

FIRST DEFIANCE FINANCIAL CORP

Form 10-Q

November 09, 2018

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, 2018

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the Transition Period from _____ to _____

Commission file number 0-26850

First Defiance Financial Corp.

(Exact name of registrant as specified in its charter)

Ohio	34-1803915
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

601 Clinton Street, Defiance, Ohio	43512
(Address of principal executive office)	(Zip Code)

Registrant's telephone number, including area code: (419) 782-5015

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 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 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 <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>
Emerging growth company <input type="checkbox"/>	

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date. Common Stock, \$.01 Par Value – 20,401,888 shares outstanding at October 31, 2018.

FIRST DEFIANCE FINANCIAL CORP.

INDEX

	Page Number
<u>PART I-FINANCIAL INFORMATION</u>	
<u>Item 1. Consolidated Condensed Financial Statements (Unaudited):</u>	
<u>Consolidated Condensed Statements of Financial Condition – September 30, 2018 and December 31, 2017</u>	<u>2</u>
<u>Consolidated Condensed Statements of Income - Three and nine months ended September 30, 2018 and 2017</u>	<u>4</u>
<u>Consolidated Condensed Statements of Comprehensive Income – Three and nine months ended September 30, 2018 and 2017</u>	<u>5</u>
<u>Consolidated Condensed Statements of Changes in Stockholders’ Equity – Nine months ended September 30, 2018 and 2017</u>	<u>6</u>
<u>Consolidated Condensed Statements of Cash Flows - Nine months ended September 30, 2018 and 2017</u>	<u>7</u>
<u>Notes to Consolidated Condensed Financial Statements</u>	<u>8</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>55</u>
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>77</u>
<u>Item 4. Controls and Procedures</u>	<u>78</u>
<u>PART II-OTHER INFORMATION:</u>	
<u>Item 1. Legal Proceedings</u>	<u>79</u>
<u>Item 1A. Risk Factors</u>	<u>79</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>79</u>
<u>Item 3. Defaults upon Senior Securities</u>	<u>79</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>79</u>

<u>Item 5. Other Information</u>	<u>79</u>
<u>Item 6. Exhibits</u>	<u>80</u>
<u>Signatures</u>	<u>81</u>

PART I-FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	September 30, 2018	December 31, 2017
Assets		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	\$55,526	\$58,693
Federal funds sold	44,000	55,000
	99,526	113,693
Securities:		
Available-for-sale, carried at fair value	282,962	260,650
Held-to-maturity, carried at amortized cost (fair value \$603 and \$649 at September 30, 2018 and December 31, 2017, respectively)	603	648
	283,565	261,298
Loans held for sale	12,485	10,435
Loans receivable, net of allowance of \$27,639 at September 30, 2018 and \$26,683 at December 31, 2017, respectively	2,428,718	2,322,030
Mortgage servicing rights	10,054	9,808
Accrued interest receivable	11,258	8,706
Federal Home Loan Bank stock	14,217	15,992
Bank owned life insurance	67,259	66,230
Premises and equipment	40,413	40,217
Real estate and other assets held for sale	1,676	1,532
Goodwill	98,569	98,569
Core deposit and other intangibles	4,705	5,703
Deferred taxes	1,385	231

Other assets	24,255	38,959
Total assets	\$3,098,085	\$2,993,403

(continued)

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	September 30, 2018	December 31, 2017
Liabilities and stockholders' equity		
Liabilities:		
Deposits	\$2,524,431	\$2,437,656
Advances from the Federal Home Loan Bank	100,220	84,279
Subordinated debentures	36,083	36,083
Securities sold under repurchase agreements	4,162	26,019
Advance payments by borrowers	4,523	2,925
Other liabilities	35,209	33,155
Total liabilities	2,704,628	2,620,117
Stockholders' equity:		
Preferred stock, \$.01 par value per share: 37,000 shares authorized; no shares issued	-	-
Preferred stock, \$.01 par value per share: 4,963,000 shares authorized; no shares issued	-	-
Common stock, \$.01 par value per share: 50,000,000 shares authorized; 25,398,992 and 25,425,682 shares issued and 20,401,461 and 20,312,082 shares outstanding at September 30, 2018 and December 31, 2017, respectively ⁽¹⁾	127	127
Additional paid-in capital	161,179	160,940
Accumulated other comprehensive income (loss), net of tax of \$(1,308) and \$117, respectively	(4,921)	217
Retained earnings	286,960	262,900
Treasury stock, at cost, 4,997,531 shares at September 30, 2018 and 5,113,600 shares at December 31, 2017 ⁽¹⁾	(49,888)	(50,898)
Total stockholders' equity	393,457	373,286
Total liabilities and stockholders' equity	\$3,098,085	\$2,993,403

(1) Share data has been adjusted to reflect a 2-for-1 stock split on July 12, 2018.

See accompanying notes.

3

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Income

(UNAUDITED)

(Amounts in Thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2018	2017	September 30, 2018	2017
Interest Income				
Loans	\$29,371	\$25,975	\$83,557	\$73,263
Investment securities:				
Taxable	1,207	896	3,445	2,817
Non-taxable	870	792	2,522	2,378
Interest-bearing deposits	275	209	945	555
FHLB stock dividends	240	209	698	562
Total interest income	31,963	28,081	91,167	79,575
Interest Expense				
Deposits	3,753	2,391	9,508	6,357
FHLB advances and other	342	431	943	1,211
Subordinated debentures	334	239	934	682
Notes payable	5	13	19	41
Total interest expense	4,434	3,074	11,404	8,291
Net interest income	27,529	25,007	79,763	71,284
Provision for loan losses	1,376	462	704	2,635
Net interest income after provision for loan losses	26,153	24,545	79,059	68,649
Non-interest Income				
Service fees and other charges	3,335	3,153	9,762	9,073
Insurance commissions	3,254	3,082	11,024	9,834
Mortgage banking income	1,877	1,698	5,632	5,266
Gain on sale of non-mortgage loans	33	82	300	172
Gain on sale or call of securities	76	158	76	425
Trust income	514	486	1,588	1,400
Income from Bank Owned Life Insurance	399	421	1,365	2,666
Other non-interest income	434	415	1,092	1,348
Total non-interest income	9,922	9,495	30,839	30,184
Non-interest Expense				
Compensation and benefits	12,882	11,780	39,016	37,588
Occupancy	2,154	1,960	6,251	5,751

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FDIC insurance premium	255	330	817	973
Financial institutions tax	531	404	1,593	1,418
Data processing	2,161	1,874	6,349	5,832
Amortization of intangibles	319	364	998	931
Other non-interest expense	3,984	3,728	13,178	11,718
Total non-interest expense	22,286	20,440	68,202	64,211
Income before income taxes	13,789	13,600	41,696	34,622
Federal income taxes	2,483	4,219	7,544	11,753
Net Income	\$11,306	\$9,381	\$34,152	\$22,869
Earnings per common share ⁽¹⁾				
Basic	\$0.55	\$0.46	\$1.68	\$1.15
Diluted	\$0.55	\$0.46	\$1.67	\$1.15
Dividends declared per share ⁽¹⁾	\$0.17	\$0.125	\$0.47	\$0.375
Average common shares outstanding ⁽¹⁾				
Basic	20,400	20,298	20,373	19,826
Diluted	20,467	20,418	20,465	19,940

(1) Share and per share data has been adjusted to reflect a 2-for-1 stock split on July 12, 2018.

See accompanying notes.

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Comprehensive Income

(UNAUDITED)

(Amounts in Thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$11,306	\$9,381	\$34,152	\$22,869
Other comprehensive income:				
Unrealized gains (losses) on securities available for sale	(2,058)	(777)	(6,487)	3,383
Reclassification adjustment for security gains included in net income ⁽¹⁾	(76)	(158)	(76)	(425)
Income tax benefit (expense)	448	327	1,378	(1,035)
Other comprehensive income (loss)	(1,686)	(608)	(5,185)	1,923
Comprehensive income	\$9,620	\$8,773	\$28,967	\$24,792

(1) Amounts are included in gains on sale or call of securities on the consolidated condensed statements of income. Income tax expense associated with the reclassification adjustments, included in federal income taxes, for the three months ended September 30, 2018 and 2017 was \$16 and \$55, respectively. Income tax expense associated with the reclassification adjustments, included in federal income taxes, for the nine months ended September 30, 2018 and 2017 was \$16 and \$148, respectively.

