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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

*(Mark One)*

**☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended September 30, 2022

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: 0-23636

**HAWTHORN BANCSHARES, INC.**

*(Exact name of registrant as specified in its charter)*

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| **Missouri** | | | **43-1626350** | | |
| *(State or other jurisdiction of* | | | *(I.R.S. Employer Identification No.*) | | |
| *incorporation or organization)* | | |  | | |

**132 East High Street, Box 688, Jefferson City, Missouri 65102**

*(Address of principal executive offices)* *(Zip Code)*

**(573) 761-6100**

*(Registrant’s telephone number, including area code)*

**N/A**

*(Former name, former address and former fiscal year, if changed since last report.)*

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

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |
| **Title of each class** | | | **Trading Symbol(s)** | | | **Name of each exchange on which registered** | | |
| Common Stock, $1.00 par value | | | HWBK | | | The Nasdaq Stock Market LLC | | |

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

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

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

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

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

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

As of November 10, 2022, the registrant had 6,768,581 shares of common stock, par value $1.00 per share, outstanding.

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**PART I – FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Balance Sheets**

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| (In thousands, except per share data) | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
|  | | | *(Unaudited)* | | |  | | |  | | |
| **ASSETS** | | |  | | |  | | |  | | |
| Cash and due from banks | | | $ | 15,081 |  |  | | | $ | 17,287 |  |
| Federal funds sold | | | 46 | | |  | | | 7,122 | | |
| Other interest-bearing deposits | | | 26,259 | | |  | | | 135,500 | | |
| Cash and cash equivalents | | | 41,386 | | |  | | | 159,909 | | |
| Certificates of deposit in other banks | | | 4,195 | | |  | | | 5,193 | | |
| Available-for-sale debt securities, at fair value | | | 245,155 | | |  | | | 310,870 | | |
| Other investments | | | 5,361 | | |  | | | 5,408 | | |
| **Total investment securities** | | | 250,516 | | |  | | | 316,278 | | |
| Loans held for investment | | | 1,491,997 | | |  | | | 1,302,133 | | |
| Allowance for loan losses | | | (15,505) | | |  | | | (16,903) | | |
| **Net loans** | | | 1,476,492 | | |  | | | 1,285,230 | | |
| Loans held for sale, at lower of cost or fair value | | | 913 | | |  | | | 2,249 | | |
| Premises and equipment - net | | | 33,334 | | |  | | | 32,719 | | |
| Mortgage servicing rights, at fair value | | | 2,906 | | |  | | | 2,659 | | |
| Other real estate owned - net | | | 9,210 | | |  | | | 10,525 | | |
| Accrued interest receivable | | | 7,048 | | |  | | | 6,621 | | |
| Cash surrender value - life insurance | | | 2,553 | | |  | | | 2,509 | | |
| Other assets | | | 19,045 | | |  | | | 7,658 | | |
| **Total assets** | | | $ | 1,847,598 |  |  | | | $ | 1,831,550 |  |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |  | | |  | | |  | | |
| Deposits | | |  | | |  | | |  | | |
| Non-interest bearing demand | | | $ | 498,653 |  |  | | | $ | 453,066 |  |
| Savings, interest checking and money market | | | 825,593 | | |  | | | 818,358 | | |
| Time deposits $250,000 and over | | | 110,859 | | |  | | | 69,075 | | |
| Other time deposits | | | 157,693 | | |  | | | 176,321 | | |
| **Total deposits** | | | 1,592,798 | | |  | | | 1,516,820 | | |
| Federal funds purchased and securities sold under agreements to repurchase | | | 5,890 | |  |  | | | 23,829 | |  |
| Federal Home Loan Bank advances and other borrowings | | | 73,000 | | |  | | | 77,418 | | |
| Subordinated notes | | | 49,486 | | |  | | | 49,486 | | |
| Operating lease liabilities | | | 1,610 | | |  | | | 1,837 | | |
| Accrued interest payable | | | 565 | | |  | | | 282 | | |
| Other liabilities | | | 8,844 | | |  | | | 12,922 | | |
| **Total liabilities** | | | 1,732,193 | | |  | | | 1,682,594 | | |
| Stockholders’ equity: | | |  | | |  | | |  | | |
| Common stock, $1.00 par value, authorized 15,000,000 shares; issued 7,284,151 and 7,023,821 shares, respectively | | | 7,284 | | |  | | | 7,024 | | |
| Surplus | | | 71,042 | | |  | | | 64,437 | | |
| Retained earnings | | | 88,214 | | |  | | | 82,300 | | |
| Accumulated other comprehensive (loss) income, net of tax | | | (40,145) | | |  | | | 3,293 | | |
| Treasury stock; 515,570, and 406,846 shares, at cost, respectively | | | (10,990) | | |  | | | (8,098) | | |
| **Total stockholders’ equity** | | | 115,405 | | |  | | | 148,956 | | |
| **Total liabilities and stockholders’ equity** | | | $ | 1,847,598 |  |  | | | $ | 1,831,550 |  |

See accompanying notes to the consolidated financial statements *(unaudited)*.

2

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Income** *(unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
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|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| ***(In thousands, except per share data)*** | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **INTEREST INCOME** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Interest and fees on loans | | | $ | 16,328 |  |  | | | $ | 15,448 |  |  | | | $ | 44,831 |  |  | | | $ | 44,311 |  |
| Interest and fees on loans held for sale | | | 23 | | |  | | | 24 | | |  | | | 69 | | |  | | | 79 | | |
| Interest on investment securities: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Taxable | | | 781 | | |  | | | 679 | | |  | | | 2,361 | | |  | | | 2,057 | | |
| Nontaxable | | | 621 | | |  | | | 493 | | |  | | | 1,822 | | |  | | | 1,114 | | |
| Federal funds sold | | | — | | |  | | | 1 | | |  | | | 5 | | |  | | | 6 | | |
| Other interest-bearing deposits and certificates of deposit in other banks | | | 76 | | |  | | | 78 | | |  | | | 179 | | |  | | | 263 | | |
| Dividends on other investments | | | 64 | | |  | | | 81 | | |  | | | 204 | | |  | | | 246 | | |
| **Total interest income** | | | 17,893 | | |  | | | 16,804 | | |  | | | 49,471 | | |  | | | 48,076 | | |
| **INTEREST EXPENSE** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Interest on deposits: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Savings, interest checking and money market | | | 1,382 | | |  | | | 280 | | |  | | | 2,275 | | |  | | | 865 | | |
| Time deposit accounts $250,000 and over | | | 345 | | |  | | | 117 | | |  | | | 588 | | |  | | | 473 | | |
| Time deposits | | | 239 | | |  | | | 320 | | |  | | | 709 | | |  | | | 1,139 | | |
| **Total interest expense on deposits** | | | 1,966 | | |  | | | 717 | | |  | | | 3,572 | | |  | | | 2,477 | | |
| Interest on federal funds purchased and securities sold under agreements to repurchase | | | 13 | | |  | | | 19 | | |  | | | 32 | | |  | | | 72 | | |
| Interest on Federal Home Loan Bank advances | | | 277 | | |  | | | 383 | | |  | | | 778 | | |  | | | 1,164 | | |
| Interest on subordinated notes | | | 570 | | |  | | | 305 | | |  | | | 1,316 | | |  | | | 921 | | |
| **Total interest expense on borrowings** | | | 860 | | |  | | | 707 | | |  | | | 2,126 | | |  | | | 2,157 | | |
| **Total interest expense** | | | 2,826 | | |  | | | 1,424 | | |  | | | 5,698 | | |  | | | 4,634 | | |
| **Net interest income** | | | 15,067 | | |  | | | 15,380 | | |  | | | 43,773 | | |  | | | 43,442 | | |
| Provision for (release of) loan losses | | | 300 | | |  | | | 300 | | |  | | | (1,000) | | |  | | | 700 | | |
| **Net interest income after provision for (release of) loan losses** | | | 14,767 | | |  | | | 15,080 | | |  | | | 44,773 | | |  | | | 42,742 | | |
| **NON-INTEREST INCOME** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Service charges and other fees | | | 693 | | |  | | | 782 | | |  | | | 2,322 | | |  | | | 2,285 | | |
| Bank card income and fees | | | 1,030 | | |  | | | 1,043 | | |  | | | 3,054 | | |  | | | 2,925 | | |
| Trust department income | | | 287 | | |  | | | 308 | | |  | | | 924 | | |  | | | 910 | | |
| Real estate servicing fees, net | | | 383 | | |  | | | 71 | | |  | | | 861 | | |  | | | 495 | | |
| Gain on sale of mortgage loans, net | | | 628 | | |  | | | 1,369 | | |  | | | 2,322 | | |  | | | 5,881 | | |
| Other | | | 464 | | |  | | | 203 | | |  | | | 1,376 | | |  | | | 514 | | |
| **Total non-interest income** | | | 3,485 | | |  | | | 3,776 | | |  | | | 10,859 | | |  | | | 13,010 | | |
| **Investment securities gains (losses), net** | | | 1 | | |  | | | 126 | | |  | | | (12) | | |  | | | 140 | | |
| **NON-INTEREST EXPENSE** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Salaries and employee benefits | | | 6,750 | | |  | | | 6,665 | | |  | | | 20,251 | | |  | | | 20,766 | | |
| Occupancy expense, net | | | 789 | | |  | | | 808 | | |  | | | 2,339 | | |  | | | 2,298 | | |
| Furniture and equipment expense | | | 774 | | |  | | | 787 | | |  | | | 2,301 | | |  | | | 2,284 | | |
| Processing, network, and bank card expense | | | 1,261 | | |  | | | 1,288 | | |  | | | 3,545 | | |  | | | 3,520 | | |
| Legal, examination, and professional fees | | | 395 | | |  | | | 357 | | |  | | | 1,210 | | |  | | | 1,146 | | |
| Advertising and promotion | | | 430 | | |  | | | 310 | | |  | | | 1,027 | | |  | | | 862 | | |
| Postage, printing, and supplies | | | 237 | | |  | | | 218 | | |  | | | 653 | | |  | | | 608 | | |
| Loan expense | | | 123 | | |  | | | 209 | | |  | | | 426 | | |  | | | 612 | | |
| Other | | | 1,436 | | |  | | | 1,127 | | |  | | | 4,210 | | |  | | | 3,295 | | |
| **Total non-interest expense** | | | 12,195 | | |  | | | 11,769 | | |  | | | 35,962 | | |  | | | 35,391 | | |
| Income before income taxes | | | 6,058 | | |  | | | 7,213 | | |  | | | 19,658 | | |  | | | 20,501 | | |
| Income tax expense | | | 1,131 | | |  | | | 1,417 | | |  | | | 3,633 | | |  | | | 3,974 | | |
| **Net income** | | | $ | 4,927 |  |  | | | $ | 5,796 |  |  | | | $ | 16,025 |  |  | | | $ | 16,527 |  |
| Basic earnings per share | | | $ | 0.73 |  |  | | | $ | 0.84 |  |  | | | $ | 2.36 |  |  | | | $ | 2.40 |  |
| Diluted earnings per share | | | $ | 0.73 |  |  | | | $ | 0.84 |  |  | | | $ | 2.36 |  |  | | | $ | 2.40 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |

See accompanying notes to the consolidated financial statements *(unaudited)*.

3

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive (Loss) Income** *(unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| ***(In thousands)*** | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Net income** | | | $ | 4,927 |  |  | | | $ | 5,796 |  |  | | | $ | 16,025 |  |  | | | $ | 16,527 |  |
| **Other comprehensive (loss) income, net of tax** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Investment securities available-for-sale: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Change in unrealized losses on investment securities available-for-sale, net of tax | | | (12,430) | | |  | | | (2,192) | | |  | | | (43,438) | | |  | | | (3,222) | | |
| Adjustment for gains on sale of investment securities, net of tax | | | — | | |  | | | (93) | | |  | | | — | | |  | | | (95) | | |
| Defined benefit pension plans: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Amortization of prior service cost included in net periodic pension cost, net of tax | | | — | | |  | | | 72 | | |  | | | — | | |  | | | 217 | | |
| **Total other comprehensive loss** | | | (12,430) | | |  | | | (2,213) | | |  | | | (43,438) | | |  | | | (3,100) | | |
| **Total comprehensive (loss) income** | | | $ | (7,503) |  |  | | | $ | 3,583 |  |  | | | $ | (27,413) |  |  | | | $ | 13,427 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |

See accompanying notes to the consolidated financial statements *(unaudited)*.

4

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Stockholders’ Equity** *(unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
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|  | | | **Three Months Ended September 30, 2022 and 2021** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| ***(In thousands, except per share data)*** | | | **Common Stock** | | |  | | | **Surplus** | | |  | | | **Retained Earnings** | | |  | | | **Accumulated Other Comprehensive Income (Loss)** | | |  | | | **Treasury Stock** | | |  | | | **Total Stockholders' Equity** | | |
| **Balance, June 30, 2022** | | | $ | 7,024 |  |  | | | $ | 71,302 |  |  | | | $ | 84,437 |  |  | | | $ | (27,715) |  |  | | | $ | (10,990) |  |  | | | $ | 124,058 |  |
| Net income | | | — | | |  | | | — | | |  | | | 4,927 | | |  | | | — | | |  | | | — | | |  | | | 4,927 | | |
| Other comprehensive loss | | | — | | |  | | | — | | |  | | | — | | |  | | | (12,430) | | |  | | | — | | |  | | | (12,430) | | |
| Purchase of treasury stock | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| Stock dividend | | | 260 | | |  | | | (260) | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| Cash dividends declared, common stock ($0.17 per share) | | | — | | |  | | | — | | |  | | | (1,150) | | |  | | | — | | |  | | | — | | |  | | | (1,150) | | |
| **Balance, September 30, 2022** | | | $ | 7,284 |  |  | | | $ | 71,042 |  |  | | | $ | 88,214 |  |  | | | $ | (40,145) |  |  | | | $ | (10,990) |  |  | | | $ | 115,405 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Balance, June 30, 2021** | | | $ | 6,769 |  |  | | | $ | 64,692 |  |  | | | $ | 72,499 |  |  | | | $ | 641 |  |  | | | $ | (8,098) |  |  | | | $ | 136,503 |  |
| Net income | | | — | | |  | | | — | | |  | | | 5,796 | | |  | | | — | | |  | | | — | | |  | | | 5,796 | | |
| Other comprehensive loss | | | — | | |  | | | — | | |  | | | — | | |  | | | (2,213) | | |  | | | — | | |  | | | (2,213) | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Stock dividend | | | 255 | | |  | | | (255) | | |  | | | — | | |  | | |  | | |  | | |  | | |  | | | — | | |
| Cash dividends declared, common stock ($0.15 per share) | | |  | | |  | | |  | | |  | | | (992) | | |  | | |  | | |  | | |  | | |  | | | (992) | | |
| **Balance, September 30, 2021** | | | $ | 7,024 |  |  | | | $ | 64,437 |  |  | | | $ | 77,303 |  |  | | | $ | (1,572) |  |  | | | $ | (8,098) |  |  | | | $ | 139,094 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30, 2022 and 2021** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| ***(In thousands, except per share data)*** | | | **Common Stock** | | |  | | | **Surplus** | | |  | | | **Retained Earnings** | | |  | | | **Accumulated Other Comprehensive Income (Loss)** | | |  | | | **Treasury Stock** | | |  | | | **Total Stockholders' Equity** | | |
| **Balance, December 31, 2021** | | | $ | 7,024 |  |  | | | $ | 64,437 |  |  | | | $ | 82,300 |  |  | | | $ | 3,293 |  |  | | | $ | (8,098) |  |  | | | $ | 148,956 |  |
| Net income | | | — | | |  | | | — | | |  | | | 16,025 | | |  | | | — | | |  | | | — | | |  | | | 16,025 | | |
| Other comprehensive loss | | | — | | |  | | | — | | |  | | | — | | |  | | | (43,438) | | |  | | | — | | |  | | | (43,438) | | |
| Purchase of treasury stock | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | (2,892) | | |  | | | (2,892) | | |
| Stock dividend | | | 260 | | |  | | | 6,605 | | |  | | | (6,865) | | |  | | | — | | |  | | | — | | |  | | | — | | |
| Cash dividends declared, common stock ($0.49 per share) | | | — | | |  | | | — | | |  | | | (3,246) | | |  | | | — | | |  | | | — | | |  | | | (3,246) | | |
| **Balance, September 30, 2022** | | | $ | 7,284 |  |  | | | $ | 71,042 |  |  | | | $ | 88,214 |  |  | | | $ | (40,145) |  |  | | | $ | (10,990) |  |  | | | $ | 115,405 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Balance, December 31, 2020** | | | $ | 6,769 |  |  | | | $ | 59,307 |  |  | | | $ | 68,935 |  |  | | | $ | 1,528 |  |  | | | $ | (5,950) |  |  | | | $ | 130,589 |  |
| Net income | | | — | | |  | | | — | | |  | | | 16,527 | | |  | | | — | | |  | | | — | | |  | | | 16,527 | | |
| Other comprehensive loss | | | — | | |  | | | — | | |  | | | — | | |  | | | (3,100) | | |  | | | — | | |  | | | (3,100) | | |
| Purchase of treasury stock | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | | (2,148) | | |  | | | (2,148) | | |
| Stock dividend | | | 255 | | |  | | | 5,130 | | |  | | | (5,385) | | |  | | |  | | |  | | |  | | |  | | | — | | |
| Cash dividends declared, common stock ($0.43 per share) | | |  | | |  | | |  | | |  | | | (2,774) | | |  | | |  | | |  | | |  | | |  | | | (2,774) | | |
| **Balance, September 30, 2021** | | | $ | 7,024 |  |  | | | $ | 64,437 |  |  | | | $ | 77,303 |  |  | | | $ | (1,572) |  |  | | | $ | (8,098) |  |  | | | $ | 139,094 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
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See accompanying notes to the consolidated financial statements *(unaudited)*.

5

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows** *(unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30,** | | | | | | | | |
| ***(In thousands)*** | | | **2022** | | |  | | | **2021** | | |
| **Cash flows from operating activities:** | | |  | | |  | | |  | | |
| Net income | | | $ | 16,025 |  |  | | | $ | 16,527 |  |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |  | | |  | | |  | | |
| (Release of) provision for loan losses | | | (1,000) | | |  | | | 700 | | |
| Depreciation expense | | | 1,615 | | |  | | | 1,727 | | |
| Net amortization of investment securities, premiums, and discounts | | | 1,086 | | |  | | | 1,337 | | |
| Change in fair value of mortgage servicing rights | | | (186) | | |  | | | 86 | | |
| Investment securities (gains) losses, net | | | 12 | | |  | | | (140) | | |
| (Gain) losses on sales and dispositions of premises and equipment | | | (147) | | |  | | | 8 | | |
| Gain on sales and dispositions of other real estate | | | (2) | | |  | | | (25) | | |
|  | | |  | | |  | | |  | | |
| (Release of) provision for other real estate owned | | | (28) | | |  | | | 97 | | |
| Increase in accrued interest receivable | | | (427) | | |  | | | (928) | | |
| Increase in cash surrender value - life insurance | | | (44) | | |  | | | (44) | | |
| Decrease in other assets | | | 155 | | |  | | | 694 | | |
| Decrease in operating lease liabilities | | | (227) | | |  | | | (227) | | |
| Increase (decrease) in accrued interest payable | | | 283 | | |  | | | (529) | | |
| (Decrease) increase in other liabilities | | | (4,185) | | |  | | | 64 | | |
| Origination of mortgage loans held for sale | | | (72,563) | | |  | | | (161,244) | | |
| Proceeds from the sale of mortgage loans held for sale | | | 76,110 | | |  | | | 167,289 | | |
| Gain on sale of mortgage loans, net | | | (2,322) | | |  | | | (5,881) | | |
|  | | |  | | |  | | |  | | |
| **Net cash provided by operating activities** | | | 14,155 | | |  | | | 19,511 | | |
| **Cash flows from investing activities:** | | |  | | |  | | |  | | |
| Purchase of certificates of deposit in other banks | | | (245) | | |  | | | (245) | | |
| Proceeds from maturities of certificates of deposit in other banks | | | 1,237 | | |  | | | 2,957 | | |
| Net (increase) decrease in loans | | | (190,215) | | |  | | | 4,121 | | |
| Purchase of available-for-sale debt securities | | | (17,318) | | |  | | | (136,686) | | |
| Proceeds from maturities of available-for-sale debt securities | | | 24,673 | | |  | | | 30,658 | | |
| Proceeds from calls of available-for-sale debt securities | | | 2,295 | | |  | | | 14,685 | | |
| Proceeds from sales of available-for-sale debt securities | | | — | | |  | | | 5,420 | | |
| Purchases of FHLB stock | | | (8,103) | | |  | | | (330) | | |
| Proceeds from sales of FHLB stock | | | 8,138 | | |  | | | 688 | | |
| Purchases of premises and equipment | | | (2,433) | | |  | | | (425) | | |
| Proceeds from sales of premises and equipment | | | 304 | | |  | | | 13 | | |
|  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |
| Proceeds from sales of other real estate and repossessed assets | | | 1,348 | | |  | | | 747 | | |
| **Net cash used in investing activities** | | | (180,319) | | |  | | | (78,397) | | |
| **Cash flows from financing activities:** | | |  | | |  | | |  | | |
| Net increase in demand deposits | | | 45,587 | | |  | | | 79,134 | | |
| Net increase (decrease) in interest-bearing transaction accounts | | | 7,235 | | |  | | | (30,743) | | |
| Net increase (decrease) in time deposits | | | 23,156 | | |  | | | (20,938) | | |
| Net decrease in federal funds purchased and securities sold under agreements to repurchase | | | (17,939) | | |  | | | (17,711) | | |
| Repayment of FHLB advances and other borrowings | | | (195,962) | | |  | | | (13,181) | | |
| FHLB advances | | | 191,544 | | |  | | | — | | |
| Purchase of treasury stock | | | (2,892) | | |  | | | (2,148) | | |
| Cash dividends paid - common stock | | | (3,088) | | |  | | | (2,624) | | |
| **Net cash provided by (used in) financing activities** | | | 47,641 | | |  | | | (8,211) | | |
| Net decrease in cash and cash equivalents | | | (118,523) | | |  | | | (67,097) | | |
| Cash and cash equivalents, beginning of period | | | 159,909 | | |  | | | 180,363 | | |
| **Cash and cash equivalents, end of period** | | | $ | 41,386 |  |  | | | $ | 113,266 |  |
|  | | |  | | |  | | |  | | |
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See accompanying notes to the consolidated financial statements *(unaudited).*

6

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows** *(unaudited) continued*

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30,** | | | | | | | | |
| ***(In thousands)*** | | | **2022** | | |  | | | **2021** | | |
|  | | |  | | |  | | |  | | |
| **Supplemental disclosures of cash flow information:** | | |  | | |  | | |  | | |
| Cash paid during the period for: | | |  | | |  | | |  | | |
| Interest | | | $ | 5,415 |  |  | | | $ | 5,163 |  |
| Income taxes | | | $ | 4,307 |  |  | | | $ | 4,729 |  |
| **Noncash investing and financing activities:** | | |  | | |  | | |  | | |
| Other real estate and repossessed assets acquired in settlement of loans net of (charge-offs) | | | $ | 3 |  |  | | | $ | 142 |  |
|  | | |  | | |  | | |  | | |

See accompanying notes to the consolidated financial statements *(unaudited).*

7

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(1) Summary of Significant Accounting Policies**

Hawthorn Bancshares, Inc. (the Company) through its subsidiary, Hawthorn Bank (the Bank), provides a broad range of banking services to individual and corporate customers located within the Missouri communities in and surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, St. Louis, and the greater Kansas City metropolitan area. The Company is subject to competition from other financial and nonfinancial institutions providing financial products. Additionally, the Company and its subsidiaries are subject to the regulations of certain regulatory agencies and undergo periodic examinations by those regulatory agencies.

The accompanying unaudited consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2021.

The preparation of the consolidated financial statements includes all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Management is required to make estimates and assumptions, including the determination of the allowance for loan losses, real estate acquired in connection with foreclosure or in satisfaction of loans, and fair values of investment securities available-for-sale that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions are subject to many risks and uncertainties, including changes in interest rates and other general economic, business and political conditions, including the effects of the novel coronavirus (COVID-19) pandemic or any resurgence thereof, including its potential effects on the economic environment, the Company's customers and operations, as well as any changes to federal, state and local government laws, regulations and orders in connection with the pandemic. Actual results could differ from those estimates. The Company’s management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

***Stock Dividend*** On July 1, 2022, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2022. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

**(2) Loans and Allowance for Loan Losses**

*Loans*

Major classifications within the Company’s held for investment loan portfolio at September 30, 2022 and December 31, 2021 is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| Commercial, financial, and agricultural(a) | | | $ | 248,913 |  |  | | | $ | 217,214 |  |
| Real estate construction − residential | | | 25,243 | | |  | | | 27,920 | | |
| Real estate construction − commercial | | | 133,186 | | |  | | | 91,369 | | |
| Real estate mortgage − residential | | | 343,661 | | |  | | | 279,346 | | |
| Real estate mortgage − commercial | | | 717,192 | | |  | | | 663,256 | | |
| Installment and other consumer | | | 23,802 | | |  | | | 23,028 | | |
| **Total loans held for investment** | | | $ | 1,491,997 |  |  | | | $ | 1,302,133 |  |

(a)Includes $0.6 million and $8.4 million of Small Business Administration Paycheck Protection (PPP) loans, net as of September 30, 2022 and December 31, 2021, respectively.

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the Missouri communities surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, St. Louis, and the greater Kansas City metropolitan area. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist

8

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

primarily of the financing of automotive vehicles. At September 30, 2022, loans of $636.5 million were pledged to the Federal Home Loan Bank (FHLB) as collateral for borrowings and letters of credit.

