00	83,733	10.00		
Common Equity Tier 1 Capital:								
Company	143,761	17.14	37,736	4.50	54,508	6.50		
Bank	131,130	15.66	37,680	4.50	54,426	6.50		
December 31, 2014								
(Dollars in Thousands)								
Bank:								
Tier 1 Capital to Average Assets	\$ 123,862	9.37	% \$ 52,876	4.00	% \$ 66,095	5.00	%	
Tier 1 Capital to Risk Weighted Assets	123,862	14.86	33,341	4.00	50,012	6.00		
Total Capital to Risk Weighted Assets	132,306	15.87	66,695	8.00	83,369	10.00		
Tangible Equity Ratio	123,862	9.37	19,828	1.50	N/A	N/A		

Beginning January 1, 2016, Basel III implements a requirement for all banking organizations to maintain a capital conservation buffer above the minimum risk-based capital requirements in order to avoid certain limitations on capital distributions, stock repurchases and discretionary bonus payments to executive officers. The capital conservation buffer will be exclusively composed of common equity tier 1 capital, and it applies to each of the three risk-based capital ratios, but not the leverage ratio. On January 1, 2016, the Company and the Bank will be expected to comply with the capital conservation buffer requirement, which will increase the three risk-based capital ratios by 0.625% each year through 2019, at which point, the minimum common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios will be 7.0%, 8.5% and 10.5%, respectively.

NOTE 8. FAIR VALUE OF ASSETS AND LIABILITIES

Fair Value Hierarchy

The Company groups its assets and liabilities 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. Transfers between levels are recognized at the end of a reporting period, if applicable.

Level 1 Valuation is based on quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market.

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Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

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

Level 3: 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 unobservable inputs to pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

**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. 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 following methods and assumptions were used by the Company in estimating fair value disclosures of its financial instruments:

• **Cash and cash equivalents.** The carrying amounts of cash and cash equivalents approximate the fair values based on the short-term nature of the assets.

• **Securities available for sale.** Included in the available for sale category are debt securities. The securities measured at fair value in Level 1 are based on quoted market prices in an active exchange market. Securities measured at fair value in Level 2 are based on pricing models that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. The Company utilizes a nationally-recognized, third-party pricing service to estimate fair value measurements for the majority of its portfolio. The pricing service evaluates each asset class based on relevant market information considering observable data, but these prices do not represent binding quotes. The fair value prices on all investments are reviewed for reasonableness by management. Securities measured at fair value in Level 3 include one collateralized debt obligation that is backed by trust preferred securities issued by banks and insurance companies. Management determined that an orderly and active market for these securities and similar securities did not exist based on a significant reduction in trading volume and widening spreads relative to historical levels. The Company estimates future cash flows discounted using a rate management believes is representative of current market conditions. Factors in determining the discount rate include the current level of deferrals and/or defaults, changes in credit rating and the financial condition of the debtors within the underlying securities, broker quotes for securities with similar structure and credit

risk, interest rate movements and pricing for new issuances.

• Federal Home Loan Bank stock. The carrying value of Federal Home Loan Bank (“FHLB”) stock approximates fair value based on the redemption provisions of the FHLB.

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Loans held for sale. The fair value of loans held for sale is estimated using quoted market prices.

Loans receivable. For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans are estimated by discounting the future cash flows using the rates at the end of the period in which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Accrued interest receivable. The carrying amount of accrued interest approximates fair value.

Deposits. The fair value of demand deposits, negotiable orders of withdrawal, regular savings, certain money market deposits and mortgagors' and investors' escrow accounts is the amount payable on demand at the reporting date. The fair value of certificates of deposit and other time deposits is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities to a schedule of aggregated expected maturities on such deposits.

Federal Home Loan Bank advances. The fair value of the advances is estimated using a discounted cash flow calculation that applies current FHLB interest rates for advances of similar maturity to a schedule of maturities of such advances.

Junior subordinated debt owed to unconsolidated trust. Rates currently available for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

Interest rate swap agreements. The fair values of the Company's interest rate swaps are obtained from a third-party pricing service and are determined using a discounted cash flow analysis on the expected cash flows of the derivative. The pricing analysis is based on observable inputs for the contractual term of the derivative, including the period to maturity and interest rate curves.

Forward loan sale commitments and derivative loan commitments. Forward loan sale commitments and derivative loan commitments are based on the fair values of the underlying mortgage loans, including the servicing rights for derivative loan commitments, and the probability of such commitments being exercised. Significant management judgment and estimation is required in determining these fair value measurements.

Off-balance sheet instruments. Fair values for off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present assets and liabilities measured at fair value on a recurring basis as of March 31, 2015 and December 31, 2014. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the three months ended March 31, 2015.



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	March 31, 2015			Total
	Level 1 (In Thousands)	Level 2	Level 3	
Assets:				
U.S. Government and agency obligations	\$25,242	\$47,176	\$—	\$72,418
Government-sponsored enterprises	—	27,676	—	27,676
Mortgage-backed securities	—	64,341	—	64,341
Corporate debt securities	—	1,000	—	1,000
Collateralized debt obligation	—	—	1,138	1,138
Obligations of state and political subdivisions	—	3,212	—	3,212
Tax-exempt securities	—	6,711	—	6,711
Forward loan sale commitments and derivative loan commitments	—	—	107	107
Total assets	\$25,242	\$150,116	\$1,245	\$176,603
Liabilities:				
Interest rate swap agreements	\$—	\$238	\$—	\$238
Total liabilities	\$—	\$238	\$—	\$238
	December 31, 2014			Total
	Level 1 (In Thousands)	Level 2	Level 3	
Assets:				
U.S. Government and agency obligations	\$21,001	\$45,390	\$—	\$66,391
Government-sponsored enterprises	—	27,488	—	27,488
Mortgage-backed securities	—	67,103	—	67,103
Corporate debt securities	—	1,000	—	1,000
Collateralized debt obligation	—	—	1,181	1,181
Obligations of state and political subdivisions	—	3,200	—	3,200
Tax-exempt securities	—	6,677	—	6,677
Forward loan sale commitments and derivative loan commitments	—	—	59	59
Total assets	\$21,001	\$150,858	\$1,240	\$173,099
Liabilities:				
Interest rate swap agreements	\$—	\$271	\$—	\$271
Total liabilities	\$—	\$271	\$—	\$271

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The following table shows a reconciliation of the beginning and ending balances for Level 3 assets:

	Collateralized Debt Obligations (In Thousands)	Derivative Loan and Forward Loan Sale Commitments, Net
Balance at December 31, 2014	\$ 1,181	\$ 59
Total realized and unrealized gains included in net income	—	48
Total unrealized losses included in other comprehensive income	(43	) —
Balance at March 31, 2015	\$ 1,138	\$ 107

## Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Company may also be required, from time to time, to measure certain other financial assets on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following table summarizes the fair value hierarchy used to determine each adjustment and the carrying value of the related individual assets at March 31, 2015 and December 31, 2014. There were no liabilities measured at fair value on a nonrecurring basis at March 31, 2015 and December 31, 2014.

