

SB FINANCIAL GROUP, INC.  
Form 10-Q  
May 08, 2014

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

FORM 10-Q

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

For the quarterly period ended March 31, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-13507

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

Ohio  
(State or other jurisdiction of  
incorporation or organization)

34-1395608  
(I.R.S. Employer  
Identification No.)

401 Clinton Street, Defiance, Ohio 43512  
(Address of principal executive offices)  
(Zip Code)

(419) 783-8950

(Registrant's telephone number, including area code)

N/A

(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  No

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

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

Large Accelerate Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Common Shares, without par value (class)	4,873,931 shares (Outstanding at May 8, 2014)
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SB FINANCIAL GROUP, INC.

FORM 10-Q

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

SB Financial Group, Inc.  
Condensed Consolidated Balance Sheets  
March 31, 2014 and December 31, 2013

(\$ in Thousands)	March 2014 (unaudited)	December 2013
<b>ASSETS</b>		
Cash and due from banks	\$14,860	\$13,137
Securities available for sale, at fair value	93,305	89,793
Loans held for sale	7,165	3,366
Loans, net of unearned income	481,924	477,303
Allowance for loan losses	(6,726 )	(6,964 )
Net loans	475,198	470,339
Premises and equipment, net	13,027	12,186
Other securities - FRB and FHLB Stock	3,748	3,748
Purchased software	387	421
Cash surrender value of life insurance	12,982	12,906
Goodwill	16,353	16,353
Core deposits and other intangibles	524	655
Foreclosed assets held for sale, net	615	651
Mortgage servicing rights	5,228	5,180
Accrued interest receivable	1,423	1,281
Other assets	1,487	1,738
<b>Total assets</b>	<b>\$646,302</b>	<b>\$631,754</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Deposits</b>		
Non interest bearing demand	\$84,265	\$81,570
Interest bearing demand	126,520	119,551
Savings	64,306	61,652
Money market	85,731	79,902
Time deposits	171,897	175,559
<b>Total deposits</b>	<b>532,719</b>	<b>518,234</b>
Notes payable	-	589
Advances from Federal Home Loan Bank	14,000	16,000
Repurchase agreements	16,905	14,696

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Trust preferred securities	20,620	20,620
Accrued interest payable	425	639
Other liabilities	4,198	4,707
Total liabilities	588,867	575,485
Equity		
Preferred stock	-	-
Common stock	12,569	12,569
Additional paid-in capital	15,391	15,412
Retained earnings	30,708	29,899
Accumulated other comprehensive income	407	74
Treasury stock	(1,640 )	(1,685 )
Total equity	57,435	56,269
Total liabilities and equity	\$646,302	\$631,754

See notes to condensed consolidated financial statements (unaudited)

Note: The balance sheet at December 31, 2013 has been derived from the audited consolidated financial statements at that date

SB Financial Group, Inc.

## Condensed Consolidated Statements of Income (Unaudited)

(\$ in thousands, except share data)

	Three Months Ended	
	March	March
	2014	2013
Interest income		
Loans		
Taxable	\$5,241	\$5,883
Nontaxable	16	24
Securities		
Taxable	309	330
Nontaxable	175	170
Total interest income	5,741	6,407
Interest expense		
Deposits	498	606
Repurchase Agreements & Other	11	16
Federal Home Loan Bank advances	74	90
Trust preferred securities	333	403
Total interest expense	916	1,115
Net interest income	4,825	5,292
Provision for loan losses	-	299
Net interest income after provision for loan losses	4,825	4,993
Noninterest income		
Wealth Management Fees	632	643
Customer service fees	610	616
Gain on sale of mtg. loans & OMSR's	572	1,484
Mortgage loan servicing fees, net	245	179
Gain on sale of non-mortgage loans	23	156
Data service fees	306	414
Net gain on sales of securities	-	20
Gain/(loss) on sale/disposal of assets	(34)	(105)
Other income	206	160
Total non-interest income	2,560	3,567
Noninterest expense		
Salaries and employee benefits	3,120	3,439
Net occupancy expense	664	650
Equipment expense	639	755
Data processing fees	211	77
Professional fees	338	429
Marketing expense	123	108

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Telephone and communication	112	158
Postage and delivery expense	204	215
State, local and other taxes	92	134
Employee expense	115	152
Intangible amortization expense	131	153
OREO Impairment	-	33
Other expenses	330	367
<b>Total non-interest expense</b>	<b>6,079</b>	<b>6,670</b>
<b>Income before income tax expense</b>	<b>1,306</b>	<b>1,890</b>
<b>Income tax expense</b>	<b>326</b>	<b>572</b>
<b>Net income</b>	<b>\$980</b>	<b>\$1,318</b>
<b>Common share data:</b>		
Basic earnings per common share	\$0.20	\$0.27
Diluted earnings per common share	\$0.20	\$0.27

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.

Consolidated Statements of Comprehensive Income (unaudited)

(\$'s in thousands)	Three Months Ended Mar.	
	2014	31, 2013
Net income	\$980	\$1,318
Other comprehensive (loss)/income:		
Available-for-sale investment securities:		
Gross unrealized holding (loss) gain arising in the period	505	(294 )
Related tax (expense) benefit	(172 )	100
Less: reclassification adjustment for (loss) realized in income	-	(20 )
Related tax benefit	-	7
Net effect on other comprehensive (loss) income	333	(207 )
Total comprehensive income	\$1,313	\$1,111

SB Financial Group, Inc.  
Consolidated Statements of Shareholders' Equity (unaudited)

(\$'s in thousands)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance, January 1, 2014	\$ -	\$ 12,569	\$ 15,412	\$ 29,899	\$ 74	\$ (1,685 )	\$ 56,269
Net Income				980			980
Other Comprehensive Income					333		333
Dividends on Common Stk., \$0.035 per share				(171 )			(171 )
Stock options exercised			(37 )			45	8
Expense of stock option plan			16				16
Balance, March 31, 2014	\$ -	\$ 12,569	\$ 15,391	\$ 30,708	\$ 407	\$ (1,640 )	\$ 57,435
Balance, January 1, 2013	\$ -	\$ 12,569	\$ 15,374	\$ 25,280	\$ 1,830	\$ (1,769 )	\$ 53,284
Net Income				1,318			1,318
Other Comprehensive Loss					(207 )		(207 )
				(122 )			(122 )



Dividends on Common Stk., \$0.025 per share								
Stock options exercised	(5	)			15			10
Expense of stock option plan	12							12
Balance, March 31, 2013	\$ -	\$ 12,569	\$ 15,381	\$ 26,476	\$ 1,623	\$ (1,754	)	\$ 54,295

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.  
Condensed Consolidated Statements of Cash Flows (Unaudited)

(\$'s in thousands)	Three Months Ended Mar. 31,	
	2014	2013
<b>Operating Activities</b>		
Net Income	\$980	\$1,318
Items (using)/providing cash		
Depreciation and amortization	305	287
Provision for loan losses	-	299
Expense of share-based compensation plan	16	12
Amortization of premiums and discounts on securities	223	273
Amortization of intangible assets	131	153
Amortization of originated mortgage servicing rights	117	330
Recapture of originated mortgage servicing rights impairment	-	(171)
Impairment of mortgage servicing rights	18	-
Proceeds from sale of loans held for sale	24,512	73,868
Originations of loans held for sale	(26,944)	(71,967)
Gain from sale of loans	(595)	(1,640)
Gain on sales of available for sale securities	-	(20)
Loss on sale of assets	33	65
Income from bank owned life insurance	(76)	(82)
OREO impairment	-	33
Changes in		
Interest receivable	(142)	(383)
Other assets	(1,525)	(2,983)
Interest payable and other liabilities	(74)	(197)
Net cash used in operating activities	(3,021)	(805)
<b>Investing Activities</b>		
Purchases of available-for-sale securities	(9,685)	(11,233)
Proceeds from maturities of available-for-sale securities	6,455	9,723
Proceeds from sales of available-for-sale securities	-	1,235
Net change in loans	(4,930)	7,450
Purchase of premises and equipment and software	(1,112)	-
Proceeds from sale of foreclosed assets	74	377
Net cash (used in) provided by investing activities	(9,198)	7,552
<b>Financing Activities</b>		
Net increase in demand deposits, money market, interest checking and savings accounts	18,147	13,931
Net decrease in certificates of deposit	(3,662)	(8,673)
Net increase in securities sold under agreements to repurchase	2,209	650
Repayment of Federal Home Loan Bank advances	(2,000)	(3,500)
Proceeds from stock options exercised	8	10
Dividends on Common Stock	(171)	-

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Repayment of notes payable	(589 )	(278 )
Net cash provided by financing activities	13,942	2,140
Increase in Cash and Cash Equivalents	1,723	8,887
Cash and Cash Equivalents, Beginning of Year	13,137	19,144
Cash and Cash Equivalents, End of Period	\$14,860	\$28,031
Supplemental Cash Flows Information		
Interest paid	\$702	\$738
Income taxes paid	\$285	\$50
Transfer of loans to foreclosed assets	\$-	\$378
Dividends Payable	\$-	\$122

See notes to condensed consolidated financial statements (unaudited)

SB FINANCIAL GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1—BASIS OF PRESENTATION

SB Financial Group, Inc. (the “Company”) is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiaries, The State Bank and Trust Company (“State Bank”), RFCBC, Inc. (“RFCBC”), Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”), Rurban Statutory Trust I (“RST I”), and Rurban Statutory Trust II (“RST II”). State Bank owns all the outstanding stock of Rurban Mortgage Company (“RMC”), and State Bank Insurance, LLC (“SBI”).