*Allowance for Loan Losses*

The following table illustrates the changes in the allowance for loan losses by portfolio segment:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30, 2022** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Commercial, Financial, & Agricultural** | | |  | | | **Real Estate Construction - Residential** | | |  | | | **Real Estate Construction - Commercial** | | |  | | | **Real Estate Mortgage - Residential** | | |  | | | **Real Estate Mortgage - Commercial** | | |  | | | **Installment and Other Consumer** | | |  | | | **Un- allocated** | | |  | | | **Total** | | |
| **Balance at beginning of period** | | | **$** | **3,005** |  |  | | | **$** | **66** |  |  | | | **$** | **762** |  |  | | | **$** | **2,747** |  |  | | | **$** | **8,410** |  |  | | | **$** | **312** |  |  | | | **$** | **51** |  |  | | | **$** | **15,353** |  |
| Additions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Provision for (release of ) loan losses | | | (124) | | |  | | | 5 | | |  | | | 87 | | |  | | | 481 | | |  | | | (414) | | |  | | | 129 | | |  | | | 136 | | |  | | | 300 | | |
| Deductions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Loans charged off | | | 46 | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | (1) | | |  | | | 146 | | |  | | | — | | |  | | | 191 | | |
| Less recoveries on loans | | | (13) | | |  | | | — | | |  | | | — | | |  | | | (4) | | |  | | | (5) | | |  | | | (21) | | |  | | |  | | |  | | | (43) | | |
| **Net loan charge-offs (recoveries)** | | | 33 | | |  | | | — | | |  | | | — | | |  | | | (4) | | |  | | | (6) | | |  | | | 125 | | |  | | | — | | |  | | | 148 | | |
| **Balance at end of period** | | | **$** | **2,848** |  |  | | | **$** | **71** |  |  | | | **$** | **849** |  |  | | | **$** | **3,232** |  |  | | | **$** | **8,002** |  |  | | | **$** | **316** |  |  | | | **$** | **187** |  |  | | | **$** | **15,505** |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30, 2021** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Commercial, Financial, & Agricultural** | | |  | | | **Real Estate Construction - Residential** | | |  | | | **Real Estate Construction - Commercial** | | |  | | | **Real Estate Mortgage - Residential** | | |  | | | **Real Estate Mortgage - Commercial** | | |  | | | **Installment and Other Consumer** | | |  | | | **Un- allocated** | | |  | | | **Total** | | |
| **Balance at beginning of period** | | | **$** | **5,336** |  |  | | | **$** | **251** |  |  | | | **$** | **495** |  |  | | | **$** | **2,467** |  |  | | | **$** | **9,915** |  |  | | | **$** | **252** |  |  | | | **$** | **19** |  |  | | | **$** | **18,735** |  |
| Additions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Provision for (release of ) loan losses | | | (609) | | |  | | | (16) | | |  | | | (70) | | |  | | | 216 | | |  | | | 780 | | |  | | | 59 | | |  | | | (60) | | |  | | | 300 | | |
| Deductions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Loans charged off | | | 45 | | |  | | | — | | |  | | | — | | |  | | | 18 | | |  | | | 15 | | |  | | | 78 | | |  | | |  | | |  | | | 156 | | |
| Less recoveries on loans | | | (19) | | |  | | | — | | |  | | | — | | |  | | | (8) | | |  | | | (1) | | |  | | | (22) | | |  | | |  | | |  | | | (50) | | |
| **Net loan charge-offs (recoveries)** | | | 26 | | |  | | | — | | |  | | | — | | |  | | | 10 | | |  | | | 14 | | |  | | | 56 | | |  | | | — | | |  | | | 106 | | |
| **Balance at end of period** | | | **$** | **4,701** |  |  | | | **$** | **235** |  |  | | | **$** | **425** |  |  | | | **$** | **2,673** |  |  | | | **$** | **10,681** |  |  | | | **$** | **255** |  |  | | | **$** | **(41)** |  |  | | | **$** | **18,929** |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30, 2022** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Commercial, Financial, & Agricultural** | | |  | | | **Real Estate Construction - Residential** | | |  | | | **Real Estate Construction - Commercial** | | |  | | | **Real Estate Mortgage - Residential** | | |  | | | **Real Estate Mortgage - Commercial** | | |  | | | **Installment and Other Consumer** | | |  | | | **Un- allocated** | | |  | | | **Total** | | |
| **Balance at beginning of period** | | | **$** | **2,717** |  |  | | | **$** | **137** |  |  | | | **$** | **588** |  |  | | | **$** | **2,482** |  |  | | | **$** | **10,662** |  |  | | | **$** | **256** |  |  | | | **$** | **61** |  |  | | | **$** | **16,903** |  |
| Additions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Provision for (release of ) loan losses | | | 188 | | |  | | | (66) | | |  | | | 261 | | |  | | | 723 | | |  | | | (2,491) | | |  | | | 259 | | |  | | | 126 | | |  | | | (1,000) | | |
| Deductions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Loans charged off | | | 106 | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | 178 | | |  | | | 262 | | |  | | | — | | |  | | | 546 | | |
| Less recoveries on loans | | | (49) | | |  | | | — | | |  | | | — | | |  | | | (27) | | |  | | | (9) | | |  | | | (63) | | |  | | | — | | |  | | | (148) | | |
| **Net loan charge-offs (recoveries)** | | | 57 | | |  | | | — | | |  | | | — | | |  | | | (27) | | |  | | | 169 | | |  | | | 199 | | |  | | | — | | |  | | | 398 | | |
| **Balance at end of period** | | | **$** | **2,848** |  |  | | | **$** | **71** |  |  | | | **$** | **849** |  |  | | | **$** | **3,232** |  |  | | | **$** | **8,002** |  |  | | | **$** | **316** |  |  | | | **$** | **187** |  |  | | | **$** | **15,505** |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30, 2021** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Commercial, Financial, & Agricultural** | | |  | | | **Real Estate Construction - Residential** | | |  | | | **Real Estate Construction - Commercial** | | |  | | | **Real Estate Mortgage - Residential** | | |  | | | **Real Estate Mortgage - Commercial** | | |  | | | **Installment and Other Consumer** | | |  | | | **Un- allocated** | | |  | | | **Total** | | |
| **Balance at beginning of period** | | | **$** | **5,121** |  |  | | | **$** | **213** |  |  | | | **$** | **475** |  |  | | | **$** | **2,679** |  |  | | | **$** | **9,354** |  |  | | | **$** | **264** |  |  | | | **$** | **7** |  |  | | | **$** | **18,113** |  |
| Additions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Provision for (release of ) loan losses | | | (522) | | |  | | | 9 | | |  | | | (50) | | |  | | | (167) | | |  | | | 1,368 | | |  | | | 110 | | |  | | | (48) | | |  | | | 700 | | |
| Deductions: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Loans charged off | | | 100 | | |  | | | — | | |  | | | — | | |  | | | 22 | | |  | | | 42 | | |  | | | 181 | | |  | | |  | | |  | | | 345 | | |
| Less recoveries on loans | | | (202) | | |  | | | (13) | | |  | | | — | | |  | | | (183) | | |  | | | (1) | | |  | | | (62) | | |  | | |  | | |  | | | (461) | | |
| **Net loan charge-offs (recoveries)** | | | (102) | | |  | | | (13) | | |  | | | — | | |  | | | (161) | | |  | | | 41 | | |  | | | 119 | | |  | | | — | | |  | | | (116) | | |
| **Balance at end of period** | | | **$** | **4,701** |  |  | | | **$** | **235** |  |  | | | **$** | **425** |  |  | | | **$** | **2,673** |  |  | | | **$** | **10,681** |  |  | | | **$** | **255** |  |  | | | **$** | **(41)** |  |  | | | **$** | **18,929** |  |

9

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Loans, or portions of loans, are charged off to the extent deemed uncollectible or a loss is confirmed. Loan charge-offs reduce the allowance for loan losses, and recoveries of loans previously charged off are added back to the allowance. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered to be impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic conditions, loan risk ratings and industry concentration.

These historical loss rates for each risk group are used as the starting point to determine loss rates for measurement purposes. The historical loan loss rates are multiplied by loss emergence periods (LEP) which represent the estimated time period between a borrower first experiencing financial difficulty and the recognition of a loss. Management's look-back period began with loss history in the first quarter 2012 as the starting point through the current quarter and it will continue to include this starting point going forward. The look-back period will continue to be evaluated and will be adjusted once a sustained loss producing downturn is recognized and found to be representative of historical losses expected for the current portfolio.

The Company’s methodology includes qualitative risk factors that allow management to adjust its estimates of losses based on the most recent information available and to address other limitations in the quantitative component based on historical loss rates. Such risk factors are generally reviewed and updated quarterly, as appropriate, and are adjusted to reflect changes in national and local economic conditions and developments, the nature, volume and terms of loans in the portfolio, including changes in volume and severity of past due loans, the volume of non-accrual loans, and the volume and severity of adversely classified or graded loans, loan concentrations, assessment of trends in collateral values, assessment of changes in the quality of the Company’s internal loan review department, and changes in lending policies and procedures, including underwriting standards and collections, charge-off and recovery practices.

The funding of $88.4 million and $47.5 million in SBA PPP loans during 2020 and 2021, respectively, required management to assess the methodology that would be adopted in regard to the allowance for loan losses applicable to these loans. Because the SBA PPP loans are expected to be mostly paid off within a year and carry a 100% credit guarantee from the SBA, management determined that no allowance for loan losses was deemed necessary for these loans. At September 30, 2022, the net balance of the PPP loans totaled $0.6 million.

All SBA PPP loans have a 1% interest rate and the Company earns a fee based upon a tiered schedule corresponding with the amount of the loan to the borrower, which is deferred and recognized over the life of the loan. The PPP loan may be forgiven by the SBA if the borrower meets certain criteria as defined by the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The Company reports these loans at their principal amount outstanding, net of unearned income, unamortized deferred loan fee income and loan origination costs. Interest is accrued as earned and loan origination fees and direct costs are deferred and accreted or amortized into interest income, as an adjustment to the yield, over the life of the loan using the level yield method. When a PPP loan is paid off or forgiven by the SBA, the remaining unaccreted or unamortized net origination fees or costs are immediately recognized into income.

10

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table illustrates the allowance for loan losses and recorded investment by portfolio segment:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **Commercial, Financial, and Agricultural** | | |  | | | **Real Estate Construction - Residential** | | |  | | | **Real Estate Construction - Commercial** | | |  | | | **Real Estate Mortgage - Residential** | | |  | | | **Real Estate Mortgage - Commercial** | | |  | | | **Installment and Other Consumer** | | |  | | | **Un- allocated** | | |  | | | **Total** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Allowance for loan losses:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Individually evaluated for impairment | | | $ | 43 |  |  | | | $ | — |  |  | | | $ | 11 |  |  | | | $ | 190 |  |  | | | $ | 57 |  |  | | | $ | 1 |  |  | | | $ | — |  |  | | | $ | 302 |  |
| Collectively evaluated for impairment | | | 2,805 | | |  | | | 71 | | |  | | | 838 | | |  | | | 3,042 | | |  | | | 7,945 | | |  | | | 315 | | |  | | | 187 | | |  | | | 15,203 | | |
| **Total** | | | $ | 2,848 |  |  | | | $ | 71 |  |  | | | $ | 849 |  |  | | | $ | 3,232 |  |  | | | $ | 8,002 |  |  | | | $ | 316 |  |  | | | $ | 187 |  |  | | | $ | 15,505 |  |
| **Loans outstanding:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Individually evaluated for impairment | | | $ | 350 |  |  | | | $ | — |  |  | | | $ | 91 |  |  | | | $ | 2,181 |  |  | | | $ | 16,308 |  |  | | | $ | 6 |  |  | | | $ | — |  |  | | | $ | 18,936 |  |
| Collectively evaluated for impairment | | | 248,563 | | |  | | | 25,243 | | |  | | | 133,095 | | |  | | | 341,480 | | |  | | | 700,884 | | |  | | | 23,796 | | |  | | | — | | |  | | | 1,473,061 | | |
| **Total** | | | $ | 248,913 |  |  | | | $ | 25,243 |  |  | | | $ | 133,186 |  |  | | | $ | 343,661 |  |  | | | $ | 717,192 |  |  | | | $ | 23,802 |  |  | | | $ | — |  |  | | | $ | 1,491,997 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Allowance for loan losses:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Individually evaluated for impairment | | | $ | 42 |  |  | | | $ | — |  |  | | | $ | 13 |  |  | | | $ | 166 |  |  | | | $ | 2,815 |  |  | | | $ | 8 |  |  | | | $ | — |  |  | | | $ | 3,044 |  |
| Collectively evaluated for impairment | | | 2,675 | | |  | | | 137 | | |  | | | 575 | | |  | | | 2,316 | | |  | | | 7,847 | | |  | | | 248 | | |  | | | 61 | | |  | | | 13,859 | | |
| **Total** | | | $ | 2,717 |  |  | | | $ | 137 |  |  | | | $ | 588 |  |  | | | $ | 2,482 |  |  | | | $ | 10,662 |  |  | | | $ | 256 |  |  | | | $ | 61 |  |  | | | $ | 16,903 |  |
| **Loans outstanding:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Individually evaluated for impairment | | | $ | 341 |  |  | | | $ | — |  |  | | | $ | 105 |  |  | | | $ | 2,391 |  |  | | | $ | 24,357 |  |  | | | $ | 60 |  |  | | | $ | — |  |  | | | $ | 27,254 |  |
| Collectively evaluated for impairment | | | 216,873 | | |  | | | 27,920 | | |  | | | 91,264 | | |  | | | 276,955 | | |  | | | 638,899 | | |  | | | 22,968 | | |  | | | — | | |  | | | 1,274,879 | | |
| **Total** | | | $ | 217,214 |  |  | | | $ | 27,920 |  |  | | | $ | 91,369 |  |  | | | $ | 279,346 |  |  | | | $ | 663,256 |  |  | | | $ | 23,028 |  |  | | | $ | — |  |  | | | $ | 1,302,133 |  |

*Impaired Loans*

Loans evaluated under Accounting Standards Codification (ASC) 310-10-35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450-20. Impaired loans individually evaluated for impairment totaled $18.9 million and $27.3 million at September 30, 2022 and December 31, 2021, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings (TDRs).

The net carrying value of impaired loans is based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At September 30, 2022, $15.9 million of impaired loans were evaluated based on the fair value less estimated selling costs of the loans' collateral compared to $24.2 million at December 31, 2021. Once the impairment amount is calculated, a specific reserve allocation is recorded. At September 30, 2022, $0.3 million of the Company’s allowance for loan losses was allocated to impaired loans totaling $18.9 million compared to $3.0 million of the Company’s allowance for loan losses allocated to impaired loans totaling $27.3 million at December 31, 2021. Management determined that $15.9 million, or 84%, of total impaired loans required no reserve allocation at September 30, 2022 compared to $16.6 million, or 61%, at December 31, 2021, primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

11

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The categories of impaired loans at September 30, 2022 and December 31, 2021 are as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| Non-accrual loans | | | $ | 17,348 |  |  | | | $ | 25,459 |  |
| Performing TDRs | | | 1,588 | | |  | | | 1,795 | | |
| **Total impaired loans** | | | $ | 18,936 |  |  | | | $ | 27,254 |  |

The following tables provide additional information about impaired loans at September 30, 2022 and December 31, 2021, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **Recorded Investment** | | |  | | | **Unpaid Principal Balance** | | |  | | | **Specific Reserves** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |
| **With no related allowance recorded:** | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate mortgage − commercial | | | $ | 15,898 |  |  | | | $ | 16,949 |  |  | | | $ | — |  |
|  | | |  | | |  | | |  | | |  | | |  | | |
| **Total** | | | $ | 15,898 |  |  | | | $ | 16,949 |  |  | | | $ | — |  |
| **With an allowance recorded:** | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, financial and agricultural | | | $ | 350 |  |  | | | $ | 384 |  |  | | | $ | 43 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate construction − commercial | | | 91 | | |  | | | 130 | | |  | | | 11 | | |
| Real estate mortgage − residential | | | 2,181 | | |  | | | 2,686 | | |  | | | 190 | | |
| Real estate mortgage − commercial | | | 410 | | |  | | | 496 | | |  | | | 57 | | |
| Installment and other consumer | | | 6 | | |  | | | 6 | | |  | | | 1 | | |
| **Total** | | | $ | 3,038 |  |  | | | $ | 3,702 |  |  | | | $ | 302 |  |
| **Total impaired loans** | | | $ | 18,936 |  |  | | | $ | 20,651 |  |  | | | $ | 302 |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **Recorded Investment** | | |  | | | **Unpaid Principal Balance** | | |  | | | **Specific Reserves** | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |
| **With no related allowance recorded:** | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate mortgage − residential | | | $ | 1,034 |  |  | | | $ | 1,152 |  |  | | | $ | — |  |
| Real estate mortgage − commercial | | | 15,593 | | |  | | | 16,057 | | |  | | | — | | |
| **Total** | | | $ | 16,627 |  |  | | | $ | 17,209 |  |  | | | $ | — |  |
| **With an allowance recorded:** | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, financial and agricultural | | | $ | 341 |  |  | | | $ | 374 |  |  | | | $ | 42 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate construction − commercial | | | 105 | | |  | | | 138 | | |  | | | 13 | | |
| Real estate mortgage − residential | | | 1,357 | | |  | | | 1,730 | | |  | | | 166 | | |
| Real estate mortgage − commercial | | | 8,764 | | |  | | | 9,142 | | |  | | | 2,815 | | |
| Installment and other consumer | | | 60 | | |  | | | 61 | | |  | | | 8 | | |
| **Total** | | | $ | 10,627 |  |  | | | $ | 11,445 |  |  | | | $ | 3,044 |  |
| **Total impaired loans** | | | $ | 27,254 |  |  | | | $ | 28,654 |  |  | | | $ | 3,044 |  |

12

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table presents by class, information related to the average recorded investment and interest income recognized on impaired loans during the periods indicated.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | | | | | | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | | | | | | | | | | | | | |
|  | | | **2022** | | | | | | | | |  | | | **2021** | | | | | | | | |  | | | **2022** | | | | | | | | |  | | | **2021** | | | | | | | | |
| *(in thousands)* | | | **Average Recorded Investment** | | |  | | | **Interest Recognized For the Period Ended** | | |  | | | **Average Recorded Investment** | | |  | | | **Interest Recognized For the Period Ended** | | |  | | | **Average Recorded Investment** | | |  | | | **Interest Recognized For the Period Ended** | | |  | | | **Average Recorded Investment** | | |  | | | **Interest Recognized For the Period Ended** | | |
| **With no related allowance recorded:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, financial and agricultural | | | $ | — |  |  | | | $ | — |  |  | | | $ | 1,517 |  |  | | | $ | 18 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 1,703 |  |  | | | $ | 31 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate mortgage − residential | | | — | |  |  | | | — | |  |  | | | 1,131 | |  |  | | | — | |  |  | | | 4 | |  |  | | | 1 | |  |  | | | 1,238 | |  |  | | | 21 | |  |
| Real estate mortgage − commercial | | | 15,937 | |  |  | | | — | |  |  | | | 9,376 | |  |  | | | — | |  |  | | | 15,752 | |  |  | | | — | |  |  | | | 9,411 | |  |  | | | — | |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Total** | | | $ | 15,937 |  |  | | | $ | — |  |  | | | $ | 12,024 |  |  | | | $ | 18 |  |  | | | $ | 15,756 |  |  | | | $ | 1 |  |  | | | $ | 12,352 |  |  | | | $ | 52 |  |
| **With an allowance recorded:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, financial and agricultural | | | $ | 322 |  |  | | | $ | 3 |  |  | | | $ | 5,295 |  |  | | | $ | 5 |  |  | | | $ | 328 |  |  | | | $ | 8 |  |  | | | $ | 5,409 |  |  | | | $ | 19 |  |
| Real estate construction − residential | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | 63 | | |  | | | — | | |
| Real estate construction − commercial | | | 93 | | |  | | | 15 | | |  | | | 109 | | |  | | | — | | |  | | | 95 | | |  | | | 45 | | |  | | | 139 | | |  | | | — | | |
| Real estate mortgage − residential | | | 2,177 | | |  | | | 6 | | |  | | | 1,713 | | |  | | | 16 | | |  | | | 2,297 | | |  | | | 22 | | |  | | | 1,691 | | |  | | | 26 | | |
| Real estate mortgage − commercial | | | 414 | | |  | | | — | | |  | | | 16,102 | | |  | | | 7 | | |  | | | 422 | | |  | | | 1 | | |  | | | 16,111 | | |  | | | 21 | | |
| Installment and other consumer | | | 99 | | |  | | | — | | |  | | | 55 | | |  | | | — | | |  | | | 118 | | |  | | | — | | |  | | | 63 | | |  | | | 3 | | |
| **Total** | | | $ | 3,105 |  |  | | | $ | 24 |  |  | | | $ | 23,274 |  |  | | | $ | 28 |  |  | | | $ | 3,260 |  |  | | | $ | 76 |  |  | | | $ | 23,476 |  |  | | | $ | 69 |  |
| **Total impaired loans** | | | $ | 19,042 |  |  | | | $ | 24 |  |  | | | $ | 35,298 |  |  | | | $ | 46 |  |  | | | $ | 19,016 |  |  | | | $ | 77 |  |  | | | $ | 35,828 |  |  | | | $ | 121 |  |

The recorded investment varies from the unpaid principal balance primarily due to partial charge-offs taken as a result of from current appraisals received. The amount recognized as interest income on impaired loans continuing to accrue interest, primarily related to TDRs, was $24,000 and $77,000 for the three and nine months ended September 30, 2022, respectively, compared to $46,000 and $121,000 for the three and nine months ended September 30, 2021, respectively. The average recorded investment in impaired loans is calculated on a monthly basis during the periods reported.

*Delinquent and Non-Accrual Loans*

The delinquency status of loans is determined based on the contractual terms of the notes. Loans are generally classified as delinquent once payments become 30 days or more past due. The Company’s policy is to discontinue the accrual of interest income on any loan when, in the opinion of management, the ultimate collectability of interest or principal is no longer probable. In general, loans are placed on non-accrual when they become 90 days or more past due. However, management considers many factors before placing a loan on non-accrual status, including the delinquency status of the loan, the overall financial condition of the borrower, the progress of management’s collection efforts and the value of the underlying collateral. Subsequent interest payments received on non-accrual loans are applied to principal if any doubt exists as to the collectability of such principal; otherwise, such receipts are recorded as interest income on a cash basis. Non-accrual loans are returned to accrual status when, in the opinion of management, the financial condition of the borrower indicates that the timely collectability of interest and principal is probable and the borrower demonstrates the ability to pay under the terms of the note through a sustained period of repayment performance, which is generally six months.

13

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table provides aging information for the Company’s past due and non-accrual loans at September 30, 2022 and December 31, 2021.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **Current or Less Than 30 Days Past Due** | | |  | | | **30 - 89 Days Past Due** | | |  | | | **90 Days Past Due And Still Accruing** | | |  | | | **Non-Accrual** | | |  | | | **Total** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, Financial, and Agricultural | | | $ | 248,707 |  |  | | | $ | 33 |  |  | | | $ | — |  |  | | | $ | 173 |  |  | | | $ | 248,913 |  |
| Real estate construction − residential | | | 25,243 | |  |  | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | 25,243 | |  |
| Real estate construction − commercial | | | 133,095 | |  |  | | | — | |  |  | | | — | |  |  | | | 91 | |  |  | | | 133,186 | |  |
| Real estate mortgage − residential | | | 342,357 | |  |  | | | 221 | |  |  | | | — | |  |  | | | 1,083 | |  |  | | | 343,661 | |  |
| Real estate mortgage − commercial | | | 700,960 | |  |  | | | 237 | |  |  | | | — | |  |  | | | 15,995 | |  |  | | | 717,192 | |  |
| Installment and Other Consumer | | | 23,720 | |  |  | | | 76 | |  |  | | | — | |  |  | | | 6 | |  |  | | | 23,802 | |  |
| **Total** | | | $ | 1,474,082 |  |  | | | $ | 567 |  |  | | | $ | — |  |  | | | $ | 17,348 |  |  | | | $ | 1,491,997 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, Financial, and Agricultural | | | $ | 217,058 |  |  | | | $ | 3 |  |  | | | $ | — |  |  | | | $ | 153 |  |  | | | $ | 217,214 |  |
| Real estate construction − residential | | | 27,920 | | |  | | | — | | |  | | | — | | |  | | | — | | |  | | | 27,920 | | |
| Real estate construction − commercial | | | 91,264 | | |  | | | — | | |  | | | — | | |  | | | 105 | | |  | | | 91,369 | | |
| Real estate mortgage − residential | | | 277,532 | | |  | | | 671 | | |  | | | 14 | | |  | | | 1,129 | | |  | | | 279,346 | | |
| Real estate mortgage − commercial | | | 638,982 | | |  | | | 245 | | |  | | | — | | |  | | | 24,029 | | |  | | | 663,256 | | |
| Installment and Other Consumer | | | 22,848 | | |  | | | 137 | | |  | | | — | | |  | | | 43 | | |  | | | 23,028 | | |
| **Total** | | | $ | 1,275,604 |  |  | | | $ | 1,056 |  |  | | | $ | 14 |  |  | | | $ | 25,459 |  |  | | | $ | 1,302,133 |  |

*Credit Quality*

The Company categorizes loans into risk categories based upon an internal rating system reflecting management’s risk assessment. Loans are placed on *watch* status when one or more weaknesses are identified that may result in the borrower being unable to meet repayment terms or when the Company’s credit position could deteriorate at some future date. Loans classified as *substandard* are inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified may have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. Such loans are characterized by the distinct possibility that the Company may sustain some loss if the deficiencies are not corrected. A loan is classified as a TDR when a borrower is experiencing financial difficulties that lead to the restructuring of a loan, and the Company grants concessions to the borrower in the restructuring that it would not otherwise consider. Loans classified as TDRs that are accruing interest are classified as performing TDRs. Loans classified as TDRs that are not accruing interest are classified as non-performing TDRs and are included with all other non-accrual loans for presentation purposes. It is the Company’s policy to discontinue the accrual of interest income on loans when management believes that the collection of interest or principal is doubtful.

14

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table presents the risk categories by class at September 30, 2022 and December 31, 2021.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **Commercial, Financial, & Agricultural** | | |  | | | **Real Estate Construction - Residential** | | |  | | | **Real Estate Construction - Commercial** | | |  | | | **Real Estate Mortgage - Residential** | | |  | | | **Real Estate Mortgage - Commercial** | | |  | | | **Installment and other Consumer** | | |  | | | **Total** | | |
| **At September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Watch | | | $ | 8,035 |  |  | | | $ | — |  |  | | | $ | 2,269 |  |  | | | $ | 6,447 |  |  | | | $ | 47,953 |  |  | | | $ | — |  |  | | | $ | 64,704 |  |
| Substandard | | | 7,064 | |  |  | | | — | |  |  | | | 3,358 | |  |  | | | 513 | |  |  | | | 2,130 | |  |  | | | — | |  |  | | | 13,065 | |  |
| Performing TDRs | | | 177 | |  |  | | | — | |  |  | | | — | |  |  | | | 1,098 | |  |  | | | 313 | |  |  | | | — | |  |  | | | 1,588 | |  |
| Non-accrual loans | | | 173 | |  |  | | | — | |  |  | | | 91 | |  |  | | | 1,083 | |  |  | | | 15,995 | |  |  | | | 6 | |  |  | | | 17,348 | |  |
| **Total** | | | $ | 15,449 |  |  | | | $ | — |  |  | | | $ | 5,718 |  |  | | | $ | 9,141 |  |  | | | $ | 66,391 |  |  | | | $ | 6 |  |  | | | $ | 96,705 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **At December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Watch | | | $ | 9,219 |  |  | | | $ | — |  |  | | | $ | 4,304 |  |  | | | $ | 12,185 |  |  | | | $ | 43,348 |  |  | | | $ | — |  |  | | | $ | 69,056 |  |
| Substandard | | | 6,284 | |  |  | | | — | |  |  | | | 2,673 | |  |  | | | 750 | |  |  | | | 2,305 | |  |  | | | — | |  |  | | | 12,012 | |  |
| Performing TDRs | | | 188 | | |  | | | — | | |  | | | — | | |  | | | 1,262 | | |  | | | 328 | | |  | | | 17 | | |  | | | 1,795 | | |
| Non-accrual loans | | | 153 | | |  | | | — | | |  | | | 105 | | |  | | | 1,129 | | |  | | | 24,029 | | |  | | | 43 | | |  | | | 25,459 | | |
| **Total** | | | $ | 15,844 |  |  | | | $ | — |  |  | | | $ | 7,082 |  |  | | | $ | 15,326 |  |  | | | $ | 70,010 |  |  | | | $ | 60 |  |  | | | $ | 108,322 |  |

*Troubled Debt Restructurings*

At September 30, 2022, loans classified as TDRs totaled $1.9 million, of which $0.3 million were classified as non-performing TDRs and $1.6 million were classified as performing TDRs. At December 31, 2021, loans classified as TDRs totaled $2.4 million, of which $0.6 million were classified as non-performing TDRs and $1.8 million were classified as performing TDRs. Both performing and non-performing TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the underlying collateral less applicable selling costs. Accordingly, specific reserves of $171,000 and $159,000 related to TDRs were allocated to the allowance for loan losses at September 30, 2022 and December 31, 2021, respectively.