	At March 31, 2015			At December 31, 2014		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
	(In Thousands)					
Impaired loans	\$—	\$—	\$ 399	\$—	\$—	\$ 356
Other real estate owned	—	—	1,324	—	—	1,271
Total assets	\$—	\$—	\$ 1,723	\$—	\$—	\$ 1,627

The following table summarizes losses resulting from fair value adjustments for assets measured at fair value on a nonrecurring basis.

	Three Months Ended March 31,	
	2015	2014
	(In Thousands)	
Impaired loans	\$ 215	\$ 56
Other real estate owned	—	35
Total losses	\$ 215	\$ 91

The Company measures the impairment of loans that are collateral dependent based on the fair value of the collateral (Level 3). The fair value of collateral used by the Company represents the amount expected to be received from the sale of the property, net of selling costs, as determined by an independent, licensed or certified appraiser using observable market data. This data includes information such as selling price of similar properties, expected future cash flows or earnings of the subject property based on current market expectations, and relevant legal, physical and economic factors. The appraised values of collateral are adjusted as necessary by management based on observable inputs for specific properties. Losses applicable to write-downs of impaired loans are based on the appraised market



value of the underlying collateral, assuming foreclosure of these loans is imminent.

The amount of other real estate owned represents the carrying value of the collateral based on the appraised value of the underlying collateral less estimated selling costs. The loss on foreclosed assets represents adjustments in the valuation recorded during the time period indicated and not for losses incurred on sales.

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## Summary of Fair Values of Financial Instruments

The estimated fair values, and related carrying or notional amounts, of the Company's financial instruments are presented in the following table. Certain financial instruments and all nonfinancial instruments are exempt from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates presented herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction at March 31, 2015 and December 31, 2014. The estimated fair value amounts at March 31, 2015 and December 31, 2014 have been measured as of each respective date, and have not been re-evaluated or updated for purposes of the consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end. The information presented should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only required for a limited portion of the Company's assets. Due to the wide range of valuation techniques and the degree of subjectivity used in making the estimate, comparisons between the Company's disclosures and those of other banks may not be meaningful.

As of March 31, 2015 and December 31, 2014, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

	March 31, 2015				
	Carrying Amount	Level 1	Level 2	Level 3	Total
(In Thousands)					
<b>Financial Assets:</b>					
Cash and cash equivalents	\$52,677	\$52,677	\$—	\$—	\$52,677
Available for sale securities	176,496	25,242	150,116	1,138	176,496
Loans held for sale	562	—	—	609	609
Loans receivable, net	1,043,160	—	—	1,064,023	1,064,023
Federal Home Loan Bank stock	10,333	—	—	10,333	10,333
Accrued interest receivable	3,835	—	—	3,835	3,835
<b>Financial Liabilities:</b>					
Deposits	1,029,647	—	—	1,032,371	1,032,371
Mortgagors' and investors' escrow accounts	2,039	—	—	2,039	2,039
Federal Home Loan Bank advances	144,006	—	145,280	—	145,280
Junior subordinated debt owed to unconsolidated trust	8,248	—	5,445	—	5,445
<b>On-balance Sheet Derivative Financial Instruments:</b>					
<b>Assets:</b>					
Derivative loan commitments	63	—	—	63	63
Forward loan sale commitments	44	—	—	44	44
<b>Liabilities:</b>					
Interest rate swap agreements	238	—	238	—	238



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	December 31, 2014				
	Carrying Amount	Level 1	Level 2	Level 3	Total
Financial Assets:					
(In Thousands)					
Cash and cash equivalents	\$39,251	\$39,251	\$—	\$—	\$39,251
Available for sale securities	173,040	21,001	150,858	1,181	173,040
Loans held for sale	747	—	—	747	747
Loans receivable, net	1,044,864	—	—	1,063,121	1,063,121
Federal Home Loan Bank stock	10,333	—	—	10,333	10,333
Accrued interest receivable	3,853	—	—	3,853	3,853
Financial Liabilities:					
Deposits	1,010,713	—	—	1,013,614	1,013,614
Mortgagors' and investors' escrow accounts	3,600	—	—	3,600	3,600
Federal Home Loan Bank advances	148,277	—	149,380	—	149,380
Junior subordinated debt owed to unconsolidated trust	8,248	—	5,815	—	5,815
On-balance Sheet Derivative Financial Instruments:					
Assets:					
Derivative loan commitments	59	—	—	59	59
Liabilities:					
Interest rate swap agreements	271	—	271	—	271

## NOTE 9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

## Derivative Financial Instruments

The Company has stand-alone derivative financial instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instruments, is reflected on the Company's balance sheets as other assets and other liabilities. The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures and does not expect any counterparties to fail their obligations.

Derivative instruments are generally either negotiated over-the-counter contracts or standardized contracts executed on a recognized exchange. Negotiated over-the-counter derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

## Derivative Instruments Designated As Hedging Instruments

The Company uses long-term variable rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments. To meet this objective, management entered into an interest rate swap agreement, characterized as a cash flow hedge, whereby the Company receives variable interest rate payments determined by three-month LIBOR in exchange for making payments at a fixed interest rate.

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At March 31, 2015 and December 31, 2014, information pertaining to the outstanding interest rate swap agreement used to hedge variable rate debt is as follows:

	March 31, 2015	December 31, 2014	
	(Dollars in Thousands)		
Notional amount	\$8,000	\$8,000	
Weighted average fixed pay rate	2.44	% 2.44	%
Weighted average variable receive rate	0.27	% 0.24	%
Weighted average maturity in years	0.7	1.0	
Unrealized loss relating to interest rate swap	\$119	\$157	

At March 31, 2015 and December 31, 2014, the unrealized loss related to the above mentioned interest rate swap was recorded as a derivative liability. Changes in the fair value of an interest rate swap designated as a hedging instrument of the variability of cash flows associated with long-term debt are reported in other comprehensive income. These amounts are subsequently reclassified into interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings.