The consolidated financial statements include the accounts of the Company, State Bank, RFCBC, RDSI, RMC, and SBI. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial statements reflect all adjustments that are, in the opinion of management, necessary to fairly present the financial position, results of operations and cash flows of the Company. Those adjustments consist only of normal recurring adjustments. Results of operations for the three months ended March 31, 2014, are not necessarily indicative of results for the complete year.

The condensed consolidated balance sheet of the Company as of December 31, 2013 has been derived from the audited consolidated balance sheet of the Company as of that date.

For further information, refer to the consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

The following paragraphs summarize the impact of new accounting pronouncements:

Accounting Standards Update (ASU) No. 2014-08: Disposals of Assets That Qualify for Discontinued Operations Presentation.

The amendments in this update address the complexity and higher costs for reporting discontinued operations. A disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The amendments also enhance convergence of the Financial Accounting Standards Board's (FASB) and the International Accounting Standards Board's (IASB) reporting requirements for discontinued operations. Management does not believe the amendments will have a material impact on the Company's Consolidated Financial Statements.

ASU No. 2014-06: Technical Corrections and Improvements Related Glossary Terms.

A standing project exists on the FASB's agenda to address feedback and to make other incremental improvements to U.S. GAAP. This perpetual project should eliminate the need for periodic agenda requests for narrow and incremental items. The Board decided that the types of issues that it will consider through this project are changes to clarify the Codification or correct unintended application of guidance that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. This Update is limited to those amendments related to the Master Glossary, including technical corrections related to glossary links, glossary term

deletions, and glossary term name changes. In addition, this Update includes more substantive, limited-scope improvements to reduce instances of the same term appearing multiple times in the Master Glossary with similar, but not entirely identical, definitions. Management does not believe these technical corrections will have a material impact on the Company's Consolidated Financial Statements.

Accounting Standards Update (ASU) No. 2014-04, Receivables (Topic 310): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.

The ASU clarifies that an in substance repossession or foreclosure occurs upon either the creditor obtaining legal title to the residential real estate property or 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. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. The amendments may be adopted using either a modified retrospective transition method or a prospective transition method. Early adoption is permitted. Management does not believe the amendments will have a material impact on the Company's Consolidated Financial Statements.

## NOTE 2—EARNINGS PER SHARE

Earnings per share (EPS) have been computed based on the weighted average number of shares outstanding during the periods presented. For the period ended March 31, 2014, share based awards totaling 66,570 common shares were not considered in computing diluted EPS as they were anti-dilutive. For the period ended March 31, 2013, share based awards totaling 66,570 common shares were not considered in computing diluted EPS as they were anti-dilutive. The average number of shares used in the computation of basic and diluted earnings per share were:

(shares in thousands)	Three Months Ended March 31,	
	2014	2013
Basic earnings per share	4,871	4,863
Diluted earnings per share	4,894	4,870

## NOTE 3 - SECURITIES

The amortized cost and appropriate fair values, together with gross unrealized gains and losses, of securities at March 31, 2014 and December 31, 2013 are as follows:

(\$'s in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Approximate Fair Value
Available-for-Sale Securities:				
March 31, 2014:				
U.S. Treasury and Government agencies	\$ 19,095	\$ 120	\$ (150 )	\$ 19,065
Mortgage-backed securities	55,381	498	(441 )	55,438
State and political subdivisions	18,188	739	(148 )	18,779
Equity securities	23	-	-	23
	\$ 92,687	\$ 1,357	\$ (739 )	\$ 93,305

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
December 31, 2013:				
U.S. Treasury and Government agencies	\$ 11,305	\$ 120	\$ (125 )	\$ 11,300
Mortgage-backed securities	57,322	417	(516 )	57,223
State and political subdivisions	17,937	546	(328 )	18,155
Money Market Mutual Fund	3,092	-	-	3,092
Equity securities	23	-	-	23
	\$ 89,679	\$ 1,083	\$ (969 )	\$ 89,793

The amortized cost and fair value of securities available for sale at March 31, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(\$'s in thousands)	Available for Sale	
	Amortized Cost	Fair Value
March 31, 2014:		
Within one year	\$96	\$96
Due after one year through five years	1,343	1,406
Due after five years through ten years	8,518	8,645
Due after ten years	27,326	27,696
	37,283	37,844
Mortgage-backed securities & equity securities	55,404	55,461
Totals	\$92,687	\$93,305

The fair value of securities pledged as collateral, to secure public deposits and for other purposes, was \$76.6 million at March 31, 2014 and \$42.3 million at December 31, 2013. The fair value of securities delivered for repurchase agreements was \$21.4 million at March 31, 2014 and \$17.5 million at December 31, 2013.

Gross gains of \$0.00 million resulting from sales of available-for-sale securities, were realized during the three-month period ending March 31, 2014. There were realized gains of \$0.02 million from sales of available-for-sale securities for the three-month period ending March 31, 2013. There were realized gains of \$0.02 million from sales of available-for-sale securities for the three-month period ending March 31, 2013. The \$0.02 million gain on sale was a reclassification from accumulated other comprehensive income (OCI) and is included in the net gain on sales of securities. The related \$0.01 million in tax expense is a reclassification from OCI and is included in the income tax expense line item in the income statement.

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments was \$37.3 million at March 31, 2014, and \$35.8 million at December 31, 2013, which was approximately 40.0 and 39.9 percent, respectively, of the Company's available-for-sale investment portfolio at such dates. Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

Securities with unrealized losses, aggregated by investment class and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2014 and December 31, 2013 are as follows:

(\$ in thousands)	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2014						
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$ 12,234	\$ (150 )	\$ -	\$ -	\$ 12,234	\$ (150 )

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Mortgage-backed securities	15,170	(214 )	5,345	(227 )	20,515	(441 )
State and political subdivisions	3,957	(118 )	637	(30 )	4,594	(148 )
	\$ 31,361	\$ (482 )	\$ 5,982	\$ (257 )	\$ 37,343	\$ (739 )

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(\$ in thousands)	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2013						
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$3,834	\$(125 )	\$-	\$-	\$3,834	\$(125 )
Mortgage-backed securities	\$24,773	\$(410 )	\$2,333	\$(106 )	\$27,106	\$(516 )
State and political subdivisions	4,868	(328 )	-	-	4,868	(328 )
	\$33,475	\$(863 )	\$2,333	\$(106 )	\$35,808	\$(969 )

The total unrealized loss as of March 31, 2014 in the securities portfolio is contained in 38% of the portfolio with a potential loss of \$0.7 million, which is down from the \$1.0 million unrealized loss at December 31, 2013. The unrealized losses are contained within 33 individual securities and are not segregated by type or duration of security. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the investment and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost. Management has determined there is no other-than-temporary-impairment on these securities.

#### NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoffs, are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Generally, all loan classes are placed on non-accrual status not later than 90 days past due, unless the loan is well-secured and in the process of collection. All interest accrued, but not collected for loans that are placed on non-accrual or charged-off, is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Loan losses are charged against the allowance when management believes the non-collectability of a loan balance is probable. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as new information becomes available.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical charge-off experience and expected loss given default derived from the Company's internal risk rating process. Other adjustments may be made to the

allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected on the historical loss or risk rating data.

A loan is considered impaired when, based on current information and events, it is probable that State Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual 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. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration each of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, agricultural, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent.

When State Bank moves a loan to non-accrual status, total unpaid interest accrued to date is reversed from income. Subsequent payments are applied to the outstanding principal balance with the interest portion of the payment recorded on the balance sheet as a contra-loan. Interest received on impaired loans may be realized once all contractual principal amounts are received or when a borrower establishes a history of six consecutive timely principal and interest payments. It is at the discretion of management to determine when a loan is placed back on accrual status upon receipt of six consecutive timely payments.

Large groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, State Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Categories of loans at March 31, 2014 and December 31, 2013 include:

(\$ in thousands)	Total Loans		Non-Accrual Loans	
	Mar. 2014	Dec. 2013	Mar. 2014	Dec. 2013
Commercial & Industrial	\$85,976	\$85,642	1,818	2,316
Commercial RE & Construction	212,502	205,301	753	532
Agricultural & Farmland	39,028	39,210	-	-
Residential Real Estate	97,857	99,620	1,555	1,651
Consumer & Other	46,836	47,804	280	345
<b>Total loans</b>	<b>482,199</b>	<b>477,577</b>	<b>\$4,406</b>	<b>\$4,844</b>
Less				
Net deferred loan fees, premiums and discounts	(275 )	(274 )		
Loans, net of unearned income	\$481,924	\$477,303		
Allowance for loan losses	\$(6,726 )	\$(6,964 )		

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The following tables present the activity in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method as of March 31, 2014, December 31, 2013 and March 31, 2013.