See accompanying notes.

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Statement of Changes in Stockholders' Equity

(UNAUDITED)

(Amounts in Thousands, except share data)

	Preferred Stock	Common Stock Shares ⁽¹⁾	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance at January 1, 2018	\$ -	20,312,082	\$ 127	\$ 160,940	\$ 217	\$ 262,900	\$(50,898)	\$ 373,286
Net income						34,152		34,152
Other comprehensive loss					(5,185)			(5,185)
Adoption of ASU 2018-02 – See Note 2					47	(47)		-
Stock based compensation expenses				295				295
Shares issued under stock option plan, net of 8,872 repurchased and retired		38,628		(93)		(270)	474	111
Restricted share activity under stock incentive plans net of 17,818 repurchased and retired		48,300		(14)		(201)	512	297
Shares issued from direct stock sales		2,451		51			24	75
Common stock dividends declared						(9,574)		(9,574)
Balance at September 30, 2018	\$ -	20,401,461	\$ 127	\$ 161,179	\$ (4,921)	\$ 286,960	\$(49,888)	\$ 393,457
	\$ -	17,966,412	\$ 127	\$ 126,390	\$ 215	\$ 240,592	\$(74,306)	\$ 293,018

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Balance at January 1, 2017									
Net income						22,869			22,869
Other comprehensive income					1,923				1,923
Stock based compensation expenses			133						133
Shares issued under stock option plan, net of 15,014 repurchased and retired	8,086		51			(83)	230		198
Capital stock issuance	2,279,004		33,792				22,740		56,532
Restricted share activity under stock incentive plans	42,754		254			(17)	280		517
Shares issued from direct stock sales	2,112		33				21		54
Common stock dividends declared						(7,320)			(7,320)
Balance at September 30, 2017	\$ -	20,298,368	\$ 127	\$ 160,653	\$ 2,138	\$ 256,041	\$(51,035)		\$ 367,924

(1) Share data has been adjusted to reflect a 2-for-1 stock split on July 12, 2018.

See accompanying notes.

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Cash Flows

(UNAUDITED)

(Amounts in Thousands)

	Nine Months Ended September 30,	
	2018	2017
Operating Activities		
Net income	\$34,152	\$22,869
Items not requiring (providing) cash:		
Provision for loan losses	704	2,635
Depreciation	2,688	2,674
Amortization of mortgage servicing rights, net of impairment recoveries	918	1,080
Amortization of core deposit and other intangible assets	998	931
Net accretion of premiums and discounts on loans and deposits	(238)	(602)
Amortization of premiums and discounts on securities	905	935
Change in deferred taxes	224	220
Proceeds from the sale of loans held for sale	161,185	157,127
Originations of loans held for sale	(160,655)	(157,321)
Gain from sale of loans	(4,044)	(3,749)
Gain from sale or call of securities	(76)	(425)
Loss on sale or disposal of premises and equipment	13	48
Gain/loss on sale / write-down of real estate and other assets held for sale	529	(57)
Stock option expense	295	133
Restricted stock expense	297	517
Income from bank owned life insurance	(1,365)	(2,666)
Excess tax benefit on stock compensation plans	(162)	(168)
Changes in:		
Accrued interest receivable	(2,552)	(1,782)
Other assets	(2,985)	(2,743)
Other liabilities	2,187	2,348
Net cash provided by operating activities	33,018	22,004
Investing Activities		
Proceeds from maturities of held-to-maturity securities	45	48
Proceeds from maturities, calls and pay-downs of available-for-sale securities	19,916	20,339

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Proceeds from sale of premises and equipment, real estate and other assets held for sale	482	1,028
Proceeds from the sale of available-for-sale securities	1,944	18,047
Proceeds from sale of non-mortgage loans	28,277	19,142
Purchases of available-for-sale securities	(51,535)	(41,235)
Proceeds from Federal Home Loan stock redemption	1,775	-
Net cash received in acquisitions	-	19,359
Investment in bank owned life insurance	-	(20,000)
Proceeds from bank owned life insurance death benefit	336	-
Proceeds from sale of bank owned life insurance	17,689	-
Purchase of portfolio mortgage loans	-	(11,476)
Purchases of premises and equipment, net	(2,911)	(2,491)
Net increase in loans receivable	(136,083)	(59,339)
Net cash used by investing activities	(120,065)	(56,578)

Financing Activities

Net increase in deposits and advance payments by borrowers	88,184	70,539
Repayment of Federal Home Loan Bank advances	(34,059)	(792)
Proceeds from Federal Home Loan Bank advances	50,000	-
Increase in notes payable	-	6,500
Decrease in securities sold under repurchase agreements	(21,857)	(8,877)
Proceeds from exercise of stock options	111	198
Proceeds from direct stock sales	75	54
Cash dividends paid on common stock	(9,574)	(7,320)
Net cash provided by financing activities	72,880	60,302
Increase in cash and cash equivalents	(14,167)	25,728
Cash and cash equivalents at beginning of period	113,693	99,003
Cash and cash equivalents at end of period	\$99,526	\$124,731

Supplemental cash flow information:

Interest paid	\$11,335	\$8,177
Income taxes paid	\$6,950	\$10,900
Transfers from loans to real estate and other assets held for sale	\$1,141	\$328
Securities purchased but not yet settled	\$577	\$-
Sale of bank owned life insurance not yet settled	\$-	\$17,840

See accompanying notes.

FIRST DEFIANCE FINANCIAL CORP.

Notes to Consolidated Condensed Financial Statements (UNAUDITED)

September 30, 2018 and 2017

1. Basis of Presentation

First Defiance Financial Corp. (“First Defiance” or the “Company”) is a unitary thrift holding company that conducts business through its three wholly owned subsidiaries, First Federal Bank of the Midwest (“First Federal” or the “Bank”), First Insurance Group of the Midwest, Inc. (“First Insurance”), and First Defiance Risk Management Inc. (“First Defiance Risk Management”). All significant intercompany transactions and balances are eliminated in consolidation.

First Federal is primarily engaged in attracting deposits from the general public through its offices and using those and other available sources of funds to originate loans primarily in the counties in which its offices are located. First Federal’s traditional banking activities include originating and servicing residential real estate, non-residential real estate, commercial, home improvement and home equity and consumer loans and providing a broad range of depository, trust and wealth management services. In addition, First Federal invests in U.S. Treasury and federal government agency obligations, obligations of the State of Ohio and its political subdivisions, mortgage-backed securities that are issued by federal agencies, including real estate mortgage investment conduits (“REMICs”) and collateralized mortgage obligations (“CMOs”), and corporate bonds.

First Insurance is an insurance agency that conducts business through offices located in the Defiance, Sylvania, Bryan, Lima, Archbold, Fostoria, Tiffin, Findlay and Bowling Green, Ohio areas. First Insurance offers property and casualty insurance, life insurance and group health insurance.

First Defiance Risk Management is a wholly-owned insurance company subsidiary of the Company that insures the Company and its subsidiaries against certain risks unique to the operations of the Company and for which insurance may not be currently available or economically feasible in today’s insurance marketplace. First Defiance Risk Management pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves.

The consolidated condensed statement of financial condition at December 31, 2017, has been derived from the audited financial statements at that date, which were included in First Defiance's Annual Report on Form 10-K for the year ended December 31, 2017 (the "2017 Form 10-K").

The accompanying consolidated condensed financial statements as of September 30, 2018, and for the three and nine month periods ended September 30, 2018 and 2017 have been prepared by First Defiance without audit and do not include information or footnotes necessary for the complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States ("GAAP"). These consolidated condensed financial statements should be read in conjunction with the financial statements and notes thereto included in the 2017 Form 10-K. However, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for the fair presentation of the financial statements have been made. The results for the three and nine month period ended September 30, 2018, are not necessarily indicative of the results that may be expected for the entire year.

On June 22, 2018, the Company announced a stock split in the form of a share distribution of one common share for each outstanding common share. The stock split was distributed on July 12, 2018 to shareholders of record as of July 2, 2018. All share and per share data in this Quarterly Report on Form 10-Q has been adjusted and is reflective of the stock split.

2. Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

Earnings Per Common Share

Basic earnings per common share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for the calculation. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, restricted stock awards and stock grants.