Risk management results for the periods ended March 31, 2015 and December 31, 2014 related to the balance sheet hedging of long-term debt indicate the hedge was 100% effective and there was no component of the derivative instrument's loss which was excluded from the assessment of hedge effectiveness.

The Company's derivative contract contains a provision establishing a collateral requirement (subject to minimum collateral posting thresholds) based on the Company's external credit rating. If the Company's junior subordinated debt rating was to fall below the level generally recognized as investment grade, the counterparty to such derivative contract could require additional collateral on the derivative transaction in a net liability position (after considering the effect of bilateral netting arrangements and posted collateral). The Company had posted collateral of \$400,000 in the normal course of business for a derivative instrument, with a credit-related contingent feature, that was in a net liability position at March 31, 2015 and December 31, 2014.

Derivative Instruments Not Designated As Hedging Instruments

Certain derivative instruments do not meet the requirements to be accounted for as hedging instruments. These undesignated derivative instruments are recognized on the consolidated balance sheets at fair value, with changes in fair value recorded in noninterest income.

Interest Rate Swap Agreement - In 2012, management entered into an interest rate swap agreement that does not meet the strict hedge accounting requirements of FASB's "Derivatives and Hedging" standard to manage the Company's exposure to interest rate movements and other identified risks. At March 31, 2015 and December 31, 2014, information pertaining to the Company's interest rate swap agreement not designated as a hedge is as follows:

	March 31, 2015	December 31, 2014	
	(Dollars in Thousands)		
Notional amount	\$15,000	\$15,000	
Weighted average fixed pay rate	1.26	% 1.26	%

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Weighted average variable receive rate	0.28	%	0.25	%
Weighted average maturity in years	1.8		2.0	
Unrealized loss relating to interest rate swap	\$119		\$114	

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015 AND 2014 AND DECEMBER 31, 2014

The Company reported a loss in fair value on the interest rate swap not designated as a hedge of \$5,000 for the three months ended March 31, 2015 and a gain in fair value of \$17,000 for the three months ended March 31, 2014 in noninterest income.

**Derivative Loan Commitments - Mortgage loan commitments** are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. The Company enters into commitments to fund residential mortgage loans at specified times in the future, with the intention that these loans will subsequently be sold in the secondary market. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the values of these loan commitments decrease. Conversely, if interest rates decrease, the value of these loan commitments increase. The notional amount of undesignated mortgage loan commitments was \$5.0 million at March 31, 2015. At March 31, 2015, the fair value of such commitments was a net asset of \$63,000.

**Forward Loan Sale Commitments - To protect against the price risk inherent in derivative loan commitments**, the Company utilizes “mandatory delivery” forward loan sale commitments to mitigate the risk of potential decreases in the value of loans that would result from the exercise of the derivative loan commitments.

With a “mandatory delivery” contract, the Company commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the Company fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor for the shortfall.

The Company expects that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The notional amount of undesignated forward loan sale commitments was \$3.7 million at March 31, 2015. At March 31, 2015, the fair value of such commitments was a net asset of \$44,000.

**Interest Rate Risk Management - Derivative Instruments**

The following table presents the fair values of derivative instruments as well as their classification on the consolidated balance sheets at March 31, 2015 and December 31, 2014.

Balance Sheet Location	March 31, 2015		December 31, 2014	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivative designated as hedging instrument:				

Derivative designated as hedging instrument:



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Interest rate swap	Other Liabilities	\$8,000	\$(119	)	\$8,000	\$(157	)
Derivatives not designated as hedging instruments:							
Interest rate swap	Other Liabilities	15,000	(119	)	15,000	(114	)
Derivative loan commitments	Other Assets	5,049	63		6,436	59	
Forward loan sale commitments	Other Assets	3,681	44		2,754	—	

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

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding changes in the Company's financial condition as of March 31, 2015 and December 31, 2014 and the results of operations for the three months ended March 31, 2015 and 2014. The information contained in this section should be read in conjunction with the consolidated financial statements and notes thereto appearing in Part I, Item 1 of this document as well as with management's discussion and analysis of financial condition and results of operations and consolidated financial statements included in the Company's 2014 Annual Report on Form 10-K.

This report may contain certain "forward-looking statements" within the meaning of the federal securities laws, which are made in good faith pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally preceded by terms such as "expects," "believes," "anticipates," "intends," "estimates," "projects" and similar expressions. These statements are not historical facts; rather, they are statements based on management's current expectations regarding our business strategies, intended results and future performance.

Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the United States government, including policies of the United States Treasury and the Federal Reserve Board, the quality and composition of the loan and investment portfolios, demand for loan products, deposit flows, competition, failing to achieve the expected cost savings or revenue synergies related to the Newport acquisition, demand for financial services in the Company's market area, changes in real estate market values in the Company's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect the Company's results are discussed in the Company's Annual Report on Form 10-K and in other reports filed with the Securities and Exchange Commission. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

#### Critical Accounting Policies

The Company considers accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. The Company considers the determination of allowance for loan losses, deferred income taxes and the impairment of long-lived assets to be its critical accounting policies. Additional information about the Company's accounting policies is included in the notes to the Company's consolidated financial statements contained in Part I, Item 1 of this document and in the Company's 2014 Annual Report on Form 10-K.

#### Impact of New Accounting Standards

Refer to Note 1 of the consolidated financial statements in this report for a discussion of recent accounting pronouncements.

Comparison of Financial Condition at March 31, 2015 and December 31, 2014

Assets:

Summary. Assets increased \$14.9 million, or 1.1%, to \$1.37 billion at March 31, 2015, principally due to increases of \$13.4 million in cash and cash equivalents and \$3.5 million in available for sale securities, partially offset by a reduction in net loans receivable of \$1.7 million.