For the Three Months Ended

March 31, 2014	Commercial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
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ALLOWANCE FOR LOAN AND LEASE LOSSES

Beginning balance	\$ 2,175	\$ 2,708	\$ 159	\$ 1,067	\$ 855	\$ 6,964
Charge Offs	(307 )	-	-	(15 )	(1 )	\$(323 )
Recoveries	10	52	-	5	18	85
Provision	24	(9 )	18	104	(137 )	-
Ending Balance	\$ 1,902	\$ 2,751	\$ 177	\$ 1,161	\$ 735	\$ 6,726

Loans Receivable at March 31, 2014

Allowance:

Ending balance:

individually

evaluated for

impairment

\$ 662	\$ 17	\$ -	\$ 236	\$ 55	\$ 970
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Ending balance:

collectively

evaluated for

impairment

\$ 1,240	\$ 2,734	\$ 177	\$ 925	\$ 680	\$ 5,756
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Loans:

Ending balance:

individually

evaluated for

impairment

\$ 1,641	\$ 633	\$ -	\$ 1,960	\$ 582	\$ 4,816
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Ending balance:

collectively

evaluated for

impairment

\$ 84,060	\$ 211,869	\$ 39,028	\$ 95,897	\$ 46,254	\$ 477,108
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For the Twelve Months Ended

December 31, 2013	Commercial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
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ALLOWANCE FOR LOAN AND LEASE LOSSES

Loans Receivable at December 31, 2013

Allowance:

Ending balance:

individually evaluated for impairment	\$ 1,079	\$ 56	\$ -	\$ 192	\$ 168	\$ 1,495
Ending balance:						
collectively evaluated for impairment	\$ 1,096	\$ 2,652	\$ 159	\$ 875	\$ 687	\$ 5,469
Loans:						
Ending balance:						
individually evaluated for impairment	\$ 2,116	\$ 649	\$ -	\$ 1,985	\$ 590	\$ 5,340
Ending balance:						
collectively evaluated for impairment	\$ 83,252	\$ 204,652	\$ 39,210	\$ 97,635	\$ 47,214	\$ 471,963

For the Three Months Ended

March 31, 2013	Commercial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
----------------	------------	---------------------------------------	-------------------------------	----------------------------	---------------------	-------

(\$'s in thousands)

## ALLOWANCE FOR LOAN AND LEASE LOSSES

Beginning balance	\$ 1,561	\$ 3,034	\$ 186	\$ 1,088	\$ 942	\$ 6,811
Charge Offs	-	(5 )	-	-	(131 )	\$(136 )
Recoveries	3	13	1	-	1	18
Provision	(84 )	224	(8 )	22	145	299
Ending Balance	\$ 1,480	\$ 3,266	\$ 179	\$ 1,110	\$ 957	\$ 6,992

The risk characteristics of each loan portfolio segment are as follows:

## Commercial and Agricultural

Commercial and agricultural loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and may include a personal guarantee. Short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

## Commercial Real Estate including Construction

Commercial real estate loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The characteristics of properties securing the Company's commercial real estate portfolio are diverse, but with geographic location almost entirely in the Company's market area. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. In general, the Company avoids financing single purpose projects unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate versus non-owner-occupied loans.

Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews and financial analysis of the developers and property owners. Construction loans are generally based on estimates of costs and value associated with the completed project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

## Residential and Consumer

Residential and consumer loans consist of two segments – residential mortgage loans and personal loans. Residential mortgage loans are secured by 1-4 family residences and are generally owner-occupied, and the Company generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer personal loans are secured by consumer personal assets, such as automobiles or recreational vehicles. Some consumer personal loans are unsecured, such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas, such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that these loans are of smaller individual amounts and spread over a large number of borrowers.

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The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of March 31, 2014 and December 31, 2013.

March 31, 2014 Loan Grade (\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
1-2	\$ 1,287	\$ 76	\$ 74	\$ -	\$ -	\$ 1,437
3	23,654	46,824	7,541	88,889	41,625	208,533
4	56,424	152,471	31,413	6,105	4,856	251,269
Total Pass	81,365	199,371	39,028	94,994	46,481	461,239
Special Mention	2,465	7,824	-	1,047	8	11,344
Substandard	50	4,554	-	261	67	4,932
Doubtful	1,821	753	-	1,555	280	4,409
Loss	-	-	-	-	-	-
Total Loans	\$ 85,701	\$ 212,502	\$ 39,028	\$ 97,857	\$ 46,836	\$ 481,924

December 31, 2013 Loan Grade (\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
1-2	\$ 1,345	\$ 81	\$ 76	\$ -	\$ 87	\$ 1,589
3	22,328	44,095	6,543	90,606	43,250	206,822
4	56,188	146,861	32,591	5,700	3,782	245,122
Total Pass	79,861	191,037	39,210	96,306	47,119	453,533
Special Mention	3,159	8,917	-	1,373	86	13,535
Substandard	32	4,815	-	290	84	5,221
Doubtful	2,316	532	-	1,651	515	5,014
Loss	-	-	-	-	-	-
Total Loans	\$ 85,368	\$ 205,301	\$ 39,210	\$ 99,620	\$ 47,804	\$ 477,303

The Company evaluates the loan risk grading system definitions and allowance for loan loss methodology on an ongoing basis.

#### Credit Risk Profile

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$100 thousand and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:



Special Mention (5): Assets have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Company's credit position at some future date. Special mention assets are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification. Ordinarily, special mention credits have characteristics which corrective management action would remedy.

Substandard (6): Loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful (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 current known facts, conditions and values, highly questionable and improbable.

Loss (8): Loans are considered uncollectable and of such little value that continuing to carry them as assets on the Company's financial statement is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass (1-4) rated loans. Pass ratings are assigned to those borrowers that do not have identified potential or well-defined weaknesses and for which there is a high likelihood of orderly repayment. All other categories are updated on a quarterly basis.

The following tables present the Company's loan portfolio aging analysis as of March 31, 2014 and December 31, 2013.

March 31, 2014 (\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
Commercial & Industrial	\$-	\$-	\$1,567	\$1,567	\$84,134	\$85,701
Commercial RE & Construction	-	-	739	739	211,763	212,502
Agricultural & Farmland	-	-	-	-	39,028	39,028
Residential Real Estate	36	-	459	495	97,362	97,857
Consumer & Other	69	18	90	177	46,659	46,836
Total Loans	\$105	\$18	\$2,855	\$2,978	\$478,946	\$481,924

December 31, 2013 (\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
Commercial & Industrial	\$-	\$-	\$1,890	\$1,890	\$83,478	\$85,368
Commercial RE & Construction	424	364	168	956	204,345	205,301
Agricultural & Farmland	-	-	-	-	39,210	39,210
Residential Real Estate	-	14	453	467	99,153	99,620
Consumer & Other	22	34	98	154	47,650	47,804
Total Loans	\$446	\$412	\$2,609	\$3,467	\$473,836	\$477,303

All loans past due 90 days are systematically placed on nonaccrual status.

A loan is considered impaired, in accordance with the impairment accounting guidance (ASC 310-10-35-16), when based on current information and events, it is probable State Bank will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans but also include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection.



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The following tables present impaired loan information as of and for the three months ended March 31, 2014 and 2013, and for the twelve months ended December 31, 2013:

Three Months Ended

March 31, 2014 (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$316	\$316	\$-	\$316	\$-
Commercial RE & Construction	447	500	-	500	-
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	612	655	-	749	13
Consumer & Other	107	107	-	114	3
All Impaired Loans < \$100,000	1,148	1,148	-	1,148	-
With a specific allowance recorded:					
Commercial & Industrial	1,325	1,625	662	1,681	-
Commercial RE & Construction	186	186	17	187	3
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,348	1,359	236	1,458	13
Consumer & Other	475	475	55	498	7
Totals:					
Commercial & Industrial	\$1,641	\$1,941	\$662	\$1,997	\$-
Commercial RE & Construction	\$633	\$686	\$17	\$687	\$3
Agricultural & Farmland	\$-	\$-	\$-	\$-	\$-
Residential Real Estate	\$1,960	\$2,014	\$236	\$2,207	\$26
Consumer & Other	\$582	\$582	\$55	\$612	\$10
All Impaired Loans < \$100,000	\$1,148	\$1,148	\$-	\$1,148	\$-

Twelve Months Ended

December 31, 2013 (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial & Industrial	\$316	\$316	\$-
Commercial RE & Construction	389	442	-
Agricultural & Farmland	-	-	-
Residential Real Estate	1,131	1,131	-
Consumer & Other	252	252	-
All Impaired Loans < \$100,000	1,242	1,242	-
With a specific allowance recorded:			
Commercial & Industrial	1,800	1,800	1,079
Commercial RE & Construction	260	260	56
Agricultural & Farmland	-	-	-
Residential Real Estate	854	854	192
Consumer & Other	338	338	168
Totals:			
Commercial & Industrial	\$2,116	\$2,116	\$1,079
Commercial RE & Construction	\$649	\$702	\$56

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Agricultural & Farmland	\$-	\$-	\$-
Residential Real Estate	\$1,985	\$1,985	\$192
Consumer & Other	\$590	\$590	\$168
All Impaired Loans < \$100,000	\$1,242	\$1,242	\$-

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## Three Months Ended

March 31, 2013 (\$'s in thousands)	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:		
Commercial & Industrial	\$24	\$-
Commercial RE & Construction	202	-
Agricultural & Farmland	-	-
Residential Real Estate	1,164	13
Consumer & Other	182	2
All Impaired Loans < \$100,000	1,172	-
With a specific allowance recorded:		
Commercial & Industrial	1,097	-
Commercial RE & Construction	197	2
Agricultural & Farmland	-	-
Residential Real Estate	1,622	16
Consumer & Other	478	8
Totals:		
Commercial & Industrial	\$1,121	\$-
Commercial RE & Construction	\$399	\$2
Agricultural & Farmland	\$-	\$-
Residential Real Estate	\$2,786	\$29
Consumer & Other	\$660	\$10
All Impaired Loans < \$100,000	\$1,172	\$-

Impaired loans less than \$100,000 are included in groups of homogenous loans. These loans are evaluated based on delinquency status.