The Company’s portfolio of loans classified as TDRs include concessions for the borrower given their financial condition such as applying interest rates below the current market rate, deferring principal payments, and extending maturity dates. There was one loan meeting the TDR criteria that was modified during the three and nine months ended September 30, 2022, respectively, compared to no loans during the three and nine months ended September 30, 2021, respectively. The Company considers a TDR to be in default when it is 90 days or more past due under the modified terms, a charge-off occurs, or it is in the process of foreclosure. There were no loans modified as a TDR that defaulted during the three and nine months ended September 30, 2022 and 2021, respectively, and within twelve months of their modification date.

*Loans Held For Sale*

The Company designates certain long-term fixed rate personal real estate loans as held for sale. In the fourth quarter of 2021, the Company elected the fair value option for all newly originated long-term personal real estate loans held for sale. As of December 31, 2021, all loans held for sale were carried at fair value. The loans are primarily sold to Freddie Mac, Fannie Mae, PennyMac, and various other secondary market investors. At September 30, 2022, the carrying amount of these loans was $0.9 million compared to $2.2 million at December 31, 2021.

15

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(3) Other Real Estate and Other Assets Acquired in Settlement of Loans**

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **September 30,** | | |  | | | **December 31,** | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |
| Commercial | | | $ | — |  |  | | | $ | 643 |  |
| Real estate construction - commercial | | | 10,094 | | |  | | | 10,166 | | |
| Real estate mortgage - residential | | | 86 | | |  | | | 117 | | |
| Real estate mortgage - commercial | | | 1,639 | | |  | | | 2,510 | | |
| Repossessed assets | | | 55 | |  |  | | | — | |  |
| Total | | | $ | 11,874 |  |  | | | $ | 13,436 |  |
| Less valuation allowance for other real estate owned | | | (2,664) | | |  | | | (2,911) | | |
| **Total other real estate owned and repossessed assets** | | | $ | 9,210 |  |  | | | $ | 10,525 |  |

Changes in the net carrying amount of other real estate owned and repossessed assets were as follows for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Balance at beginning of period** | | | $ | 11,819 | |  | | | $ | 14,552 | |  | | | $ | 13,436 | |  | | | $ | 14,905 | |
| Additions net of (charge-offs) | | | 55 | | |  | | | 112 | | |  | | | 3 | | |  | | | 142 | | |
| Proceeds from sales | | | — | |  |  | | | (423) | |  |  | | | (1,348) | |  |  | | | (747) | |  |
| Charge-offs against the valuation allowance for other real estate owned, net | | | — | |  |  | | | (470) | | |  | | | (219) | |  |  | | | (554) | | |
| Net gain on sales | | | — | | |  | | | — | | |  | | | 2 | | |  | | | 25 | | |
| Total other real estate owned | | | 11,874 | | |  | | | 13,771 | | |  | | | 11,874 | | |  | | | 13,771 | | |
| Less valuation allowance for other real estate owned | | | (2,664) | |  |  | | | (2,157) | |  |  | | | (2,664) | |  |  | | | (2,157) | |  |
| **Balance at end of period** | | | $ | 9,210 | |  | | | $ | 11,614 | |  | | | $ | 9,210 | |  | | | $ | 11,614 | |

At September 30, 2022, $0.2 million of consumer mortgage loans secured by residential real estate properties were in the process of foreclosure compared to $0.2 million of consumer mortgage loans at December 31, 2021.

Activity in the valuation allowance for other real estate owned was as follows for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Balance at beginning of period** | | | $ | 2,664 | |  | | | $ | 2,614 | |  | | | $ | 2,911 | |  | | | $ | 2,614 | |
| Provision for other real estate owned | | | — | | |  | | | 13 | | |  | | | (28) | | |  | | | 97 | | |
| Charge-offs | | | — | | |  | | | (470) | | |  | | | (219) | | |  | | | (554) | | |
| **Balance at end of period** | | | $ | 2,664 | |  | | | $ | 2,157 | |  | | | $ | 2,664 | |  | | | $ | 2,157 | |

16

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(4) Investment Securities**

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2022 and December 31, 2021 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | |  | | |  | | | **Gross Unrealized** | | | | | | | | |  | | |  | | |
| *(in thousands)* | | | **Total Amortized Cost** | | |  | | | **Gains** | | |  | | | **Losses** | | |  | | | **Fair Value** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | $ | 3,555 |  |  | | | $ | — |  |  | | | $ | (49) |  |  | | | $ | 3,506 |  |
| U.S. government and federal agency obligations | | | 592 | | |  | | | — | | |  | | | (34) | | |  | | | 558 | | |
| U.S. government-sponsored enterprises | | | 26,499 | | |  | | | — | | |  | | | (2,896) | | |  | | | 23,603 | | |
| Obligations of states and political subdivisions | | | 134,747 | | |  | | | — | | |  | | | (32,591) | | |  | | | 102,156 | | |
| Mortgage-backed securities | | | 120,977 | | |  | | | 7 | | |  | | | (18,038) | | |  | | | 102,946 | | |
| Other debt securities (a) | | | 11,825 | | |  | | | — | | |  | | | (646) | | |  | | | 11,179 | | |
| Bank issued trust preferred securities (a) | | | 1,486 | | |  | | | — | | |  | | | (279) | | |  | | | 1,207 | | |
| **Total available-for-sale securities** | | | $ | 299,681 |  |  | | | $ | 7 |  |  | | | $ | (54,533) |  |  | | | $ | 245,155 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | $ | 3,909 |  |  | | | $ | 11 |  |  | | | $ | (3) |  |  | | | $ | 3,917 |  |
| U.S. government and federal agency obligations | | | 1,314 | | |  | | | 5 | | |  | | | — | | |  | | | 1,319 | | |
| U.S. government-sponsored enterprises | | | 26,498 | | |  | | | 70 | | |  | | | (196) | | |  | | | 26,372 | | |
| Obligations of states and political subdivisions | | | 128,093 | | |  | | | 1,605 | | |  | | | (474) | | |  | | | 129,224 | | |
| Mortgage-backed securities | | | 137,286 | | |  | | | 791 | | |  | | | (1,611) | | |  | | | 136,466 | | |
| Other debt securities (a) | | | 11,825 | | |  | | | 482 | | |  | | | (23) | | |  | | | 12,284 | | |
| Bank issued trust preferred securities (a) | | | 1,486 | | |  | | | — | | |  | | | (198) | | |  | | | 1,288 | | |
| **Total available-for-sale securities** | | | $ | 310,411 |  |  | | | $ | 2,964 |  |  | | | $ | (2,505) |  |  | | | $ | 310,870 |  |

(a) Certain hybrid instruments possessing characteristics typically associated with debt obligations.

The Company’s investment securities are classified as available for sale. Agency bonds and notes, SBA guaranteed loan certificates, residential and commercial agency mortgage-backed securities, and agency collateralized mortgage obligations (CMO) include securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal Home Loan Bank (FHLB), which are U.S. government-sponsored enterprises.

Debt securities with carrying values aggregating approximately $169.0 million and $275.4 million at September 30, 2022 and December 31, 2021, respectively, were pledged to secure public funds, securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

17

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The amortized cost and fair value of debt securities classified as available-for-sale at September 30, 2022, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without prepayment penalties.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **Amortized Cost** | | |  | | | **Fair Value** | | |
| Due in one year or less | | | $ | 5,732 |  |  | | | $ | 5,675 |  |
| Due after one year through five years | | | 22,437 | | |  | | | 20,913 | | |
| Due after five years through ten years | | | 28,976 | | |  | | | 25,920 | | |
| Due after ten years | | | 121,559 | | |  | | | 89,701 | | |
| Total | | | 178,704 | | |  | | | 142,209 | | |
| Mortgage-backed securities | | | 120,977 | | |  | | | 102,946 | | |
| **Total available-for-sale securities** | | | $ | 299,681 |  |  | | | $ | 245,155 |  |

*Other Investment Securities*

Other investment securities include equity securities with readily determinable fair values and other investment securities that do not have readily determinable fair values. Investments in FHLB stock, and Midwest Independent Bank (MIB) bankers bank stock, that do not have readily determinable fair values, are required for membership in those organizations.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| **Other securities:** | | |  | | |  | | |  | | |
| FHLB stock | | | $ | 5,162 | |  | | | $ | 5,197 | |
| MIB stock | | | 151 | | |  | | | 151 | | |
| Equity securities with readily determinable fair values | | | 48 | | |  | | | 60 | | |
| **Total other investment securities** | | | $ | 5,361 | |  | | | $ | 5,408 | |

18

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Gross unrealized losses on debt securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2022 and December 31, 2021 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Less than 12 months** | | | | | | | | |  | | | **12 months or more** | | | | | | | | |  | | |  | | |  | | |  | | |
| *(in thousands)* | | | **Fair Value** | | |  | | | **Unrealized Losses** | | |  | | | **Fair Value** | | |  | | | **Unrealized Losses** | | |  | | | **Total Fair Value** | | |  | | | **Total Unrealized Losses** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | $ | 2,758 |  |  | | | $ | (46) |  |  | | | $ | 748 |  |  | | | $ | (3) |  |  | | | $ | 3,506 |  |  | | | $ | (49) |  |
| U.S. government and federal agency obligations | | | 558 | |  |  | | | (34) | |  |  | | | — | |  |  | | | — | |  |  | | | 558 | |  |  | | | (34) | |  |
| U.S. government-sponsored enterprises | | | 19,487 | |  |  | | | (2,012) | |  |  | | | 4,116 | |  |  | | | (884) | |  |  | | | 23,603 | |  |  | | | (2,896) | |  |
| Obligations of states and political subdivisions | | | 75,649 | |  |  | | | (20,664) | |  |  | | | 26,507 | |  |  | | | (11,927) | |  |  | | | 102,156 | |  |  | | | (32,591) | |  |
| Mortgage-backed securities | | | 60,397 | |  |  | | | (7,945) | |  |  | | | 41,998 | |  |  | | | (10,093) | |  |  | | | 102,395 | |  |  | | | (18,038) | |  |
| Other debt securities | | | 11,179 | |  |  | | | (646) | |  |  | | | — | |  |  | | | — | |  |  | | | 11,179 | |  |  | | | (646) | |  |
| Bank issued trust preferred securities | | | — | |  |  | | | — | |  |  | | | 1,207 | |  |  | | | (279) | |  |  | | | 1,207 | |  |  | | | (279) | |  |
| **Total** | | | $ | 170,028 |  |  | | | $ | (31,347) |  |  | | | $ | 74,576 |  |  | | | $ | (23,186) |  |  | | | $ | 244,604 |  |  | | | $ | (54,533) |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| *(in thousands)* | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | $ | 1,758 |  |  | | | $ | (3) |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 1,758 |  |  | | | $ | (3) |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. government-sponsored enterprises | | | 18,304 | |  |  | | | (196) | |  |  | | | — | |  |  | | | — | |  |  | | | 18,304 | |  |  | | | (196) | |  |
| Obligations of states and political subdivisions | | | 39,221 | |  |  | | | (474) | |  |  | | | — | |  |  | | | — | |  |  | | | 39,221 | |  |  | | | (474) | |  |
| Mortgage-backed securities | | | 89,520 | |  |  | | | (1,579) | |  |  | | | 1,864 | |  |  | | | (32) | |  |  | | | 91,384 | |  |  | | | (1,611) | |  |
| Other debt securities | | | 3,802 | |  |  | | | (23) | |  |  | | | — | |  |  | | | — | |  |  | | | 3,802 | |  |  | | | (23) | |  |
| Bank issued trust preferred securities | | | — | |  |  | | | — | |  |  | | | 1,288 | |  |  | | | (198) | |  |  | | | 1,288 | |  |  | | | (198) | |  |
| **Total** | | | $ | 152,605 |  |  | | | $ | (2,275) |  |  | | | $ | 3,152 |  |  | | | $ | (230) |  |  | | | $ | 155,757 |  |  | | | $ | (2,505) |  |

The total available-for-sale portfolio consisted of approximately 444 securities at September 30, 2022. The portfolio included 438 securities having an aggregate fair value of $244.6 million that were in a loss position at September 30, 2022. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $74.6 million at fair value at September 30, 2022. The $54.5 million aggregate unrealized loss included in accumulated other comprehensive loss at September 30, 2022 was caused by interest rate fluctuations.

The total available-for-sale portfolio consisted of approximately 435 securities at December 31, 2021. The portfolio included 134 securities having an aggregate fair value of $155.8 million that were in a loss position at December 31, 2021. Securities identified as temporarily impaired which had been in a loss position for 12 months or longer totaled $3.2 million at fair value at December 31, 2021. The $2.5 million aggregate unrealized loss included in accumulated other comprehensive loss at December 31, 2021 was caused by interest rate fluctuations.

Because the decline in fair value is attributable to changes in interest rates and not credit quality, these investments were not considered other-than-temporarily impaired at September 30, 2022 and December 31, 2021, respectively. In the absence of changes in credit quality of these investments, the fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date, or if market yields for such investments decline. In addition, the Company does not have the intent to sell these investments over the period of recovery, and it is not more likely than not that the Company will be required to sell such investment securities.

19

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The following table presents the gross realized gains and losses from sales and calls of available-for-sale securities, as well as gains and losses on equity securities from fair value adjustments which have been recognized in earnings for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended June 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Investment securities gains (losses), net** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Available-for-sale securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Gross realized gains | | | $ | — | |  | | | $ | 119 | |  | | | $ | — | |  | | | $ | 121 | |
| Gross realized losses | | | — | | |  | | | — | | |  | | | — | | |  | | | — | |  |
| Other-than-temporary impairment recognized | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| **Other investment securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Fair value adjustments, net | | | 1 | | |  | | | 7 | |  |  | | | (12) | | |  | | | 19 | | |
| **Investment securities gains (losses), net** | | | $ | 1 | |  | | | $ | 126 | |  | | | $ | (12) | |  | | | $ | 140 | |

**(5) Intangible Assets**

*Mortgage Servicing Rights*

At September 30, 2022, the Company was servicing approximately $247.6 million of loans sold to the secondary market compared to $270.0 million at December 31, 2021, and $277.1 million at September 30, 2021. Mortgage loan servicing fees, reported in real estate servicing fees, net, earned on loans sold were $0.2 million and $0.7 million for the three and nine months ended September 30, 2022, respectively, compared to $0.2 million and $0.6 million for the three and nine months ended September 30, 2021, respectively.

The table below presents changes in mortgage servicing rights (MSRs) for the periods indicated.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Balance at beginning of period** | | | $ | 2,730 | |  | | | $ | 2,775 | |  | | | $ | 2,659 | |  | | | $ | 2,445 | |
| Originated mortgage servicing rights | | | 21 | | |  | | | 66 | | |  | | | 61 | | |  | | | 359 | | |
| Changes in fair value: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Due to changes in model inputs and assumptions (1) | | | 228 | | |  | | | (13) | | |  | | | 418 | | |  | | | 269 | |  |
| Other changes in fair value (2) | | | (73) | | |  | | | (110) | | |  | | | (232) | |  |  | | | (355) | |  |
| Total changes in fair value | | | 155 | | |  | | | (123) | | |  | | | 186 | | |  | | | (86) | | |
| **Balance at end of period** | | | $ | 2,906 | |  | | | $ | 2,718 | |  | | | $ | 2,906 | |  | | | $ | 2,718 | |

|  |  |  |
| --- | --- | --- |
|  |  |  |
|  | | |

(1)The change in fair value resulting from changes in valuation inputs or assumptions, reported in real estate servicing fees, net, used in the valuation model reflects the change in discount rates and prepayment speed assumptions primarily due to changes in interest rates.

(2)Other changes in fair value, reported in real estate servicing fees, net, reflect changes due to customer payments and passage of time.

The following key data and assumptions were used in estimating the fair value of the Company’s MSRs as of September 30, 2022 and 2021, respectively:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30,** | | | | | | | | |
|  | | | **2022** | | |  | | | **2021** | | |
| Weighted average constant prepayment rate | | | 7.30 | | % |  | | | 11.41 | | % |
| Weighted average note rate | | | 3.42 | | % |  | | | 3.38 | | % |
| Weighted average discount rate | | | 10.00 | | % |  | | | 8.00 | | % |
| Weighted average expected life (in years) | | | 6.98 | | |  | | | 6.03 | | |

20

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(6) Deposits**

The table below represents the aggregate amount of time deposits with balances that met or exceeded the Federal Deposit Insurance Corporation (FDIC) insurance limit of $250,000 and brokered deposits for the periods indicated.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(aggregate amounts in thousands)* | | |  |  |  |  | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| Time deposits with balances > $250,000 | | |  |  |  |  | | | $ | 110,859 |  |  | | | $ | 69,075 |  |
| Brokered deposits | | |  |  |  |  | | | $ | 36,086 |  |  | | | $ | 20,202 |  |

|  |  |  |
| --- | --- | --- |
|  |  |  |
|  | | |

**(7) Federal Funds Purchased and Securities Sold under Agreements to Repurchase**

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| Federal funds purchased | | | $ | — |  |  | | | $ | — |  |
| Repurchase agreements | | | 5,890 | |  |  | | | 23,829 | |  |
| Total | | | $ | 5,890 |  |  | | | $ | 23,829 |  |

The Company offers a sweep account program whereby amounts in excess of an established limit are “swept” from the customer’s demand deposit account on a daily basis into retail repurchase agreements pursuant to individual repurchase agreements between the Company and its customers*.* Repurchase agreements are agreements to sell securities subject to an obligation to repurchase the same or similar securities. They are accounted for as collateralized financing transactions, not as sales and purchases of the securities portfolio. The securities collateral pledged for the repurchase agreements with customers is maintained by a designated third-party custodian*.* The collateral amounts pledged to repurchase agreements by remaining maturity in the table below are limited to the outstanding balances of the related asset or liability; thus amounts of excess collateral are not shown.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Repurchase Agreements** | | | **Remaining Contractual Maturity of the Agreements** | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Overnight and continuous** | | |  | | | **Less than 90 days** | | |  | | | **Greater than 90 days** | | |  | | | **Total** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. government-sponsored enterprises | | | $ | 5,890 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 5,890 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Total** | | | $ | 5,890 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 5,890 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. government-sponsored enterprises | | | $ | 9,113 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 9,113 |  |
| Mortgage-backed securities | | | 14,716 | | |  | | | — | | |  | | | — | | |  | | | 14,716 | | |
| **Total** | | | $ | 23,829 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 23,829 |  |

**(8) Leases**

The Company's leases primarily consist of office space and bank branches with remaining lease terms of generally 1 to 10 years. As of September 30, 2022, operating right of use (ROU) assets and liabilities were $1.6 million and $1.6 million, respectively. As of September 30, 2022, the weighted-average remaining lease term on these operating leases is approximately 5.9 years and the weighted-average discount rate used to measure the lease liabilities was approximately 4.0%.

Operating leases in which the Company is the lessee are recorded as operating lease ROU assets and operating lease liabilities. Currently, the Company does not have any finance leases. The ROU assets are included in premises and equipment, net on the consolidated balance sheets.

Operating lease ROU assets represent the Company's right to use an underlying asset during the lease term and operating lease liabilities represent the Company's obligation to make lease payments arising from the lease. ROU assets and

21

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

operating lease liabilities are recognized at lease commencement based on the present value of the remaining lease payments using a discount rate that represents the Company's incremental borrowing rate at the lease commencement date.

Operating lease cost, which is comprised of amortization of the ROU asset and the implicit interest accreted on the operating lease liability, is recognized on a straight-line basis over the lease term, and is recorded in net occupancy expense in the consolidated statements of income. The operating lease cost was $93,000 and $280,000 for the three and nine months ended September 30, 2022, respectively, compared to $93,000 and $289,000 for the three and nine months ended September 30, 2021, respectively.

At adoption of Accounting Standards Update (ASU) 2016-02 on January 1, 2019, lease and non-lease components of new lease agreements are accounted for separately. Lease components include fixed payments including rent, real estate taxes and insurance costs and non-lease components include common-area maintenance costs. Leases with an initial term of 12 months or less are not recorded on the balance sheet; the Company recognizes lease expense for these leases on a straight-line basis over the lease term. Operating lease expense for these leases was $21,000 and $65,000 for the three and nine months ended September 30, 2022, respectively, compared to $24,000 and $56,000 for the three and nine months ended September 30, 2021, respectively.

The table below summarizes the maturity of remaining operating lease liabilities:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| **Lease payments due in:** | | | **Operating Lease** | | |
| *(in thousands)* | | |  | | |
| 2022 (excluding 9 months ended September 30, 2022) | | | $ | 92 | |
| 2023 | | | 367 | | |
| 2024 | | | 258 | | |
| 2025 | | | 257 | | |
| 2026 | | | 259 | | |
|  | | |  | | |
|  | | |  | | |
| Thereafter | | | 571 | | |
| Total lease payments | | | 1,804 | | |
| Less imputed interest | | | (194) | |  |
| Total lease liabilities, as reported | | | $ | 1,610 | |

**(9) Income Taxes**

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 18.7% and 18.5% for the three and nine months ended September 30, 2022, respectively, compared to 19.6% and 19.4% for the three and nine months ended September 30, 2021, respectively.

The decrease in the effective tax rate for the three months ended September 30, 2022 compared to the three months ended September 30, 2021 was primarily attributable to the decrease in earnings and the benefit recorded pertaining to the historical tax credit. The decrease in the effective tax rate for the nine months ended September 30, 2022 compared to the nine months ended September 30, 2021 was primarily attributable to the decrease in earnings and the benefit recorded pertaining to the historical tax credit. The effective tax rate for each of the three and nine months ended September 30, 2022 and 2021, respectively, is lower than the U.S. federal statutory rate of 21% primarily due to tax-free revenues.

Included in the effective tax rate is a $13,000 and $40,000 benefit associated with a historic tax credit investment for the three and nine months ended September 30, 2022, respectively. The investment is expected to generate a $331,000 tax benefit over the life of the project and is being recognized under the deferral method of accounting.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income of the appropriate character during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning initiatives in making this assessment. In management's opinion, the Company will more likely than not realize the benefits of its deferred tax assets and, therefore, has not established a valuation allowance against its deferred tax assets as of September 30, 2022. Management arrived at this conclusion based upon the level of historical taxable income and projections for future taxable income of the appropriate character over the periods in which the deferred tax assets are deductible.

22

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The Company follows ASC Topic 740, *Income Taxes,* which addresses the accounting for uncertain tax positions*.* For each of the nine months ended September 30, 2022 and 2021, respectively, the Company did not have any uncertain tax provisions, and did not record any related tax liabilities.

**(10) Stockholders’ Equity**

*Accumulated Other Comprehensive Income (Loss)*

The following table summarizes the change in the components of the Company’s accumulated other comprehensive income (loss) for the nine months ended September 30, 2022 and 2021:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30, 2022** | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Unrealized Gains (Losses) on Securities (1)** | | |  | | | **Unrecognized Net Pension and Postretirement Costs (2)** | | |  | | | **Accumulated Other Comprehensive Income (Loss)** | | |
| **Balance at beginning of period** | | | $ | 362 |  |  | | | $ | 2,931 |  |  | | | $ | 3,293 |  |
| Other comprehensive loss, before reclassifications | | | (54,985) | |  |  | | | — | |  |  | | | (54,985) | |  |
| Amounts reclassified from accumulated other comprehensive income (loss) | | | — | |  |  | | | — | |  |  | | | — | |  |
| Current period other comprehensive loss, before tax | | | (54,985) | |  |  | | | — | |  |  | | | (54,985) | |  |
| Income tax benefit | | | 11,547 | |  |  | | | — | |  |  | | | 11,547 | |  |
| Current period other comprehensive loss, net of tax | | | (43,438) | |  |  | | | — | |  |  | | | (43,438) | |  |
| **Balance at end of period** | | | $ | (43,076) |  |  | | | $ | 2,931 |  |  | | | $ | (40,145) |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30, 2021** | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Unrealized Gains (Losses) on Securities (1)** | | |  | | | **Unrecognized Net Pension and Postretirement Costs (2)** | | |  | | | **Accumulated Other Comprehensive Income (Loss)** | | |
| **Balance at beginning of period** | | | $ | 3,353 |  |  | | | $ | (1,825) |  |  | | | $ | 1,528 |  |
| Other comprehensive (loss) income, before reclassifications | | | (4,105) | |  |  | | | 275 | |  |  | | | (3,830) | |  |
| Amounts reclassified from accumulated other comprehensive (loss) income | | | (95) | |  |  | | | — | |  |  | | | (95) | |  |
| Current period other comprehensive (loss) income, before tax | | | (4,200) | |  |  | | | 275 | |  |  | | | (3,925) | |  |
| Income tax benefit (expense) | | | 883 | |  |  | | | (58) | |  |  | | | 825 | |  |
| Current period other comprehensive (loss) income, net of tax | | | (3,317) | |  |  | | | 217 | |  |  | | | (3,100) | |  |
| **Balance at end of period** | | | $ | 36 |  |  | | | $ | (1,608) |  |  | | | $ | (1,572) |  |

|  |  |  |
| --- | --- | --- |
|  |  |  |
|  | | |

(1)The pre-tax amounts reclassified from accumulated other comprehensive income (loss) are included in investment securities gains (losses), net in the consolidated statements of income.

(2)The pre-tax amounts reclassified from accumulated other comprehensive income (loss) are included in the computation of net periodic pension cost.

**(11) Employee Benefit Plans**

*Employee Benefits*

Employee benefits charged to operating expenses are summarized in the table below for the periods indicated.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| Payroll taxes | | | $ | 338 | |  | | | $ | 310 | |  | | | $ | 1,123 | |  | | | $ | 1,102 | |
| Medical plans | | | 426 | | |  | | | 436 | | |  | | | 1,368 | | |  | | | 1,405 | | |
| 401(k) match and profit sharing | | | 411 | | |  | | | 513 | | |  | | | 1,206 | | |  | | | 1,456 | | |
| Periodic pension cost | | | 402 | | |  | | | 449 | | |  | | | 1,206 | | |  | | | 1,347 | | |
| Other | | | 20 | | |  | | | 3 | | |  | | | 32 | | |  | | | 10 | | |
| **Total employee benefits** | | | $ | 1,597 | |  | | | $ | 1,711 | |  | | | $ | 4,936 | |  | | | $ | 5,320 | |

23

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The Company's profit-sharing plan includes a matching 401(k) portion, in which the Company matches the first 3% of eligible employee contributions. The Company made annual contributions for the discretionary portion in an amount up to 6% of income before income taxes and before contributions to the profit-sharing and pension plans for all participants, limited to the maximum amount deductible for federal income tax purposes, for each of the periods shown. In addition, employees were able to make additional tax-deferred contributions.

*Other Plans*

On November 7, 2018, the Board of Directors of the Company adopted a supplemental executive retirement plan (SERP), effective as of January 1, 2018. The SERP provides select employees who satisfy certain eligibility requirements with certain benefits upon retirement, termination of employment or death.

The accrued liability relating to the SERP was $1.6 million as of September 30, 2022, and the expense for the three and nine months ended September 30, 2022 was $93,000 and $279,000, respectively, compared to $97,000 and 290,000, for the three and nine months ended September 30, 2021, respectively, and is recognized over the required service period.

*Pension*

The Company provides a noncontributory defined benefit pension plan for all full-time and eligible employees. Beginning January 1, 2018 and for all retrospective periods presented, the Company adopted the guidance under ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. Under the guidance, only the service cost component of the net periodic benefit cost is reported in the same income statement line item as salaries and benefits, and the remaining components are reported as other non-interest expense. An employer is required to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Under the Company’s funding policy for the defined benefit pension plan, contributions are made to a trust as necessary to provide for current service and for any unfunded accrued actuarial liabilities over a reasonable period. To the extent that these requirements are fully covered by assets in the trust, a contribution might not be made in a particular year. The Company made a pension contribution of $1.0 million on April 1, 2022.