Loans Receivable, Net. Contributing to the decrease of \$1.7 million in net loans receivable were reductions in multi-family and commercial real estate loans and SBA and USDA guaranteed loans, offset by increases in construction, condominium association and other commercial business loans. Changes in the loan portfolio consisted of the following:

Residential Real Estate. Residential mortgage loans comprised 41.0% of the total loan portfolio at March 31, 2015 and remained stable at \$430.7 million. Residential mortgage loan originations increased \$12.0 million, or 121.7%, during the first quarter of 2015 over the comparable period in 2014, as a result of lower interest rates and increased activity in the housing market.

Multi-family and Commercial Real Estate. Multi-family and commercial real estate loans represented 28.1% of total loans at March 31, 2015 and decreased \$3.3 million, or 1.1%, during the first quarter of 2015. Loan originations for multi-family and commercial real estate loans were \$11.8 million, representing an increase of \$2.4 million during the first quarter of 2015 compared to the same period in 2014.

Construction. Construction loans, which include both residential and commercial construction loans, increased \$1.8 million for the first quarter of 2015 as a result of commercial construction volume.

Commercial Business. Commercial business loans represented 24.1% of total loans at March 31, 2015. Commercial business loans increased \$676,000, or 0.3%, for the first quarter of 2015 primarily due to increases of \$1.3 million and \$1.1 million in condominium association loans and other commercial loans, respectively, offset by a decrease of \$2.6 million in SBA and USDA guaranteed loans. Commercial business loan originations decreased \$10.5 million, offset by an increase of \$10.8 million in purchased commercial business loans for the first quarter of 2015 compared to the same period in 2014. At March 31, 2015, unfunded lines of credit related to time share lending totaled \$29.9 million as a result of an experienced lender dedicated to identifying new opportunities for growth within the time share industry.

Consumer. Consumer loans represented 5.3% of the Company's total loan portfolio at March 31, 2015. Consumer loans decreased \$707,000 during the first quarter of 2015 primarily as a result of a decrease of \$500,000 in indirect automobile loans. Loan originations for consumer loans totaled \$4.6 million, representing a decrease of \$1.3 million, for the first quarter of 2015 over the comparable period in 2014.

The allowance for loan losses totaled \$8.1 million at March 31, 2015 compared to \$7.8 million at December 31, 2014. The ratio of the allowance for loan losses to total loans increased to 0.77% at March 31, 2015 from 0.74% at December 31, 2014. This was necessitated by an increase in commercial loans (other than non-guaranteed SBA and USDA loans) which carry a higher degree of risk than other loans held in portfolio and a reduction in guaranteed SBA and USDA loans which require no reserve.

The following table provides information with respect to nonperforming assets and TDRs as of the dates indicated.

	March 31 2015	December 31, 2014		
Nonaccrual loans:			(Dollars in Thousands)	
Real estate loans:				
Residential - 1 to 4 family	\$2,954	\$3,167		
Multi-family and commercial	1,089	907		
Total real estate loans	4,043	4,074		
Commercial business loans - Other	693	446		
Consumer loans:				
Home equity	24	23		
Total nonaccrual loans	4,760	4,543		
Accruing loans past due 90 days or more	—	459		
Total nonperforming loans <sup>(1)</sup>	4,760	5,002		
Other real estate owned, net <sup>(2)</sup>	1,324	1,271		
Total nonperforming assets	6,084	6,273		
Accruing troubled debt restructurings	3,393	3,387		
Total nonperforming assets and troubled debt restructurings	\$9,477	\$9,660		
Allowance for loan losses as a percent of nonperforming loans	169.81	% 155.88		%
Total nonperforming loans to total loans	0.45	% 0.48		%
Total nonperforming loans to total assets	0.35	% 0.37		%
Total nonperforming assets and troubled debt restructurings to total assets	0.69	% 0.72		%

<sup>(1)</sup> Includes nonperforming TDRs totaling \$410,000 and \$603,000 at March 31, 2015 and December 31, 2014, respectively.

<sup>(2)</sup> Other real estate owned balances are shown net of related write-downs.

The decrease in nonperforming assets was primarily due to a decrease in loans past due 90 days or more at March 31, 2015. Nonperforming residential mortgage loans decreased \$213,000 during the first quarter of 2015, while commercial business loans and multi-family and commercial real estate loans increased \$247,000 and \$182,000, respectively.

Other real estate owned increased \$53,000 to \$1.3 million from December 31, 2014 to March 31, 2015, due to the addition of one residential property and capital improvements on one commercial property. At March 31, 2015, other real estate owned included four commercial properties and one residential property.

Over the past few years, the Company has sought to restructure nonperforming loans rather than pursue foreclosure or liquidation, believing this approach achieves the best economic outcome for the Company in view of the current economic environment. Modified payment terms for TDRs generally involve deferred principal payments, interest rate concessions, a combination of deferred principal payments and interest rate concessions or a combination of maturity extensions and interest rate concessions. TDRs decreased to \$3.8 million at March 31, 2015, compared to \$4.0 million at December 31, 2014. Of the TDRs, \$3.4 million were performing in accordance with their restructured terms at both March 31, 2015 and December 31, 2014. The Company anticipates that these borrowers will repay all contractual principal and interest in accordance with the terms of their restructured loan agreements.

#### Liabilities:

Summary. Liabilities increased \$13.6 million, or 1.1%, to \$1.21 billion at March 31, 2015 compared to \$1.19 billion at December 31, 2014. Deposits increased \$18.9 million, or 1.9%, which included increases in NOW and money

market accounts and certificates of deposit of \$22.4 million and \$6.1 million, respectively, partially offset by decreases of \$8.4 million and \$1.3 million in noninterest-bearing demand deposits and savings accounts,

respectively. Deposit growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products. Borrowings (including subordinated debt) decreased \$4.3 million from \$156.5 million at December 31, 2014 to \$152.3 million at March 31, 2015, resulting from net repayments of FHLB advances.

#### Equity:

Summary. Shareholders' equity increased \$1.3 million from \$157.7 million at December 31, 2014 to \$159.0 million at March 31, 2015. The increase in shareholders' equity was attributable to net income of \$921,000, an increase in net unrealized gain on available for sale securities aggregating \$702,000 (net of taxes) and the exercise of stock options of \$2.2 million, partially offset by common shares repurchased totaling \$2.3 million and dividends declared of \$493,000.