Interest income recognized on a cash basis does not materially differ from interest income recognized on an accrual basis.

#### Troubled Debt Restructured (TDR) Loans

TDRs are modified loans where a concession was provided to a borrower experiencing financial difficulties. Loan modifications are considered TDRs when the concessions provided are not available to the borrower through either normal channels or other sources. However, not all loan modifications are TDRs.

#### TDR Concession Types

The Company's standards relating to loan modifications consider, among other factors, minimum verified income requirements, cash flow analysis, and collateral valuations. Each potential loan modification is reviewed individually and the terms of the loan are modified to meet a borrower's specific circumstances at a point in time. All loan modifications, including those classified as TDRs, are reviewed and approved. The types of concessions provided to borrowers include:

- Interest rate reduction: A reduction of the stated interest rate to a nonmarket rate for the remaining original life of the debt. The Company also may grant interest rate concessions for a limited timeframe on a case by case basis.
- Amortization or maturity date change beyond what the collateral supports, including a concession that does any of the following:

- (1) Lengthens the amortization period of the amortized principal beyond market terms. This concession reduces the minimum monthly payment and increases the amount of the balloon payment at the end of the term of the loan. Principal is generally not forgiven.
- (2) Reduces the amount of loan principal to be amortized. This concession also reduces the minimum monthly payment and increases the amount of the balloon payment at the end of the term of the loan. Principal is generally not forgiven.

(3) Extends the maturity date or dates of the debt beyond what the collateral supports. This concession generally applies to loans without a balloon payment at the end of the term of the loan. In addition, there may be instances where renewing loans potentially require non-market terms and would then be reclassified as TDRs.

• Other: A concession that is not categorized as one of the concessions described above. These concessions include, but are not limited to: principal forgiveness, collateral concessions, covenant concessions, and reduction of accrued interest. Principal forgiveness may result from any TDR modification of any concession type.

The table below presents the activity of TDRs during the three months ended March 31, 2014, and March 31, 2013.

During the three months ended March 31, 2014, there was no TDR activity.

(\$ in thousands)	Number of Loans	March 31, 2013		Total Modification
		Pre-Modification Recorded Balance	Post Modification Recorded Balance	
Residential Real Estate	1	\$ 14	\$ 14	\$ 14
Home Equity & Consumer	1	13	13	13
<b>Total Modifications</b>	<b>2</b>	<b>\$ 27</b>	<b>\$ 27</b>	

  

(\$ in thousands)	Interest Only	Term	Combination	Total Modification
Home Equity & Consumer	-	-	13	13
<b>Total Modifications</b>	<b>\$-</b>	<b>\$ -</b>	<b>\$ 27</b>	<b>\$ 27</b>

The loans described above increased the allowance for loan and lease losses ("ALLL") by \$0.01 million in the three month period ending March 31, 2013.



Troubled Debt Restructurings Modified in the Past 12 Months that have Subsequently Defaulted as of March 31,  
2014

(\$ in thousands)	Number of Contracts	Recorded Balance
Residential Real Estate	3	\$62
Home Equity & Consumer	-	-
	3	\$62

Troubled Debt Restructurings Modified in the Past 12 Months that have Subsequently Defaulted as of March 31,  
2013

(\$ in thousands)	Number of Contracts	Recorded Balance
Residential Real Estate	2	\$19
Consumer & Other	-	-
	2	\$19

#### NOTE 5 – DERIVATIVE FINANCIAL INSTRUMENTS

##### Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company manages its exposures to a wide variety of business and operational risks primarily through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing and duration of the Company's known or expected cash payments principally related to certain variable-rate assets.

##### Non-designated Hedges

The Company does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of March 31, 2014 and December 31, 2013, the notional amount of customer-facing swaps was approximately \$13.3 million and \$13.5 million, respectively. This amount is offset with third party counterparties, as described above.

The Company has minimum collateral posting thresholds with its derivative counterparties. As of March 31, 2014 and December 31, 2013, the Company had posted cash as collateral in the amount of \$0.3 million and \$0.2 million,

respectively.

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## Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the Balance Sheet, as of March 31, 2014 and December 31, 2013.

(\$ in thousands)	Asset Derivatives March 31, 2014		Liability Derivatives March 31, 2014	
	Balance Sheet	Fair	Balance Sheet	Fair
Derivatives not designated as hedging instruments:	Location	Value	Location	Value
Interest rate contracts	Other Assets	\$250	Other Liabilities	\$250
Derivatives not designated as hedging instruments:	Asset Derivatives December 31, 2013		Liability Derivatives December 31, 2013	
	Balance Sheet	Fair	Balance Sheet	Fair
Derivatives not designated as hedging instruments:	Location	Value	Location	Value
Interest rate contracts	Other Assets	\$257	Other Liabilities	\$257

## Effect of Derivative Instruments on the Income Statement

The Company's derivative financial instruments had no net effect on the Income Statements for the three months ended March 31, 2014 and 2013.

## NOTE 6 – FAIR VALUE OF ASSETS AND LIABILITIES

Fair value 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. A fair value measurement must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

Level 2 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 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis, recognized in the accompanying balance sheets, as well as the general classifications of such assets pursuant to the valuation hierarchy.

## Available-for-Sale Securities

The fair values of available-for-sale securities are determined by various valuation methodologies. Level 1 securities include money market mutual funds. Level 1 inputs include quoted prices in an active market. Level 2 securities include U.S. treasury and government agencies, mortgage-backed securities, obligations of political and state subdivisions and equity securities. Level 2 inputs do not include quoted prices for individual securities in active markets; however, they do include inputs that are either directly or indirectly observable for the individual security being valued. Such observable inputs include interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, credit risks and default rates. Also included are inputs derived principally from or corroborated by observable market data by correlation or other means.

## Interest Rate Contracts

The fair values of interest rate contracts are based upon the estimated amount the Company would receive or pay to terminate the contracts or agreements, taking into account underlying interest rates, creditworthiness of underlying customers for credit derivatives and, when appropriate, the creditworthiness of the counterparties.

The following table presents the fair value measurements of assets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at March 31, 2014 and December 31, 2013.

(\$'s in thousands)	Description	Fair Values			
		at 3/31/2014	Fair Value Measurements Using:		
			Level 1	Level 2	Level 3
Available-for-Sale Securities:					
	U.S. Treasury and Government Agencies	\$19,065	\$-	\$19,065	\$-
	Mortgage-backed securities	55,438	-	55,438	-
	State and political subdivisions	18,779	-	18,779	-
	Equity securities	23	-	23	-
	Interest rate contracts - assets	250	-	250	-
	Interest rate contracts - liabilities	(250 )	-	(250 )	-

(\$'s in thousands)	Description	Fair Values			
		at 12/31/2013	Fair Value Measurements Using:		
			Level 1	Level 2	Level 3
Available-for-Sale Securities:					
	U.S. Treasury and Government Agencies	\$11,300	\$-	\$11,300	\$-
	Mortgage-backed securities	57,223	-	57,223	-
	State and political subdivisions	18,155	-	18,155	-
	Money Market Mutual Funds	3,092	3,092	-	-
	Equity securities	23	-	23	-
	Interest rate contracts - assets	257	-	257	-
	Interest rate contracts - liabilities	(257 )	-	(257 )	-

Level 1 – Quoted Prices in Active Markets for Identical Assets

Level 2 – Significant Other Observable Inputs

Level 3 – Significant Unobservable Inputs

The following is a description of the valuation methodologies and inputs used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

## Collateral-dependent Impaired Loans, NET of ALLL

Loans for which it is probable the Company will not collect all principal and interest due according to contractual terms are measured for impairment. The estimated fair value of collateral-dependent impaired loans is based on the appraised value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy. This method requires obtaining an independent appraisal of the collateral, which is reviewed for accuracy and consistency by Credit Administration. These appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by applying a discount factor to

the value based on the Company's loan review policy. All impaired loans held by the Company were collateral dependent at March 31, 2014 and December 31, 2013.

### Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees, miscellaneous income and float; marginal costs of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

### Foreclosed Assets Held For Sale

Foreclosed assets held for sale are carried at the lower of fair value at acquisition date or current estimated fair value less estimated cost to sell when the real estate is acquired. Estimated fair value of foreclosed assets held for sale is based on appraisals or evaluations. Foreclosed assets held for sale are classified within Level 3 of the fair value hierarchy.

Appraisals of foreclosed assets held for sale are obtained when the real estate is acquired and subsequently as deemed necessary by Credit Administration. These independent appraisals of the collateral are reviewed for accuracy and consistency by Credit Administration. The appraisers are selected from the list of approved appraisers maintained by management.