Effective July 1, 2017, the Company amended the pension plan to effectuate a “soft freeze” such that no individual hired (or rehired in the case of a former employee) by the Company after September 30, 2017, whether or not such individual is or was a vested member in the plan, will be eligible to be an active member and be entitled to accrue any benefits under the plan.

*Components of Net Pension Cost and Other Amounts Recognized in Accumulated Other Comprehensive Income (Loss)*

The following items are components of net pension cost for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| Service cost - benefits earned during the year | | | $ | 373 |  |  | | | $ | 423 |  |  | | | $ | 1,118 |  |  | | | $ | 1,269 |  |
| Interest costs on projected benefit obligations (a) | | | 294 | |  |  | | | 268 | |  |  | | | 881 | |  |  | | | 804 | |  |
| Expected return on plan assets (a) | | | (570) | |  |  | | | (461) | |  |  | | | (1,711) | |  |  | | | (1,382) | |  |
| Expected administrative expenses | | | 29 | |  |  | | | 26 | |  |  | | | 89 | |  |  | | | 78 | |  |
| Amortization of prior service cost (a) | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | — | |  |
| Amortization of unrecognized net loss (a) | | | — | |  |  | | | 92 | |  |  | | | — | |  |  | | | 275 | |  |
| **Net periodic pension cost** | | | $ | 125 |  |  | | | $ | 348 |  |  | | | $ | 376 |  |  | | | $ | 1,044 |  |

|  |  |  |
| --- | --- | --- |
|  |  |  |
|  | | |

(a)The components of net periodic pension cost other than the service cost and expected administrative expenses are included in other non-interest expense.

Net periodic pension benefit costs include interest costs based on an assumed discount rate, the expected return on plan assets based on actuarially derived market-related values, and the amortization of net actuarial losses. Net periodic postretirement benefit costs include service costs, interest costs based on an assumed discount rate, and the amortization of prior service credits and net actuarial gains. Differences between expected and actual results in each year are included in the net actuarial gain or loss amount, which is recognized in other comprehensive income. The net actuarial gain or loss in

24

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

excess of a 10% corridor is amortized in net periodic benefit cost over the average remaining service period of active participants in the pension plan. The prior service credit is amortized over the average remaining service period to full eligibility for participating employees expected to receive benefits. Currently, there is no prior service cost or net transition (asset)/obligation to be amortized.

**(12) Earnings per Share**

*Stock Dividend*

On July 1, 2022, the Company paid a special stock dividend of 4.0% to common shareholders of record at the close of business on June 15, 2022. For all periods presented, share information, including basic and diluted earnings per share, has been adjusted retroactively to reflect this change.

Basic earnings per share is computed by dividing income available to shareholders by the weighted average number of shares outstanding during the period. Diluted earnings per share gives effect to all dilutive potential shares that were outstanding during the period.

Presented below is a summary of the components used to calculate basic and diluted earnings per common share for the periods indicated, which have been restated to reflect all stock dividends:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(dollars in thousands, except per share data)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Basic earnings per share:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Net income available to shareholders | | | $ | 4,927 | |  | | | $ | 5,796 | |  | | | $ | 16,025 | |  | | | $ | 16,527 | |
| Average shares outstanding | | | 6,768,581 | | |  | | | 6,877,305 | | |  | | | 6,800,309 | | |  | | | 6,877,435 | | |
| **Basic earnings per share** | | | $ | 0.73 | |  | | | $ | 0.84 | |  | | | $ | 2.36 | |  | | | $ | 2.40 | |
| **Diluted earnings per share:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Net income available to shareholders | | | $ | 4,927 | |  | | | $ | 5,796 | |  | | | $ | 16,025 | |  | | | $ | 16,527 | |
| Average shares outstanding | | | 6,768,581 | | |  | | | 6,877,305 | | |  | | | 6,800,309 | | |  | | | 6,877,435 | | |
| **Diluted earnings per share** | | | $ | 0.73 | |  | | | 0.84 | | |  | | | $ | 2.36 | |  | | | $ | 2.40 | |

*Repurchase Program*

The Company's 2019 Repurchase Plan was amended during the second quarter of 2021 to authorize the purchase of up to an additional $5.0 million in market value of the Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as the timing of any such purchases.

The Company repurchased 108,724 common shares under the plan during the nine months ended September 30, 2022, at an average cost of $26.60 per share totaling $2.9 million. As of September 30, 2022, $2.1 million remained available for share repurchases pursuant to the plan.

**(13) Fair Value Measurements**

Fair value represents the amount expected to be received to sell an asset or paid to transfer a liability in its principal or most advantageous market in an orderly transaction between market participants at the measurement date.

Depending on the nature of the asset or liability, the Company uses various valuation methodologies and assumptions to estimate fair value. The measurement of fair value under U.S. GAAP uses a hierarchy intended to maximize the use of observable inputs and minimize the use of unobservable inputs. This hierarchy uses three levels of inputs to measure the fair value of assets and liabilities as follows.

The fair value hierarchy is as follows:

25

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

Level 1 – Inputs are unadjusted quoted prices for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and is used to measure fair value whenever available. A contractually binding sales price also provides reliable evidence of fair value.

Level 2 – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 – Inputs are unobservable inputs for the asset or liability and significant to the fair value. These may be internally developed using the Company’s best information and assumptions that a market participant would consider.

In accordance with fair value accounting guidance, the Company measures, records, and reports various types of assets and liabilities at fair value on either a recurring or non-recurring basis in the Consolidated Financial Statements. Nonfinancial assets measured at fair value on a non-recurring basis would include foreclosed real estate, long-lived assets, and core deposit intangible assets, which are reviewed when circumstances or other events indicate that impairment may have occurred.

***Valuation Methods for Assets and Liabilities Measured at Fair Value on a Recurring Basis***

Following is a description of the Company’s valuation methodologies used for assets and liabilities recorded at fair value on a recurring basis:

*Available-for-sale Securities*

The fair value measurements of the Company’s investment securities are determined by a third-party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things. The fair value measurements are subject to independent verification to another pricing source by management each quarter for reasonableness.

*Other Investment Securities*

Other investment securities include equity securities with readily determinable fair values and other investment securities that do not have readily determinable fair values. Investments in Federal Home Loan Bank (FHLB) stock, and Midwest Independent Bank (MIB) bankers bank stock, that do not have readily determinable fair values, are required for membership in those organizations. Equity securities that are not actively traded are classified in level 2.

Equity securities with readily determinable fair values are recorded at fair value, with changes in fair value reflected in earnings. Equity securities that do not have readily determinable fair values are carried at cost and are periodically assessed for impairment. The Company uses level 1 inputs to value equity securities that are traded in active markets.

*Loans Held for Sale*

The fair value of the committed in forward sale agreements loans is the price at which they could be sold in the principal market at the measurement date, therefore the Company classifies as level 2.

*Derivative Assets and Liabilities*

Derivative assets and liabilities include interest rate lock commitments (IRLCs) and forward sale commitments. The fair values of IRLCs and forward sale commitments are determined using readily observable market data such as interest rates, prices, volatility factors, and customer credit-related adjustments. For IRLCs, the fair value is subject to the anticipated loan funding probability (pull-through rate), which is considered an unobservable factor. Factors that affect pull-through rates include origination channel, current mortgage interest rates in the market versus the interest rate incorporated in the IRLC, the purpose of the mortgage, stage of completion of the underlying application and underwriting process, and the time remaining until the IRLC expires. The Company classifies IRLCs as level 3 due to the unobservable input of pull-through rates.

26

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

*Mortgage Servicing Rights*

The fair value of mortgage servicing rights is based on the discounted value of estimated future cash flows utilizing contractual cash flows, servicing rate, constant prepayment rate, servicing cost, and discount rate factors. Accordingly, the fair value is estimated based on a valuation model that calculates the present value of estimated future net servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, market discount rates, cost to service, float earnings rates, and other ancillary income, including late fees. The valuation models estimate the present value of estimated future net servicing income. The Company classifies its servicing rights as Level 3.

27

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | |  | | |  | | | **Fair Value Measurements** | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Fair Value** | | |  | | | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | | |  | | | **Other Observable Inputs (Level 2)** | | |  | | | **Significant Unobservable Inputs (Level 3)** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Assets:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | $ | 3,506 |  |  | | | $ | 3,506 |  |  | | | $ | — |  |  | | | $ | — |  |
| U.S. government and federal agency obligations | | | 558 | | |  | | | — | | |  | | | 558 | | |  | | | — | | |
| U.S. government-sponsored enterprises | | | 23,603 | | |  | | | — | | |  | | | 23,603 | | |  | | | — | | |
| Obligations of states and political subdivisions | | | 102,156 | | |  | | | — | | |  | | | 102,156 | | |  | | | — | | |
| Mortgage-backed securities | | | 102,946 | | |  | | | — | | |  | | | 102,946 | | |  | | | — | | |
| Other debt securities | | | 11,179 | | |  | | | — | | |  | | | 11,179 | | |  | | | — | | |
| Bank-issued trust preferred securities | | | 1,207 | | |  | | | — | | |  | | | 1,207 | | |  | | | — | | |
| Equity securities | | | 48 | | |  | | | 48 | | |  | | | — | | |  | | | — | | |
| Interest rate lock commitments | | | 10 | | |  | | | — | | |  | | | — | | |  | | | 10 | | |
| Forward sale commitments | | | 35 | | |  | | | — | | |  | | | 35 | | |  | | | — | | |
| Loans held for sale | | | 913 | | |  | | | — | | |  | | | 913 | | |  | | | — | | |
| Mortgage servicing rights | | | 2,906 | | |  | | | — | | |  | | | — | | |  | | | 2,906 | | |
| **Total** | | | $ | 249,067 |  |  | | | $ | 3,554 |  |  | | | $ | 242,597 |  |  | | | $ | 2,916 |  |
| **Liabilities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Interest rate lock commitments | | | $ | 76 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 76 |  |
| **Total** | | | $ | 76 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 76 |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Assets:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | $ | 3,917 |  |  | | | $ | 3,917 |  |  | | | $ | — |  |  | | | $ | — |  |
| U.S. government and federal agency obligations | | | 1,319 | | |  | | | — | | |  | | | 1,319 | | |  | | | — | | |
| U.S. government-sponsored enterprises | | | 26,372 | | |  | | | — | | |  | | | 26,372 | | |  | | | — | | |
| Obligations of states and political subdivisions | | | 129,224 | | |  | | | — | | |  | | | 129,224 | | |  | | | — | | |
| Mortgage-backed securities | | | 136,466 | | |  | | | — | | |  | | | 136,466 | | |  | | | — | | |
| Other debt securities | | | 12,284 | | |  | | | — | | |  | | | 12,284 | | |  | | | — | | |
| Bank-issued trust preferred securities | | | 1,288 | | |  | | | — | | |  | | | 1,288 | | |  | | | — | | |
| Equity securities | | | 60 | | |  | | | 60 | | |  | | | — | | |  | | | — | | |
| Interest rate lock commitments | | | 312 | | |  | | | — | | |  | | | — | | |  | | | 312 | | |
| Forward sale commitments | | | 12 | | |  | | | — | | |  | | | 12 | | |  | | | — | | |
| Loans held for sale | | | 2,249 | | |  | | | — | | |  | | | 2,249 | | |  | | | — | | |
| Mortgage servicing rights | | | 2,659 | | |  | | | — | | |  | | | — | | |  | | | 2,659 | | |
| **Total** | | | $ | 316,162 |  |  | | | $ | 3,977 |  |  | | | $ | 309,214 |  |  | | | $ | 2,971 |  |
| **Liabilities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Interest rate lock commitments | | | $ | 26 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 26 |  |
| **Total** | | | $ | 26 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 26 |  |

28

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Fair Value Measurements Using Significant Unobservable Inputs (Level 3)** | | | | | | | | | | | | | | | | | | | | |
|  | | | **Mortgage Servicing Rights** | | | | | | | | |  | | | **Interest Rate Lock Commitments** | | | | | | | | |
|  | | | **Nine Months Ended September 30,** | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| Balance at beginning of period | | | $ | 2,659 | |  | | | $ | 2,445 | |  | | | $ | 286 | |  | | | $ | — | |
| Total gains or (losses) (realized/unrealized): | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Included in earnings | | | 186 | | |  | | | (86) | | |  | | | (22) | |  |  | | | — | |  |
| Included in other comprehensive income | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| Purchases | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| Sales | | | — | | |  | | | — | | |  | | | (474) | | |  | | | — | | |
| Issues | | | 61 | | |  | | | 359 | | |  | | | 144 | | |  | | | — | | |
| Settlements | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| Balance at end of period | | | $ | 2,906 | |  | | | $ | 2,718 | |  | | | $ | (66) | |  | | | $ | — | |

***Valuation Methods for Assets and Liabilities Measured at Fair Value on a Non-recurring Basis***

Following is a description of the Company’s valuation methodologies used for assets and liabilities recorded at fair value on a non-recurring basis:

*Collateral Dependent Impaired Loans*

While the overall loan portfolio is not carried at fair value, the Company periodically records non-recurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Non-recurring adjustments also include certain impairment amounts for collateral dependent loans when establishing the allowance for loan losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan. In determining the value of real estate collateral, the Company relies on external and internal appraisals of property values depending on the size and complexity of the real estate collateral. The Company maintains staff trained to perform in-house evaluations and also to review third-party appraisal reports for reasonableness. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgments based on the experience and expertise of internal specialists. Values of all loan collateral are regularly reviewed by a senior loan committee. Because many of these inputs are not observable, the measurements are classified as Level 3. As of September 30, 2022, the Company identified $15.9 million in collateral-dependent impaired loans that required no specific allowance for loan losses. Related to these loans, there were $61,000 and $86,000 in charge-offs recorded during the three and nine months ended September 30, 2022, respectively. As of September 30, 2021, the Company identified $31.2 million in collateral-dependent impaired loans that had specific allowances for losses aggregating $4.7 million. Related to these loans, there were $33,000 and $69,000 in charge-offs recorded during the three and nine months ended September 30, 2021, respectively.

*Other Real Estate and Foreclosed Assets*

Other real estate owned (OREO) and foreclosed assets consisted of loan collateral repossessed through foreclosure. This collateral is comprised of commercial and residential real estate and other non-real estate property, including autos, manufactured homes, and construction equipment. Subsequent to foreclosure, these assets initially are carried at fair value of the collateral less estimated selling costs. Fair value, when recorded, is generally based upon appraisals by approved, independent state-certified appraisers. Like impaired loans, appraisals on OREO may be discounted based on the Company’s historical knowledge, changes in market conditions from the time of appraisal or other information available. During the holding period, valuations are updated periodically, and the assets may be written down to reflect a new cost basis. Because many of these inputs are not observable, the measurements are classified as Level 3.

29

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | |  | | |  | | | **Fair Value Measurements Using** | | | | | | | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **Total Fair Value** | | |  | | | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | | |  | | | **Other Observable Inputs (Level 2)** | | |  | | | **Significant Unobservable Inputs (Level 3)** | | |  | | | **Three Months Ended September 30, Total Gains (Losses)\*** | | |  | | | **Nine Months Ended September 30, Total Gains (Losses)\*** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Assets:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Collateral dependent impaired loans: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate mortgage - commercial | | | $ | 15,898 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 15,898 |  |  | | | $ | (23) |  |  | | | $ | (48) |  |
| Installment and other consumer | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | (38) | |  |  | | | (38) | |  |
| Total | | | $ | 15,898 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 15,898 |  |  | | | $ | (61) |  |  | | | $ | (86) |  |
| Other real estate and repossessed assets | | | $ | 9,210 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 9,210 |  |  | | | $ | — |  |  | | | $ | (22) |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **September 30, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Assets:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Collateral dependent impaired loans: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, financial, & agricultural | | | $ | 3,960 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 3,960 |  |  | | | $ | — |  |  | | | $ | — |  |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate mortgage - residential | | | 324 | |  |  | | | — | |  |  | | | — | |  |  | | | 324 | |  |  | | | (18) | |  |  | | | (22) | |  |
| Real estate mortgage - commercial | | | 22,266 | |  |  | | | — | |  |  | | | — | |  |  | | | 22,266 | |  |  | | | (15) | |  |  | | | (41) | |  |
| Installment and other consumer | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | — | |  |  | | | (6) | |  |
| Total | | | $ | 26,550 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 26,550 |  |  | | | $ | (33) |  |  | | | $ | (69) |  |
| Other real estate and repossessed assets | | | $ | 11,614 |  |  | | | $ | — |  |  | | | $ | — |  |  | | | $ | 11,614 |  |  | | | $ | (12) |  |  | | | $ | (71) |  |

|  |  |  |
| --- | --- | --- |
|  |  |  |
|  | | |

\*Total losses reported for other real estate and foreclosed assets includes charge-offs, valuation write downs, and net losses taken during the periods reported.

**(14) Fair Value of Financial Instruments**

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate such value:

***Loans***

Fair values are estimated for portfolios with similar financial characteristics. Loans are segregated by type, such as commercial, real estate, and consumer. Each loan category is further segmented into fixed and variable interest rate categories. The fair value of loans, or exit price, is estimated by using the future value of discounted cash flows using comparable market rates for similar types of loan products and adjusted for market factors. The discount rates used are estimated using comparable market rates for similar types of loan products adjusted to be commensurate with the credit risk, overhead costs, and optionality of such instruments.

***Federal Funds Sold, Cash, and Due from Banks***

The carrying amounts of short-term federal funds sold, interest-earning deposits with banks, and cash and due from banks approximate fair value. Federal funds sold classified as short-term generally mature in 90 days or less.

***Certificates of Deposit in Other Banks***

Certificates of deposit are other investments made by the Company with other financial institutions that are carried at cost which is equal to fair value.

***Cash Surrender Value - Life Insurance***

The fair value of Bank-owned life insurance (BOLI) approximates the carrying amount. Upon liquidation of these investments, the Company would receive the cash surrender value which equals the carrying amount.

30

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

***Accrued Interest Receivable and Payable***

For accrued interest receivable and payable, the carrying amount is a reasonable estimate of fair value because of the short maturity for these financial instruments.

***Deposits***

The fair value of deposits with no stated maturity, such as non-interest-bearing demand, NOW accounts, savings, and money market, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

***Federal Funds Purchased and Securities Sold Under Agreements to Repurchase***

For Federal funds purchased and securities sold under agreements to repurchase, the carrying amount is a reasonable estimate of fair value, as such instruments reprice in a short time period.

***Subordinated Notes and Other Borrowings***

The fair value of subordinated notes and other borrowings is based on the discounted value of contractual cash-flows. The discount rate is estimated using the rates currently offered for other borrowed money of similar remaining maturities.

31

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

A summary of the carrying amounts and fair values of the Company’s financial instruments at September 30, 2022 and December 31, 2021 is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | |  | | |  | | |  | | |  | | | **September 30, 2022** | | | | | | | | | | | | | | |
|  | | |  | | |  | | |  | | |  | | | **Fair Value Measurements** | | | | | | | | | | | | | | |
|  | | | **September 30, 2022** | | | | | | | | |  | | | **Quoted Prices in Active Markets for Identical Assets** | | |  | | | **Other Observable Inputs** | | |  | | | **Net Significant Unobservable Inputs** | | |
| *(in thousands)* | | | **Carrying amount** | | |  | | | **Fair value** | | |  | | | **(Level 1)** | | |  | | | **(Level 2)** | | |  | | | **(Level 3)** | | |
| **Assets:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Cash and due from banks | | | $ | 15,081 |  |  | | | $ | 15,081 |  |  | | | $ | 15,081 |  |  | | | $ | — |  |  | | | $ | — |  |
| Federal funds sold and overnight interest-bearing deposits | | | 26,305 | | |  | | | 26,305 | | |  | | | 26,305 | | |  | | | — | | |  | | | — | | |
| Certificates of deposit in other banks | | | 4,195 | | |  | | | 4,195 | | |  | | | 4,195 | | |  | | | — | | |  | | | — | | |
| Available-for-sale securities | | | 245,155 | | |  | | | 245,155 | | |  | | | 3,506 | | |  | | | 241,649 | | |  | | | — | | |
| Other investment securities | | | 5,361 | | |  | | | 5,361 | | |  | | | 48 | | |  | | | 5,313 | | |  | | | — | | |
| Loans, net | | | 1,476,492 | | |  | | | 1,424,475 | | |  | | | — | | |  | | | — | | |  | | | 1,424,475 | | |
| Loans held for sale | | | 913 | | |  | | | 913 | | |  | | | — | | |  | | | 913 | | |  | | | — | | |
| Cash surrender value - life insurance | | | 2,553 | | |  | | | 2,553 | | |  | | | — | | |  | | | 2,553 | | |  | | | — | | |
| Interest rate lock commitments | | | 10 | | |  | | | 10 | | |  | | | — | | |  | | | — | | |  | | | 10 | | |
| Forward sale commitments | | | 35 | | |  | | | 35 | | |  | | | — | | |  | | | 35 | | |  | | | — | | |
| Accrued interest receivable | | | 7,048 | | |  | | | 7,048 | | |  | | | 7,048 | | |  | | | — | | |  | | | — | | |
| Total | | | $ | 1,783,148 |  |  | | | $ | 1,731,131 |  |  | | | $ | 56,183 |  |  | | | $ | 250,463 |  |  | | | $ | 1,424,485 |  |
| **Liabilities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Deposits: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Non-interest bearing demand | | | $ | 498,653 |  |  | | | $ | 498,653 |  |  | | | $ | 498,653 |  |  | | | $ | — |  |  | | | $ | — |  |
| Savings, interest checking and money market | | | 825,593 | | |  | | | 825,593 | | |  | | | 825,593 | | |  | | | — | | |  | | | — | | |
| Time deposits | | | 268,552 | | |  | | | 264,472 | | |  | | | — | | |  | | | — | | |  | | | 264,472 | | |
| Federal funds purchased and securities sold under agreements to repurchase | | | 5,890 | | |  | | | 5,890 | | |  | | | 5,890 | | |  | | | — | | |  | | | — | | |
| Federal Home Loan Bank advances and other borrowings | | | 73,000 | | |  | | | 73,000 | | |  | | | — | | |  | | | 73,000 | | |  | | | — | | |
| Subordinated notes | | | 49,486 | | |  | | | 40,187 | | |  | | | — | | |  | | | 40,187 | | |  | | | — | | |
| Interest rate lock commitments | | | 76 | | |  | | | 76 | | |  | | | — | | |  | | | — | | |  | | | 76 | | |
| Accrued interest payable | | | 565 | | |  | | | 565 | | |  | | | 565 | | |  | | | — | | |  | | | — | | |
| Total | | | $ | 1,721,815 |  |  | | | $ | 1,708,436 |  |  | | | $ | 1,330,701 |  |  | | | $ | 113,187 |  |  | | | $ | 264,548 |  |

32

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | |  | | |  | | |  | | |  | | | **December 31, 2021** | | | | | | | | | | | | | | |
|  | | |  | | |  | | |  | | |  | | | **Fair Value Measurements** | | | | | | | | | | | | | | |
|  | | | **December 31, 2021** | | | | | | | | |  | | | **Quoted Prices in Active Markets for Identical Assets** | | |  | | | **Other Observable Inputs** | | |  | | | **Net Significant Unobservable Inputs** | | |
| *(in thousands)* | | | **Carrying amount** | | |  | | | **Fair value** | | |  | | | **(Level 1)** | | |  | | | **(Level 2)** | | |  | | | **(Level 3)** | | |
| **Assets:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Cash and due from banks | | | $ | 17,287 |  |  | | | $ | 17,287 |  |  | | | $ | 17,287 |  |  | | | $ | — |  |  | | | $ | — |  |
| Federal funds sold and overnight interest-bearing deposits | | | 142,622 | |  |  | | | 142,622 | |  |  | | | 142,622 | |  |  | | | — | |  |  | | | — | |  |
| Certificates of deposit in other banks | | | 5,193 | |  |  | | | 5,193 | |  |  | | | 5,193 | |  |  | | | — | |  |  | | | — | |  |
| Available-for-sale securities | | | 310,870 | |  |  | | | 310,870 | |  |  | | | 3,917 | |  |  | | | 306,953 | |  |  | | | — | |  |
| Other investment securities | | | 5,408 | |  |  | | | 5,408 | |  |  | | | 60 | |  |  | | | 5,348 | |  |  | | | — | |  |
| Loans, net | | | 1,285,230 | |  |  | | | 1,308,539 | |  |  | | | — | |  |  | | | — | |  |  | | | 1,308,539 | |  |
| Loans held for sale | | | 2,249 | |  |  | | | 2,249 | |  |  | | | — | |  |  | | | 2,249 | |  |  | | | — | |  |
| Cash surrender value - life insurance | | | 2,509 | |  |  | | | 2,509 | |  |  | | | — | |  |  | | | 2,509 | |  |  | | | — | |  |
| Interest rate lock commitments | | | 312 | |  |  | | | 312 | |  |  | | | — | |  |  | | | — | |  |  | | | 312 | |  |
| Forward sale commitments | | | 12 | |  |  | | | 12 | |  |  | | | — | |  |  | | | 12 | |  |  | | | — | |  |
| Accrued interest receivable | | | 6,621 | |  |  | | | 6,621 | |  |  | | | 6,621 | |  |  | | | — | |  |  | | | — | |  |
| Total | | | $ | 1,778,313 |  |  | | | $ | 1,801,622 |  |  | | | $ | 175,700 |  |  | | | $ | 317,071 |  |  | | | $ | 1,308,851 |  |
| **Liabilities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Deposits: | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Non-interest bearing demand | | | $ | 453,066 |  |  | | | $ | 453,066 |  |  | | | $ | 453,066 |  |  | | | $ | — |  |  | | | $ | — |  |
| Savings, interest checking and money market | | | 818,358 | |  |  | | | 818,358 | |  |  | | | 818,358 | |  |  | | | — | |  |  | | | — | |  |
| Time deposits | | | 245,396 | |  |  | | | 246,025 | |  |  | | | — | |  |  | | | — | |  |  | | | 246,025 | |  |
| Federal funds purchased and securities sold under agreements to repurchase | | | 23,829 | |  |  | | | 23,829 | |  |  | | | 23,829 | |  |  | | | — | |  |  | | | — | |  |
| Federal Home Loan Bank advances and other borrowings | | | 77,418 | |  |  | | | 78,152 | |  |  | | | — | |  |  | | | 78,152 | |  |  | | | — | |  |
| Subordinated notes | | | 49,486 | |  |  | | | 42,908 | |  |  | | | — | |  |  | | | 42,908 | |  |  | | | — | |  |
| Interest rate lock commitments | | | 26 | |  |  | | | 26 | |  |  | | | — | |  |  | | | — | |  |  | | | 26 | |  |
| Accrued interest payable | | | 282 | |  |  | | | 282 | |  |  | | | 282 | |  |  | | | — | |  |  | | | — | |  |
| Total | | | $ | 1,667,861 |  |  | | | $ | 1,662,646 |  |  | | | $ | 1,295,535 |  |  | | | $ | 121,060 |  |  | | | $ | 246,051 |  |

***Off-Balance Sheet Financial Instruments***

The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the likelihood of the counterparties drawing on such financial instruments, and the present creditworthiness of such counterparties. The Company believes such commitments have been made on terms that are competitive in the markets in which it operates.

***Limitations***

The fair value estimates provided are made at a point in time based on market information and information about the financial instruments. Because no market exists for a portion of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the fair value estimates.