Accumulated Other Comprehensive Income. Accumulated other comprehensive income is comprised of the unrealized gains and losses on available for sale securities and unrealized gains and losses on an interest rate swap designated as a hedge, net of taxes. The net unrealized gains on available for sale securities, net of taxes, totaled \$901,000 at March 31, 2015 compared to net unrealized gains of \$199,000 at December 31, 2014. The net unrealized loss on the interest rate swap, net of taxes, totaled \$79,000 at March 31, 2015 compared to \$104,000 at December 31, 2014.

#### Results of Operations for the Three Months Ended March 31, 2015 and 2014

General. The Company's results of operations depend primarily on net interest income, which is the difference between the interest income earned on the Company's interest-earning assets, such as loans and investments, and the interest expense on its interest-bearing liabilities, such as deposits and borrowings. The Company also generates noninterest income such as gains on the sale of securities, fees earned from mortgage banking activities, fees from deposits, trust and investment management services, insurance commissions and other fees. The Company's noninterest expenses primarily consist of employee compensation and benefits, occupancy, computer services, furniture and equipment, outside professional services, electronic banking fees, FDIC deposit insurance and regulatory assessments, marketing and other general and administrative expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, governmental policies and actions of regulatory agencies.

Summary. The Company reported net income of \$921,000 for the quarter ended March 31, 2015 compared to \$906,000 for the quarter ended March 31, 2014.

Interest and Dividend Income. Interest and dividend income decreased \$601,000, or 5.0%, to \$11.5 million for the quarter ended March 31, 2015, compared to the same period in 2014. The decrease in interest and dividend income was primarily due to both a lower average yield and lower average balance on loans versus the same period in 2014. Interest income on loans and securities reflect net amortization of \$171,000 for the quarter ended March 31, 2015 and net accretion of \$86,000 for the quarter ended March 31, 2014, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets for the three months ended March 31, 2015 decreased 15 basis points to 3.73% compared to 3.88% for the three months ended March 31, 2014. Average interest-earning assets decreased \$14.6 million to \$1.25 billion during the first quarter of 2015, due to a decrease in the average balance of loans of \$15.0 million and other interest-earning assets of \$390,000, offset by an increase of \$748,000 in the average balance of securities compared to the same quarter in 2014.

Interest Expense. For the quarter ended March 31, 2015, interest expense decreased \$37,000, or 1.8%, resulting from a lower average balance of FHLB advances. Lower interest expense on interest-bearing liabilities reflect net accretion of \$344,000 and \$487,000 for the quarters ended March 31, 2015 and 2014, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. Average interest-bearing deposits increased \$19.7 million to \$879.3 million and the average rate paid increased 1 basis point to 0.63%. Increases in the

average balance of certificates of deposit totaled \$24.4 million, while the average balance of NOW and money market deposits and savings accounts decreased \$3.8 million and \$1.1 million, respectively. The

average balance of FHLB advances decreased \$32.4 million while the average rate increased 11 basis points to 1.66%.

Average Balance Sheet. The following sets forth information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resulting yields and rates paid, interest rate spread, net interest margin and the ratio of average interest-earning assets to average interest-bearing liabilities for the periods indicated.

	At or For the Three Months Ended March 31, 2015		Average Yield/ Rate	2014		Average Yield/ Rate	
	Average Balance	Interest & Dividends		Average Balance	Interest & Dividends		
	(Dollars in Thousands)						
Interest-earning assets:							
Loans <sup>(1) (2)</sup>	\$ 1,038,229	\$ 10,614	4.15	% \$ 1,053,192	\$ 11,087	4.27	%
Securities <sup>(3)</sup>	186,630	857	1.86	185,882	985	2.15	
Other interest-earning assets	24,514	19	0.31	24,904	13	0.21	
Total interest-earning assets	1,249,373	11,490	3.73	1,263,978	12,085	3.88	
Noninterest-earning assets	106,269			92,965			
Total assets	\$ 1,355,642			\$ 1,356,943			
Interest-bearing liabilities:							
Deposits:							
Business checking	\$ 263	\$ —	—	% \$ 101	\$ —	—	%
NOW and money market	452,910	132	0.12	456,713	150	0.13	
Savings <sup>(4)</sup>	45,086	18	0.16	46,142	20	0.18	
Certificates of deposit <sup>(5)</sup>	381,051	1,218	1.30	356,621	1,149	1.31	
Total interest-bearing deposits	879,310	1,368	0.63	859,577	1,319	0.62	
Federal Home Loan Bank advances	145,558	596	1.66	177,930	682	1.55	
Subordinated debt	8,248	83	4.08	8,248	83	4.08	
Total interest-bearing liabilities	1,033,116	2,047	0.80	1,045,755	2,084	0.81	
Noninterest-bearing liabilities	164,331			156,138			
Total liabilities	1,197,447			1,201,893			
Total shareholders' equity	158,195			155,050			
Total liabilities and shareholders' equity	\$ 1,355,642			\$ 1,356,943			
Net interest-earning assets	\$ 216,257			\$ 218,223			
Tax equivalent net interest income <sup>(3)</sup>		9,443			10,001		
Tax equivalent interest rate spread <sup>(6)</sup>			2.93	%		3.07	%
			3.07	%		3.21	%



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Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup>

Average of interest-earning assets to average interest-bearing liabilities	120.93	%	120.87	%
Less tax equivalent adjustment <sup>(3)</sup>	(20	)	(14	)
Net interest income	\$9,423		\$9,987	

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- (1) Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale and excludes the allowance for loan losses.
- (2) Loan fees are included in interest income and are immaterial.
- (3) Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amounts reported in the statements of income.
- (4) Includes mortgagors' and investors' escrow accounts.
- (5) Includes brokered deposits.
- (6) Tax equivalent net interest rate spread represents the difference between the weighted average yield on interest-earning assets and the weighted average cost of interest-bearing liabilities.
- (7) Tax equivalent net interest margin represents tax equivalent net interest income divided by average interest-earning assets.