The following table presents the fair value measurements of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fell at March 31, 2014 and December 31, 2013:

(\$'s in thousands)	Description	Fair Values			
		at 3/31/2014	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3	
Impaired loans		\$3,637	\$-	\$-	\$3,637
Mortgage servicing rights		1,958	-	-	1,958

  

(\$'s in thousands)	Description	Fair Values			
		at 12/31/2013	Fair Value Measurements Using:		
		Level 1	Level 2	Level 3	
Impaired loans		\$3,540	\$-	\$-	\$3,540
Mortgage servicing rights		2,029	-	-	2,029
Foreclosed assets		45	-	-	45

## Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements.

(\$'s in thousands)	Fair Value at 3/31/2014	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
Collateral-dependent impaired loans	\$ 3,637	Market comparable properties	Comparability adjustments (%)	Not available
Mortgage servicing rights	1,958	Discounted cash flow	Discount Rate	9.88 %
			Constant prepayment rate	8.80 %
			P&I earnings credit	0.15 %
			T&I earnings credit	1.69 %
			Inflation for cost of servicing	1.50 %
(\$'s in thousands)	Fair Value at 12/31/2013	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
Collateral-dependent impaired loans	\$ 3,540	Market comparable properties	Comparability adjustments (%)	Not available
Mortgage servicing rights	2,029	Discounted cash flow	Discount Rate	10.25 %
			Constant prepayment rate	8.50 %
			P&I earnings credit	0.17 %
			T&I earnings credit	1.54 %
			Inflation for cost of servicing	1.50 %
Foreclosed assets	45	Market comparable properties	Marketability discount	10.00 %

There were no changes in the inputs or methodologies used to determine fair value at March 31, 2014 as compared to December 31, 2013.

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying balance sheets at amounts other than fair value.

Cash and Due From Banks, Federal Reserve and Federal Home Loan Bank Stock and Accrued Interest Payable and Receivable

The carrying amount approximates the fair value.



### Loans Held for Sale

The fair value of loans held for sale is based upon quoted market prices, where available, or is determined by discounting estimated cash flows using interest rates approximating the Company's current origination rates for similar loans and adjusted to reflect the inherent credit risk.

### Loans

The estimated fair value for loans receivable, including loans held for sale, net, is based on estimates of the rate State Bank would charge for similar loans at March 31, 2014 and December 31, 2013, applied for the time period until the loans are assumed to re-price or be paid.

### Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees, miscellaneous income and float; marginal costs of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

### Deposits, Repurchase agreements, Notes payable & FHLB advances

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount approximates the fair value. The estimated fair value for fixed-maturity time deposits, as well as borrowings, is based on estimates of the rate State Bank could pay on similar instruments with similar terms and maturities at March 31, 2014 and December 31, 2013.

### Loan Commitments

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The estimated fair values for other financial instruments and off-balance-sheet loan commitments approximate cost at March 31, 2014 and December 31, 2013 and are not considered significant to this presentation.

## Trust Preferred Securities

The fair value for Trust Preferred Securities is estimated by discounting the cash flows using an appropriate discount rate.

The following table presents estimated fair values of the Company's other financial instruments carried at other than fair value. The fair values of certain of these instruments were calculated by discounting expected cash flows, which involves significant judgments by management and uncertainties. Fair value is the estimated amount at which financial assets or liabilities could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Because no market exists for certain of these financial instruments, and because management does not intend to sell these financial instruments, the Company does not know whether the fair values shown below represent values at which the respective financial instruments could be sold individually or in the aggregate.

March 31, 2014 (\$'s in thousands)	Carrying Amount	Fair Value Measurements Using		
		(Level 1)	(Level 2)	(Level 3)
<b>Financial assets</b>				
Cash and cash equivalents	\$ 14,860	\$ 14,860	\$-	\$-
Loans held for sale	7,165	-	7,404	-
Loans, net of allowance for loan losses	475,198	-	-	476,510
Federal Reserve and FHLB Bank stock	3,748	-	3,748	-
Mortgage Servicing Rights	5,228	-	-	6,232
Accrued interest receivable	1,423	-	1,423	-
<b>Financial liabilities</b>				
Deposits	\$ 532,719	\$ 84,265	\$ 450,974	\$-
FHLB advances	14,000	-	13,945	-
Repurchase agreements	16,905	-	16,905	-
Trust preferred securities	20,620	-	17,250	-
Accrued interest payable	425	-	425	-
<b>December 31, 2013</b>				
(\$'s in thousands)	Carrying Amount	Fair Value Measurements Using		
		(Level 1)	(Level 2)	(Level 3)
<b>Financial assets</b>				
Cash and cash equivalents	\$ 13,137	\$ 13,137	\$-	\$-
Loans held for sale	3,336	-	3,476	-
Loans, net of allowance for loan losses	470,339	-	-	469,505
Federal Reserve and FHLB Bank stock	3,748	-	3,748	-
Mortgage Servicing Rights	5,180	-	-	6,237
Accrued interest receivable	1,281	-	1,281	-
<b>Financial liabilities</b>				
Deposits	\$ 518,234	\$-	\$ 439,273	\$-
Notes payable	589	-	600	-
FHLB advances	16,000	-	15,955	-
Repurchase agreements	14,696	-	14,696	-
Trust preferred securities	20,620	-	15,566	-
Accrued interest payable	639	-	639	-



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

### Cautionary Statement Regarding Forward-Looking Information

This Quarterly Report on Form 10-Q, including Management's Discussion and Analysis of Financial Condition and Results of Operations, contains certain forward-looking statements that are provided to assist in the understanding of anticipated future financial performance. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance. Examples of forward-looking statements include: (a) projections of income or expense, earnings per share, the payments or non-payments of dividends, capital structure and other financial items; (b) statements of plans and objectives of the Company or our management or Board of Directors, including those relating to products or services; (c) statements of future economic performance; and (d) statements of assumptions underlying such statements. Words such as "anticipates", "believes", "plans", "intends", "expects", "projects", "estimates", "should", "may", "would be", "will allow", "will likely result", "will continue", "will remain", or other expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying those statements. Forward-looking statements are based on management's expectations and are subject to a number of risks and uncertainties. Although management believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from those expressed or implied in such statements. Risks and uncertainties that could cause actual results to differ materially include, without limitation, changes in interest rates, changes in the competitive environment, and changes in banking regulations or other regulatory or legislative requirements affecting bank holding companies. Additional detailed information concerning a number of important factors which could cause actual results to differ materially from the forward-looking statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations is available in the Company's filings with the Securities and Exchange Commission, including the disclosure under the heading "Item 1A. Risk Factors" of Part I of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013. Undue reliance should not be placed on the forward-looking statements, which speak only as of the date hereof. Except as may be required by law, the Company undertakes no obligation to update any forward-looking statement to reflect unanticipated events or circumstances after the date on which the statement is made.

### Overview of SB Financial

SB Financial Group, Inc. ("SB Financial" or the "Company") is a bank holding company registered with the Federal Reserve Board. SB Financial's wholly-owned subsidiary, The State Bank and Trust Company ("State Bank"), is an Ohio-chartered bank engaged in commercial banking. SB Financial's technology subsidiary, Rurban Data Services, Inc. ("RDSI"), provides item processing services to community banks and businesses.

Rurban Statutory Trust I ("RST") was established in August 2000. In September 2000, RST completed a pooled private offering of 10,000 Trust Preferred Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures of the Company with terms substantially similar to the Trust Preferred Securities. The sole assets of RST are the junior subordinated debentures, and the back-up obligations, in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST.

Rurban Statutory Trust II ("RST II") was established in August 2005. In September 2005, RST II completed a pooled private offering of 10,000 Trust Preferred Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures of the Company with terms substantially similar to the Trust Preferred Securities. The sole assets of RST II are the junior subordinated debentures, and the back-up obligations, in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST II.

RFCBC, Inc. (“RFCBC”) is an Ohio corporation and wholly-owned subsidiary of the Company that was incorporated in August 2004. RFCBC operates as a loan subsidiary in servicing and working out problem loans.

State Bank Insurance, LLC (“SBI”) is an Ohio corporation and a wholly-owned subsidiary of State Bank that was incorporated in June of 2010. SBI is an insurance company that engages in the sale of insurance products to retail and commercial customers of State Bank.

Unless the context indicates otherwise, all references herein to “we”, “us”, “our”, or the “Company” refer to SB Financial Group, Inc. and its consolidated subsidiaries.

## Recent Regulatory Developments

### Consumer Financial Protection Bureau

The Dodd-Frank Act was enacted into law on July 21, 2010. The Dodd-Frank Act is significantly changing the regulation of financial institutions and the financial services industry. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the new law and the effects they will have on the Company will not be known for months and even years.