33

**HAWTHORN BANCSHARES, INC.**

**AND SUBSIDIARIES**

Notes to the Consolidated Financial Statements

*(Unaudited)*

**(15) Commitments and Contingencies**

The Company issues financial instruments with off-balance-sheet risk in the normal course of business of meeting the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments may involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets.

The Company’s extent of involvement and maximum potential exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for financial instruments included on its consolidated balance sheets. At September 30, 2022, no amounts have been accrued for any estimated losses for these financial instruments.

The contractual amount of off-balance-sheet financial instruments were as follows as of the dates indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| Commitments to extend credit | | | $ | 362,569 | |  | | | $ | 396,958 | |
| Interest rate lock commitments | | | 6,520 | | |  | | | 16,161 | | |
| Forward sale commitments | | | 923 | | |  | | | 2,199 | | |
| Standby letters of credit | | | 56,240 | | |  | | | 35,514 | | |
| **Total** | | | $ | 426,252 | |  | | | $ | 450,832 | |

***Commitments***

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

The Company has two types of commitments related to mortgage loans held for sale: interest rate lock commitments and forward loan sale commitments. Interest rate lock commitments are commitments to extend credit to a customer that has an interest rate lock and are considered derivative instruments.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third-party. These standby letters of credit are primarily issued to support contractual obligations of the Company’s customers. The approximate remaining term of standby letters of credit range from one month to five years at September 30, 2022.

***Pending Litigation***

The Company and its subsidiaries are defendants in various legal actions incidental to the Company’s past and current business activities. Based on the Company’s analysis, and considering the inherent uncertainties associated with litigation, management does not believe that it is reasonably possible that these legal actions will materially adversely affect the Company’s consolidated financial condition or results of operations in the near term. The Company records a loss accrual for all legal matters for which it deems a loss is probable and can be reasonably estimated. Some legal matters, which are at early stages in the legal process, have not yet progressed to the point where a loss is deemed probable or an amount can be estimated.

34

**Item 2 - *Management’s Discussion and Analysis of Financial Condition and Results of Operations***

***Forward-Looking Statements***

This report contains certain forward-looking statements with respect to the financial condition, results of operations, plans, objectives, future performance and business of Hawthorn Bancshares, Inc., and its subsidiaries (collectively, the Company, we, our, or us), including, without limitation:

•statements that are not historical in nature, and

•statements preceded by, followed by or that include the words *believes*, *expects, may, will, should, could, anticipates, estimates, intends, plans, hopes* or similar expressions.

Forward-looking statements are not guarantees of future performance or results. They involve risks, uncertainties and assumptions. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

•competitive pressures among financial services companies may increase significantly,

•changes in the interest rate environment may reduce interest margins,

•general economic conditions, either nationally or in Missouri, may be less favorable than expected and may adversely affect the quality of our loans and other assets,

•increases in non-performing assets in the Company’s loan portfolios and adverse economic conditions may necessitate increases to our provisions for loan losses,

•costs or difficulties related to any integration of any business of the Company and its acquisition targets may be greater than expected,

•legislative, regulatory or tax law changes may adversely affect the business in which the Company and its subsidiaries are engaged,

•credit and market risks relating to increasing inflation,

•changes may occur in the securities markets, and

•the COVID-19 pandemic, or any resurgence thereof, or other external events may adversely affect the Company.

We have described additional factors that could cause actual results to be materially different from those described in the forward-looking statements under the caption *Risk Factors* in the Company’s Annual Report on Form 10-K for the year ended December 31, 2021, and in other reports filed with the SEC from time to time. Other factors that have not been identified in this report could also have this effect. You are cautioned not to put undue reliance on any forward-looking statement, which speak only as of the date they were made. Except as required by law, the Company undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events, or changes in its business, results of operations or financial condition over time.

35

***Overview***

Crucial to the Company’s community banking strategy is growth in its commercial banking services, retail mortgage lending and retail banking services. Through the branch network of its subsidiary bank, Hawthorn Bank (the Bank), the Company, with $1.8 billion in assets at September 30, 2022, provides a broad range of commercial and personal banking services. The Bank’s specialties include commercial banking for small and mid-sized businesses, including equipment, operating, commercial real estate, Small Business Administration (SBA) loans, and personal banking services including real estate mortgage lending, installment and consumer loans, certificates of deposit, individual retirement and other time deposit accounts, checking accounts, savings accounts, and money market accounts. Other financial services that the Company provides include trust services that include estate planning, investment and asset management services and a comprehensive suite of cash management services. The geographic areas in which the Company provides products and services include the Missouri communities in and surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, St. Louis, and the greater Kansas City metropolitan area.

The Company’s primary source of revenue is net interest income derived primarily from lending and deposit taking activities. Much of the Company’s business is commercial, commercial real estate development, and residential mortgage lending. The Company’s income from mortgage brokerage activities is directly dependent on mortgage rates and the level of home purchases and refinancing activity.

The success of the Company’s growth strategy depends primarily on the ability of the Bank to generate an increasing level of loans and deposits at acceptable risk levels and on acceptable terms without significant increases in non-interest expenses relative to revenues generated. The Company’s financial performance also depends, in part, on its ability to manage various portfolios and to successfully introduce additional financial products and services by expanding new and existing customer relationships, utilizing improved technology, and enhancing customer satisfaction. Furthermore, the success of the Company’s growth strategy depends on its ability to maintain sufficient regulatory capital levels during periods in which general economic conditions are unfavorable and despite economic conditions being beyond its control.

The Bank is a full-service bank that conducts a general banking business, offering its customers checking and savings accounts, debit cards, certificates of deposit, safety deposit boxes and a wide range of lending services, including commercial and industrial loans, residential real estate loans, single payment personal loans, installment loans and credit card accounts. In addition, the Bank provides trust services.

The deposit accounts of the Bank are insured by the Federal Deposit Insurance Corporation (FDIC) to the extent provided by law. The operations of the Bank are supervised and regulated by the FDIC and the Missouri Division of Finance. Periodic examinations of the Bank are conducted by representatives of the FDIC and the Missouri Division of Finance. Such regulations, supervision and examinations are principally for the benefit of depositors, rather than for the benefit of shareholders. The Company is subject to supervision and examination by the Board of Governors of the Federal Reserve System.

36

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The following accounting policies are considered most critical to the understanding of the Company’s financial condition and results of operations. These critical accounting policies require management’s most difficult, subjective and complex judgments about matters that are inherently uncertain. Because these estimates and judgments are based on current circumstances, they may change over time or prove to be inaccurate based on actual experiences. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of a materially different financial condition and/or results of operations could reasonably be expected. The impact and any associated risks related to the critical accounting policies on the business operations are discussed throughout *Management’s Discussion and Analysis of Financial Condition and Results of Operations*, where such policies affect the reported and expected financial results.

***Allowance for Loan Losses***

Management has identified the accounting policy related to the allowance for loan losses as critical to the understanding of the Company’s results of operations, since the application of this policy requires significant management assumptions and estimates that could result in materially different amounts to be reported if conditions or underlying circumstances were to change. Further discussion of the methodology used in establishing the allowance and the impact of any associated risks related to these policies on the Company’s business operations is provided in *Note 1 - Summary of Significant Accounting Policies* and is also discussed in the *Lending and Credit Management* section below. Many of the loans are deemed collateral dependent for purposes of the measurement of the impairment loss, thus the fair value of the underlying collateral and sensitivity of such fair values due to changing market conditions, supply and demand, condition of the collateral and other factors can be volatile over periods of time. Such volatility can have an impact on the financial performance of the Company.

37

**Executive Summary**

The Company has prepared all of the consolidated financial information in this report in accordance with U.S. GAAP. In preparing the consolidated financial statements in accordance with U.S. GAAP, the Company makes estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurances that actual results will not differ from those estimates.

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|  | | |  | **The Three Months Ended** | | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| *(Dollars in thousands, except per share data)* | | |  |  |  |  |  |  |  | | | **September 30, 2022** | | |  | | | **June 30, 2022** | | |  | | | **September 30, 2021** | | |
| Net interest income | | |  |  |  |  |  |  |  | | | $ | 15,067 |  |  | | | $ | 14,561 |  |  | | | $ | 15,380 |  |
| Provision for loan losses | | |  |  |  |  |  |  |  | | | 300 | | |  | | | 1,200 | | |  | | | 300 | | |
| Non-interest income | | |  |  |  |  |  |  |  | | | 3,485 | | |  | | | 3,648 | | |  | | | 3,776 | | |
| Investment securities gains (losses), net | | |  |  |  |  |  |  |  | | | 1 | | |  | | | (9) | | |  | | | 126 | | |
| Non-interest expense | | |  |  |  |  |  |  |  | | | 12,195 | | |  | | | 11,540 | | |  | | | 11,769 | | |
| **Income before income taxes** | | |  |  |  |  |  |  |  | | | 6,058 | | |  | | | 5,460 | | |  | | | 7,213 | | |
| Income tax expense | | |  |  |  |  |  |  |  | | | 1,131 | | |  | | | 971 | | |  | | | 1,417 | | |
| **Net income** | | |  |  |  |  |  |  |  | | | $ | 4,927 |  |  | | | $ | 4,489 |  |  | | | $ | 5,796 |  |
| Basic earnings per share | | |  |  |  |  |  |  |  | | | $ | 0.73 | |  | | | $ | 0.66 | |  | | | $ | 0.84 | |
| Diluted earnings per share | | |  |  |  |  |  |  |  | | | $ | 0.73 | |  | | | $ | 0.66 | |  | | | $ | 0.84 | |
| Efficiency ratio (1) | | |  |  |  |  |  |  |  | | | 65.73% | | |  | | | 63.38% | | |  | | | 61.44% | | |
| Net interest spread | | |  |  |  |  |  |  |  | | | 3.28% | | |  | | | 3.47% | | |  | | | 3.62% | | |
| Net interest margin | | |  |  |  |  |  |  |  | | | 3.56% | | |  | | | 3.64% | | |  | | | 3.78% | | |
|  | | |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  |  |  |  |  |  |  | | |  | | |  | | | **Nine Months Ended** | | | | | | | | |
|  | | |  |  |  |  |  |  |  | | |  | | |  | | | **September 30,** | | | | | | | | |
| *(Dollars in thousands, except per share data)* | | |  |  |  |  |  |  |  | | |  | | |  | | | **2022** | | |  | | | **2021** | | |
| Net interest income | | |  |  |  |  |  |  |  | | |  | | |  | | | $ | 43,773 |  |  | | | $ | 43,442 |  |
| (Release of) provision for loan losses | | |  |  |  |  |  |  |  | | |  | | |  | | | (1,000) | | |  | | | 700 | | |
| Non-interest income | | |  |  |  |  |  |  |  | | |  | | |  | | | 10,859 | | |  | | | 13,010 | | |
| Investment securities (losses) gains, net | | |  |  |  |  |  |  |  | | |  | | |  | | | (12) | | |  | | | 140 | | |
| Non-interest expense | | |  |  |  |  |  |  |  | | |  | | |  | | | 35,962 | | |  | | | 35,391 | | |
| **Income before income taxes** | | |  |  |  |  |  |  |  | | |  | | |  | | | 19,658 | | |  | | | 20,501 | | |
| Income tax expense | | |  |  |  |  |  |  |  | | |  | | |  | | | 3,633 | | |  | | | 3,974 | | |
| **Net income** | | |  |  |  |  |  |  |  | | |  | | |  | | | $ | 16,025 |  |  | | | $ | 16,527 |  |
| Basic earnings per share | | |  |  |  |  |  |  |  | | |  | | |  | | | $ | 2.36 | |  | | | $ | 2.40 | |
| Diluted earnings per share | | |  |  |  |  |  |  |  | | |  | | |  | | | $ | 2.36 | |  | | | $ | 2.40 | |
| Efficiency ratio (1) | | |  |  |  |  |  |  |  | | |  | | |  | | | 65.83% | | |  | | | 62.69% | | |
| Net interest spread | | |  |  |  |  |  |  |  | | |  | | |  | | | 3.36% | | |  | | | 3.43% | | |
| Net interest margin | | |  |  |  |  |  |  |  | | |  | | |  | | | 3.57% | | |  | | | 3.60% | | |
|  | | |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |
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(1)Efficiency ratio is calculated as non-interest expense as a percentage of revenue. Total revenue is calculated as net interest income plus non-interest income.

38

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|  | | |  |  |  |  |  |  |  | **The Three Months Ended** | | | | | | | | | | | | | | |  | | | **As of and for the Nine months ended** | | | | | | | | |
|  | | |  |  |  |  |  |  |  | **September 30, 2022** | | |  | | | **June 30, 2022** | | |  | | | **September 30, 2021** | | |  | | | **September 30, 2022** | | |  | | | **September 30, 2021** | | |
| **Key financial ratios** | | |  |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Book value per share | | |  |  |  |  |  |  |  | $ | 16.97 | |  | | | $ | 18.20 | |  | | | $ | 20.22 | |  | | |  | | |  | | |  | | |
| Market price per share | | |  |  |  |  |  |  |  | $ | 21.86 | |  | | | $ | 25.49 | |  | | | $ | 22.27 | |  | | |  | | |  | | |  | | |
| Cash dividends paid on common stock | | |  |  |  |  |  |  |  | $ | 1,105 | |  | | | $ | 990 | |  | | | $ | 954 | |  | | | $ | 3,088 | |  | | | $ | 2,624 | |
| Return on total assets | | |  |  |  |  |  |  |  | 1.08% | | |  | | | 1.04% | | |  | | | 1.33% | | |  | | | 1.21% | | |  | | | 1.28% | | |
| Return on stockholders' equity | | |  |  |  |  |  |  |  | 15.30% | | |  | | | 14.00% | | |  | | | 16.49% | | |  | | | 16.00% | | |  | | | 16.37% | | |
| Average stockholders' equity to total assets | | |  |  |  |  |  |  |  | 7.06% | | |  | | | 7.40% | | |  | | | 8.05% | | |  | | | 7.55% | | |  | | | 7.82% | | |
|  | | |  |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Capital Ratios** | | |  |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Stockholders' equity to assets | | |  |  |  |  |  |  |  | 6.25% | | |  | | | 6.93% | | |  | | | 8.00% | | |  | | |  | | |  | | |  | | |
| Total risk-based capital ratio | | |  |  |  |  |  |  |  | 13.84% | | |  | | | 13.97% | | |  | | | 15.01% | | |  | | |  | | |  | | |  | | |
| Tier 1 risk-based capital ratio | | |  |  |  |  |  |  |  | 12.25% | | |  | | | 12.53% | | |  | | | 13.64% | | |  | | |  | | |  | | |  | | |
| Common equity Tier 1 capital | | |  |  |  |  |  |  |  | 9.82% | | |  | | | 9.85% | | |  | | | 10.26% | | |  | | |  | | |  | | |  | | |
| Tier 1 leverage ratio (1) | | |  |  |  |  |  |  |  | 10.60% | | |  | | | 10.98% | | |  | | | 10.82% | | |  | | |  | | |  | | |  | | |
|  | | |  |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Asset Quality** | | |  |  |  |  |  |  |  |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Net-charge-offs (recoveries) | | |  |  |  |  |  |  |  | $ | 148 |  |  | | | $ | 126 |  |  | | | $ | 106 |  |  | | | $ | 398 |  |  | | | $ | (116) |  |
| Non-performing loans | | |  |  |  |  |  |  |  | $ | 17,348 |  |  | | | $ | 17,817 |  |  | | | $ | 32,835 |  |  | | |  | | |  | | |  | | |
| Classified assets | | |  |  |  |  |  |  |  | $ | 96,705 |  |  | | | $ | 99,200 |  |  | | | $ | 111,697 |  |  | | |  | | |  | | |  | | |
| Non-performing loans to total loans | | |  |  |  |  |  |  |  | 1.16% | | |  | | | 1.25% | | |  | | | 2.56% | | |  | | |  | | |  | | |  | | |
| Non-performing assets to total assets | | |  |  |  |  |  |  |  | 1.44% | | |  | | | 1.51% | | |  | | | 2.56% | | |  | | |  | | |  | | |  | | |
| Allowance for loan losses to total loans | | |  |  |  |  |  |  |  | 1.04% | | |  | | | 1.08% | | |  | | | 1.48% | | |  | | |  | | |  | | |  | | |
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(1)Tier 1 leverage ratio is calculated by dividing Tier 1 capital by average total consolidated assets

***Results of Operations Highlights***

***Consolidated net income*** of $4.9 million for the third quarter 2022 increased $0.4 million, or 9.8%, compared to the second quarter 2022 ("linked quarter") and decreased $0.9 million, or 15.0%, from the third quarter 2021 (the "prior year quarter"). Earnings per diluted share were $0.73 for the third quarter 2022 compared to $0.66 and $0.84 for the linked quarter and prior year quarter, respectively. For the third quarter 2022, the return on average assets was 1.08%, the return on average stockholders’ equity was 15.30%, and the efficiency ratio was 65.7%.

***Consolidated net income*** of $16.0 million, or $2.36 per diluted share, for the nine months ended September 30, 2022 decreased $0.5 million, or 3.0%, compared to $16.5 million, or $2.40 per diluted share, for the nine months ended September 30, 2021. For the nine months ended September 30, 2022, the return on average assets was 1.21%, the return on average stockholders’ equity was 16.00%, and the efficiency ratio was 65.8%.

***Net interest income*** of $15.1 million for the third quarter 2022 increased $0.5 million from the linked quarter, and decreased $0.3 million from the prior year quarter. Net interest margin, on a fully taxable equivalent basis ("FTE") basis, was 3.56% for the third quarter, a decrease from 3.64% and 3.78% for the linked quarter and the prior year quarter, respectively.

***Net interest income*** of $43.8 million for the nine months ended September 30, 2022 increased $0.3 million compared to $43.4 million for the nine months ended September 30, 2021. Net interest margin, on a fully taxable equivalent basis ("FTE") basis, was 3.57% for the nine months ended September 30, 2022, a decrease from 3.60% for the nine months ended September 30, 2021. These changes are discussed in greater detail under the *Average Balance Sheet Data and Rate and Volume Analysis* section below.

***Non-interest income*** for the third quarter 2022 was $3.5 million, a decrease of $0.2 million, or 4.5%, from the linked quarter, and a decrease of $0.3 million, or 7.7%, from the prior year quarter. The change in the current quarter compared to

39

the prior year quarter was primarily due to the decrease in the gain on sale of real estate mortgages of $0.7 million, or 54.1%.

***Non-interest income*** of $10.9 million for the nine months ended September 30, 2022 decreased $2.2 million, or 16.5%, compared to $13.0 million for the nine months ended September 30, 2021. The change was primarily due to the decrease in the gain on sale of real estate mortgages of $3.6 million, or 60.5%. These changes are discussed in greater detail under the *Non-interest Income and Expense* section below.

***Non-interest expense*** for the third quarter 2022 was $12.2 million, an increase of $0.7 million, or 5.7%, from the linked quarter, and an increase of $0.4 million, or 3.6%, from the prior year quarter. The change in the current quarter compared to the linked quarter was primarily due to the increase in salary and benefits expenses, processing, network, and bankcard expense, and advertising and promotion expenses.

***Non-interest expense*** for the nine months ended September 30, 2022 was $36.0 million, an increase of $0.6 million, or 1.6%, from the nine months ended September 30, 2021. The change was primarily due to the new software maintenance agreements and the change in the fair value adjustment for mortgage banking derivatives, partially offset by a decrease in salary and benefits and loan expense. These changes are discussed in greater detail under the *Non-interest Income and Expense* section below.

***Balance Sheet Highlights***

***Loans*** – Loans held for investment increased by $64.2 million, or 4.5%, equal to $1.5 billion as of September 30, 2022 as compared to the end of the linked quarter. Year-over-year, loans held for investment grew $209.2 million, or 16.3%, from $1.3 billion as of September 30, 2021.

***Asset quality*** – Non-performing loans totaled $17.3 million at September 30, 2022, a decrease of $0.5 million from $17.8 million at the end of the linked quarter, and a decrease of $15.5 million from $32.8 million at the end of the prior year quarter. The reduction in non-performing loans in the current quarter as compared to the prior year quarter was primarily due to three large non-accrual loan relationships returning to accrual status. The allowance for loan losses to total loans was 1.04% at September 30, 2022, compared to 1.30% at December 31, 2021 and 1.48% at September 30, 2021. These changes are discussed in greater detail under the *Lending and Credit Management* section below.

***Deposit*s** – Total deposits increased by $62.0 million, or 4.0%, equal to $1.6 billion as of September 30, 2022 as compared to the end of the linked quarter. Year-over-year deposits grew $181.7 million, or 12.9%, from $1.4 billion as of September 30, 2021.

***Capital*** – Total shareholder’s equity was $115.4 million and the common equity to assets ratio was 6.25% at September 30, 2022 as compared to 6.93% and 8.00% at the end of the linked quarter and the prior year quarter, respectively. Regulatory capital ratios remain “well-capitalized,” with a tier 1 leverage ratio of 10.60% and a total risk-based capital ratio of 13.84% at September 30, 2022.

***Average Balance Sheet Data***

***Net interest income*** is the largest source of revenue resulting from the Company’s lending, investing, borrowing, and deposit gathering activities. It is affected both by changes in the level of interest rates and changes in the amounts and mix of interest earning assets and interest-bearing liabilities. The following table presents average balance sheet data, net interest income, average yields of earning assets, average costs of interest-bearing liabilities, net interest spread and net interest margin on a fully taxable equivalent basis for each of the three and nine month periods ended September 30, 2022 and 2021, respectively. The average balances used in this table and other statistical data were calculated using average daily balances.

40

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|  | | | **Three Months Ended September 30, 2022** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|  | | | **2022** | | | | | | | | | | | | | | | **2021** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **Average Balance** | | |  | | | **Interest Income/ Expense (1)** | | |  | | | **Rate Earned/ Paid (1)** | | | **Average Balance** | | |  | | | **Interest Income/ Expense (1)** | | |  | | | **Rate Earned/ Paid (1)** | | |
| **ASSETS** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Loans: (2) (3)** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial | | | $ | 245,877 | |  | | | $ | 3,211 | |  | | | 5.18% | | | $ | 247,564 | |  | | | $ | 4,575 | |  | | | 7.33% | | |
| Real estate construction - residential | | | 24,249 | | |  | | | 333 | | |  | | | 5.45 | | | 35,358 | | |  | | | 453 | | |  | | | 5.08 | | |
| Real estate construction - commercial | | | 127,594 | | |  | | | 1,522 | | |  | | | 4.73 | | | 75,081 | | |  | | | 885 | | |  | | | 4.68 | | |
| Real estate mortgage - residential | | | 323,158 | | |  | | | 3,581 | | |  | | | 4.40 | | | 270,464 | | |  | | | 2,863 | | |  | | | 4.20 | | |
| Real estate mortgage - commercial | | | 702,139 | | |  | | | 7,597 | | |  | | | 4.29 | | | 633,238 | | |  | | | 6,590 | | |  | | | 4.13 | | |
| Installment and other consumer | | | 23,738 | | |  | | | 206 | | |  | | | 3.44 | | | 24,363 | | |  | | | 242 | | |  | | | 3.94 | | |
| **Total loans** | | | $ | 1,446,755 | |  | | | $ | 16,450 | |  | | | 4.51% | | | $ | 1,286,068 | |  | | | $ | 15,608 | |  | | | 4.81% | | |
| **Loans held for sale** | | | 1,560 | | |  | | | 23 | | |  | | | 5.85 | | | 3,092 | | |  | | | 24 | | |  | | | 3.08 | | |
| **Investment securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | 3,586 | | |  | | | 12 | | |  | | | 1.33 | | | 3,033 | | |  | | | 4 | | |  | | | 0.52 | | |
| U.S. government and federal agency obligations | | | 25,440 | | |  | | | 87 | | |  | | | 1.36 | | | 20,819 | | |  | | | 75 | | |  | | | 1.43 | | |
| Obligations of states and political subdivisions | | | 113,003 | | |  | | | 1,040 | | |  | | | 3.65 | | | 114,804 | | |  | | | 868 | | |  | | | 3.00 | | |
| Mortgage-backed securities | | | 111,616 | | |  | | | 493 | | |  | | | 1.75 | | | 130,659 | | |  | | | 443 | | |  | | | 1.35 | | |
| Other debt securities | | | 12,781 | | |  | | | 163 | | |  | | | 5.06 | | | 10,608 | | |  | | | 128 | | |  | | | 4.79 | | |
| **Total investment securities** | | | 266,426 | | |  | | | 1,795 | | |  | | | 2.67 | | | 279,923 | | |  | | | 1,518 | | |  | | | 2.15 | | |
| Other investment securities | | | 5,431 | | |  | | | 64 | | |  | | | 4.68 | | | 6,010 | | |  | | | 81 | | |  | | | 5.35 | | |
| Federal funds sold | | | 46 | | |  | | | — | | |  | | | — | | | 6,829 | | |  | | | 1 | | |  | | | 0.06 | | |
| Interest bearing deposits in other financial institutions | | | 15,462 | | |  | | | 76 | | |  | | | 1.95 | | | 84,825 | | |  | | | 78 | | |  | | | 0.36 | | |
| **Total interest earning assets** | | | $ | 1,735,680 | |  | | | $ | 18,408 | |  | | | 4.21% | | | $ | 1,666,747 | |  | | | $ | 17,310 | |  | | | 4.12% | | |
| All other assets | | | 88,159 | | |  | | |  | | |  | | |  | | | 84,269 | | |  | | |  | | |  | | |  | | |
| Allowance for loan losses | | | (15,431) | | |  | | |  | | |  | | |  | | | (18,801) | | |  | | |  | | |  | | |  | | |
| **Total assets** | | | $ | 1,808,408 | |  | | |  | | |  | | |  | | | $ | 1,732,215 | |  | | |  | | |  | | |  | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Savings | | | $ | 182,364 | |  | | | $ | 16 | |  | | | 0.03% | | | $ | 161,308 | |  | | | $ | 14 | |  | | | 0.03% | | |
| NOW accounts | | | 268,780 | | |  | | | 646 | | |  | | | 0.95 | | | 225,351 | | |  | | | 130 | | |  | | | 0.23 | | |
| Interest checking | | | 47,788 | | |  | | | 264 | | |  | | | 2.19 | | | 37,391 | | |  | | | 45 | | |  | | | 0.48 | | |
| Money market | | | 302,773 | | |  | | | 456 | | |  | | | 0.60 | | | 281,425 | | |  | | | 91 | | |  | | | 0.13 | | |
| Time deposits | | | 273,550 | | |  | | | 584 | | |  | | | 0.85 | | | 252,731 | | |  | | | 437 | | |  | | | 0.69 | | |
| **Total interest bearing deposits** | | | $ | 1,075,255 | |  | | | $ | 1,966 | |  | | | 0.73% | | | $ | 958,206 | |  | | | $ | 717 | |  | | | 0.30% | | |
| Federal funds purchased and securities sold under agreements to repurchase | | | 6,181 | | |  | | | 13 | | |  | | | 0.84 | | | 29,753 | | |  | | | 19 | | |  | | | 0.25 | | |
| Federal Home Loan Bank advances and other borrowings | | | 75,262 | | |  | | | 277 | | |  | | | 1.46 | | | 93,533 | | |  | | | 383 | | |  | | | 1.62 | | |
| Subordinated notes | | | 49,486 | | |  | | | 570 | | |  | | | 4.57 | | | 49,486 | | |  | | | 305 | | |  | | | 2.45 | | |
| **Total borrowings** | | | 130,929 | | |  | | | 860 | | |  | | | 2.61 | | | 172,772 | | |  | | | 707 | | |  | | | 1.62 | | |
| **Total interest bearing liabilities** | | | $ | 1,206,184 | |  | | | $ | 2,826 | |  | | | 0.93% | | | $ | 1,130,978 | |  | | | $ | 1,424 | |  | | | 0.50% | | |
| Demand deposits | | | 464,377 | | |  | | |  | | |  | | |  | | | 445,062 | | |  | | |  | | |  | | |  | | |
| Other liabilities | | | 10,100 | | |  | | |  | | |  | | |  | | | 16,723 | | |  | | |  | | |  | | |  | | |
| **Total liabilities** | | | $ | 1,680,661 | |  | | |  | | |  | | |  | | | $ | 1,592,763 | |  | | |  | | |  | | |  | | |
| Stockholders' equity | | | 127,747 | | |  | | |  | | |  | | |  | | | 139,452 | | |  | | |  | | |  | | |  | | |
| **Total liabilities and stockholders' equity** | | | $ | 1,808,408 | |  | | |  | | |  | | |  | | | $ | 1,732,215 | |  | | |  | | |  | | |  | | |
| **Net interest income (FTE)** | | |  | | |  | | | $ | 15,582 | |  | | |  | | |  | | |  | | | $ | 15,886 | |  | | |  | | |
| **Net interest spread** | | |  | | |  | | |  | | |  | | | 3.28% | | |  | | |  | | |  | | |  | | | 3.62% | | |
| **Net interest margin** | | |  | | |  | | |  | | |  | | | 3.56% | | |  | | |  | | |  | | |  | | | 3.78% | | |

(1)Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21%, net of nondeductible interest expense, for the three months ended September 30, 2022 and 2021. Such adjustments totaled $0.5 million and $0.5 million for the three months ended September 30, 2022 and 2021, respectively.