The following table sets forth the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have on the Company's interest income and interest expense for the periods presented. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the rate and volume columns. For purposes of this table, changes attributable to both changes in rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

	Three Months Ended March 31, 2015 and 2014			
	Increase (Decrease) Due To		Net	
	Rate	Volume		
	(In Thousands)			
Interest-earning assets:				
Interest and dividend income:				
Loans <sup>(1)(2)</sup>	\$ (317	) \$ (156	) \$ (473	)
Securities <sup>(3)</sup>	(132	) 4	(128	)
Other interest-earning assets	6	—	6	
Total interest-earning assets	(443	) (152	) (595	)
Interest-bearing liabilities:				
Interest expense:				
Deposits <sup>(4)</sup>	(28	) 77	49	
Federal Home Loan Bank advances	31	(117	) (86	)
Total interest-bearing liabilities	3	(40	) (37	)
Change in net interest income	\$ (446	) \$ (112	) \$ (558	)

- (1) Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale.
- (2) Loan fees are included in interest income and are immaterial.
- (3) Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amount reported in the statements of income.
- (4) Includes mortgagors' and investors' escrow accounts and brokered deposits.

Provision for Loan Losses. The provision for loan losses decreased \$95,000 for the first quarter of 2015 compared to the same period in 2014, as a result of reductions in nonperforming loans, a decrease in charge-offs and reserves for impaired loans. At March 31, 2015, nonperforming loans totaled \$4.8 million, compared to \$6.0 million at March 31, 2014, resulting from decreases in nonperforming residential mortgage loans and multi-family and commercial mortgage loans of \$928,000 and \$609,000, respectively. Net loan charge-offs were \$49,000 and \$94,000 for the quarters ended March 31, 2015 and 2014, respectively.

Noninterest Income. The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

	Three Months Ended March		Change	
	31, 2015	2014	Dollars	Percent
	(Dollars in Thousands)			
Service fees	\$1,648	\$1,718	\$(70 )	(4.1 )%
Wealth management fees	298	323	(25 )	(7.7 )
Increase in cash surrender value of bank-owned life insurance	162	142	20	14.1
Net gain on sales of securities	—	35	(35 )	(100.0 )
Mortgage banking	147	160	(13 )	(8.1 )
Net gain (loss) on fair value of derivatives	(5 )	17	(22 )	(129.4 )
Other	87	377	(290 )	(76.9 )
Total noninterest income	\$2,337	\$2,772	\$(435 )	(15.7 )%

Decreases in other noninterest income, service fees and wealth management fees contributed to lower noninterest income during 2015, partially offset by an increase in the cash surrender value of bank owned life insurance policies for 2015. Service fees and wealth management fees decreased \$70,000 and \$25,000, respectively, compared to the same period in the prior year, as a result of a reduction in overdraft privilege fees and lower trust and investment service fees. Other noninterest income declined \$290,000 for the first quarter of 2015 over the comparable period in 2014. For the first quarter in 2014, other noninterest income included the reimbursement of \$250,000 in legal fees and other foreclosure expenses incurred in a prior period on two commercial loans.

Noninterest Expenses. The following table shows the components of noninterest expenses and the dollar and percentage changes for the periods presented.

	Three Months Ended March		Change	
	31, 2015	2014	Dollars	Percent
	(Dollars in Thousands)			
Salaries and employee benefits	\$4,944	\$5,200	\$(256 )	(4.9 )%
Occupancy and equipment	2,053	2,107	(54 )	(2.6 )
Computer and electronic banking services	1,297	1,352	(55 )	(4.1 )
Outside professional services	466	449	17	3.8
Marketing and advertising	246	226	20	8.8
Supplies	148	168	(20 )	(11.9 )
FDIC deposit insurance and regulatory assessments	245	349	(104 )	(29.8 )
Core deposit intangible amortization	150	164	(14 )	(8.5 )
Other real estate operations	82	169	(87 )	(51.5 )
Other	430	770	(340 )	(44.2 )
Total noninterest expenses	\$10,061	\$10,954	\$(893 )	(8.2 )%

Noninterest expenses decreased \$893,000 for the first quarter of 2015 compared to the same period in 2014. Salaries and employee benefits declined \$256,000, resulting from a reduction in staffing levels year-over-year. The Bank's conversion to a state-chartered financial institution effective in December 2014 contributed to the decrease of \$104,000 in the regulatory assessment for the first quarter of 2015. Costs associated with other real estate owned declined \$87,000 during the first quarter of 2015. Additionally, computer and occupancy expenses



decreased \$55,000 and \$54,000, respectively, for the first quarter of 2015 compared to the same period in 2014 due primarily to savings in electronic banking services and efficiencies in the phone system. For the comparable period in 2014, higher other noninterest expenses included fraudulent debit card transactions of \$240,000 and prepayment penalties totaling \$75,000 for the early extinguishment of certain Federal Home Loan Bank borrowings.

**Income Tax Provision.** The provision for income taxes decreased \$26,000 for the quarter ended March 31, 2015 compared to the same period in 2014. The effective tax rate for the quarters ended March 31, 2015 and 2014 was 32.5% and 34.1%, respectively. The lower effective tax rate for the quarter ended March 31, 2015 was due to lower pre-tax income.

#### Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations of a short- and long-term nature. The Bank's primary sources of funds consist of deposit inflows, loan sales and repayments, maturities and sales of securities and FHLB borrowings. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows, mortgage prepayments and loan and security sales are greatly influenced by general interest rates, economic conditions and competition.

The Bank's most liquid assets are cash and cash equivalents. The levels of these assets depend on the Bank's operating, financing, lending and investing activities during any given period. At March 31, 2015, cash and cash equivalents totaled \$52.7 million. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$176.5 million at March 31, 2015. In addition, at March 31, 2015, the Bank had the ability to borrow an additional \$116.0 million from the FHLB, which included overnight lines of credit of \$10.0 million. On that date, the Bank had FHLB advances outstanding of \$144.0 million and no overnight advances outstanding. Additionally, the Bank has the ability to access the Federal Reserve Bank's Discount Window on a collateralized basis and maintains a \$7.0 million unsecured line of credit with a financial institution to access federal funds. The Bank believes that its liquid assets combined with the available line from the FHLB provide adequate liquidity to meet its current financial obligations.

The Bank's primary investing activities are the origination, purchase and sale of loans and the purchase and sale of securities. For the three months months ended March 31, 2015, the Bank originated \$48.8 million of loans and purchased \$10.3 million of securities and \$11.3 million of loans. For the year ended December 31, 2014, the Bank originated \$168.0 million of loans and purchased \$36.2 million of securities and \$59.9 million of loans.