Among the provisions already implemented pursuant to the Dodd-Frank Act, the following provisions have or may have an effect on the business of the Company and its subsidiaries:

- the CFPB has been formed with broad powers to adopt and enforce consumer protection regulations;
- the federal law prohibiting the payment of interest on commercial demand deposit accounts was eliminated effective July 21, 2011;
- the standard maximum amount of deposit insurance per customer was permanently increased to \$250,000;
- the assessment base for determining deposit insurance premiums has been expanded from domestic deposits to average assets minus average tangible equity;
- public companies in all industries are required to provide shareholders the opportunity to cast a non-binding advisory vote on executive compensation;
- new capital regulations for bank holding companies have been adopted, which will impose stricter requirements, and any new trust preferred securities issued after May 19, 2010 will no longer constitute Tier I capital; and
- new corporate governance requirements applicable generally to all public companies in all industries require new compensation practices and disclosure requirements, including requiring companies to “claw back” incentive compensation under certain circumstances, to consider the independence of compensation advisors and to make additional disclosures in proxy statements with respect to compensation matters.

Many provisions of the Dodd-Frank Act have not yet been implemented and will require interpretation and rule making by federal regulators. As a result, the ultimate effect of the Dodd-Frank Act on the Company cannot yet be determined. However, it is likely that the implementation of these provisions will increase compliance costs and fees paid to regulators, along with possibly restricting the operations of the Company and its subsidiaries.

### The Volcker Rule

In December 2013, five federal agencies adopted a final regulation implementing the Volcker Rule provision of the Dodd-Frank Act (the “Volcker Rule”). The Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The trading activity includes a purchase or sale as principal of a security, derivative, commodity future or option on any such instrument in order to benefit from short-term price movements or to realize short-term profits. The Volcker Rule exempts specified U.S. Government, agency and/or municipal obligations, and it excepts trading conducted in certain capacities,

including as a broker or other agent, through a deferred compensation or pension plan, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities.

The Volcker Rule also prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund, with a number of exceptions. The Company does not engage in any of the trading activities or have any ownership interest in or relationship with any of the types of funds regulated by the Volcker Rule.

#### Executive and Incentive Compensation

In June 2010, the Federal Reserve Board, the OCC and the FDIC issued joint interagency guidance on incentive compensation policies (the “Joint Guidance”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. This principles-based guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (a) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (b) be compatible with effective internal controls and risk management and (c) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Pursuant to the Joint Guidance, the Federal Reserve Board will review as part of a regular, risk-focused examination process, the incentive compensation arrangements of financial institutions such as the Company. Such reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination and deficiencies will be incorporated into the institution’s supervisory ratings, which can affect the institution’s ability to make acquisitions and take other actions. Enforcement actions may be taken against an institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization’s safety and soundness and prompt and effective measures are not being taken to correct the deficiencies.

On February 7, 2011, federal banking regulatory agencies jointly issued proposed rules on incentive-based compensation arrangements under applicable provisions of the Dodd-Frank Act (the “Proposed Rules”). The Proposed Rules generally apply to financial institutions with \$1.0 billion or more in assets that maintain incentive-based compensation arrangements for certain covered employees. The Proposed Rules (i) prohibit covered financial institutions from maintaining incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risk by providing the covered person with “excessive” compensation; (ii) prohibit covered financial institutions from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to a material financial loss, (iii) require covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with the Proposed Rules and (iv) require covered financial institutions to provide enhanced disclosure to regulators regarding their incentive-based compensation arrangements for covered person within 90 days following the end of the fiscal year.

Pursuant to rules adopted by the stock exchanges and approved by the SEC in January 2013 under the Dodd-Frank Act, public companies are required to implement “clawback” procedures for incentive compensation payments and to disclose the details of the procedures which allow recovery of incentive compensation that was paid on the basis of erroneous financial information necessitating a restatement due to material noncompliance with financial reporting requirements. This clawback policy is intended to apply to compensation paid within a three-year look-back window of the restatement and would cover all executives who received incentive awards. Public company compensation committee members are also required to meet heightened independence requirements and to consider the independence of compensation consultants, legal counsel and other advisors to the compensation committee. The compensation committees must have the authority to hire advisors and to have the company fund reasonable



compensation of such advisors.

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### Effect of Environmental Regulation

Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has not had a material effect upon the capital expenditures, earnings or competitive position of the Company and its subsidiaries. The Company believes that the nature of the operations of its subsidiaries has little, if any, environmental impact. The Company, therefore, anticipates no material capital expenditures for environmental control facilities for its current fiscal year or for the foreseeable future. The Company's subsidiaries may be required to make capital expenditures for environmental control facilities related to properties which they may acquire through foreclosure proceedings in the future; however, the amount of such capital expenditures, if any, is not currently determinable.

### Regulatory Capital

The FRB has adopted risk-based capital guidelines for bank holding companies and for state member banks, such as State Bank. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk weighted assets by assigning assets and off-balance-sheet items to broad risk categories. The minimum ratio of total capital to risk weighted assets (including certain off-balance-sheet items, such as standby letters of credit) is 8%. Of that 8%, at least 4% must be comprised of common shareholders' equity (including retained earnings but excluding treasury stock), non-cumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, less goodwill and certain other intangible assets ("Tier 1 capital"). The remainder of total risk-based capital ("Tier 2 capital") may consist, among other things, of certain amounts of mandatory convertible debt securities, subordinated debt, preferred stock not qualifying as Tier 1 capital, allowance for loan and lease losses and net unrealized gains, after applicable taxes, on available-for-sale equity securities with readily determinable fair values, all subject to limitations established by the guidelines. Under the guidelines, capital is compared to the relative risk related to the balance sheet. To derive the risk included in the balance sheet, one of four risk weights (0%, 20%, 50%, and 100%) is applied to different balance sheet and off-balance sheet assets, primarily based on the relative credit risk of the counterparty. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

In July 2013, the FRB and the federal banking agencies published final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and State Bank. These rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. "Basel III" refers to various documents released by the Basel Committee on Banking Supervision.

Effective in 2015, State Bank and the Company will be subject to new capital regulations (with some provisions transitioned into full effectiveness over two to four years). The new requirements create a new required ratio for common equity Tier 1 ("CET1") capital, increases the leverage and Tier 1 capital ratios, changes the risk-weights of certain assets for purposes of the risk-based capital ratios, creates an additional capital conservation buffer over the required capital ratios and changes what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Company to pay dividends, repurchase shares or pay discretionary bonuses.

When these new requirements become effective, certain of the minimum capital requirements for State Bank will change. The minimum leverage ratio of 4% of adjusted total assets and total capital ratio of 8% of risk-weighted assets will remain the same; however, the Tier 1 capital ratio will increase from 4.0% to 6.5% of risk-weighted assets. In addition, the Company will have to meet the new minimum CET1 capital ratio of 4.5% of risk-weighted assets. CET1 consists generally of common stock, retained earnings and accumulated other comprehensive income (AOCI), subject to certain adjustments.

Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock will be deducted from capital, subject to a two-year transition period. In addition, Tier 1 capital will include AOCI, which includes all unrealized gains and losses on available for sale debt and equity securities, subject to a two-year transition period. Because of its asset size, State Bank has the one-time option of deciding in the first quarter of 2015 whether to permanently opt-out of the inclusion of AOCI in its capital calculations. State Bank is considering whether to take advantage of this opt-out to reduce the impact of market volatility on its regulatory capital levels.

The new requirements also include changes in the risk-weights of certain assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in nonaccrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less; a 250% risk weight (up from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital; and increased risk-weights (0% to 600%) for equity exposures.

In addition to the minimum CET1, Tier 1 and total capital ratios, State Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above each of the required minimum capital levels in order to avoid limitations on paying dividends, engaging in share repurchases and paying certain discretionary bonuses. This new capital conservation buffer requirement is phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented in January 2019.

The FRB's prompt corrective action standards will change when these new capital ratios become effective. Under the new standards, in order to be considered well-capitalized, State Bank will be required to have at least a CET1 ratio of 6.5% (new), a Tier 1 ratio of 8% (increased from 6%), a total capital ratio of 10% (unchanged) and a leverage ratio of 5% (unchanged) and not be subject to specified requirements to meet and maintain a specific capital ratio for a capital measure.

State Bank conducted a proforma analysis of the application of these new capital requirements as of September 30, 2013. Based on that analysis, State Bank determined that as of September 30, 2013, it would have met all the new requirements, including the full 2.5% capital conservation buffer, and would have remained well capitalized if these new requirements had been in effect on that date.

In addition, as noted above, beginning in 2016, if State Bank does not have the required capital conservation buffer, its ability to pay dividends to the Company would be limited.

#### Critical Accounting Policies

Note 1 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013 describes the significant accounting policies used in the development and presentation of the Company's financial statements. The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The Company's financial position and results of operations can be affected by these estimates and assumptions and are integral to the understanding of reported results. Critical accounting policies are those policies that management believes are the most important to the portrayal of the Company's financial condition and results, and they require management to make estimates that are difficult, subjective, or complex.

**Allowance for Loan Losses** - The allowance for loan losses provides coverage for probable losses inherent in the Company's loan portfolio. Management evaluates the adequacy of the allowance for loan losses each quarter based on changes, if any, in underwriting activities, loan portfolio composition (including product mix and geographic, industry or customer-specific concentrations), trends in loan performance, regulatory guidance and economic factors. This evaluation is inherently subjective, as it requires the use of significant management estimates. Many factors can affect management's estimates of specific and expected losses, including volatility of default probabilities, rating migrations, loss severity and economic and political conditions. The allowance is increased through provisions charged to operating earnings and reduced by net charge-offs.