(2)Non-accruing loans are included in the average amounts outstanding.

(3)Fees and costs on loans are included in interest income ($20,000 and $2.0 million of PPP fees were included in commercial loan income for the three months ended September 30, 2022 and 2021, respectively)

41

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30, 2022** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|  | | | **2022** | | | | | | | | | | | | | | | **2021** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **Average Balance** | | |  | | | **Interest Income/ Expense (1)** | | |  | | | **Rate Earned/ Paid (1)** | | | **Average Balance** | | |  | | | **Interest Income/ Expense (1)** | | |  | | | **Rate Earned/ Paid (1)** | | |
| **ASSETS** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Loans: (2) (3)** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial | | | $ | 233,076 | |  | | | $ | 8,860 | |  | | | 5.08% | | | $ | 253,878 | |  | | | $ | 11,732 | |  | | | 6.18% | | |
| Real estate construction - residential | | | 23,627 | | |  | | | 865 | | |  | | | 4.89 | | | 34,625 | | |  | | | 1,274 | | |  | | | 4.92 | | |
| Real estate construction - commercial | | | 110,540 | | |  | | | 3,683 | | |  | | | 4.45 | | | 77,115 | | |  | | | 2,676 | | |  | | | 4.64 | | |
| Real estate mortgage - residential | | | 300,518 | | |  | | | 9,461 | | |  | | | 4.21 | | | 264,699 | | |  | | | 8,546 | | |  | | | 4.32 | | |
| Real estate mortgage - commercial | | | 685,041 | | |  | | | 21,743 | | |  | | | 4.24 | | | 624,455 | | |  | | | 19,809 | | |  | | | 4.24 | | |
| Installment and other consumer | | | 22,987 | | |  | | | 614 | | |  | | | 3.57 | | | 25,044 | | |  | | | 750 | | |  | | | 4.00 | | |
| **Total loans** | | | $ | 1,375,789 | |  | | | $ | 45,226 | |  | | | 4.40% | | | $ | 1,279,816 | |  | | | $ | 44,787 | |  | | | 4.68% | | |
| **Loans held for sale** | | | 1,841 | | |  | | | 69 | | |  | | | 5.01 | | | 4,262 | | |  | | | 79 | | |  | | | 2.48 | | |
| **Investment securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | 3,909 | | |  | | | 29 | | |  | | | 0.99 | | | 3,026 | | |  | | | 13 | | |  | | | 0.57 | | |
| U.S. government and federal agency obligations | | | 26,235 | | |  | | | 271 | | |  | | | 1.38 | | | 22,579 | | |  | | | 275 | | |  | | | 1.63 | | |
| Obligations of states and political subdivisions | | | 118,845 | | |  | | | 3,152 | | |  | | | 3.55 | | | 88,333 | | |  | | | 1,989 | | |  | | | 3.01 | | |
| Mortgage-backed securities | | | 120,806 | | |  | | | 1,503 | | |  | | | 1.66 | | | 125,813 | | |  | | | 1,249 | | |  | | | 1.33 | | |
| Other debt securities | | | 13,080 | | |  | | | 476 | | |  | | | 4.87 | | | 11,675 | | |  | | | 430 | | |  | | | 4.92 | | |
| **Total investment securities** | | | 282,875 | | |  | | | 5,431 | | |  | | | 2.57 | | | 251,426 | | |  | | | 3,956 | | |  | | | 2.10 | | |
| Other investment securities | | | 5,430 | | |  | | | 204 | | |  | | | 5.02 | | | 6,021 | | |  | | | 246 | | |  | | | 5.46 | | |
| Federal funds sold | | | 2,285 | | |  | | | 5 | | |  | | | 0.29 | | | 10,979 | | |  | | | 6 | | |  | | | 0.07 | | |
| Interest bearing deposits in other financial institutions | | | 34,210 | | |  | | | 179 | | |  | | | 0.70 | | | 108,021 | | |  | | | 263 | | |  | | | 0.33 | | |
| **Total interest earning assets** | | | $ | 1,702,430 | |  | | | $ | 51,114 | |  | | | 4.01% | | | $ | 1,660,525 | |  | | | $ | 49,337 | |  | | | 3.97% | | |
| All other assets | | | 85,993 | | |  | | |  | | |  | | |  | | | 84,682 | | |  | | |  | | |  | | |  | | |
| Allowance for loan losses | | | (15,575) | | |  | | |  | | |  | | |  | | | (18,579) | | |  | | |  | | |  | | |  | | |
| **Total assets** | | | $ | 1,772,848 | |  | | |  | | |  | | |  | | | $ | 1,726,628 | |  | | |  | | |  | | |  | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Savings | | | $ | 179,952 | |  | | | $ | 45 | |  | | | 0.03% | | | $ | 153,730 | |  | | | $ | 40 | |  | | | 0.03% | | |
| NOW accounts | | | 267,266 | | |  | | | 1,196 | | |  | | | 0.60 | | | 227,925 | | |  | | | 402 | | |  | | | 0.24 | | |
| Interest checking | | | 34,404 | | |  | | | 346 | | |  | | | 1.34 | | | 46,661 | | |  | | | 168 | | |  | | | 0.48 | | |
| Money market | | | 295,105 | | |  | | | 688 | | |  | | | 0.31 | | | 280,839 | | |  | | | 255 | | |  | | | 0.12 | | |
| Time deposits | | | 260,610 | | |  | | | 1,297 | | |  | | | 0.67 | | | 255,494 | | |  | | | 1,612 | | |  | | | 0.84 | | |
| **Total interest bearing deposits** | | | $ | 1,037,337 | |  | | | $ | 3,572 | |  | | | 0.46% | | | $ | 964,649 | |  | | | $ | 2,477 | |  | | | 0.34% | | |
| Federal funds purchased and securities sold under agreements to repurchase | | | 8,812 | | |  | | | 32 | | |  | | | 0.49 | | | 38,797 | | |  | | | 72 | | |  | | | 0.25 | | |
| Federal Home Loan Bank advances and other borrowings | | | 76,278 | | |  | | | 778 | | |  | | | 1.36 | | | 95,486 | | |  | | | 1,164 | | |  | | | 1.63 | | |
| Subordinated notes | | | 49,486 | | |  | | | 1,316 | | |  | | | 3.56 | | | 49,486 | | |  | | | 921 | | |  | | | 2.49 | | |
| **Total borrowings** | | | 134,576 | | |  | | | 2,126 | | |  | | | 2.11 | | | 183,769 | | |  | | | 2,157 | | |  | | | 1.57 | | |
| **Total interest bearing liabilities** | | | $ | 1,171,913 | |  | | | $ | 5,698 | |  | | | 0.65% | | | $ | 1,148,418 | |  | | | $ | 4,634 | |  | | | 0.54% | | |
| Demand deposits | | | 455,689 | | |  | | |  | | |  | | |  | | | 426,290 | | |  | | |  | | |  | | |  | | |
| Other liabilities | | | 11,339 | | |  | | |  | | |  | | |  | | | 16,953 | | |  | | |  | | |  | | |  | | |
| **Total liabilities** | | | $ | 1,638,941 | |  | | |  | | |  | | |  | | | $ | 1,591,661 | |  | | |  | | |  | | |  | | |
| Stockholders' equity | | | 133,907 | | |  | | |  | | |  | | |  | | | 134,967 | | |  | | |  | | |  | | |  | | |
| **Total liabilities and stockholders' equity** | | | $ | 1,772,848 | |  | | |  | | |  | | |  | | | $ | 1,726,628 | |  | | |  | | |  | | |  | | |
| **Net interest income (FTE)** | | |  | | |  | | | $ | 45,416 | |  | | |  | | |  | | |  | | | $ | 44,703 | |  | | |  | | |
| **Net interest spread** | | |  | | |  | | |  | | |  | | | 3.36% | | |  | | |  | | |  | | |  | | | 3.43% | | |
| **Net interest margin** | | |  | | |  | | |  | | |  | | | 3.57% | | |  | | |  | | |  | | |  | | | 3.60% | | |

(1)Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21%, net of nondeductible interest expense, for the nine months ended September 30, 2022 and 2021. Such adjustments totaled $1.6 million and $1.3 million for the nine months ended September 30, 2022 and 2021, respectively.

(2)Non-accruing loans are included in the average amounts outstanding.

(3)Fees and costs on loans are included in interest income ($0.4 million and $4.0 million of PPP fees were included in commercial loan income for the nine months ended September 30, 2022 and 2021, respectively).

42

***Rate and Volume Analysis***

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest-earning assets and interest-bearing liabilities, identifying changes related to volumes and rates for the three and nine months ended September 30, 2022 compared to the three and nine months ended September 30, 2021. The change in interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | | | | | | | |
|  | | | **2022 vs. 2021** | | | | | | | | | | | | | | |  | | | **2022 vs. 2021** | | | | | | | | | | | | | | |
|  | | |  | | |  | | | **Change due to** | | | | | | | | |  | | |  | | |  | | | **Change due to** | | | | | | | | |
| *(in thousands)* | | | **Total Change** | | |  | | | **Average Volume** | | |  | | | **Average Rate** | | |  | | | **Total Change** | | |  | | | **Average Volume** | | |  | | | **Average Rate** | | |
| **Interest income on a fully taxable equivalent basis: (1)** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Loans: (2) (3)** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial | | | $ | (1,364) |  |  | | | $ | (31) |  |  | | | $ | (1,333) |  |  | | | $ | (2,872) |  |  | | | $ | (908) |  |  | | | $ | (1,964) |  |
| Real estate construction - residential | | | (120) | | |  | | | (151) | | |  | | | 31 | | |  | | | (409) | | |  | | | (402) | |  |  | | | (7) | |  |
| Real estate construction - commercial | | | 637 | | |  | | | 626 | | |  | | | 11 | | |  | | | 1007 | | |  | | | 1117 | |  |  | | | (110) | |  |
| Real estate mortgage - residential | | | 718 | | |  | | | 579 | | |  | | | 139 | | |  | | | 915 | | |  | | | 1133 | |  |  | | | (218) | |  |
| Real estate mortgage - commercial | | | 1,007 | | |  | | | 738 | | |  | | | 269 | | |  | | | 1,934 | | |  | | | 1921 | |  |  | | | 13 | |  |
| Installment and other consumer | | | (36) | | |  | | | (6) | | |  | | | (30) | | |  | | | (136) | | |  | | | (59) | |  |  | | | (77) | |  |
| **Loans held for sale** | | | (1) | | |  | | | (16) | | |  | | | 15 | | |  | | | (10) | | |  | | | (61) | |  |  | | | 51 | |  |
| **Investment securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| U.S. Treasury | | | 8 | | |  | | | 1 | | |  | | | 7 | | |  | | | 16 | | |  | | | 5 | |  |  | | | 11 | |  |
| U.S. government and federal agency obligations | | | 12 | | |  | | | 16 | | |  | | | (4) | | |  | | | (4) | | |  | | | 41 | |  |  | | | (45) | |  |
| Obligations of states and political subdivisions | | | 172 | | |  | | | (14) | | |  | | | 186 | | |  | | | 1,163 | | |  | | | 768 | |  |  | | | 395 | |  |
| Mortgage-backed securities | | | 50 | | |  | | | (71) | | |  | | | 121 | | |  | | | 254 | | |  | | | (52) | |  |  | | | 306 | |  |
| Other debt securities | | | 35 | | |  | | | 27 | | |  | | | 8 | | |  | | | 46 | | |  | | | 51 | |  |  | | | (5) | |  |
| Other investment securities | | | (17) | | |  | | | (7) | | |  | | | (10) | | |  | | | (42) | | |  | | | (23) | |  |  | | | (19) | |  |
| Federal funds sold | | | (1) | | |  | | | (1) | | |  | | | — | | |  | | | (1) | | |  | | | (7) | |  |  | | | 6 | |  |
| Interest bearing deposits in other financial institutions | | | (2) | | |  | | | (106) | | |  | | | 104 | | |  | | | (84) | | |  | | | (260) | |  |  | | | 176 | |  |
| **Total interest income** | | | $ | 1,098 |  |  | | | $ | 1,584 |  |  | | | $ | (486) |  |  | | | $ | 1,777 |  |  | | | $ | 3,264 |  |  | | | $ | (1,487) |  |
| **Interest expense:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Savings | | | $ | 2 |  |  | | | $ | 2 |  |  | | | $ | — |  |  | | | $ | 5 |  |  | | | $ | 6 |  |  | | | $ | (1) |  |
| NOW accounts | | | 516 | | |  | | | 30 | |  |  | | | 486 | |  |  | | | 794 | | |  | | | 82 | |  |  | | | 712 | |  |
| Interest checking | | | 219 | | |  | | | 16 | |  |  | | | 203 | |  |  | | | 178 | | |  | | | (54) | |  |  | | | 232 | |  |
| Money market | | | 365 | | |  | | | 8 | |  |  | | | 357 | |  |  | | | 433 | | |  | | | 13 | |  |  | | | 420 | |  |
| Time deposits | | | 147 | | |  | | | 38 | |  |  | | | 109 | |  |  | | | (315) | | |  | | | 32 | |  |  | | | (347) | |  |
| Federal funds purchased and securities sold under agreements to repurchase | | | (6) | | |  | | | (24) | |  |  | | | 18 | | |  | | | (40) | | |  | | | (80) | |  |  | | | 40 | | |
| Federal Home Loan Bank advances and other borrowings | | | (106) | | |  | | | (70) | |  |  | | | (36) | | |  | | | (386) | | |  | | | (213) | |  |  | | | (173) | | |
| Subordinated notes | | | 265 | | |  | | | — | |  |  | | | 265 | | |  | | | 395 | | |  | | | — | |  |  | | | 395 | | |
| **Total interest expense** | | | $ | 1,402 |  |  | | | $ | — |  |  | | | $ | 1,402 |  |  | | | $ | 1,064 |  |  | | | $ | (214) |  |  | | | $ | 1,278 |  |
| **Net interest income on a fully taxable equivalent basis** | | | $ | (304) |  |  | | | $ | 1,584 |  |  | | | $ | (1,888) |  |  | | | $ | 713 |  |  | | | $ | 3,478 |  |  | | | $ | (2,765) |  |

(1)Interest income and yields are presented on a fully taxable equivalent basis using the federal statutory income tax rate of 21%, net of nondeductible interest expense, for the three and nine months ended September 30, 2022 and 2021, respectively. Such adjustments totaled $0.5 million and $1.6 million for the three and nine months ended September 30, 2022 compared to $0.5 million and $1.3 million for the three and nine months ended September 30, 2021, respectively.

(2)Non-accruing loans are included in the average amounts outstanding.

(3)Fees and costs on loans are included in interest income ($20,000 and $0.4 million of PPP fees were included in commercial loan income for the three and nine months ended September 30, 2022 compared to $2.0 million and $4.0 million for the nine months ended September 30, 2021, respectively).

43

Financial results for the quarter ended September 30, 2022 compared to the quarter ended September 30, 2021 reflected a decrease in net interest income, on a tax equivalent basis, of $0.3 million, or 1.9%, and the financial results for the nine months ended September 30, 2022 compared to the nine months ended September 30, 2021 reflected an increase of $0.7 million, or 1.6%. Measured as a percentage of average earning assets, the net interest margin (expressed on a fully taxable equivalent basis) decreased to 3.56% for the quarter ended September 30, 2022 compared to 3.78% for the quarter ended September 30, 2021, and decreased to 3.57% for the nine months ended September 30, 2022 compared to 3.60% for the nine months ended September 30, 2021. Driving the decrease in net interest income in the quarter compared to the prior year quarter was higher interest expense for interest bearing liabilities, partially offset by higher interest income resulting from growth in loans of 12.5%. The significant loan growth more than offset the reduction in PPP fee income of $2.0 million from the prior year quarter. Driving the increase in net interest income for the current year compared to the prior year, on a year-to-date basis, was higher interest income resulting from growth in loans of 7.5%, and investment securities portfolio of 12.5%, partially offset by higher interest expense for interest bearing liabilities and a reduction of PPP fee income of $3.7 million.

Average interest-earning assets increased $68.9 million, or 4.1%, to $1.74 billion for the quarter ended September 30, 2022 compared to $1.67 billion for the quarter ended September 30, 2021, and average interest-bearing liabilities increased $75.2 million, or 6.6%, to $1.21 billion for the quarter ended September 30, 2022 compared to $1.13 billion for the quarter ended September 30, 2021.

Average interest-earning assets increased $41.9 million, or 2.5%, to $1.70 billion for the nine months ended September 30, 2022 compared to $1.66 billion for the nine months ended September 30, 2021, and average interest-bearing liabilities increased $23.5 million, or 2.0%, to $1.17 billion for the nine months ended September 30, 2022 compared to $1.15 billion for the nine months ended September 30, 2021.

***Total interest income*** (expressed on a fully taxable equivalent basis) was $18.4 million and $51.1 million for the three and nine months ended September 30, 2022, respectively, compared to $17.3 million and $49.3 million for the three and nine months ended September 30, 2021, respectively. The Company’s rates earned on interest earning assets were 4.21% and 4.01% for the three and nine months ended September 30, 2022, respectively, compared to 4.12% and 3.97% for the three and nine months ended September 30, 2021, respectively.

***Interest income on loans held for investment*** was $16.5 million and $45.2 million for the three and nine months ended September 30, 2022, respectively, compared to $15.6 million and $44.8 million for the three and nine months ended September 30, 2021, respectively.

Average loans outstanding increased $160.7 million, or 12.5%, to $1.45 billion for the quarter ended September 30, 2022 compared to $1.29 billion for the quarter ended September 30, 2021. The average yield on loans decreased to 4.51% for the quarter ended September 30, 2022 compared to 4.81% for the quarter ended September 30, 2021.

Average loans outstanding increased $96.0 million, or 7.5%, to $1.38 billion for the nine months ended September 30, 2022 compared to $1.28 billion for the nine months ended September 30, 2021. The average yield on loans decreased to 4.40% for the nine months ended September 30, 2022 compared to 4.68% for the nine months ended September 30, 2021. See the *Lending and Credit Management* section for further discussion of changes in the composition of the lending portfolio.

***Interest income on available-for-sale securities*** was $1.8 million and $5.4 million for the three and nine months ended September 30, 2022, respectively, compared to $1.5 million and $4.0 million for the three and nine months ended September 30, 2021, respectively.

Average securities decreased $13.5 million, or 4.8%, to $266.4 million for the quarter ended September 30, 2022 compared to $279.9 million for the quarter ended September 30, 2021. The average yield on securities increased to 2.67% for the quarter ended September 30, 2022 compared to 2.15% for the quarter ended September 30, 2021. See the *Liquidity Management* section for further discussion.

Average securities increased $31.4 million, or 12.5%, to $282.9 million for the nine months ended September 30, 2022 compared to $251.4 million for the nine months ended September 30, 2021. The average yield on securities increased to

44

2.57% for the nine months ended September 30, 2022 compared to 2.10% for the nine months ended September 30, 2021. See the *Liquidity Management* section for further discussion.

***Total interest expense*** increased to $2.8 million for the quarter ended September 30, 2022 compared to $1.4 million for the quarter ended September 30, 2021, and increased to $5.7 million for the nine months ended September 30, 2022 compared to $4.6 million for the nine months ended September 30, 2021. The Company’s rates paid on interest bearing-liabilities were 0.93% and 0.65% for the three and nine months ended September 30, 2022, respectively, compared to 0.50% and 0.54% for the three and nine months ended September 30, 2021, respectively. See the *Liquidity Management* section for further discussion.

***Interest expense on deposits*** increased to $2.0 million for the quarter ended September 30, 2022 compared to $0.7 million for the quarter ended September 30, 2021, and increased to $3.6 million for the nine months ended September 30, 2022 compared to $2.5 million for the nine months ended September 30, 2021.

Average interest-bearing deposits increased $117.0 million, or 12.2%, to $1.08 billion for the quarter ended September 30, 2022 compared to $0.96 billion for the quarter ended September 30, 2021. The average cost of deposits increased to 0.73% for the quarter ended September 30, 2022 compared to 0.30% for the quarter ended September 30, 2021.

Average interest-bearing deposits increased $72.7 million, or 7.5%, to $1.04 billion for the nine months ended September 30, 2022 compared to $0.96 billion for the nine months ended September 30, 2021. The average cost of deposits increased to 0.46% for the nine months ended September 30, 2022 compared to 0.34% for the nine months ended September 30, 2021.

***Interest expense on borrowings*** increased to $0.9 million for the quarter ended September 30, 2022 compared to $0.7 million for the quarter ended September 30, 2021, and decreased to $2.1 million for the nine months ended September 30, 2022 compared to $2.2 million for the nine months ended September 30, 2021.

Average borrowings decreased to $130.9 million for the quarter ended September 30, 2022 compared to $172.8 million for the quarter ended September 30, 2021. The average cost of borrowings increased to 2.61% for the quarter ended September 30, 2022 compared to 1.62% for the quarter ended September 30, 2021. The increase in cost of funds primarily resulted from higher market interest rates.

Average borrowings decreased to $134.6 million for the nine months ended September 30, 2022 compared to $183.8 million for the nine months ended September 30, 2021. The average cost of borrowings increased to 2.11% for the nine months ended September 30, 2022 compared to 1.57% for the nine months ended September 30, 2021. The increase in cost of funds primarily resulted from higher market interest rates.

***Non-interest Income and Expense***

**Non-interest income for the periods indicated was as follows:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | | | | | | | | **Nine Months Ended September 30,** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **2022** | | | **2021** | | | **$ Change** | | |  | | | **% Change** | | | **2022** | | | **2021** | | | **$ Change** | | |  | | | **% Change** | | |
| **Non-interest income** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Service charges and other fees | | | $ | 693 |  | $ | 782 |  | $ | (89) |  |  | | | (11.4) | | % | $ | 2,322 |  | $ | 2,285 |  | $ | 37 |  |  | | | 1.6 | | % |
| Bank card income and fees | | | 1,030 | |  | 1,043 | |  | (13) | |  |  | | | (1.2) | | % | 3,054 | |  | 2,925 | |  | 129 | |  |  | | | 4.4 | | % |
| Trust department income | | | 287 | |  | 308 | |  | (21) | |  |  | | | (6.8) | | % | 924 | |  | 910 | |  | 14 | |  |  | | | 1.5 | | % |
| Real estate servicing fees, net | | | 383 | |  | 71 | |  | 312 | |  |  | | | 439.4 | | % | 861 | |  | 495 | |  | 366 | |  |  | | | 73.9 | | % |
| Gain on sales of mortgage loans, net | | | 628 | |  | 1,369 | |  | (741) | |  |  | | | (54.1) | | % | 2,322 | |  | 5,881 | |  | (3,559) | |  |  | | | (60.5) | | % |
| Other | | | 464 | |  | 203 | |  | 261 | |  |  | | | 128.6 | | % | 1,376 | |  | 514 | |  | 862 | |  |  | | | 167.7 | | % |
| **Total non-interest income** | | | $ | 3,485 |  | $ | 3,776 |  | $ | (291) |  |  | | | (7.7) | | % | $ | 10,859 |  | $ | 13,010 |  | $ | (2,151) |  |  | | | (16.5) | | % |
| Non-interest income as a % of total revenue \* | | | 18.8 | | % | 19.7 | | % |  | | |  | | |  | | | 19.9 | | % | 23.0 | | % |  | | |  | | |  | | |

\*Total revenue is calculated as net interest income plus non-interest income.

45

***Total non-interest income*** decreased $0.3 million, or 7.7%, to $3.5 million for the third quarter ended September 30, 2022 compared to $3.8 million for the third quarter ended September 30, 2021, and decreased $2.2 million, or 16.5%, to $10.9 million for the nine months ended September 30, 2022 compared to $13.0 million for the nine months ended September 30, 2021. The decrease was primarily due to the decrease in gain on sale of real estate mortgages due to lower volumes of real estate mortgage loans sold as further discussed below.

***Real estate servicing fees, net*** of the change in valuation of mortgage servicing rights (MSRs) increased to $0.4 million for the quarter ended September 30, 2022 compared to $0.1 million for the quarter ended September 30, 2021, and increased to $0.9 million for the nine months ended September 30, 2022 compared to $0.5 million for the nine months ended September 30, 2021.

Mortgage loan servicing fees earned on loans sold were $0.2 million and $0.7 million for the three and nine months ended September 30, 2022, respectively, compared to $0.2 million and $0.6 million for the three and nine months ended September 30, 2021, respectively. The current quarter's MSR valuation increased $155,000 and $186,000 from the end of the linked quarter and December 31, 2021, respectively, primarily due to an increase in market rates. Mortgage rates have increased significantly to over 6.0% for a new thirty-year conforming mortgage. The Company was servicing $247.6 million of mortgage loans at September 30, 2022 compared to $270.0 million and $277.1 million at December 31, 2021 and September 30, 2021, respectively.

***Gain on sales of mortgage loans*** decreased $0.7 million to $0.6 million for the third quarter ended September 30, 2022 compared to $1.4 million for the third quarter ended September 30, 2021, and decreased $3.6 million to $2.3 million for the nine months ended September 30, 2022 compared to $5.9 million for the nine months ended September 30, 2021.

The Company sold $21.4 million and $76.1 million of loans for the three and nine months ended September 30, 2022, respectively, compared to $39.1 million and $167.3 million for the three and nine months ended September 30, 2021, respectively. Loans sold to the secondary market slowed after strong sales during the first nine months of 2021.

***Other Income*** increased $0.3 million to $0.5 million for the quarter ended September 30, 2022 compared to $0.2 million for the quarter ended September 30, 2021, and increased $0.9 million to $1.4 million for the nine months ended September 30, 2022 compared to $0.5 million for the nine months ended September 30, 2021. The increase primarily resulted from mortgage banking derivative income, interest component of net pension cost, net gain on sale of property in other real estate owned, and income received from the Missouri Department of Transportation related to a land easement.