Financing activities consist primarily of activity in deposit accounts and in borrowed funds. The net increase in total deposits, including mortgagors' and investors' escrow accounts, was \$17.4 million for the three months months ended March 31, 2015. Certificates of deposit due within one year of March 31, 2015 totaled \$179.7 million, or 17.5% of total deposits. Management believes that the amount of deposits in shorter-term certificates of deposit reflects customers' hesitancy to invest their funds in longer-term certificates of deposit due to the uncertain interest rate environment. To compensate, the Bank has increased the duration of its borrowings with the FHLB. The Bank will be required to seek other sources of funds, including other certificates of deposit and lines of credit, if maturing certificates of deposit are not retained. Depending on market conditions, the Bank may be required to pay higher rates on such deposits or other borrowings than are currently paid on certificates of deposit. Additionally, a shorter duration in the securities portfolio may be necessary to provide liquidity to compensate for any deposit outflows. The Bank believes, however, based on past experience, a significant portion of its certificates of deposit will be retained. The Bank has the ability, if necessary, to adjust the interest rates offered to its customers in an effort to attract and retain deposits.

Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by the Bank and its local competitors and other factors. The Bank generally manages the pricing of its deposits to be competitive and to increase core deposits and commercial banking relationships. Occasionally, the Bank offers promotional rates on certain deposit products to attract deposits.

FHLB advances decreased \$4.3 million during the three months months ended March 31, 2015 and decreased \$28.0 million during the year ended December 31, 2014.

The Company repurchased 193,549 shares of the Company's common stock at a cost of \$2.3 million during the first three months months of 2015 and 74,441 shares of the Company's common stock at a cost of \$758,000 during the year ended December 31, 2014. Additional discussion about the Company's liquidity and capital resources is contained in Item 7 in the Company's 2014 Annual Report on Form 10-K.

SI Financial Group, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, SI Financial Group is responsible for paying any dividends declared to its shareholders and making payments on its subordinated debentures. SI Financial Group may continue to repurchase shares of its common stock in the future. SI Financial Group's primary sources of funds are interest and dividends on securities and dividends received from the Bank. The amount of dividends that the Bank may declare and pay to SI Financial Group in any calendar year cannot exceed net profits for that year to date plus retained net profits (as defined) for the preceding two calendar years. SI Financial Group believes that such restriction will not have an impact on SI Financial Group's ability to meet its ongoing cash obligations. At March 31, 2015, SI Financial Group had cash and cash equivalents of \$11.2 million and available for sale securities of \$4.0 million.

#### Payments Due Under Contractual Obligations

Information relating to payments due under contractual obligations is presented in the Company's Form 10-K for the year ended December 31, 2014. There were no material changes in the Company's payments due under contractual obligations between December 31, 2014 and March 31, 2015.

#### Off-Balance Sheet Arrangements

As a financial services provider, we routinely are a party to various financial instruments with off-balance sheet risks, such as commitments to extend credit, standby letters of credit and unused lines of credit. While these contractual obligations represent our future cash requirements, a significant portion of the commitments to extend credit may expire without being drawn upon. The contractual amounts of commitments to extend credit represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer defaults and the value of any existing collateral becomes worthless. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments whose contract amounts represent credit risk at March 31, 2015 and December 31, 2014 are as follows:

	March 31, 2015 (In Thousands)	December 31, 2014
Commitments to extend credit:		
Commitments to originate loans	\$ 16,833	\$ 26,170
Undisbursed construction loans	23,956	25,107
Undisbursed home equity lines of credit	46,964	45,403
Undisbursed commercial lines of credit	57,680	60,363
Overdraft protection lines	1,258	1,230
Standby letters of credit	144	81
Total commitments	\$ 146,835	\$ 158,354



Future loan commitments at March 31, 2015 and December 31, 2014 included fixed-rate loan commitments of \$8.1 million and \$10.8 million, respectively, at interest rates ranging from 2.75% to 5.50% and 3.00% to 5.75%, respectively.

The Bank is a limited partner in two small business investment corporations ("SBICs"). At March 31, 2015, the Bank's remaining off-balance sheet commitment for the capital investment in the SBICs was \$1.5 million. The Bank recorded no write downs of the SBICs during the three months ended March 31, 2015 and 2014.

For the three months months ended March 31, 2015, with the exception of the aforementioned commitments, the Company did not engage in any additional off-balance sheet transactions reasonably likely to have a material effect on the Company's financial condition, results of operations or cash flows. See Notes 6 and 12 to the consolidated financial statements contained in the Company's 2014 Annual Report on Form 10-K.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

#### Qualitative Aspects of Market Risk

The primary market risk affecting the financial condition and operating results of the Company is interest rate risk. Interest rate risk is the exposure of current and future earnings and capital arising from movements in interest rates. The Company manages the interest rate sensitivity of its interest-bearing liabilities and interest-earning assets in an effort to minimize the adverse effects of changes in the interest rate environment. To reduce the volatility of its earnings, the Company has sought to improve the match between asset and liability maturities and rates, while maintaining an acceptable interest rate spread. The Company's strategy for managing interest rate risk generally is to emphasize the origination of adjustable-rate mortgage loans for retention in its loan portfolio. However, the ability to originate adjustable-rate loans depends to a great extent on market interest rates and borrowers' preferences. As an alternative to adjustable-rate mortgage loans, the Company purchases variable-rate SBA and USDA loans in the secondary market that are fully guaranteed by the U.S. government. These loans have a significantly shorter duration than fixed-rate mortgage loans. Fixed-rate mortgage loans typically have an adverse effect on interest rate sensitivity compared to adjustable-rate loans. Accordingly, the Company has sold more longer-term fixed-rate mortgage loans in the secondary market in recent periods to manage interest rate risk. The Company offers 10-year fixed-rate mortgage loans that it retains in its portfolio. The Company may offer attractive rates for existing certificates of deposit accounts to extend their maturities. The Company also uses shorter-term investment securities and longer-term borrowings from the FHLB to help manage interest rate risk.

The Company has an Asset/Liability Committee to communicate, coordinate and control all aspects involving asset/liability management. The committee establishes and monitors the volume, maturities, pricing and mix of assets and funding sources with the objective of managing assets and funding sources to provide results that are consistent with liquidity, growth, risk limits and profitability goals.

In July 2010, the Company entered into an interest rate swap agreement with a third-party financial institution with a notional amount of \$8.0 million, whereby the counterparty will pay a variable rate equal to three-month LIBOR and the Company will pay a fixed rate of 2.44%. The agreement was effective on December 15, 2010 and terminates on December 15, 2015. This agreement was designated as a cash flow hedge against the trust preferred securities issued by SI Capital Trust II. This effectively fixes the interest rate on the \$8.0 million of trust preferred securities at 4.14% for the period of December 15, 2010 through December 15, 2015.