Goodwill and Other Intangibles

Goodwill resulting from business combinations prior to January 1, 2009, represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected November 30 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on First Defiance's balance sheet.

Other intangible assets consist of core deposit and acquired customer relationship intangible assets arising from whole bank, insurance and branch acquisitions. They are initially recorded at fair value and then amortized on an accelerated basis over their estimated lives, which range from five years for non-compete agreements to 10 to 20 years for core deposit and customer relationship intangibles.

Accounting Standards Adopted in 2018

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers.” This standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies generally will be required to use more judgment and make more estimates than under current guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Subsequent to the issuance of ASU 2014-09, the FASB issued targeted updates to clarify specific implementation issues including ASU No. 2016-08, “Principal versus Agent Considerations (Reporting Revenue Gross versus Net),” ASU No. 2016-10, “Identifying Performance Obligations and Licensing,” ASU No. 2016-12, “Narrow-Scope Improvements and Practical Expedients,” and ASU No. 2016-20 “Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.” For financial reporting purposes, this standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including trust and asset management fees, deposit related fees, interchange fees, merchant income, and annuity and insurance commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company adopted ASU 2014-09 and its related amendments on its required effective date of January 1, 2018, utilizing the modified retrospective approach. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary. See “Revenue Recognition” below for additional information related to revenue generated from contracts with customers.

In January 2016, the FASB issued ASU No. 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities.” This ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments by making targeted improvements to GAAP as follows: (1) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (3) eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (4) eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (5) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (6) require an entity to present separately in other comprehensive

income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (7) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans receivable) on the balance sheet or the accompanying notes to the financial statements; and (8) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The adoption of ASU No. 2016-01 on January 1, 2018, did not have a material impact on the Company's consolidated financial statements. Also in conjunction with the adoption, the Company's fair value measurement of financial instruments was based upon an exit price notion as required in ASU 2016-01. The guidance was applied on a prospective approach resulting in prior-periods no longer being comparable.

In February 2018, the FASB issued ASU No. 2018-02, “Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” This ASU allows a reclassification from accumulated other comprehensive income (“AOCI”) to retained earnings for certain income tax effects stranded in AOCI as a result of public law No. 115-97, known as the Tax Cuts and Jobs Act (“Tax Act”). Consequently, the reclassification eliminates the stranded tax effects resulting from the Tax Act and is intended to improve the usefulness of information reported to financial statement users. However, because the ASU only relates to the reclassification of the income tax effects of the Tax Act, the underlying guidance that requires the effect of a change in tax laws or rates to be included in income from continuing operations is not affected. The Company adopted ASU No. 2018-02 during the first quarter of 2018, and elected to reclassify the income tax effects of the Tax Act from AOCI to retained earnings. The reclassification increased AOCI and decreased retained earnings by \$47,000, with zero net effect on total shareholders’ equity.

Accounting Standards Pending Adoption

In February 2016, the FASB issued ASU No. 2016-02 — Leases (Topic 842). The objective of the update is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company has not yet selected a transition method as it is in the process of determining the effect of the ASU on its consolidated financial statements and disclosures. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore, not recognized on the Company’s consolidated condensed statements of financial condition. The Company expects the new guidance will require these lease agreements to now be recognized on the consolidated condensed statements of financial condition as a right-of-use asset and a corresponding lease liability. Therefore, the Company’s preliminary evaluation indicates the provisions of ASU No. 2016-02 are expected to impact the Company’s consolidated condensed statements of financial condition, along with our regulatory capital ratios. However, the Company continues to evaluate the extent of potential impact the new guidance will have on the Company’s consolidated financial statements. At September 30, 2018, the Company had contractual operating lease commitments of approximately \$11.0 million, before considering renewal options that are generally present.

In June 2016, the FASB issued ASU No. 2016-13, “Measurement of Credit Losses on Financial Instruments.” This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren’t measured at fair value through net income. In issuing the standard, the FASB is responding to criticism that today’s guidance delays recognition of credit losses. The standard will replace today’s “incurred loss” approach with an “expected loss” model. The new model, referred to as the current expected credit loss (“CECL”) model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments, and financial guarantees. The CECL model does not apply to available-for-sale (“AFS”) debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. As a result, entities will recognize improvements to estimated credit losses immediately in earnings rather than as interest income over time, as they do today. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. ASU 2016-13 also expands the disclosure requirements regarding an entity’s assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. ASU No. 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard’s provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company has begun its implementation efforts by establishing a Company-wide implementation committee along with engaging a third-party software vendor to assist in the implementation process. The committee’s initial review indicates the Company has maintained sufficient historical loan data to support the requirement of this pronouncement and is currently evaluating the various loss methodologies to determine their correlations to the Company’s loan segments historical performance. Early adoption is permitted, however, the Company does not currently plan to adopt this ASU early.

Revenue Recognition

Accounting Standards Codification (“ASC”) 606, Revenue from Contracts with Customers (“ASC 606”), establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity’s contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of the Company’s revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as loans, letters of credit, and investment securities, as well as revenue related to mortgage servicing activities, as these activities are subject to other GAAP discussed elsewhere within the Company’s disclosures. Descriptions of the Company’s revenue-generating activities that are within the scope of ASC 606, which are presented in the Company’s statement of income as components of non-interest income are as follows:

Service charges on deposit accounts - these represent general service fees for monthly account maintenance and activity or transaction-based fees and consist of transaction-based revenue, time-based revenue (service period), item-based revenue or some other individual attribute-based revenue. Revenue is recognized when our performance obligation is completed which is generally monthly for account maintenance services or when a transaction has been completed (such as a wire transfer). Payment for such performance obligations are generally received at the time the performance obligations are satisfied. Service charges on deposit accounts that are within the scope of ASC 606 were \$2.0 million in the third quarter of 2018 and \$5.7 million for the nine months ended September 30, 2018. Income from services charges on deposit accounts is included in service fees and other charges in non-interest income.

Interchange income - this represents fees earned from debit cardholder transactions. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrent with the transaction processing services provided to the cardholder. Interchange fees in the third quarter of 2018 and for the nine months ended September 30, 2018, which are reported net of network related charges, were \$1.0 million and \$3.0 million, respectively. Interchange income is included in service fees and other charges in non-interest income.

Wealth management and trust fee income - this represents monthly fees due from wealth management customers as consideration for managing the customers' assets. Wealth management and trust services include custody of assets, investment management, escrow services, and fees for trust services and similar fiduciary activities. Revenue is recognized when our performance obligation is completed each month, which is generally the time that payment is received. Also included are fees received from a third party broker-dealer as part of a revenue-sharing agreement for fees earned from customers that we refer to the third party. These fees are paid to us by the third party on a quarterly basis and recognized ratably throughout the quarter as our performance obligation is satisfied. Revenue from wealth management and trust services were \$188,000 and \$515,000, respectively, in the third quarter of 2018 and \$618,000 and \$1.6 million, respectively, for the nine months ended September 30, 2018. Income from wealth management services is included in other non-interest income in total non-interest income. Trust fees are reported separately in total non-interest income.

Gain/loss on sales of other real estate owned ("OREO") - the Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain or loss on sale if a significant financing component is present. Income from the gain/loss on sales of OREO was \$10,000 in the third quarter of 2018 and \$28,000 for the nine months ended September 30, 2018. Income from the gain or loss on sales of OREO is included in other non-interest income in total non-interest income.

Insurance commissions - this represents new commissions that are recognized when the Company sells insurance policies to customers. The Company is also entitled to renewal commissions and, in some cases, contingent commissions in the form of profit sharing which are recognized in subsequent periods. The initial commission is recognized when the insurance policy is sold to a customer. Renewal commission is variable consideration and is recognized in subsequent periods when the uncertainty around variable consideration is subsequently resolved (i.e., when customer renews the policy). Contingent commission is also a variable consideration that is not recognized until the variability surrounding realization of revenue is resolved. Another source of variability is the ability of the policy holder to cancel the policy anytime and in such cases, the Company may be required, under the terms of the contract, to return part of the commission received. The variability related to cancellation of the policy is not deemed significant and thus, does not impact the amount of revenue recognized. In the event the policyholder chooses to cancel the policy at any time, the revenue for amounts which qualify for claw-back are reversed in the period the cancellation occurs. Management views the income sources from insurance commissions in two categories: (i) new/renewal commissions and (ii) contingent commissions. Insurance commissions, new and renewal was \$3.3 million in the third quarter of 2018. Insurance commissions were \$11.0 million for the nine months ended September 30, 2018, of which, \$10.0 million were new/renewal commissions and \$1.0 million were contingent commissions.