The following table presents the gross realized gains and losses from sales and calls of available-for-sale securities, as well as gains and losses on equity securities from fair value adjustments which have been recognized in earnings:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | |
| *(in thousands)* | | | **2022** | | |  | | | **2021** | | |  | | | **2022** | | |  | | | **2021** | | |
| **Investment securities gains (losses), net** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Available-for-sale securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Gross realized gains | | | $ | — | |  | | | $ | 119 | |  | | | $ | — | |  | | | $ | 121 | |
| Gross realized losses | | | — | | |  | | | — | | |  | | | — | | |  | | | — | |  |
| Other-than-temporary impairment recognized | | | — | | |  | | | — | | |  | | | — | | |  | | | — | | |
| **Other investment securities:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Fair value adjustments, net | | | 1 | | |  | | | 7 | | |  | | | (12) | | |  | | | 19 | | |
| **Investment securities gains (losses), net** | | | $ | 1 | |  | | | $ | 126 | |  | | | $ | (12) | |  | | | $ | 140 | |

46

**Non-interest expense for the periods indicated was as follows:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30,** | | | | | | | | | | | | | | |  | | | **Nine Months Ended September 30,** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **2022** | | | **2021** | | | **$ Change** | | |  | | | **% Change** | | |  | | | **2022** | | | **2021** | | | **$ Change** | | |  | | | **% Change** | | |
| **Non-interest expense** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Salaries | | | $ | 5,153 |  | $ | 4,954 |  | $ | 199 |  |  | | | 4.0% | | |  | | | $ | 15,315 |  | $ | 15,446 |  | $ | (131) |  |  | | | (0.9)% | | |
| Employee benefits | | | 1,597 | |  | 1,711 | |  | (114) | |  |  | | | (6.7) | | |  | | | 4,936 | |  | 5,320 | |  | (384) | |  |  | | | (7.2) | | |
| Occupancy expense, net | | | 789 | |  | 808 | |  | (19) | |  |  | | | (2.4) | | |  | | | 2,339 | |  | 2,298 | |  | 41 | |  |  | | | 1.8 | | |
| Furniture and equipment expense | | | 774 | |  | 787 | |  | (13) | |  |  | | | (1.7) | | |  | | | 2,301 | |  | 2,284 | |  | 17 | |  |  | | | 0.7 | | |
| Processing, network and bank card expense | | | 1,261 | |  | 1,288 | |  | (27) | |  |  | | | (2.1) | | |  | | | 3,545 | |  | 3,520 | |  | 25 | |  |  | | | 0.7 | | |
| Legal, examination, and professional fees | | | 395 | |  | 357 | |  | 38 | |  |  | | | 10.6 | | |  | | | 1,210 | |  | 1,146 | |  | 64 | |  |  | | | 5.6 | | |
| Advertising and promotion | | | 430 | |  | 310 | |  | 120 | |  |  | | | 38.7 | | |  | | | 1,027 | |  | 862 | |  | 165 | |  |  | | | 19.1 | | |
| Postage, printing, and supplies | | | 237 | |  | 218 | |  | 19 | |  |  | | | 8.7 | | |  | | | 653 | |  | 608 | |  | 45 | |  |  | | | 7.4 | | |
| Loan expense | | | 123 | |  | 209 | |  | (86) | |  |  | | | (41.1) | | |  | | | 426 | |  | 612 | |  | (186) | |  |  | | | (30.4) | | |
| Other | | | 1,436 | |  | 1,127 | |  | 309 | |  |  | | | 27.4 | | |  | | | 4,210 | |  | 3,295 | |  | 915 | |  |  | | | 27.8 | | |
| **Total non-interest expense** | | | $ | 12,195 |  | $ | 11,769 |  | $ | 426 |  |  | | | 3.6% | | |  | | | $ | 35,962 |  | $ | 35,391 |  | $ | 571 |  |  | | | 1.6% | | |
| Efficiency ratio\* | | | 65.7 | | % | 61.4 | | % |  | | |  | | |  | | |  | | | 65.8 | | % | 62.7 | | % |  | | |  | | |  | | |
| Number of full-time equivalent employees | | | 299 | |  | 302 | |  |  | | |  | | |  | | |  | | | 299 | |  | 302 | |  |  | | |  | | |  | | |

\*Efficiency ratio is calculated as non-interest expense as a percent of revenue. Total revenue is calculated as net interest income plus non-interest income.

***Total non-interest expense*** increased $0.4 million to $12.2 million for the quarter ended September 30, 2022 compared to $11.8 million for the quarter ended September 30, 2021, and increased $0.6 million to $36.0 million for the nine months ended September 30, 2022 compared to $35.4 million for the nine months ended September 30, 2021.

***Salaries*** increased $0.2 million, or 4.0%, to $5.2 million for the quarter ended September 30, 2022 compared to $5.0 million for the quarter ended September 30, 2021, and decreased $0.1 million, or 0.9%, to $15.3 million for the nine months ended September 30, 2022 compared to $15.4 million for the nine months ended September 30, 2021. The decrease for the nine months ended September 30, 2022 was primarily due to reduced commissions based on lower loan volume. See *Gains on sales of mortgage loans* discussion above.

***Employee benefits*** decreased $0.1 million, or 6.7%, to $1.6 million for the quarter ended September 30, 2022 compared to $1.7 million for the quarter ended September 30, 2021, and decreased $0.4 million, or 7.2%, to $4.9 million for the nine months ended September 30, 2022 compared to $5.3 million for the nine months ended September 30, 2021. The decreases were primarily due to a decrease in 401(k) plan contributions, medical premiums, and pension cost due to lower annual discount rate assumptions compared to the prior year's annual assumptions.

***Other non-interest expense*** increased $0.3 million, or 27.4%, to $1.4 million for the quarter ended September 30, 2022 compared to $1.1 million for the quarter ended September 30, 2021, and increased $0.9 million, or 27.8%, to $4.2 million for the nine months ended September 30, 2022 compared to $3.3 million for the nine months ended September 30, 2021. The increases were primarily related to the change in the fair value adjustment for mortgage banking derivatives, insurance expense, telephone, and software expense related to network upgrades and maintenance agreements.

***Income taxes***

Income taxes as a percentage of earnings before income taxes as reported in the consolidated financial statements were 18.7% and 18.5% for the three and nine months ended September 30, 2022, respectively, compared to 19.6% and 19.4% for the three and nine months ended September 30, 2021, respectively.

The decrease in the effective tax rate for the three months ended September 30, 2022 compared to the three months ended September 30, 2021 was primarily attributable to the decrease in earnings and the benefit recorded pertaining to the historical tax credit. The decrease in the effective tax rate for the nine months ended September 30, 2022 compared to the nine months ended September 30, 2021 was primarily attributable to the decrease in earnings and the benefit recorded pertaining to the historical tax credit. The effective tax rate for each of the three and nine months ended September 30, 2022 and 2021, respectively, is lower than the U.S. federal statutory rate of 21% primarily due to tax-free revenues.

47

Included in the effective tax rate is a $13,000 and $40,000 benefit associated with a historic tax credit investment for the three and nine months ended September 30, 2022, respectively. The investment is expected to generate a $331,000 tax benefit over the life of the project and is being recognized under the deferral method of accounting.

**Lending and Credit Management**

Interest earned on the loan portfolio is a primary source of interest income for the Company. Net loans represented 79.9% of total assets as of September 30, 2022 compared to 70.2% as of December 31, 2021.

Lending activities are conducted pursuant to an established loan policy approved by the Bank’s Board of Directors. The Bank’s credit review process is overseen by regional loan committees with established loan approval limits. In addition, a senior loan committee reviews all credit relationships in aggregate over an established dollar amount. The senior loan committee meets weekly and is comprised of senior managers of the Bank.

Major classifications within the Company’s held for investment loan portfolio as of the dates indicated is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **September 30, 2022** | | | | | |  | | | **December 31, 2021** | | | | | |
| *(Dollars in thousands)* | | | **Amount** | | | **% of Loans** | | |  | | | **Amount** | | | **% of Loans** | | |
| Commercial, financial, and agricultural (a) | | | $ | 248,913 |  | 16.7 | | % |  | | | $ | 217,214 |  | 16.7 | | % |
| Real estate construction − residential | | | 25,243 | |  | 1.7 | |  |  | | | 27,920 | |  | 2.1 | |  |
| Real estate construction − commercial | | | 133,186 | |  | 8.9 | |  |  | | | 91,369 | |  | 7.0 | |  |
| Real estate mortgage − residential | | | 343,661 | |  | 23.0 | |  |  | | | 279,346 | |  | 21.5 | |  |
| Real estate mortgage − commercial | | | 717,192 | |  | 48.1 | |  |  | | | 663,256 | |  | 50.9 | |  |
| Installment and other consumer | | | 23,802 | |  | 1.6 | |  |  | | | 23,028 | |  | 1.8 | |  |
| **Total loans held for investment** | | | $ | 1,491,997 |  | 100.0 | | % |  | | | $ | 1,302,133 |  | 100.0 | | % |

(a)Includes $0.6 million and $8.4 million of SBA PPP loans, net as of September 30, 2022 and December 31, 2021, respectively.

The Company extends credit to its local community markets through traditional real estate mortgage products. The Company does not participate in credit extension to sub-prime residential real estate markets. The Company does not lend funds for transactions defined as “highly leveraged” by bank regulatory authorities or for foreign loans. Additionally, the Company does not have any concentrations of loans exceeding 10% of total loans that are not otherwise disclosed in the loan portfolio composition table. The Company does not have any interest-earning assets that would have been included in non-accrual, past due, or restructured loans if such assets were loans.

The Company generally does not retain long-term fixed rate residential mortgage loans in its portfolio. Fixed rate loans conforming to standards required by the secondary market are offered to qualified borrowers but are not funded until the Company has a non-recourse purchase commitment from the secondary market at a predetermined price. During the nine months ended September 30, 2022, the Company sold approximately $76.1 million of loans to investors compared to $167.3 million for the nine months ended September 30, 2021. At September 30, 2022, the Company was servicing approximately $247.6 million of loans sold to the secondary market compared to $270.0 million at December 31, 2021, and $277.1 million at September 30, 2021.

*Risk Elements of the Loan Portfolio*

Management, the senior loan committee, and internal loan review, formally review all loans in excess of certain dollar amounts (periodically established) at least annually. Loans in excess of $2.0 million in aggregate and all adversely classified credits identified by management are reviewed by the senior loan committee. In addition, all other loans are reviewed on a risk weighted selection process. The senior loan committee reviews and reports to the Board of Directors, at scheduled meetings: past due, classified, and watch list loans in order to classify or reclassify loans as loans requiring attention, substandard, doubtful, or loss. During this review, management also determines which loans should be considered impaired. Management follows the guidance provided in the Financial Accounting Standards Board's (FASB) ASC Topic 310-10-35 in identifying and measuring loan impairment. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type,

48

delinquencies, current economic conditions, loan risk ratings and industry concentration. Management believes, but there can be no assurance, that these procedures keep management informed of potential problem loans. Based upon these procedures, both the allowance and provision for loan losses are adjusted to maintain the allowance at a level considered necessary by management to provide for probable losses inherent in the loan portfolio.

*Non-performing Assets*

The following table summarizes non-performing assets at the dates indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **September 30,** | | |  | | | **December 31,** | | |
| *(Dollars in thousands)* | | | **2022** | | |  | | | **2021** | | |
|  | | |  | | |  | | |  | | |
| **Non-accrual loans:** | | |  | | |  | | |  | | |
| Commercial, financial, and agricultural | | | $ | 173 | |  | | | $ | 153 | |
|  | | |  | | |  | | |  | | |
| Real estate construction − commercial | | | 91 | | |  | | | 105 | | |
| Real estate mortgage − residential | | | 1,083 | | |  | | | 1,129 | | |
| Real estate mortgage − commercial | | | 15,995 | | |  | | | 24,029 | | |
| Installment and other consumer | | | 6 | | |  | | | 43 | | |
| **Total** | | | $ | 17,348 | |  | | | $ | 25,459 | |
| **Loans contractually past - due 90 days or more and still accruing:** | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |
| Real estate mortgage − residential | | | $ | — | |  | | | $ | 14 | |
|  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |
| **Total** | | | $ | — | |  | | | $ | 14 | |
| **Total non-performing loans (a)** | | | 17,348 | | |  | | | 25,473 | | |
| **Other real estate owned and repossessed assets** | | | 9,210 | | |  | | | 10,525 | | |
| **Total non-performing assets** | | | $ | 26,558 | |  | | | $ | 35,998 | |
|  | | |  | | |  | | |  | | |
| Loans held for investment | | | $ | 1,491,997 | |  | | | $ | 1,302,133 | |
| Allowance for loan losses to loans | | | 1.04 | | % |  | | | 1.30 | | % |
| Non-accrual loans to total loans | | | 1.16 | | % |  | | | 1.96 | | % |
| Non-performing loans to loans (a) | | | 1.16 | | % |  | | | 1.96 | | % |
| Non-performing assets to loans (b) | | | 1.78 | | % |  | | | 2.76 | | % |
| Non-performing assets to assets (b) | | | 1.44 | | % |  | | | 1.97 | | % |
| Allowance for loan losses to non-accrual loans | | | 89.38 | | % |  | | | 66.39 | | % |
| Allowance for loan losses to non-performing loans | | | 89.38 | | % |  | | | 66.36 | | % |

(a)Non-performing loans include loans 90 days past due and accruing, non-accrual loans, and non-performing TDRs included in non-accrual loans and 90 days past due.

(b)Non-performing assets include non-performing loans and other real estate owned and repossessed assets.

Total non-performing assets were $26.6 million, or 1.78% of total loans, at September 30, 2022 compared to $36.0 million, or 2.76% of total loans, at December 31, 2021.

Total non-accrual loans at September 30, 2022 decreased $8.1 million, or 31.9%, to $17.3 million compared to $25.5 million at December 31, 2021. There were no loans past due 90 days and still accruing interest at September 30, 2022 compared to $14,000 at December 31, 2021. Other real estate and repossessed assets were $9.2 million and $10.5 million at September 30, 2022 and December 31, 2021, respectively. During the nine months ended September 30, 2022, there were $3,000 of non-accrual loans, net of charge-offs taken, added to other real estate owned and repossessed assets compared to $142,000 during the nine months ended September 30, 2021.

As of September 30, 2022, approximately $14.7 million of loans classified as substandard, which include performing TDRs, and were not included in the non-performing asset table, were identified as potential problem loans having more than normal risk which raised doubts as to the ability of the borrower to comply with present loan repayment terms, compared to $13.8 million at December 31, 2021. Management believes the allowance for loan losses was sufficient to cover the risks and probable losses related to such loans at September 30, 2022 and December 31, 2021, respectively.

49

The following table summarizes the Company’s TDRs at the dates indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **September 30, 2022** | | | | | | | | | | | | | | |  | | | **December 31, 2021** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **Number of contracts** | | |  | | | **Recorded Investment** | | |  | | | **Specific Reserves** | | |  | | | **Number of contracts** | | |  | | | **Recorded Investment** | | |  | | | **Specific Reserves** | | |
| **Performing TDRs** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Commercial, financial and agricultural | | | 3 | | |  | | | $ | 177 | |  | | | $ | 23 | |  | | | 2 | | |  | | | $ | 188 | |  | | | $ | 24 | |
| Real estate mortgage − residential | | | 5 | | |  | | | 1,098 | | |  | | | 53 | | |  | | | 6 | | |  | | | 1,262 | | |  | | | 56 | | |
| Real estate mortgage − commercial | | | 2 | | |  | | | 313 | | |  | | | 53 | | |  | | | 2 | | |  | | | 328 | | |  | | | 38 | | |
| Installment and other consumer | | | 0 | | |  | | | — | | |  | | | — | | |  | | | 2 | | |  | | | 17 | | |  | | | 2 | | |
| **Total performing TDRs** | | | 10 | | |  | | | $ | 1,588 | |  | | | $ | 129 | |  | | | 12 | | |  | | | $ | 1,795 | |  | | | $ | 120 | |
| **Non-performing TDRs** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Real estate mortgage − residential | | | 5 | | |  | | | $ | 330 | |  | | | $ | 42 | |  | | | 5 | | |  | | | $ | 561 | |  | | | $ | 39 | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Total non-performing TDRs** | | | 5 | | |  | | | $ | 330 | |  | | | $ | 42 | |  | | | 5 | | |  | | | $ | 561 | |  | | | $ | 39 | |
| **Total TDRs** | | | 15 | | |  | | | $ | 1,918 | |  | | | $ | 171 | |  | | | 17 | | |  | | | $ | 2,356 | |  | | | $ | 159 | |

At September 30, 2022, loans classified as TDRs totaled $1.9 million, with $0.2 million of specific reserves, compared to $2.4 million of loans classified as TDRs, with $0.2 million of specific reserves, at December 31, 2021. Non-performing loans, included $0.3 million of loans classified as TDRs at September 30, 2022 compared to $0.6 million at December 31, 2021. Both performing and non-performing TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the underlying collateral less applicable selling costs if the loan is collateral dependent. The net decrease in total TDRs from December 31, 2021 to September 30, 2022 was primarily due to $439,000 of payments received on TDRs.

**Allowance for Loan Losses and Provision**

*Allowance for Loan Losses*

The following table is a summary of the allocation of the allowance for loan losses:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **September 30, 2022** | | | | | |  | | | **December 31, 2021** | | | | | |  |  |  |  |  |  |
| *(in thousands)* | | | **Amount** | | | **% of loans in each category to total loans** | | |  | | | **Amount** | | | **% of loans in each category to total loans** | | |  |  |  |  |  |  |
| **Allocation of allowance for loan losses at end of period:** | | |  | | |  | | |  | | |  | | |  | | |  |  |  |  |  |  |
| Commercial, financial, and agricultural | | | $ | 2,848 |  | 16.7 | | % |  | | | $ | 2,717 |  | 16.7 | | % |  |  |  |  |  |  |
| Real estate construction − residential | | | 71 | |  | 1.7 | |  |  | | | 137 | |  | 2.1 | |  |  |  |  |  |  |  |
| Real estate construction − commercial | | | 849 | |  | 8.9 | |  |  | | | 588 | |  | 7.0 | |  |  |  |  |  |  |  |
| Real estate mortgage − residential | | | 3,232 | |  | 23.0 | |  |  | | | 2,482 | |  | 21.5 | |  |  |  |  |  |  |  |
| Real estate mortgage − commercial | | | 8,002 | |  | 48.1 | |  |  | | | 10,662 | |  | 50.9 | |  |  |  |  |  |  |  |
| Installment and other consumer | | | 316 | |  | 1.6 | |  |  | | | 256 | |  | 1.8 | |  |  |  |  |  |  |  |
| Unallocated | | | 187 | |  | — | |  |  | | | 61 | |  | — | |  |  |  |  |  |  |  |
| **Total** | | | $ | 15,505 |  | 100.0 | | % |  | | | $ | 16,903 |  | 100.0 | | % |  |  |  |  |  |  |

The allowance for loan losses was $15.5 million, or 1.04%, of loans outstanding at September 30, 2022 compared to $16.9 million, or 1.30%, of loans outstanding at December 31, 2021. The ratio of the allowance for loan losses to non-performing loans was 89.38% at September 30, 2022, compared to 66.36% at December 31, 2021.

50

The following table is a summary of the general and specific allocations of the allowance for loan losses:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| **Allocation of allowance for loan losses:** | | |  | | |  | | |  | | |
| Individually evaluated for impairment − specific reserves | | | $ | 302 |  |  | | | $ | 3,044 |  |
| Collectively evaluated for impairment − general reserves | | | 15,203 | |  |  | | | 13,859 | |  |
| **Total** | | | $ | 15,505 |  |  | | | $ | 16,903 |  |

The *specific reserve component* applies to loans evaluated individually for impairment. The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals and/or internal evaluations, or by discounting the total expected future cash flows. Once the impairment amount is calculated, a specific reserve allocation is recorded. At September 30, 2022, $0.3 million of the Company’s ALL was allocated to impaired loans totaling approximately $18.9 million compared to $3.0 million of the Company’s ALL allocated to impaired loans totaling approximately $27.3 million at December 31, 2021. Management determined that $15.9 million, or 84%, of total impaired loans required no reserve allocation at September 30, 2022 compared to $16.6 million, or 61%, at December 31, 2021, primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The *incurred loss component* of the general reserve, or loans collectively evaluated for impairment, is determined by applying loss rates to pools of loans by asset type. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type. The look-back period begins with loss history in the first quarter 2012 as the starting point through the current quarter and it will continue to include this starting point going forward. Management determined that the look-back period should be expanded until a loss-producing downturn is recognized. This would be accomplished by allowing the look-back period to shift forward by eliminating the earliest loss period and replenishing it with losses from the most recent period. The look-back period is consistently evaluated for relevance given the current facts and circumstances.

These historical loss rates for each risk group are used as the starting point to determine loss rates for measurement purposes. The historical loan loss rates are multiplied by loss emergence periods (LEP) which represent the estimated time period between a borrower first experiencing financial difficulty and the recognition of a loss.

The Company’s methodology includes qualitative risk factors that allow management to adjust its estimates of losses based on the most recent information available and to address other limitations in the quantitative component based on historical loss rates. Such risk factors are generally reviewed and updated quarterly, as appropriate, and are adjusted to reflect changes in national and local economic conditions and developments, the nature, volume and terms of loans in the portfolio, including changes in volume and severity of past due loans, the volume of non-accrual loans, and the volume and severity of adversely classified or graded loans, loan concentrations, assessment of trends in collateral values, assessment of changes in the quality of the Company’s internal loan review department, and changes in lending policies and procedures, including underwriting standards and collections, charge-off and recovery practices.

The specific and general reserve allocations represent management’s best estimate of probable losses inherent in the loan portfolio at the evaluation date. Although the ALL is comprised of specific and general allocations, the entire ALL is available to absorb any credit losses.

The decrease in the allowance for loan losses from December 31, 2021 as compared to September 30, 2022 primarily resulted from one large non-accrual loan relationship impacted by COVID-19 that returned to performing status. This transition was made according to the Company’s established internal loan policies regarding loan performance as well as consultation with industry experts. This transition back to performing status also reduced specific reserves based on the attributes of the individual loan collateral, to the general allocations method described above. The Company continues to monitor the risks associated with its non-performing loans. Partially offsetting this decrease in the allowance for loan losses was an increase in the reserve due to the significant loan growth that occurred during the first nine months of 2022.

*Provision*

The Company recognized a provision expense and a negative provision expense for loan losses of $0.3 million and $1.0 million for the three and nine months ended September 30, 2022, respectively, compared to $0.3 million and $0.7 million provision expense for the three and nine months ended September 30, 2021, respectively. The negative provision

51

expense primarily resulted from the release of specific reserves totaling $2.8 million in the first quarter of 2022 due to returning the balances related to one loan relationship to accrual from non-accrual status.

The following table summarizes loan loss experience for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Three Months Ended September 30, 2022** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|  | | | **2022** | | | | | | | | | | | | | | |  | | | **2021** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **Net Charge-offs (Recoveries)** | | |  | | | **Average Loans** | | |  | | | **Net (Recoveries) Charge-offs / Average Loans** | | |  | | | **Net Charge-offs (Recoveries)** | | |  | | | **Average Loans** | | |  | | | **Net (Recoveries) Charge-offs / Average Loans** | | |
| Commercial, financial, and agricultural | | | $ | 33 |  |  | | | $ | 245,877 |  |  | | | 0.01 | | % |  | | | $ | 26 |  |  | | | $ | 247,564 |  |  | | | 0.01 | | % |
| Real estate construction − residential | | | — | |  |  | | | 24,249 | |  |  | | | — | |  |  | | | — | |  |  | | | 35,358 | |  |  | | | — | |  |
| Real estate construction − commercial | | | — | |  |  | | | 127,594 | |  |  | | | — | |  |  | | | — | |  |  | | | 75,081 | |  |  | | | — | |  |
| Real estate mortgage − residential | | | (4) | |  |  | | | 323,158 | |  |  | | | — | |  |  | | | 10 | |  |  | | | 270,464 | |  |  | | | — | |  |
| Real estate mortgage − commercial | | | (6) | |  |  | | | 702,139 | |  |  | | | — | |  |  | | | 14 | |  |  | | | 633,238 | |  |  | | | — | |  |
| Installment and other consumer | | | 125 | |  |  | | | 23,738 | |  |  | | | 0.53 | |  |  | | | 56 | |  |  | | | 24,363 | |  |  | | | 0.23 | |  |
| **Total** | | | $ | 148 | |  | | | $ | 1,446,755 |  |  | | | 0.01 | | % |  | | | $ | 106 | |  | | | $ | 1,286,068 |  |  | | | 0.01 | | % |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Nine Months Ended September 30,** | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|  | | | **2022** | | | | | | | | | | | | | | |  | | | **2021** | | | | | | | | | | | | | | |
| *(Dollars in thousands)* | | | **Net Charge-offs (Recoveries)** | | |  | | | **Average Loans** | | |  | | | **Net (Recoveries) Charge-offs / Average Loans** | | |  | | | **Net Charge-offs (Recoveries)** | | |  | | | **Average Loans** | | |  | | | **Net (Recoveries) Charge-offs / Average Loans** | | |
| Commercial, financial, and agricultural | | | $ | 57 |  |  | | | $ | 233,076 |  |  | | | 0.02 | | % |  | | | $ | (102) |  |  | | | $ | 253,878 |  |  | | | (0.04) | | % |
| Real estate construction − residential | | | — | |  |  | | | 23,627 | |  |  | | | — | |  |  | | | (13) | |  |  | | | 34,625 | |  |  | | | (0.04) | |  |
| Real estate construction − commercial | | | — | |  |  | | | 110,540 | |  |  | | | — | |  |  | | | — | |  |  | | | 77,115 | |  |  | | | — | |  |
| Real estate mortgage − residential | | | (27) | |  |  | | | 300,518 | |  |  | | | (0.01) | |  |  | | | (161) | |  |  | | | 264,699 | |  |  | | | (0.06) | |  |
| Real estate mortgage − commercial | | | 169 | |  |  | | | 685,041 | |  |  | | | 0.02 | |  |  | | | 41 | |  |  | | | 624,455 | |  |  | | | 0.01 | |  |
| Installment and other consumer | | | 199 | |  |  | | | 22,987 | |  |  | | | 0.87 | |  |  | | | 119 | |  |  | | | 25,044 | |  |  | | | 0.48 | |  |
| **Total** | | | $ | 398 | |  | | | $ | 1,375,789 |  |  | | | 0.03 | | % |  | | | $ | (116) | |  | | | $ | 1,279,816 |  |  | | | (0.01) | | % |

*Net Loan Charge-offs (recoveries)*

The Company’s net charge-offs were $0.1 million, or 0.01% of average loans, for the quarter ended September 30, 2022 compared to $0.1 million, or 0.01% of average loans, for the quarter ended September 30, 2021, and net charge-offs were $0.4 million, or 0.03% of average loans, for the nine months ended September 30, 2022 compared to net recoveries of $0.1 million, or (0.01)% of average loans, for the nine months ended September 30, 2021.

*Loans Held For Sale*

The Company designates certain long-term fixed rate personal real estate loans as held for sale. In the fourth quarter of 2021, the Company elected the fair value option for all newly originated long-term personal real estate loans held for sale. As of December 31, 2021, all loans held for sale were carried at fair value. The loans are primarily sold to Freddie Mac, Fannie Mae, and PennyMac and other various secondary market investors. At September 30, 2022, the carrying amount of these loans was $0.9 million compared to $2.2 million at December 31, 2021.

52

***Liquidity and Capital Resources***

**Liquidity Management**

The role of liquidity management is to ensure funds are available to meet depositors’ withdrawal and borrowers’ credit demands while at the same time maximizing profitability. This is accomplished by balancing changes in demand for funds with changes in the supply of those funds. Liquidity to meet these demands is provided by maturing assets, short-term liquid assets that can be converted to cash and the ability to attract funds from external sources, principally depositors. Due to the nature of services offered by the Company, management prefers to focus on transaction accounts and full service relationships with customers as the primary sources of funding.