The Company determines the amount of the allowance based on relative risk characteristics of the loan portfolio. The allowance recorded for commercial loans is based on reviews of individual credit relationships and an analysis of the migration of commercial loans and actual loss experience. The allowance recorded for homogeneous consumer loans is based on an analysis of loan mix, risk characteristics of the portfolio, fraud loss and bankruptcy experiences, and historical losses, adjusted for current trends, for each homogeneous category or group of loans. The allowance for credit losses relating to impaired loans is based on the loan's observable market price, the collateral for certain collateral-dependent loans, or the discounted cash flows using the loan's effective interest rate.

Regardless of the extent of the Company's analysis of customer performance, portfolio trends or risk management processes, certain inherent but undetected losses are probable within the loan portfolio. This is due to several factors, including inherent delays in obtaining information regarding a customer's financial condition or changes in their unique business conditions, the subjective nature of individual loan evaluations, collateral assessments and the interpretation of economic trends. Volatility of economic or customer-specific conditions affecting the identification and estimation of losses for larger non-homogeneous credits and the sensitivity of assumptions utilized to establish allowances for homogenous groups of loans are also factors. The Company estimates a range of inherent losses related to the existence of these exposures. The estimates are based upon the Company's evaluation of imprecise risk associated with the commercial and consumer allowance levels and the estimated impact of the current economic environment. To the extent that actual results differ from management's estimates, additional loan loss provisions may be required that could adversely impact earnings for future periods.

Goodwill and Other Intangibles - The Company records all assets and liabilities acquired in purchase acquisitions, including goodwill and other intangibles, at fair value as required. Goodwill is subject, at a minimum, to annual tests for impairment. Other intangible assets are amortized over their estimated useful lives using straight-line or accelerated methods, and are subject to impairment if events or circumstances indicate a possible inability to realize the carrying amount. The initial goodwill and other intangibles recorded and subsequent impairment analysis requires management to make subjective judgments concerning estimates of how the acquired asset will perform in the future. Events and factors that may significantly affect the estimates include, among others, customer attrition, changes in revenue growth trends, specific industry conditions and changes in competition. A decrease in earnings resulting from these or other factors could lead to an impairment of goodwill that could adversely impact earnings for future periods.

Three Months Ended March 31, 2014 compared to Three Months Ended March 31, 2013

**Net Income:** Net income for the first quarter of 2014 was \$1.0 million, or \$0.20 per diluted share, compared to net income of \$1.3 million, or \$0.27 per diluted share, for the first quarter of 2013. For the quarter, the Banking Group (consisting primarily of State Bank), had net income of \$1.4 million, which is down 21.4 percent compared to the net income of \$1.8 million from the year ago first quarter. RDSI reported a net loss of \$68 thousand compared to net income of \$24 thousand from the year ago first quarter.

**Provision for Loan Losses:** The first quarter provision for loan losses was \$0.00 million compared to \$0.3 million for the year-ago quarter. Charge-offs for the quarter were \$0.2 million compared to \$0.1 million for the year-ago quarter. Total delinquent loans ended the quarter at \$3.0 million, which is even to the prior year.

Asset Quality Review – For the Period Ended (\$'s in Thousands)	March 31, 2014	December 31, 2013	March 31, 2013
Net charge-offs	\$ 238	\$ 747	\$ 118
Nonaccruing loans	4,406	4,844	4,811
Accruing Trouble Debt Restructures	1,793	1,739	1,273
Nonaccruing and restructured loans	6,199	6,583	6,084
OREO / OAO	615	651	2,270
Nonperforming assets	6,814	7,233	8,354
Nonperforming assets/Total assets	1.05	% 1.14	% 1.30
Allowance for loan losses/Total loans	1.40	% 1.46	% 1.54
Allowance for loan losses/Nonperforming loans	108.5	% 105.8	% 114.9

**Consolidated Revenue:** Total revenue, consisting of net interest income fully taxable equivalent (FTE) and noninterest income, was \$7.5 million for the first quarter of 2014, a decrease of \$1.5 million, or 16.5 percent, from the \$9.0 million generated during the 2013 first quarter.

Net interest income (FTE) was \$4.9 million, which is down \$0.5 million from the prior year first quarter's \$5.4 million. The Company's earning assets increased \$10.1 million, but this was offset by a 55 basis point decrease in the yield on earning assets. The net interest margin for the first quarter of 2014 was 3.46 percent compared to 3.86 percent for the first quarter of 2013.

Noninterest income was \$2.6 million for the 2014 first quarter compared to \$3.6 million for the prior year period. Excluding data service fees, which are contributed by RDSI, the remaining noninterest income is generated by the Banking Group. RDSI fees continue to trail the prior year due to client losses.

State Bank originated \$33.6 million of mortgage loans compared to \$72.0 million for the first quarter of 2013. These first quarter 2014 originations and subsequent sales resulted in \$0.6 million of gains, which compares to gains of \$1.5 million for the first quarter of 2013. Net mortgage banking revenue was \$0.8 million due to the lowered volumes and no recapture of OMSR impairment.

**Consolidated Noninterest Expense:** Noninterest expense for the first quarter of 2014 was \$6.1 million, compared to \$6.7 million in the prior-year first quarter. The decrease in noninterest expenses compared to the prior year was volume related (mortgage commission and balance growth incentive) which offset higher weather related costs.

**Income Taxes:** Income taxes for the first quarter of 2014 were \$0.3 million compared to \$0.6 million for the first quarter of 2013. The decrease was due primarily to the decrease in pre-tax income compared to the prior year.





## Changes in Financial Condition

Total assets at March 31, 2014 were \$646.3 million, an increase of \$14.5 million or 2.3 percent since 2013 year end. Total loans, net of unearned income, were \$481.9 million as of March 31, 2014, up \$4.6 million from year end, an increase of 1.0 percent.

Total deposits at March 31, 2014 were \$532.7 million, an increase of \$14.5 million as compared to December 2013 balances. Borrowed funds (consisting of notes payable, FHLB advances, and REPOs) totaled \$30.9 million at March 31, 2014. This is down slightly from year end when borrowed funds totaled \$31.3 million. Total equity for the Company of \$57.4 million now stands at 8.9 percent of total assets, which is flat from the December 31, 2013 level of 8.9 percent.

## Capital Resources

At March 31, 2014, actual capital levels and minimum required levels were as follows (\$'s in thousands):

	Actual Amount	Ratio		Minimum Required For Capital Adequacy Purposes Amount	Ratio		Minimum Required To Be Well Capitalized Under Prompt Corrective Action Regulations Amount	Ratio
Total capital (to risk weighted assets)								
Consolidated	\$65,942	13.4	%	\$39,427	8.0	%	\$-	N/A
State Bank	\$61,204	12.4	%	39,618	8.0	%	\$49,522	10.0 %

Both the Company and State Bank were categorized as well capitalized at March 31, 2014.

## LIQUIDITY

Liquidity relates primarily to the Company's ability to fund loan demand, meet deposit customers' withdrawal requirements and provide for operating expenses. Assets used to satisfy these needs consist of cash and due from banks, federal funds sold, interest-earning deposits in other financial institutions, securities available-for-sale and loans held for sale. These assets are commonly referred to as liquid assets. Liquid assets were \$115.3 million at March 31, 2014, compared to \$106.3 million at December 31, 2013.

Liquidity risk arises from the possibility that the Company may not be able to meet the Company's financial obligations and operating cash needs or may become overly reliant upon external funding sources. In order to manage this risk, the Board of Directors of the Company has established a Liquidity Policy that identifies primary sources of liquidity, establishes procedures for monitoring and measuring liquidity and quantifies minimum liquidity requirements. This policy designates the Asset/Liability Committee ("ALCO") as the body responsible for meeting these objectives. The ALCO reviews liquidity regularly and evaluates significant changes in strategies that affect balance sheet or cash flow positions. Liquidity is centrally managed on a daily basis by the Company's Chief Financial Officer and Asset Liability Manager.

The Company's commercial real estate, first mortgage residential and multi-family mortgage portfolio of \$310.4 million at March 31, 2014 and \$304.9 million at December 31, 2013, which can and has been used to collateralize borrowings, is an additional source of liquidity. Management believes the Company's current liquidity level, without these borrowings, is sufficient to meet its liquidity needs. At March 31, 2014, all eligible commercial real estate, first

mortgage residential and multi-family mortgage loans were pledged under an FHLB blanket lien.

The cash flow statements for the periods presented provide an indication of the Company's sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statements for the three months ended March 31, 2014 and 2013 follows.

The Company experienced negative cash flows from operating activities for the three months ended March 31, 2014 and March 31, 2013. Net cash used in operating activities was \$3.0 million for the three months ended March 31, 2014 and \$0.8 million for the three months ended March 31, 2013. Highlights for the current year include \$24.5 million in proceeds from the sale of loans, which is down 49.4 million from the prior year. Originations of loans held for sale was a use of cash of \$26.9 million, which is also down from the prior year, by \$45.0 million. For the three months ended March 31, 2014, there was a net increase of Origination Mortgage Servicing Rights (OMSR) impairment of \$0.02 million, and gain on sale of loans of \$0.6 million.