In January 2012, the Company entered into an interest rate swap agreement with a third-party financial institution with a notional amount of \$15.0 million, whereby the counterparty will pay a variable rate equal to three-month LIBOR and the Company will pay a fixed rate of 1.26%. The agreement was effective on January 11, 2012 and terminates on January 11, 2017. This agreement was not designated as a hedging instrument.

#### Quantitative Aspects of Market Risk

The Company analyzes its interest rate sensitivity position to manage the risk associated with interest rate movements through the use of interest income simulation. The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are “interest rate sensitive.” An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period. The

Company's goal is to manage asset and liability positions to moderate the effect of interest rate fluctuations on net interest income.

#### Net Interest Income Simulation Analysis

Interest income simulations are completed quarterly and presented to the Asset/Liability Committee. The simulations provide an estimate of the impact of changes in interest rates on net interest income under a range of assumptions. The numerous assumptions used in the simulation process are reviewed by the Asset/Liability Committee on a quarterly basis. Changes to these assumptions can significantly affect the results of the simulation. The simulation incorporates assumptions regarding the potential timing in the repricing of certain assets and liabilities when market rates change and the changes in spreads between different market rates. The simulation analysis incorporates management's current assessment of the risk that pricing margins will change adversely over time due to competition or other factors. Simulation analysis is only an estimate of the Company's interest rate risk exposure at a particular point in time. The Company continually reviews the potential effect changes in interest rates could have on the repayment of rate sensitive assets and funding requirements of rate sensitive liabilities.

The table below sets forth an approximation of the Company's exposure as a percentage of estimated net interest income for the next 12- and 24-month periods using interest income simulation. The simulation uses projected repricing of assets and liabilities at March 31, 2015 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rates can have a significant impact on interest income simulation. Because of the large percentage of loans and mortgage-backed securities the Company holds, rising or falling interest rates have a significant impact on the prepayment speeds of the Company's earning assets that in turn affect the rate sensitivity position. When interest rates rise, prepayments tend to slow. When interest rates fall, prepayments tend to rise. The Company's asset sensitivity would be reduced if prepayments slow and vice versa. While the Company believes such assumptions to be reasonable, there can be no assurance that assumed prepayment rates will approximate actual future mortgage-backed security and loan repayment activity.

The following table reflects changes in estimated net interest income for the Company at March 31, 2015.

	Percentage Change in Estimated Net Interest Income Over			
	12 Months		24 Months	
100 basis point decrease in rates	(2.10	)%	(3.44	)%
200 basis point increase in rates	(0.46	)	(1.45	)
300 basis point increase in rates	(0.38	)	(0.99	)

As indicated by the results of the above scenarios, net interest income would be adversely affected (within our internal guidelines) in the 12- and 24-month periods if rates decreased 100 basis points and only minimally impacted if rates increased 300 and 200 basis points as a result of the Company's initiative to position the balance sheet for the anticipated increase in market interest rates. The Company's strategy for mitigating interest rate risk includes the purchase of adjustable-rate investment securities and SBA and USDA loans that will reprice in a rising rate environment, selling longer-term and lower fixed-rate residential mortgage loans in the secondary market, restructuring FHLB advances to current lower market interest rates while extending their duration and utilizing certain derivative instruments such as forward loan sale commitments to manage the risk of loss associated with its mortgage banking activities. Additionally, the interest rate swap agreement used to hedge the interest rate of the Company's long-term variable-rate debt effectively converts the debt to a fixed-rate of interest, which reflects favorably on net interest income in a rising rate environment.



## Item 4. Controls and Procedures.

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. No changes in the Company's internal control over financial reporting occurred during the quarter ended March 31, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings.

The Company is not involved in any pending legal proceedings believed by management to be material to the Company's financial condition or results of operations. Periodically, there have been various claims and lawsuits against the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds a security interest, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. Management believes that these legal proceedings would not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

## Item 1A. Risk Factors.

There are no material changes from the risk factors set forth under Part I, Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2014, which could materially and adversely affect the Company's business, financial condition or future results. The risks described in the Company's Annual Report on Form 10-K are not the only risks that the Company faces. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results.

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

The Company's repurchases of equity securities for the three months ended March 31, 2015 were as follows:

Period	Total Number of Shares Purchased <sup>(1)</sup>	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs
January 1 - 31, 2015	—	\$—	—	—
February 1 - 28, 2015	5,841	11.78	—	—
March 1 - 31, 2015	187,708	12.15	12,300	617,700
Total	193,549	\$12.14	12,300	

<sup>(1)</sup> On March 12, 2015, the Company announced that the Board of Directors had approved a stock repurchase program authorizing the Company to repurchase up to 5%, or 630,000 shares, of its common stock from time to time, depending on market conditions. The stock repurchase program will continue until it is completed or terminated by the Board of Directors.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

3.1 Articles of Incorporation of SI Financial Group, Inc. <sup>(1)</sup>

3.2 Bylaws of SI Financial Group, Inc. <sup>(2)</sup>

4 Specimen Stock Certificate of SI Financial Group, Inc. <sup>(1)</sup>

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32 18 U.S.C. Section 1350 Certifications

101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2015, formatted in eXtensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Statement of Changes in Shareholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) related Notes to Consolidated Financial Statements.

<sup>(1)</sup> Incorporated herein by reference into this document from the Exhibits on the Registration Statement on Form S-1 (File No. 333-169302), and any amendments thereto, filed with the Securities and Exchange Commission on September 10, 2010.

<sup>(2)</sup> Incorporated herein by reference into this document from the Exhibits to the Company's Current Report on Form 8-K (File No. 000-54241) filed with the Securities and Exchange Commission on November 21, 2014.



SIGNATURES

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

SI FINANCIAL GROUP, INC.

Date: May 7, 2015

/s/ Rheo A. Brouillard  
Rheo A. Brouillard  
President and Chief Executive Officer  
(principal executive officer)

Date: May 7, 2015

/s/ Lauren L. Murphy  
Lauren L. Murphy  
Senior Vice President and Chief Financial  
Officer  
(principal accounting and financial officer)