3. Fair Value

FASB ASC Topic 820, Fair Value Measurements, defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

The methods of determining the fair value of assets and liabilities presented in this note are consistent with the methodologies disclosed in Note 22 of the 2017 Form 10-K, except for the valuation of loans which was impacted by the adoption of ASU 2016-01 as discussed in Note 2 above. Prior to adopting the amendments included in the standard, the Company was permitted to measure fair value under an entry price notion. The entry price notion previously applied by the Company used a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument. The exit price notion uses the same approach, but also incorporates other factors, such as enhanced credit risk, illiquidity risk and market factors that sometimes exist in exit prices in dislocated markets. As of September 30, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. In that regard, ASC 820 established a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

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 or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by a correlation or other means.

Level 3: Unobservable inputs for determining fair value of assets and liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Available for sale securities - Securities classified as available for sale are generally reported at fair value utilizing Level 2 inputs where the Company obtains fair value measurements from an independent pricing service that uses matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows and the bonds' terms and conditions, among other things. Securities in Level 2 include U.S. federal government agencies, mortgage-backed securities, corporate bonds and municipal securities.

Impaired loans - Fair values for impaired collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisers and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value on the cost to replace the current property. Value of market comparison approach evaluates the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investor's required return. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Comparable sales adjustments are based on known sales prices of similar type and similar use properties and duration of time that the property has been on the market to sell. Such adjustments made in the appraisal process are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Real estate held for sale - Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are then reviewed monthly by members of the asset review committee for valuation changes and are accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which may utilize a single valuation approach or a combination of approaches including cost, comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments may be significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the

Company's asset quality or collections department reviews the assumptions and approaches utilized in the appraisal. Appraisal values are discounted from 0% to 30% to account for other factors that may impact the value of collateral. In determining the value of impaired collateral dependent loans and other real estate owned, significant unobservable inputs may be used, which include but are not limited to: physical condition of comparable properties sold, net operating income generated by the property and investor rates of return.

Mortgage servicing rights - On a quarterly basis, mortgage servicing rights are evaluated for impairment based upon the fair value of the rights as compared to the carrying amount. If the carrying amount of an individual tranche exceeds fair value, impairment is recorded on that tranche so that the servicing asset is carried at fair value. Fair value is determined at a tranche level based on a model that calculates the present value of estimated future net servicing income. The valuation model utilizes assumptions that market participants would use in estimating future net servicing income and are validated against available market data (Level 2).

Mortgage banking derivative - The fair value of mortgage banking derivatives are evaluated monthly based on derivative valuation models using quoted prices for similar assets adjusted for specific attributes of the commitments and other observable market data at the valuation date (Level 2).

The following table summarizes the financial assets measured at fair value on a recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured on a Recurring Basis

September 30, 2018	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Available for sale securities:				
Obligations of U.S. federal government corporations and agencies	\$-	\$2,470	\$ -	\$2,470
Mortgage-backed - residential REMICs	-	66,463	-	66,463
Collateralized mortgage obligations-residential	-	2,814	-	2,814
Corporate bonds	-	97,970	-	97,970
Obligations of state and political subdivisions	-	13,057	-	13,057
Mortgage banking derivative - asset	-	100,188	-	100,188
	-	665	-	665

December 31, 2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Available for sale securities:				
Obligations of U.S. federal government corporations and agencies	\$-	\$508	\$ -	\$508
Mortgage-backed - residential REMICs	-	59,269	-	59,269
Collateralized mortgage obligations-residential	-	1,065	-	1,065
Preferred stock	-	93,876	-	93,876
Corporate bonds	1	-	-	1
Obligations of state and political subdivisions	-	13,103	-	13,103
Mortgage banking derivative - asset	-	92,828	-	92,828
Mortgage banking derivative -liability	-	609	-	609
	-	11	-	11

The following table summarizes the financial assets measured at fair value on a non-recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured on a Non-Recurring Basis

September 30, 2018	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Impaired loans				
Commercial real estate	\$-	\$ -	\$410	\$410
Commercial	-	-	1,713	1,713
Total impaired loans	-	-	2,123	2,123
Mortgage servicing rights	-	567	-	567
Real estate held for sale				
Commercial real estate	-	-	739	739
Total real estate held for sale	-	-	739	739

December 31, 2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
	(In Thousands)			
Impaired loans				
Commercial real estate	\$-	-	\$1,787	\$1,787

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Commercial			2,817	2,817
Total impaired loans	-	-	4,604	4,604
Mortgage servicing rights	-	534	-	534
Real estate held for sale				
Commercial real estate	-	-	227	227
Total real estate held for sale	-	-	227	227

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of September 30, 2018, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs	Weighted Average
	(Dollars in Thousands)				
Impaired Loans- Applies to all loan classes	\$2,123	Appraisals which utilize sales comparison, net income and cost approach	Discounts for collection issues and changes in market conditions	10-30%	14%
Real estate held for sale – Applies to all classes	\$739	Appraisals which utilize sales comparison, net income and cost approach	Discounts for changes in market conditions	20%	20%

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of December 31, 2017, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value	Valuation Technique	Unobservable Inputs	Range of Inputs	Weighted Average
	(Dollars in Thousands)				
Impaired Loans- Applies to all loan classes	\$4,604	Appraisals which utilize sales comparison, net income and cost approach	Discounts for collection issues and changes in market conditions	10-20%	10%
Real estate held for sale – Applies to all classes	\$227	Appraisals which utilize sales comparison, net income and cost approach	Discounts for changes in market conditions	0%	0%

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of \$2.1 million, with a valuation allowance of \$10,000 and a fair value of \$4.6 million, with a no valuation allowance at September 30, 2018 and December 31, 2017, respectively. A provision expense of \$1.1 million and \$1.2 million for the three and nine months ended September 30, 2018, and a provision expense of \$8,000 and \$821,000 for the three months and nine months ended September 30, 2017, respectively, were included in earnings.

Mortgage servicing rights are carried at the lower of cost or fair value. Certain mortgage servicing right tranches had a fair value of \$567,000 with a valuation allowance of \$341,000 and a fair value of \$534,000 with a valuation allowance of \$432,000 at September 30, 2018 and December 31, 2017, respectively. A recovery of \$8,000 and \$91,000 for the three and nine months ended September 30, 2018, respectively, and a charge of \$27,000 and a recovery of \$21,000 for the three and nine months ended September 30, 2017, respectively, was included in earnings.

Real estate held for sale is determined using Level 3 inputs which include appraisals and adjusted for estimated costs to sell. The change in fair value of real estate held for sale was \$8,000 and \$552,000 for the three and nine months ended September 30, 2018, respectively, which was recorded directly as an adjustment to current earnings through non-interest expense. The change in fair value of real estate held for sale was \$20,000 for the three and nine months ended September 30, 2017.

In accordance with FASB ASC Topic 825, the Fair Value Measurements tables are a comparative condensed consolidated statement of financial condition based on carrying amount and estimated fair values of financial instruments as of September 30, 2018, and December 31, 2017. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of First Defiance.

Much of the information used to arrive at “fair value” is highly subjective and judgmental in nature and therefore the results may not be precise. Subjective factors include, among other things, estimated cash flows, risk characteristics and interest rates, all of which are subject to change. With the exception of investment securities, the Company’s financial instruments are not readily marketable and market prices do not exist. Since negotiated prices for the instruments, which are not readily marketable, depend greatly on the motivation of the buyer and seller, the amounts that will actually be realized or paid per settlement or maturity of these instruments could be significantly different.

The carrying amount of cash and cash equivalents and notes payable, as a result of their short-term nature, is considered to be equal to fair value and are classified as Level 1.

It was not practicable to determine the fair value of Federal Home Loan Bank of Cincinnati (“FHLB”) stock due to restrictions placed on its transferability.