The Company experienced negative cash flows from investing activities for the three months ended March 31, 2014 and positive cash flows from investing activities for the three months ended March 31, 2013. Net cash flows used in investing activities was \$9.2 million for the three months ended March 31, 2014 and cash flows provided by investing activities was \$7.6 million for the three months ended March 31, 2013. Highlights for the three months ended March 31, 2014 include \$9.7 million in purchases of available-for-sale securities. These cash payments were offset by \$6.4 million in proceeds from maturities of securities, which is down \$3.3 million from the prior three month period. The Company experienced a \$4.9 million decrease in loans, which is down \$12.4 million from the prior year three month period. Sales of foreclosed assets provided cash of \$0.08 million for the three months ended March 31, 2014.

The Company experienced positive cash flows from financing activities for the three months ended March 31, 2014 and March 31, 2013. Net cash flow provided by financing activities was \$14.0 million for the three months ended March 31, 2014 and \$2.1 million for the three months ended March 31, 2013. Highlights for the current period include a \$18.1 million increase in transaction deposits for the three months ended March 31, 2014, which is up from the \$13.9 million increase in transaction deposits for the three months ended March 31, 2013. Certificates of deposit declined by \$3.7 million in the current year compared to a decline of \$8.7 million for the prior year. FHLB advances were reduced by \$2.0 million for the three months ended March 31, 2014.

ALCO uses an economic value of equity (“EVE”) analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis calculates the net present value of the Company’s assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. The likelihood of a decrease in rates as of March 31, 2014 and December 31, 2013 was considered unlikely given the current interest rate environment and therefore, only the minus 100 basis point rate change was included in this analysis. The results of this analysis are reflected in the following tables for March 31, 2014 and December 31, 2013.

March 31, 2014

Economic Value of Equity

(\$’s in thousands)

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	108,572	14,953	15.97
+300 basis points	106,465	12,846	13.72
+200 basis points	103,385	9,766	10.43
+100 basis points	99,363	5,744	6.14
Base Case	93,619	-	-
-100 basis points	86,782	(6,837 )	(7.30 )

December 31, 2013

Economic Value of Equity

(\$’s in thousands)

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	105,687	13,393	14.51 %
+300 basis points	103,812	11,517	12.48 %
+200 basis points	101,018	8,724	9.45 %
+100 basis points	97,311	5,017	5.44 %
Base Case	92,294	-	-
-100 basis points	86,266	(6,029 )	(6.53 %)

Off-Balance-Sheet Borrowing Arrangements:

Significant additional off-balance-sheet liquidity is available in the form of FHLB advances and unused federal funds lines from correspondent banks. Management expects the risk of changes in off-balance-sheet arrangements to be immaterial to earnings.

The Company’s commercial real estate, first mortgage residential and multi-family mortgage portfolios of \$310.4 million have been pledged to meet FHLB collateralization requirements as of March 31, 2014. Based on the current collateralization requirements of the FHLB, the Company had approximately \$33.0 million of additional borrowing capacity at March 31, 2014. The Company also had \$16.5 million in unpledged securities that may be used to pledge for additional borrowings.

At March 31, 2014, the Company had unused federal funds lines totaling \$11.5 million, with a zero balance outstanding.

The Company’s contractual obligations as of March 31, 2014 were comprised of long-term debt obligations, other debt obligations, operating lease obligations and other long-term liabilities. Long-term debt obligations are comprised of FHLB Advances of \$16.9 million, and Trust Preferred securities of \$20.6. The operating lease obligations consist of a lease on the RDSI-North building of \$162 thousand per year and a lease on the DCM-Lansing facility of \$105

thousand per year. Total time deposits at March 31, 2014 were \$171.9 million, of which \$79.4 million matures beyond one year.

Also, as of March 31, 2014, the Company had commitments to sell mortgage loans totaling \$7.1 million. The Company believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If the Company requires funds beyond its internal funding capabilities, advances from the FHLB of Cincinnati and other financial institutions are available.

## ASSET LIABILITY MANAGEMENT

Asset liability management involves developing, executing and monitoring strategies to maintain appropriate liquidity, maximize net interest income and minimize the impact that significant fluctuations in market interest rates would have on current and future earnings. The business of the Company and the composition of its balance sheet consist of investments in interest-earning assets (primarily loans, mortgage-backed securities, and securities available for sale) which are primarily funded by interest-bearing liabilities (deposits and borrowings). With the exception of specific loans which are originated and held for sale, all of the financial instruments of the Company are for other than trading purposes. All of the Company's transactions are denominated in U.S. dollars with no specific foreign exchange exposure. In addition, the Company has limited exposure to commodity prices related to agricultural loans. The impact of changes in foreign exchange rates and commodity prices on interest rates are assumed to be insignificant. The Company's financial instruments have varying levels of sensitivity to changes in market interest rates resulting in market risk. Interest rate risk is the Company's primary market risk exposure; to a lesser extent, liquidity risk also impacts market risk exposure.

Interest rate risk is the exposure of a banking institution's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value; however, excessive levels of interest rate risk could pose a significant threat to the Company's earnings and capital base. Accordingly, effective risk management that maintains interest rate risks at prudent levels is essential to the Company's safety and soundness.

Evaluating a financial institution's exposure to changes in interest rates includes assessing both the adequacy of the management process used to control interest rate risk and the organization's quantitative level of exposure. When assessing the interest rate risk management process, the Company seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain interest rate risks at prudent levels of consistency and continuity. Evaluating the quantitative level of interest rate risk exposure requires the Company to assess the existing and potential future effects of changes in interest rates on its consolidated financial condition, including capital adequacy, earnings, liquidity and asset quality (when appropriate).

The Federal Reserve Board together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Company adopted a Joint Agency Policy Statement on interest rate risk effective June 26, 1996. The policy statement provides guidance to examiners and bankers on sound practices for managing interest rate risk, which will form the basis for ongoing evaluation of the adequacy of interest rate risk management at supervised institutions. The policy statement also outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing interest rate risk. Specifically, the guidance emphasizes the need for active board of director and senior management oversight and a comprehensive risk management process that effectively identifies, measures and controls interest rate risk.

Financial institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Since market interest rates change over time, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest rate changes. For example, assume that an institution's assets carry intermediate or long-term fixed rates and that those assets are funded with short-term liabilities. If market interest rates rise by the time the short-term liabilities must be refinanced, the increase in the institution's interest expense on its liabilities may not be sufficiently offset if assets continue to earn at the long-term fixed rates. Accordingly, an institution's profits

could decrease on existing assets because the institution will either have lower net interest income or possibly, net interest expense. Similar risks exist when assets are subject to contractual interest rate ceilings, or rate-sensitive assets are funded by longer-term, fixed-rate liabilities in a declining rate environment.

There are several ways an institution can manage interest rate risk including: 1) matching repricing periods for new assets and liabilities, for example, by shortening or lengthening terms of new loans, investments, or liabilities; 2) selling existing assets or repaying certain liabilities; and 3) hedging existing assets, liabilities, or anticipated transactions. An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest rate risk. Interest rate swaps, futures contracts, options on futures contracts, and other such derivative financial instruments can be used for this purpose. Because these instruments are sensitive to interest rate changes, they require management's expertise to be effective. The Company has not purchased derivative financial instruments in the past but may purchase such instruments in the future if market conditions are favorable.

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

Management believes there has been no material change in the Company's market risk from the information contained in the Company's Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2013.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

With the participation of the President and Chief Executive Officer (the principal executive officer) and the Executive Vice President and Chief Financial Officer (the principal financial officer) of the Company, the Company's management has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the quarterly period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Company's President and Chief Executive Officer and the Company's Executive Vice President and Chief Financial Officer have concluded that:

- information required to be disclosed by the Company in this Quarterly Report on Form 10-Q and other reports which the Company files or submits under the Exchange Act would be 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;
- information required to be disclosed by the Company in this Quarterly Report on Form 10-Q and other reports which the Company files or submits under the Exchange Act would be recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and
- the Company's disclosure controls and procedures were effective as of the end of the quarterly period covered by this Quarterly Report on Form 10-Q.

#### Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's fiscal quarter ended March 31, 2014, 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

In the ordinary course of our business, the Company and its subsidiaries are parties to various legal actions which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability, if any, with respect to these legal actions cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

### Item 1A. Risk Factors

There are certain risks and uncertainties in our business that could cause our actual results to differ materially from those anticipated. A detailed discussion of our risk factors is included in “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes to the risk factors as presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

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

(a) Not applicable

(b) Not applicable

(c) Repurchases of Common Shares

The Company did not have any repurchases of common shares during the three months ended March 31, 2014.

### Item 3. Defaults Upon Senior Securities

Not applicable

### Item 4. Mine Safety Disclosures

Not applicable

### Item 5. Other Information

Not applicable

### Item 6. Exhibits

#### Exhibits

31.1 – Rule 13a-14(a)/15d-14(a) Certification (Principal Executive Officer)

31.2 – Rule 13a-14(a)/15d-14(a) Certification (Principal Financial Officer)

32.1 – Section 1350 Certification (Principal Executive Officer)

32.2 – Section 1350 Certification (Principal Financial Officer)



SIGNATURES

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

SB FINANCIAL GROUP, INC.

Date: May 8, 2014

By

Mark A. Klein  
President & Chief Executive Officer

By

Anthony V. Cosentino  
Executive Vice President &  
Chief Financial Officer