The Company’s Asset/Liability Committee (ALCO), primarily made up of senior management, has direct oversight responsibility for the Company’s liquidity position and profile. A combination of daily, weekly, and monthly reports provided to management detail the following: internal liquidity metrics, composition and level of the liquid asset portfolio, timing differences in short-term cash flow obligations, available pricing and market access to the financial markets for capital, and exposure to contingent draws on the Company’s liquidity.

The Company has a number of sources of funds to meet liquidity needs on a daily basis. The Company’s most liquid assets are comprised of available-for-sale investment securities, not including other debt securities, federal funds sold, and excess reserves held at the Federal Reserve.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| Federal funds sold | | | $ | 46 |  |  | | | $ | 7,122 |  |
| Other interest-bearing deposits | | | 26,259 | | |  | | | 135,500 | | |
| Certificates of deposit in other banks | | | 4,195 | |  |  | | | 5,193 | |  |
| Available-for-sale investment securities | | | 245,155 | | |  | | | 310,870 | | |
| **Total** | | | $ | 275,655 |  |  | | | $ | 458,685 |  |

Federal funds sold and resale agreements normally have overnight maturities and are used for general daily liquidity purposes. The fair value of the available-for-sale investment portfolio was $245.2 million at September 30, 2022 and included an unrealized net loss of $54.5 million. The portfolio includes projected maturities and mortgage-backed securities pay-downs of approximately $5.7 million over the next twelve months, which offer resources to meet either new loan demand or reductions in the Company’s borrowings.

The Company pledges portions of its investment securities portfolio to secure public fund deposits, federal funds purchase lines, securities sold under agreements to repurchase, borrowing capacity at the Federal Reserve Bank, and for other purposes as required or permitted by law. At September 30, 2022 and December 31, 2021, the Company’s unpledged securities in the available-for-sale portfolio totaled approximately $76.1 million and $35.5 million, respectively.

Total investment securities pledged for these purposes were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| **Investment securities pledged for the purpose of securing:** | | |  | | |  | | |  | | |
| Federal Reserve Bank borrowings | | | $ | 8,040 |  |  | | | $ | 10,778 |  |
| Federal funds purchased and securities sold under agreements to repurchase | | | 8,513 | | |  | | | 28,769 | | |
| Other deposits | | | 152,454 | | |  | | | 235,829 | | |
| **Total pledged, at fair value** | | | $ | 169,007 |  |  | | | $ | 275,376 |  |

Liquidity is available from the Company’s base of core customer deposits, defined as demand, interest checking, savings, money market deposit accounts, and time deposits less than $250,000, less all brokered deposits under $250,000. At September 30, 2022, such deposits totaled $1.4 billion and represented 90.8% of the Company’s total deposits. These core deposits are normally less volatile and are often tied to other products of the Company through long lasting relationships.

53

Core deposits at September 30, 2022 and December 31, 2021 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| **Core deposit base:** | | |  | | |  | | |  | | |
| Non-interest bearing demand | | | $ | 498,653 |  |  | | | $ | 453,066 |  |
| Interest checking | | | 341,096 | |  |  | | | 357,825 | |  |
| Savings and money market | | | 448,411 | |  |  | | | 440,331 | |  |
| Other time deposits | | | 157,444 | |  |  | | | 175,827 | |  |
| **Total** | | | $ | 1,445,604 |  |  | | | $ | 1,427,049 |  |

Estimated uninsured deposits totaled $538.5 million, including $110.9 million of certificates of deposit, at September 30, 2022, compared to $513.5 million, including $69.1 million of certificates of deposit, at December 31, 2021. The Company had brokered deposits totaling $36.1 million and $20.2 million at September 30, 2022 and December 31, 2021, respectively.

Other components of liquidity are the level of borrowings from third-party sources and the availability of future credit. The Company’s outside borrowings are comprised of securities sold under agreements to repurchase, Federal Home Loan Bank advances, and subordinated notes. Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which the Company maintains approved credit lines. As of September 30, 2022, under agreements with these unaffiliated banks, the Bank may borrow up to $60.0 million in federal funds on an unsecured basis and $7.6 million on a secured basis. There were no federal funds purchased outstanding at September 30, 2022. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of the Company’s investment portfolio. At September 30, 2022, there were $5.9 million in repurchase agreements. The Company may periodically borrow additional short-term funds from the Federal Reserve Bank through the discount window, although no such borrowings were outstanding at September 30, 2022.

The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB) and has access to credit products of the FHLB. As of September 30, 2022, the Bank had $73.0 million in outstanding borrowings with the FHLB. In addition, the Company has $49.5 million in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

Borrowings outstanding at September 30, 2022 and December 31, 2021 were as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |
| *(in thousands)* | | | **September 30, 2022** | | |  | | | **December 31, 2021** | | |
| **Borrowings:** | | |  | | |  | | |  | | |
| Federal funds purchased and securities sold under agreements to repurchase | | | $ | 5,890 |  |  | | | $ | 23,829 |  |
| Federal Home Loan Bank advances | | | 73,000 | | |  | | | 77,418 | | |
| Subordinated notes | | | 49,486 | | |  | | | 49,486 | | |
|  | | |  | | |  | | |  | | |
| **Total** | | | $ | 128,376 |  |  | | | $ | 150,733 |  |

The Company pledges certain assets, including loans and investment securities to the Federal Reserve Bank, FHLB, and other correspondent banks as security to establish lines of credit and borrow from these entities. Based on the type and value of collateral pledged, the FHLB establishes a collateral value from which the Company may draw advances against this collateral. This collateral is also used to enable the FHLB to issue letters of credit in favor of public fund depositors of the Company. The Federal Reserve Bank also establishes a collateral value of assets pledged to support borrowings from the discount window.

54

The following table reflects collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to the Company as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **September 30, 2022** | | | | | | | | | | | | | | | | | | | | |  | | | **December 31, 2021** | | | | | | | | | | | | | | | | | | | | |
| *(in thousands)* | | | **FHLB** | | |  | | | **Federal Reserve Bank** | | |  | | | **Federal Funds Purchased Lines** | | |  | | | **Total** | | |  | | | **FHLB** | | |  | | | **Federal Reserve Bank** | | |  | | | **Federal Funds Purchased Lines** | | |  | | | **Total** | | |
| Advance equivalent | | | $ | 320,097 | |  | | | $ | 7,567 | |  | | | $ | 60,000 | |  | | | $ | 387,664 | |  | | | $ | 273,479 | |  | | | $ | 10,384 | |  | | | $ | 60,000 | |  | | | $ | 343,863 | |
| Letters of credit | | | (53,500) | |  |  | | | — | | |  | | | — | | |  | | | (53,500) | |  |  | | | (31,000) | |  |  | | | — | | |  | | | — | | |  | | | (31,000) | |  |
| Advances outstanding | | | (73,000) | |  |  | | | — | | |  | | | — | | |  | | | (73,000) | |  |  | | | (77,418) | |  |  | | | — | | |  | | | — | | |  | | | (77,418) | |  |
| **Total available** | | | $ | 193,597 | |  | | | $ | 7,567 | |  | | | $ | 60,000 | |  | | | $ | 261,164 | |  | | | $ | 165,061 | |  | | | $ | 10,384 | |  | | | $ | 60,000 | |  | | | $ | 235,445 | |

At September 30, 2022, loans of $636.5 million were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit. At September 30, 2022, investments with a market value of $8.0 million were pledged to secure federal funds purchase lines and borrowing capacity at the Federal Reserve Bank.

Based upon the above, management believes the Company has more than adequate liquidity, both on balance sheet and through the additional funding capacity with the FHLB, the Federal Reserve Bank and Federal funds purchased lines to meet future anticipated needs in both the short and long-term.

**Sources and Uses of Funds**

Cash and cash equivalents were $41.4 million at September 30, 2022 compared to $159.9 million at December 31, 2021. The $118.5 million decrease resulted from changes in the various cash flows produced by operating, investing, and financing activities of the Company, as shown in the accompanying consolidated statement of cash flows for the nine months ended September 30, 2022. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of $14.2 million for the nine months ended September 30, 2022.

Investing activities, consisting mainly of purchases, sales and maturities of available-for-sale securities, and changes in the level of the loan portfolio, used total cash of $180.3 million during the nine months ended September 30, 2022. The cash outflow primarily consisted of a net increase in loans held for investment of $190.2 million and $17.3 million in purchases of investment securities partially offset by $27.0 million from maturities and calls and sales of investment securities.

Financing activities provided total cash of $47.6 million during the nine months ended September 30, 2022, resulting primarily from a $76.0 million increase in demand deposits, interest-bearing transaction accounts and time deposits. These increases were partially offset by a $17.9 million decrease in securities sold under agreements to repurchase.

In the normal course of business, the Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through the Company’s various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of the Company’s liquidity. The Company had $426.3 million in unused loan commitments and standby letters of credit as of September 30, 2022. Although the Company’s current liquidity resources are adequate to fund this commitment level, the nature of these commitments is such that the likelihood of such a funding demand is very low.

The Company is a legal entity, separate and distinct from the Bank, which must provide its own liquidity to meet its operating needs. The Company’s ongoing liquidity needs primarily include funding its operating expenses, paying cash dividends to its shareholders and, to a lesser extent, repurchasing its shares of common stock. The Company paid cash dividends to its shareholders totaling approximately $3.1 million and $2.6 million for the nine months ended September 30, 2022 and 2021, respectively. A large portion of the Company’s liquidity is obtained from the Bank in the form of dividends. The Bank declared and paid $9.0 million and $6.5 million in dividends to the Company during the nine months ended September 30, 2022 and 2021, respectively. At September 30, 2022 and December 31, 2021, the Company had cash and cash equivalents totaling $3.1 million and $1.8 million, respectively. Subject to declaration by the Company's Board of Directors, the Company expects to continue paying quarterly cash dividends as a part of its current capital allocation strategy. Future dividends will be subject to the determination, declaration and discretion of the Company's Board of Directors and compliance with applicable regulatory capital requirements.

55

The Company's 2019 Repurchase Plan was amended during the second quarter 2021 to authorize the purchase of up to an additional $5.0 million in market value of the Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as the timing of any such purchases. The Company repurchased 108,724 common shares under the plan during the nine months ended September 30, 2022, at an average cost of $26.60 per share totaling $2.9 million.

The repurchases under these authorizations may be effectuated in the open market, by block purchase, in privately negotiated transactions, or through other transactions managed by broker-dealers, or any combination thereof. No time limit was set for the completion of these authorized share repurchases. As of September 30, 2022, $2.1 million remained available for the repurchase of shares pursuant to the share repurchase authorizations. The Company may continue to repurchase shares under its share repurchase authorizations, but the amount and timing of such repurchases will be dependent on a number of factors, including the price of its common stock and other cash flow needs. There is no assurance that the Company will repurchase up to the full amount remaining under its share repurchase authorizations.

**Capital Management**

The Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company’s consolidated financial statements. Under capital adequacy guidelines, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification of the Company and the Bank are subject to qualitative judgments by the regulators about components, risk-weightings, and other factors.

The Basel III regulatory capital framework (the "Basel III Capital Rules") adopted by U.S. federal regulatory authorities, among other things, (i) establishes the capital measure called "Common Equity Tier 1" ("CET1"), (ii) specifies that Tier 1 capital consist of CET1 and "Additional Tier 1 Capital" instruments meeting stated requirements, (iii) requires that most deductions/adjustments to regulatory capital measures be made to CET1 and not to other components of capital and (iv) defines the scope of the deductions/adjustments to the capital measures.

Additionally, the Basel III Capital Rules require that the Company maintain a 2.5% capital conservation buffer with respect to each of CET1, Tier 1 and total capital to risk-weighted assets, which provides for capital levels that exceed the minimum risk-based capital adequacy requirements. A financial institution with a conservation buffer of less than the required amount is subject to limitations on capital distributions, including dividend payments and stock repurchases, and certain discretionary bonus payments to executive officers.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of CET1, Tier 1 and total capital to risk-weighted assets, and of Tier 1 capital to average assets, each as defined in the regulations. Management believes, as of September 30, 2022, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

Financial institutions are categorized as well capitalized or adequately capitalized, based on minimum total risk-based, Tier 1 risk-based, CET1 and Tier 1 leverage ratios. As shown in the table below, the Company’s capital ratios exceeded the regulatory definition of adequately capitalized as of September 30, 2022 and December 31, 2021. Based upon the information in its most recently filed call report, the Bank met the capital ratios necessary to be well-capitalized. The regulatory authorities can apply changes in classification of assets and such changes may retroactively subject the Company to changes in capital ratios. Any such change could reduce one or more capital ratios below well-capitalized status. In addition, a change may result in imposition of additional assessments by the FDIC or could result in regulatory actions that could have a material effect on our condition and results of operations. In addition, bank holding companies generally are required to maintain a Tier 1 leverage ratio of at least 4%.

Because the Bank had less than $15.0 billion in total consolidated assets as of December 31, 2009, the Company is allowed to continue to classify its trust preferred securities, all of which were issued prior to May 19, 2010, as Tier 1 capital.

56

Under the Basel III requirements, at September 30, 2022 and December 31, 2021, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions, as shown in the following table as of periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | | **Actual** | | | | | | | | |  | | | **Minimum Capital Required - Basel III Fully Phased-In** | | | | | | | | |  | | | **Required to be Considered Well- Capitalized** | | | | | | | | |
| *(Dollars in thousands)* | | | **Amount** | | |  | | | **Ratio** | | |  | | | **Amount** | | |  | | | **Ratio** | | |  | | | **Amount** | | |  | | | **Ratio** | | |
| **September 30, 2022** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Total Capital (to risk-weighted assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 219,214 |  |  | | | 13.84 | | % |  | | | $ | 166,292 |  |  | | | 10.50 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 217,040 | | |  | | | 13.73 | | % |  | | | 165,928 | | |  | | | 10.50 | | % |  | | | 158,027 | | |  | | | 10.00 | | % |
| **Tier 1 Capital (to risk-weighted assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 194,017 |  |  | | | 12.25 | | % |  | | | $ | 134,617 |  |  | | | 8.50 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 201,375 | | |  | | | 12.74 | | % |  | | | 134,323 | | |  | | | 8.50 | | % |  | | | 126,421 | | |  | | | 8.00 | | % |
| **Common Equity Tier 1 Capital (to risk-weighted assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 155,549 |  |  | | | 9.82 | | % |  | | | $ | 110,861 |  |  | | | 7.00 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 201,375 | | |  | | | 12.74 | | % |  | | | 110,619 | | |  | | | 7.00 | | % |  | | | 102,717 | | |  | | | 6.50 | | % |
| **Tier 1 leverage ratio (to adjusted average assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 194,017 |  |  | | | 10.60 | | % |  | | | $ | 73,184 |  |  | | | 4.00 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 201,375 | | |  | | | 10.97 | | % |  | | | 73,443 | | |  | | | 4.00 | | % |  | | | 91,803 | | |  | | | 5.00 | | % |
|  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **December 31, 2021** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| **Total Capital (to risk-weighted assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 210,726 |  |  | | | 14.79 | | % |  | | | $ | 149,640 |  |  | | | 10.50 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 210,148 | | |  | | | 14.78 | | % |  | | | 149,339 | | |  | | | 10.50 | | % |  | | | 142,228 | | |  | | | 10.00 | | % |
| **Tier 1 Capital (to risk-weighted assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 193,663 |  |  | | | 13.59 | | % |  | | | $ | 121,137 |  |  | | | 8.50 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 193,085 | | |  | | | 13.58 | | % |  | | | 120,894 | | |  | | | 8.50 | | % |  | | | 113,782 | | |  | | | 8.00 | | % |
| **Common Equity Tier 1 Capital (to risk-weighted assets):** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 145,663 |  |  | | | 10.22 | | % |  | | | $ | 99,760 |  |  | | | 7.00 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 193,085 | | |  | | | 13.58 | | % |  | | | 99,559 | | |  | | | 7.00 | | % |  | | | 92,448 | | |  | | | 6.50 | | % |
| **Tier 1 leverage ratio:** | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |  | | |
| Company | | | $ | 193,663 |  |  | | | 11.01 | | % |  | | | $ | 70,342 |  |  | | | 4.00 | | % |  | | | $ | — |  |  | | | N.A% | | |
| Bank | | | 193,085 | | |  | | | 11.04 | | % |  | | | 69,959 | | |  | | | 4.00 | | % |  | | | 87,449 | | |  | | | 5.00 | | % |

57

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

**Asset/Liability and Interest Rate Risk**

Management and the Board of Directors are responsible for managing interest rate risk and employing risk management policies that monitor and limit this exposure. Interest rate risk is measured using net interest income simulations and market value of portfolio equity analyses. These analyses use various assumptions, including the nature and timing of interest rate changes, yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, and reinvestment/replacement of asset and liability cash flows.

The principal objective of the Company’s asset and liability management function is to evaluate the interest rate risk within the balance sheet and pursue a controlled assumption of interest rate risk while maximizing earnings and preserving adequate levels of liquidity and capital. The asset and liability management function is under the guidance of the ALCO with direction from the Board of Directors. The ALCO meets monthly to review, among other things, the sensitivity of the Company’s assets and liabilities to interest rate changes, local and national market conditions and rates. The ALCO also reviews the liquidity, capital, deposit mix, loan mix and investment positions of the Company.

Instantaneous parallel rate shift scenarios are modeled and utilized to evaluate risk and establish exposure limits for acceptable changes in net interest margin. These scenarios, known as rate shocks, simulate an instantaneous change in interest rates and use various assumptions, including, but not limited to, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment and replacement of asset and liability cash flows.

Management analyzes the economic value of equity as a secondary measure of interest rate risk. This is a complementary measure to net interest income where the calculated value is the result of the market value of assets less the market value of liabilities. The economic value of equity is a longer term view of interest rate risk because it measures the present value of the future cash flows. The impact of changes in interest rates on this calculation is analyzed for the risk to our future earnings and is used in conjunction with the analyses on net interest income.

The table below illustrates the impact of an immediate and sustained 200 and 100 basis point increase and a 200 and 100 basis point decrease in interest rates on net interest income based on the interest rate risk model at September 30, 2022 and December 31, 2021.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | | |  | | | **% Change in projected net interest income** | | | | | | | | |
| **Hypothetical shift in interest rates** | | |  | | | **September 30,** | | |  | | | **December 31,** | | |
| ***(bps)*** | | |  | | | **2022** | | |  | | | **2021** | | |
| 200 | | |  | | | 0.88% | | |  | | | 4.47% | | |
| 100 | | |  | | | 1.27% | | |  | | | 1.80% | | |
| (100) | | |  | | | (0.50) | | % |  | | | (3.12) | | % |
| (200) | | |  | | | (2.11) | | % |  | | | (4.02) | | % |

The change in the Company’s interest rate risk exposure from December 31, 2021 to September 30, 2022 was primarily due to a change in the profile of the Company’s earning assets. At December 31, 2021, the Company had significant balances in overnight Federal funds sold as the Company had greater liquidity due to higher balances in customer deposit accounts, including a seasonal spike in certain public funds customer’s account balances. This type of earning asset reprices immediately as interest rates change. Since December 31, 2021, the balances in Federal funds sold have reduced significantly, in large measure due to funding the significant growth in loans during the first nine months of 2022. Management believes the change in projected net interest income from interest rate shifts of up 200 bps and down 200 bps is an acceptable level of interest rate risk.

Many assumptions are used to calculate the impact of interest rate fluctuations. Actual results may be significantly different than our projections due to several factors, including the timing and frequency of rate changes, market conditions and the shape of the yield curve. The computations of interest rate risk shown above do not include actions that management may undertake to manage the risks in response to anticipated changes in interest rates and actual results may also differ due to any actions taken in response to the changing rates.

58

**Effects of Inflation**

The effects of inflation on financial institutions are different from the effects on other commercial enterprises since financial institutions make few significant capital or inventory expenditures, which are directly affected by changing prices. Because bank assets and liabilities are virtually all monetary in nature, inflation does not affect a financial institution as much as do changes in interest rates. The general level of inflation does underlie the general level of most interest rates, but interest rates do not increase at the rate of inflation as do prices of goods and services. Rather, interest rates react more to changes in the expected rate of inflation and to changes in monetary and fiscal policy.

Inflation does have an impact on the growth of total assets in the banking industry, often resulting in a need to increase capital at higher than normal rates to maintain an appropriate capital to asset ratio. In the opinion of management, inflation did not have a significant effect on the Company’s operations for the three months ended September 30, 2022.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Our Company’s management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as defined in Rules 13a – 15(e) or 15d – 15(e) of the Securities Exchange Act of 1934 as of September 30, 2022. Based upon and as of the date of that evaluation, our principal executive and principal financial officers concluded that our disclosure controls and procedures were designed, and were effective, to provide reasonable assurance that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported as and when required. It should be noted that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Because of these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all circumstances.

**Changes in Internal Control Over Financial Reporting**

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Securities Exchange Act of 1934) that occurred during the three months ended September 30, 2022 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

**Impact of New Accounting Standards**

***Financial Instruments:***

In March 2022 the FASB issued ASU 2022-02 *Financial Instruments****–****Credit Losses (Topic 326);* ***T****roubled Debt Restructurings and Vintage Disclosures****.*** This ASU eliminates the accounting guidance on troubled debt restructurings for creditors in ASC 310-40 and amends the guidance on “vintage disclosures” to require disclosure of current-period gross write-offs by year of origination. The ASU also updates the requirements related to accounting for credit losses under ASC 326 and adds enhanced disclosures for creditors with respect to loan refinancings and restructurings for borrowers experiencing financial difficulty. The amendments in this update will be effective for fiscal years beginning after December 15, 2022 for entities that have adopted the amendments in ASU 2016-13, *Financial Instruments–Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments*. The Company is evaluating the additional disclosure requirements and does not expect them to have a material effect on the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses* *(Topic 326):* *Measurement of Credit Losses on Financial Instruments* (CECL)*.* The revised accounting guidance will remove all recognition thresholds and will require a company to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument's contractual life. It also amends the credit loss measurement guidance for available-for-sale debt securities and beneficial interests in securitized financial assets. This new accounting guidance will be effective for interim and annual reporting periods beginning after December 15, 2022.

The Company's CECL committee implemented a model from a third-party vendor and continues to run parallel calculations to evaluate CECL model assumptions developed by comparing results to current allowance for loan loss calculations. In addition, the Company engaged a third-party, independent firm experienced in CECL matters to perform a validation of the model. The Company currently expects to record a one-time adjustment to retained earnings to increase

59

the allowance for loan losses. The amount of the adjustments will be impacted by each portfolio’s composition and credit quality at the adoption date as well as economic conditions and forecasts at that time. Based on implementation progress to date, the Company believes the capital adequacy requirements to which it and the Bank are subject to, and its business strategies and practices, will not be materially impacted following the adoption on January 1, 2023.

***Rate Reform*** In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848) - Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. The amendments in this update provide optional guidance for a limited period of time to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting. It provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference LIBOR or another reference rate expected to be discontinued. The amendments in this update are effective for all entities as of March 12, 2020 through December 31, 2022. The Company is currently evaluating the impact of the reference rate reform on the Company’s consolidated financial statements.

60

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information required by this Item is set forth in *Note 15 -* *Commitments and Contingencies, Pending Litigation,* in our Company’s Notes to Consolidated Financial Statements (*unaudited)*.

**Item 1A. Risk Factors**

There has been no material change in risk factors previously disclosed under Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2021.

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

**The Company's Purchases of Equity Securities**

The following table summarizes the purchases made by or on behalf of the Company or certain affiliated purchasers of shares of the Company's common stock during the quarter ended September 30, 2022:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Period** | | |  | | | **(a) Total Number of Shares (or Units) Purchased** | | |  | | | **(b) Average Price Paid per Share (or Unit)** | | |  | | | **(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs** | | |  | | | **(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs \*** | | |
| July 1-31, 2022 | | |  | | | — | | |  | | | $ | — | |  | | | — | | |  | | | $ | 2,108,107 | |
| August 1-31, 2022 | | |  | | | — | | |  | | | $ | — | |  | | | — | | |  | | | $ | 2,108,107 | |
| September 1-30, 2022 | | |  | | | — | | |  | | | $ | — | |  | | | — | | |  | | | $ | 2,108,107 | |
| Total | | |  | | | — | | |  | | | $ | — | |  | | | — | | |  | | | $ | 2,108,107 | |

\*The Company's 2019 Repurchase Plan was amended during the second quarter 2021 to authorize the purchase of up to an additional $5.0 million in market value of the Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as the timing of any such purchases. As of September 30, 2022, $2.1 million remained available for share repurchases pursuant to that authorization.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

61

**Item 6. Exhibits**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |
| **Exhibit No.** | | |  | | | **Description** | | |
| 3.1 | | |  | | | [Restated Articles of Incorporation of the Company (filed as Exhibit 3.1 to the Company's current report on Form 8-K on August 9, 2007 and incorporated herein by reference).](http://www.sec.gov/Archives/edgar/data/893847/000129993307004833/exhibit1.htm) | | |
| 3.2 | | |  | | | [Amended and Restated Bylaws of the Company (filed as Exhibit 3.1 to the Company's current report on Form 8-K on January 27, 2021 and incorporated herein by reference).](https://www.sec.gov/Archives/edgar/data/893847/000155837021000457/hwbk-20210127xex3d1.htm) | | |
| 4.1 | | |  | | | [Specimen certificate representing shares of the Company's $1.00 par value Common Stock (filed as Exhibit 4.1 to the Company's current report on Form 8-K/A on June 23, 2017 and incorporated herein by reference).](https://www.sec.gov/Archives/edgar/data/893847/000141588917001027/ex4-06232017_100639.htm) | | |
| 31.1 | | |  | | | [Certificate of the Chief Executive Officer of the Company pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](a2022q3ex311.htm) | | |
| 31.2 | | |  | | | [Certificate of the Chief Financial Officer of the Company pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](a2022q3ex312.htm) | | |
| 32.1 | | |  | | | [Certificate of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.](a2022q3ex321.htm) | | |
| 32.2 | | |  | | | [Certificate of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.](a2022q3ex322.htm) | | |
| 101.INS | | |  | | | Inline XBRL Instance Document (the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document). | | |
| 101.SCH | | |  | | | Inline XBRL Taxonomy Extension Schema Document. | | |
| 101.CAL | | |  | | | Inline XBRL Taxonomy Extension Calculation Linkbase Document. | | |
| 101.DEF | | |  | | | Inline XBRL Taxonomy Extension Definition Linkbase Document. | | |
| 101.LAB | | |  | | | Inline XBRL Taxonomy Extension Label Linkbase Document. | | |
| 101.PRE | | |  | | | Inline XBRL Taxonomy Extension Presentation Linkbase Document. | | |
| 104 | | |  | | | Cover Page Interactive Data File (formatted as inline XBRL and contained in Exhibit 101). | | |

62

**SIGNATURES**

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

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
|  | | | **HAWTHORN BANCSHARES, INC.** | | |
|  | | |  | | |
| Date | | |  | | |
|  | | |  | | |
|  | | | /s/ David T. Turner | | |
|  | | |  | | |
| November 10, 2022 | | | David T. Turner, Chairman of the Board, President and | | |
|  | | | Chief Executive Officer (Principal Executive Officer) | | |
|  | | |  | | |
|  | | | /s/ Stephen E. Guthrie | | |
|  | | |  | | |
| November 10, 2022 | | | Stephen E. Guthrie, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | | |
|  | | |  | | |

63