The Company adopted the amendments to ASU 2016-01 relating to the loan portfolio in the first quarter of 2018 and an exit price income approach is now used to determine the fair value. The loans were valued on an individual basis, with consideration given to the loans underlying characteristics, including account types, remaining terms (in months), annual interest rates or coupons, interest types, past delinquencies, timing of principal and interest payments, current market rates, loss exposures, and remaining balances. The model utilizes a discounted cash flow approach to estimate the fair value of the loans using assumptions for the coupon rates, remaining maturities, prepayment speeds, projected default probabilities, losses given defaults, and estimates of prevailing discount rates. The discounted cash flow approach models the credit losses directly in the projected cash flows. The model applies various assumptions regarding credit, interest, and prepayment risks for the loans based on loan types, payment types and fixed or variable classifications. As of December 31, 2017, the fair value was estimated by discounting the future cash flows using the rates at which similar notes would be written for the same remaining maturities or an entry price income approach. The market rates used were based on current rates the Company would impose for similar loans and reflect a market participant assumption about risks associated with non-performance, illiquidity, and the structure and term of the loans along with local economic and market conditions. For all periods presented, the estimated fair value of impaired loans is based on the fair value of the collateral, less estimated cost to sell, or the present value of the loan’s expected future cash flows (discounted at the loan’s effective interest rate). All impaired loans are classified as Level 3 within the valuation hierarchy.

The fair value of accrued interest receivable is equal to the carrying amounts resulting in a Level 2 or Level 3 classification which is consistent with its underlying value.

The fair value of non-interest bearing deposits are considered equal to the amount payable on demand at the reporting date (i.e. carrying value) and are classified as Level 1. The fair value of savings, checking and certain money market accounts are equal to their carrying amounts and are a Level 2 classification. Fair values of fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

The fair values of securities sold under repurchase agreements are equal to their carrying amounts resulting in a Level 2 classification. The carrying value of subordinated debentures and deposits with fixed maturities is estimated based discounted cash flow analyses based on interest rates currently being offered on instruments with similar characteristics and maturities resulting in a Level 3 classification.

FHLB advances with maturities greater than 90 days are valued based on a discounted cash flow analysis, using interest rates currently being quoted for similar characteristics and maturities resulting in a Level 2 classification. The cost or value of any call or put options is based on the estimated cost to settle the option at September 30, 2018.

Fair Value Measurements at September 30, 2018

(In Thousands)

	Carrying Value	Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	\$99,526	\$99,526	\$99,526	\$-	\$-
Investment securities	283,565	283,565	-	283,565	-
Federal Home Loan Bank Stock	14,217	N/A	N/A	N/A	N/A
Loans, net, including loans held for sale	2,441,203	2,395,975	-	12,887	2,383,088
Accrued interest receivable	11,258	11,258	11	1,665	9,582
Financial Liabilities:					
Deposits	\$2,524,431	\$2,516,006	\$556,316	\$1,959,690	\$-
Advances from Federal Home Loan Bank	100,220	99,043	-	99,043	-
Securities sold under repurchase agreements	4,162	4,162	-	4,162	-
Subordinated debentures	36,083	34,986	-	-	34,986

Fair Value Measurements at December 31, 2017

(In Thousands)

	Carrying Value	Total	Level 1	Level 2	Level 3
Financial Assets:					
Cash and cash equivalents	\$113,693	\$113,693	\$113,693	\$-	\$-
Investment securities	261,298	261,299	1	261,298	-
Federal Home Loan Bank Stock	15,992	N/A	N/A	N/A	N/A
	2,332,465	2,315,791	-	10,830	2,304,961

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Loans, net, including loans held for sale					
Accrued interest receivable	8,706	8,706	13	917	7,776
Financial Liabilities:					
Deposits	\$2,437,656	\$2,444,683	\$571,360	\$1,873,323	\$-
Advances from Federal Home Loan Bank	84,279	83,261	-	83,261	-
Securities sold under repurchase agreements	26,019	26,019	-	26,019	-
Subordinated debentures	36,083	35,385	-	-	35,385

4. Stock Compensation Plans

First Defiance has established equity based compensation plans for its directors and employees. On February 27, 2018, the Board adopted, and the shareholders approved at the 2018 Annual Shareholders Meeting, the First Defiance Financial Corp. 2018 Equity Incentive Plan (the “2018 Equity Plan”). The 2018 Equity Plan replaced all existing plans, although the Company’s former equity plans remain in existence to the extent there were outstanding grants thereunder at the time the 2018 Equity Plan was approved. All awards currently outstanding under prior plans will remain in effect in accordance with their respective terms. Any new awards will be made under the 2018 Equity Plan. The 2018 Equity Plan allows for issuance of up to 900,000 common shares through the award of options, stock grants, restricted stock units (“RSU”), stock appreciation rights or other stock-based awards.

As of September 30, 2018, 39,400 options to acquire First Defiance shares were outstanding at option prices based on the market value of the underlying shares on the date the options were granted. Options granted vest 20% per year. All options expire ten years from the date of grant. Vested options of retirees expire on the earlier of the scheduled expiration date or three months after the retirement date.

Annually, the Company approves a Short-Term Equity Incentive Plan (“STIP”) and a Long-Term Equity Incentive Plan (“LTIP”) for selected members of management.

Under the 2017 and 2018 STIPs, the participants could earn between 10% to 45% of their salary for potential payout based on the achievement of certain corporate performance targets during the calendar year. The final amount of benefits under the STIPs is determined as of December 31 of the same year and paid out in cash in the first quarter of the following year. The participants are required to be employed on the day of payout in order to receive the payment.

Under each LTIP, the participants may earn between 20% to 45% of their salary for potential payout in the form of equity awards based on the achievement of certain corporate performance targets over a three-year period. The Company granted 49,052, 41,314 and 41,676 RSU’s to the participants in the 2016, 2017 and 2018 LTIPs, respectively, effective January 1 in the year the award was made, which represents the maximum target award. The amount of benefit under each LTIP will be determined individually at the end of the 36 month performance period ending December 31. The benefits earned under each LTIP will be paid out in equity in the first quarter following the end of the performance period. The participants are required to be employed on the day of payout in order to receive the payment.

A total of 49,514 RSU’s were issued to the participants of the 2015 LTIP in the first quarter of 2018 for the three year performance period ended December 31, 2017.

In the nine months ended September 30, 2018, the Company also granted to employees 23,952 restricted shares, of which 7,348 were RSUs and 16,604 were restricted stock grants. Of the 16,604 restricted shares granted, 4,104 were issued to directors and have a one-year vesting period. The remaining 12,500 were issued to employees and have a three-year vesting period. The fair value of all granted restricted shares was determined by the stock price at the date of the grant.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

There were no options granted during the three or nine months ended September 30, 2018, or September 30, 2017.

Following is stock option activity under the plans during the nine months ended September 30, 2018:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in 000's)
Options outstanding, January 1, 2018	86,900	\$ 10.81		
Forfeited or cancelled	-	-		
Exercised	(47,500)	) 8.15		
Granted	-	-		
Options outstanding, September 30, 2018	39,400	\$ 14.00	5.21	\$ 635
Vested or expected to vest at September 30, 2018	39,400	\$ 14.00	5.21	\$ 635
Exercisable at September 30, 2018	23,900	\$ 12.22	4.39	\$ 428

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Proceeds of options exercised	\$ -	\$ -	\$ 111	\$ 198
Related tax benefit recognized	-	-	28	54
Intrinsic value of options exercised	-	-	1,034	301

As of September 30, 2018, there was \$63,000 of total unrecognized compensation cost related to unvested stock options granted under the Company's equity plans. The cost is expected to be recognized over a weighted-average period of 1.7 years.

At September 30, 2018, 144,586 RSU's and 34,372 restricted stock grants were unvested. Compensation expense is recognized over the performance period based on the achievements of targets as established under the plan documents. A total expense of \$470,000 and \$1.4 million was recorded during the three and nine months ended September 30, 2018 compared to an expense of \$373,000 and \$1.5 million for the three and nine months ended September 30, 2017. There was approximately \$622,000 and \$774,000 included within other liabilities at September 30, 2018 and December 31, 2017, respectively, related to the STIP.

	Restricted Stock Units		Stock Grants	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Unvested Shares				
Unvested at January 1, 2018	145,076	\$ 20.26	21,072	\$ 25.28
Granted	49,024	26.97	66,118	19.68
Vested	(49,514)	16.15	(52,818)	16.81
Forfeited	-	-	-	-
Unvested at September 30, 2018	144,586	\$ 23.94	34,372	\$ 30.19

The maximum amount of compensation expense that may be recorded for the 2018 STIP and the 2016, 2017 and 2018 LTIPs at September 30, 2018, is approximately \$4.3 million. However, the estimated expense expected to be recorded as of September 30, 2018, based on the performance measures in the plans, is \$3.5 million of which \$1.3 million is unrecognized at September 30, 2018, and will be recognized over the remaining performance periods.

5. Dividends on Common Stock

First Defiance declared and paid a \$0.15 per common stock dividend in the first and second quarters of 2018 and a \$0.17 per common stock dividend in the third quarter of 2018. Dividends declared and paid were \$0.125 per common stock dividend in the first, second and third quarters of 2017.

6. Earnings Per Common Share

Basic earnings per share are calculated using the two-class method. The two-class method is an earnings allocation formula under which earnings per share is calculated from common stock and participating securities according to dividends declared and participation rights in undistributed earnings. Under this method, all earnings distributed and undistributed, are allocated to participating securities and common shares based on their respective rights to receive dividends. Unvested share-based payment awards that contain non-forfeitable rights to dividends are considered participating securities (i.e., unvested restricted stock), not subject to performance based measures.

The following table sets forth the computation of basic and diluted earnings per common share:

	Three Months Ended		Nine Months Ended	
	September 30, 2018	2017	September 30, 2018	2017
	(In Thousands, except per share data)			
Basic Earnings Per Share:				
Net income available to common shareholders	\$11,306	\$9,381	\$34,152	\$22,869
Less: Income allocated to participating securities	1	1	3	3
Net income allocated to common shareholders	11,305	9,380	34,149	22,866
Weighted average common shares outstanding including participating securities ⁽¹⁾	20,409	20,308	20,382	19,836
Less: Participating securities	9	10	9	10
Average common shares ⁽¹⁾	20,400	20,298	20,373	19,826
Basic earnings per common share	\$0.55	\$0.46	1.68	1.15
Diluted Earnings Per Share:				
Net income allocated to common shareholders	\$11,305	\$9,380	\$34,149	\$22,866
Weighted average common shares outstanding for basic earnings per common share ⁽¹⁾	20,400	20,298	20,373	19,826
Add: Dilutive effects of stock options	67	120	92	114
Average shares and dilutive potential common shares ⁽¹⁾	20,467	20,418	20,465	19,940
Diluted earnings per common share	\$0.55	\$0.46	1.67	1.15

(1) Share and per share data has been adjusted for a 2-for-1 stock split on July 12, 2018.

There were no shares excluded from the diluted earnings per share calculation for the three and nine months ended September 30, 2018 and September 30, 2017, as no shares were anti-dilutive during these time periods.

7. Investment Securities

The following is a summary of available-for-sale and held-to-maturity securities:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At September 30, 2018				
Available-for-Sale Securities:				
Obligations of U.S. federal government corporations and agencies	\$2,519	\$ -	\$ (49)	) \$2,470
Mortgage-backed securities – residential REMICs	68,863	25	(2,425)	) 66,463
Collateralized mortgage obligations	2,842	-	(28)	) 2,814
Corporate bonds	100,874	15	(2,919)	) 97,970
Obligations of state and political subdivisions	12,911	146	-	) 13,057
Total Available-for-Sale	100,592	1,034	(1,438)	) 100,188
	\$288,601	\$ 1,220	\$ (6,859)	) \$282,962

	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
(In Thousands)				
Held-to-Maturity Securities*:				
FHLMC certificates	\$8	\$ -	\$ -	\$ 8
FNMA certificates	33	-	-	33
GNMA certificates	13	-	-	13
Obligations of state and political subdivisions	549	-	-	549
Total Held-to Maturity	\$603	\$ -	\$ -	\$ 603

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Thousands)				
At December 31, 2017				
Available-for-sale				
Obligations of U.S. federal government corporations and agencies	\$518	\$ -	\$ (10)	) \$508
Mortgage-backed securities - residential REMICs	59,942	90	(763)	) 59,269
Collateralized mortgage obligations	1,072	-	(7)	) 1,065
Preferred stock	94,588	180	(892)	) 93,876
Corporate bonds	-	1	-	) 1
Obligations of state and political subdivisions	12,914	189	-) 13,103
	90,692	2,426	(290)) 92,828

Total Available-for-Sale	\$259,726	\$ 2,886	\$ (1,962)	\$260,650
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	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In Thousands)			
Held-to-Maturity*				
FHLMC certificates	\$ 10	\$ -	\$ -	\$ 10
FNMA certificates	41	1	-	42
GNMA certificates	17	-	-	17
Obligations of states and political subdivisions	580	-	-	580
Total Held-to-Maturity	\$648	\$ 1	\$ -	\$ 649

* FHLMC, FNMA, and GNMA certificates are residential mortgage-backed securities.

The amortized cost and fair value of the investment securities portfolio at September 30, 2018, are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. For purposes of the maturity table, mortgage-backed securities (“MBS”), collateralized mortgage obligations (“CMO”) and REMICs, which are not due at a single maturity date, have not been allocated over the maturity groupings. These securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	\$1,410	\$1,414	\$ 31	\$ 31
Due after one year through five years	23,134	23,379	-	-
Due after five years through ten years	38,981	39,586	518	518
Due after ten years	52,497	51,336	-	-
MBS/CMO/REMIC	172,579	167,247	54	54
	\$288,601	\$282,962	\$ 603	\$ 603

Investment securities with a carrying amount of \$144.5 million at September 30, 2018, were pledged as collateral on public deposits, securities sold under repurchase agreements and the Federal Reserve discount window.

As of September 30, 2018, the Company’s investment portfolio consisted of 438 securities, 223 of which were in an unrealized loss position.

The following tables summarize First Defiance's securities that were in an unrealized loss position at September 30, 2018, and December 31, 2017:

	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Losses
(In Thousands)						
At September 30, 2018						
Available-for-sale securities:						
Obligations of U.S. government corporations and agencies	\$1,971	\$ (29)	\$499	\$ (20)	\$2,470	\$ (49)
Mortgage-backed securities-residential REMICs	36,748	(873)	28,676	(1,552)	65,424	(2,425)
Collateralized mortgage obligations	2,814	(28)	-	-	2,814	(28)
Obligations of state and political subdivisions	66,743	(1,457)	29,441	(1,462)	96,184	(2,919)
Total temporarily impaired securities	36,875	(815)	8,408	(623)	45,283	(1,438)
	\$145,151	\$ (3,202)	\$67,024	\$ (3,657)	\$212,175	\$ (6,859)

	Duration of Unrealized Loss Position					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Unrealized Losses
(In Thousands)						
At December 31, 2017						
Available-for-sale securities:						
Obligations of U.S. government corporations and agencies	\$-	\$ -	\$508	\$ (10)	\$508	\$ (10)
Mortgage-backed securities-residential REMICs	27,881	(215)	19,038	(548)	46,919	(763)
Collateralized mortgage obligations	1,065	(7)	-	-	1,065	(7)
Obligations of state and political subdivisions	49,107	(320)	20,804	(572)	69,911	(892)
Held to maturity securities:	14,249	(163)	3,370	(127)	17,619	(290)
Total temporarily impaired securities	12	-	9	-	21	-
	\$92,314	\$ (705)	\$43,729	\$ (1,257)	\$136,043	\$ (1,962)

There were net realized gains of \$76,000 (\$60,000 after tax) from the sales and calls of investment securities for the three and nine months ended September 30, 2018, while there were net realized gains of \$158,000 (\$103,000 after tax) in the third quarter of 2017 and \$425,000 (\$276,000 after tax) for the nine months ended September 30, 2017.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment portfolio is evaluated for OTTI by segregating the portfolio into two general segments. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC Topic 320, Investments-Debt and Equity Securities. Certain collateralized debt obligations (“CDOs”) are evaluated for OTTI under FASB ASC Topic 325, Investment – Other.

When OTTI occurs under either model, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected compared to the book value of the security and is recognized in earnings. The amount of OTTI related to other factors shall be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

With the exception of corporate bonds, the above securities all have fixed interest rates, and all securities have defined maturities. Their fair value is sensitive to movements in market interest rates. First Defiance has the ability and intent to hold these investments for a time necessary to recover the amortized cost without impacting its liquidity position and it is not more than likely that the Company will be required to sell the investments before anticipated recovery.

For the three and nine months ended September 30, 2018 and 2017, management determined there was no OTTI.

The proceeds from the sales and calls of securities and the associated gains and losses are listed below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In Thousands)			
Proceeds	\$1,944	\$10,226	\$1,944	\$18,047
Gross realized gains	76	166	76	433
Gross realized losses	-	(8)	-	(8)

8. Loans

Loans receivable consist of the following:

	September 30, 2018	December 31, 2017
Real Estate:	(In Thousands)	
Secured by 1-4 family residential	\$313,300	\$274,862
Secured by multi-family residential	270,554	248,092
Secured by commercial real estate	1,092,533	987,129
Construction	274,344	265,476
	1,950,731	1,775,559
Other Loans:		
Commercial	489,393	526,142
Home equity and improvement	129,295	135,457
Consumer finance	32,379	29,109
	651,067	690,708
Total loans	2,601,798	2,466,267
Deduct:		
Undisbursed loan funds	(143,286)	(115,972)
Net deferred loan origination fees and costs	(2,155)	(1,582)
Allowance for loan loss	(27,639)	(26,683)
Totals	\$2,428,718	\$2,322,030

Loan segments have been identified by evaluating the portfolio based on collateral and credit risk characteristics.

The following table discloses allowance for loan loss activity for the quarters ended September 30, 2018 and 2017 by portfolio segment (In Thousands):

Quarter Ended September 30, 2018	1-4 Family Residential Real Estate	Multi- Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer Finance	Total
Beginning Allowance	\$ 2,682	\$ 2,913	\$ 11,253	\$ 737	\$ 7,455	\$ 2,032	\$ 249	\$ 27,321
Charge-Offs	(136)	0	(1,048)	0	(528)	(36)	(25)	(1,773)
Recoveries	27	38	182	0	413	47	8	715
Provisions	251	61	1,281	(122)	(179)	28	56	1,376
Ending Allowance	\$ 2,824	\$ 3,012	\$ 11,668	\$ 615	\$ 7,161	\$ 2,071	\$ 288	\$ 27,639

Quarter Ended September 30, 2017	1-4 Family Residential Real Estate	Multi- Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer Finance	Total
Beginning Allowance	\$ 2,641	\$ 2,193	\$ 10,136	\$ 540	\$ 7,973	\$ 2,199	\$ 233	\$ 25,915
Charge-Offs	(60)	0	0	0	(64)	(92)	(20)	(236)
Recoveries	11	0	103	0	18	59	9	200
Provisions	(54)	110	232	38	98	19	19	462
Ending Allowance	\$ 2,538	\$ 2,303	\$ 10,471	\$ 578	\$ 8,025	\$ 2,185	\$ 241	\$ 26,341

The following table discloses allowance for loan loss activity for the year-to-date periods ended September 30, 2018 and September 30, 2017 by portfolio segment (In Thousands):

Year-to-date Period Ended September 30, 2018	1-4 Family Residential Real Estate	Multi- Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer Finance	Total
Beginning Allowance	\$ 2,532	\$ 2,702	\$ 10,354	\$ 647	\$ 7,965	\$ 2,255	\$ 228	\$ 26,683
Charge-Offs	(230)	0	(1,357)	0	(709)	(194)	(128)	(2,618)
Recoveries	85	40	392	0	2,200	132	21	2,870
Provisions	437	270	2,279	(32)	(2,295)	(122)	167	704
Ending Allowance	\$ 2,824	\$ 3,012	\$ 11,668	\$ 615	\$ 7,161	\$ 2,071	\$ 288	\$ 27,639

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Year-to-date Period Ended September 30, 2017	1-4 Family Residential Real Estate	Multi- Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity and Improvement	Consumer Finance	Total
Beginning Allowance	\$ 2,627	\$ 2,228	\$ 10,625	\$ 450	\$ 7,361	\$ 2,386	\$ 207	\$ 25,884
Charge-Offs	(109)	0	(400)	0	(2,091)	(246)	(112)	(2,958)
Recoveries	100	32	220	0	227	118	83	780
Provisions	(80)	43	26	128	2,528	(73)	63	2,635
Ending Allowance	\$ 2,538	\$ 2,303	\$ 10,471	\$ 578	\$ 8,025	\$ 2,185	\$ 241	\$ 26,341

30

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2018 (In Thousands):

	1-4 Family Residential Real Estate	Multi Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity & Improvement	Consumer Finance	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 190	\$ 2	\$ 97	\$ -	\$ 117	\$ 255	\$ 1	\$ 662
Collectively evaluated for impairment	2,634	3,010	11,571	615	7,044	1,816	287	26,977
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	\$ 2,824	\$ 3,012	\$ 11,668	\$ 615	\$ 7,161	\$ 2,071	\$ 288	\$ 27,639
Loans:								
Loans individually evaluated for impairment	\$ 6,972	\$ 1,582	\$ 26,594	\$ -	\$ 12,950	\$ 1,082	\$ 31	\$ 49,211
Loans collectively evaluated for impairment	305,798	268,989	1,069,197	130,516	478,336	129,100	32,450	2,414,386

Loans acquired with deteriorated credit quality	1,017	297	850	-	177	-	-	2,341
Total ending loans balance	\$313,787	\$270,868	\$1,096,641	\$130,516	\$491,463	\$130,182	\$32,481	\$2,465,938

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2017 (In Thousands):

	1-4 Family Residential Real Estate	Multi Family Residential Real Estate	Commercial Real Estate	Construction	Commercial	Home Equity & Improvement	Consumer Finance	Total
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 167	\$ 7	\$ 118	\$ -	\$ 187	\$ 279	\$ -	\$ 758
Collectively evaluated for impairment	2,365	2,695	10,236	647	7,778	1,976	228	25,925
Acquired with deteriorated credit quality	-	-	-	-	-	-	-	-
Total ending allowance balance	\$ 2,532	\$ 2,702	\$ 10,354	\$ 647	\$ 7,965	\$ 2,255	\$ 228	\$ 26,683
Loans:								
Loans individually evaluated for impairment	\$ 6,910	\$ 2,278	\$ 31,821	\$ -	\$ 14,373	\$ 1,176	\$ 50	\$ 56,608
Loans collectively evaluated for impairment	267,377	245,823	956,238	149,174	513,218	135,098	29,125	2,296,053

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Loans acquired with deteriorated credit quality	1,069	301	2,121	-	337	-	-	3,828
Total ending loans balance	\$ 275,356	\$ 248,402	\$ 990,180	\$ 149,174	\$ 527,928	\$ 136,274	\$ 29,175	\$ 2,356,489

The following table presents the average balance, interest income recognized and cash basis income recognized on impaired loans by class of loans (In Thousands):

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	\$4,848	\$ 41	\$ 41	\$4,695	\$ 113	\$ 110
Residential Non Owner Occupied	2,371	31	31	2,424	105	102
Total Residential Real Estate	7,219	72	72	7,119	218	212
Construction	-	-	-	-	-	-
Multi-Family	1,582	22	22	1,744	71	70
CRE Owner Occupied	10,058	57	49	10,545	179	156
CRE Non Owner Occupied	2,321	19	18	2,815	76	75
Agriculture Land	14,115	150	96	13,370	400	248
Other CRE	1,223	25	25	1,346	75	67
Total Commercial Real Estate	27,717	251	188	28,076	730	546
Commercial Working Capital	10,181	91	84	8,059	196	180
Commercial Other	3,282	34	31	3,809	88	83
Total Commercial	13,463	125	115	11,868	284	263
Home Equity and Improvement	1,091	9	9	1,195	29	29
Consumer Finance	33	1	1	35	3	3
Total Impaired Loans	\$51,105	\$ 480	\$ 407	\$50,037	\$ 1,334	\$ 1,123

The following table presents the average balance, interest income recognized and cash basis income recognized on impaired loans by class of loans (In Thousands):

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Average Balance	Interest Income Recognized	Cash Basis Income Recognized	Average Balance	Interest Income Recognized	Cash Basis Income Recognized
Residential Owner Occupied	\$4,188	\$ 37	\$ 37	\$3,699	\$ 99	\$ 99
Residential Non Owner Occupied	2,706	33	33	3,136	104	104
Total Residential Real Estate	6,894	70	70	6,835	203	203
Construction	-	-	-	-	-	-
Multi-Family	2,084	9	9	2,534	28	28
CRE Owner Occupied	12,127	24	22	9,613	70	70
CRE Non Owner Occupied	3,484	32	31	3,845	105	98
Agriculture Land	13,547	148	44	8,719	335	126
Other CRE	1,590	27	22	1,637	50	42
Total Commercial Real Estate	30,748	231	119	23,814	560	336
Commercial Working Capital	7,033	38	38	5,115	86	90
Commercial Other	5,926	31	27	5,126	82	60
Total Commercial	12,959	69	65	10,241	168	150
Home Equity and Improvement	1,206	11	10	1,228	32	31
Consumer Finance	54	1	1	62	3	4
Total Impaired Loans	\$53,945	\$ 391	\$ 274	\$44,714	\$ 994	\$ 752

The following table presents loans individually evaluated for impairment by class of loans (In Thousands):

	September 30, 2018			December 31, 2017		
	Unpaid Principal Balance*	Recorded Investment	Allowance for Loan Losses Allocated	Unpaid Principal Balance*	Recorded Investment	Allowance for Loan Losses Allocated
With no allowance recorded:						
Residential Owner Occupied	\$751	\$ 625	\$ -	\$2,507	\$ 2,364	\$ -
Residential Non Owner Occupied	999	1,004	-	1,711	1,708	-
Total 1-4 Family Residential Real Estate	1,750	1,629	-	4,218	4,072	-
Multi-Family Residential Real Estate	1,530	1,537	-	2,095	2,102	-
CRE Owner Occupied	7,086	5,835	-	12,273	11,804	-
CRE Non Owner Occupied	1,913	1,748	-	3,085	2,925	-
Agriculture Land	13,675	13,883	-	13,029	13,185	-
Other CRE	471	479	-	981	768	-
Total Commercial Real Estate	23,145	21,945	-	29,368	28,682	-
Construction	-	-	-	-	-	-
Commercial Working Capital	9,657	9,420	-	5,462	5,422	-
Commercial Other	2,736	2,548	-	9,916	7,644	-
Total Commercial	12,393	11,968	-	15,378	13,066	-
Home Equity and Home Improvement	-	-	-	630	584	-
Consumer Finance	-	-	-	42	42	-
Total loans with no allowance recorded	\$38,818	\$ 37,079	\$ -	\$51,731	\$ 48,548	\$ -
With an allowance recorded:						
Residential Owner Occupied	\$4,169	\$ 4,129	\$ 165	\$1,841	\$ 1,814	\$ 137
Residential Non Owner Occupied	1,210	1,214	25	1,031	1,024	30
Total 1-4 Family Residential Real Estate	5,379	5,343	190	2,872	2,838	167
Multi-Family Residential Real Estate	44	45	2	175	176	7
CRE Owner Occupied	3,656	3,172	40	2,007	1,546	44
CRE Non Owner Occupied	624	485	20	651	593	28
Agriculture Land	281	279	5	293	292	14
Other CRE	1,130	713	32	909	708	32
Total Commercial Real Estate	5,691	4,649	97	3,860	3,139	118
Construction	-	-	-	-	-	-
Commercial Working Capital	526	528	62	447	449	77
Commercial Other	456	454	55	854	858	110
Total Commercial	982	982	117	1,301	1,307	187
Home Equity and Home Improvement	1,159	1,082	255	596	592	279
Consumer Finance	31	31	1	8	8	-
Total loans with an allowance recorded	\$13,286	\$ 12,132	\$ 662	\$8,812	\$ 8,060	\$ 758

* Presented gross of charge-offs

The following table presents the current balance of the aggregate amounts of non-performing assets, comprised of non-performing loans and real estate owned on the dates indicated:

	September	December
	30,	31,
	2018	2017
	(In Thousands)	
Non-accrual loans	\$20,929	\$ 30,715
Loans over 90 days past due and still accruing	-	-
Total non-performing loans	20,929	30,715
Real estate and other assets held for sale	1,676	1,532
Total non-performing assets	\$22,605	\$ 32,247
Troubled debt restructuring, still accruing	\$12,611	\$ 13,770

The following table presents the aging of the recorded investment in past due and non-accrual loans as of September 30, 2018, by class of loans (In Thousands):

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non- Accrual
Residential Owner Occupied	\$192,769	\$372	\$1,427	\$1,756	\$3,555	\$3,167
Residential Non Owner Occupied	117,104	163	22	174	359	333
Total 1-4 Family Residential Real Estate	309,873	535	1,449	1,930	3,914	3,500
Multi-Family Residential Real Estate	270,868	-	-	-	-	118
CRE Owner Occupied	413,049	321	2	158	481	5,172
CRE Non Owner Occupied	503,533	-	-	140	140	790
Agriculture Land	127,076	39	-	2,988	3,027	5,319
Other Commercial Real Estate	49,335	-	-	-	-	290
Total Commercial Real Estate	1,092,993	360	2	3,286	3,648	11,571
Construction	130,516	-	-	-	-	-
Commercial Working Capital	213,113	17	-	2,870	2,887	4,359
Commercial Other	274,999	31	-	433	464	772
Total Commercial	488,112	48	-	3,303	3,351	5,131
Home Equity/Home Improvement	128,489	1,348	138	207	1,693	562

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Consumer Finance	32,228	186	44	23	253	34
Total Loans	\$2,453,079	\$2,477	\$1,633	\$8,749	\$12,859	\$20,916

36

The following table presents the aging of the recorded investment in past due and non-accrual loans as of December 31, 2017, by class of loans (In Thousands):

	Current	30-59 days	60-89 days	90+ days	Total Past Due	Total Non- Accrual
Residential Owner Occupied	\$175,139	\$821	\$1,033	\$1,227	\$3,081	\$2,510
Residential Non Owner Occupied	96,400	495	8	233	736	520
Total 1-4 Family Residential Real Estate	271,539	1,316	1,041	1,460	3,817	3,030
Multi-Family Residential Real Estate	247,980	422	-	-	422	128
CRE Owner Occupied	393,125	195	188	1,268	1,651	10,775
CRE Non Owner Occupied	403,656	1	91	424	516	2,431
Agriculture Land	131,753	412	-	66	478	4,144
Other Commercial Real Estate	58,784	13	-	204	217	734
Total Commercial Real Estate	987,318	621	279	1,962	2,862	18,084
Construction	149,174	-	-	-	-	-
Commercial Working Capital	233,632	102	1,264	876	2,242	2,369
Commercial Other	291,455	82	-	517	599	6,474
Total Commercial	525,087	184	1,264	1,393	2,841	8,843
Home Equity and Home Improvement	133,144	2,490	434	206	3,130	591
Consumer Finance	28,800	293	80	2	375	27
Total Loans	\$2,343,042	\$5,326	\$3,098	\$5,023	\$13,447	\$30,703

Troubled Debt Restructurings

As of September 30, 2018, and December 31, 2017, the Company had a recorded investment in troubled debt restructurings (“TDRs”) of \$20.3 million and \$21.7 million, respectively. The Company allocated \$658,000 and \$751,000 of specific reserves to those loans at September 30, 2018, and December 31, 2017, respectively, and had committed to lend additional amounts totaling up to \$278,000 and \$242,000 at September 30, 2018, and December 31, 2017, respectively.

The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Each TDR is uniquely designed to meet the specific needs of the borrower. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions and converting revolving credit lines to term loans. Additional collateral or an additional guarantor is often requested when granting a concession. Commercial mortgage loans modified in a TDR often involve temporary interest-only payments, re-amortization of remaining debt in order to lower payments and sometimes reducing the interest rate lower than the current market rate. Residential mortgage loans modified in a TDR are comprised of loans where monthly payments are lowered, either through interest rate reductions or principal only payments for a period of time, to accommodate the borrowers’ financial needs, interest is capitalized into principal, or the term and amortization are extended. Home equity modifications are made infrequently and usually involve providing an interest rate that is lower than the borrower would be able to obtain due to credit issues. All retail loans where the borrower is in bankruptcy are classified as TDRs regardless of whether or not a concession is made.

Of the loans modified in a TDR, as of September 30, 2018, \$7.7 million were on non-accrual status and partial charge-offs have in some cases been taken against the outstanding balance. Loans modified as a TDR may have the financial effect of increasing the allowance associated with the loan. If the loan is determined to be collateral dependent, the estimated fair value of the collateral, less any selling costs is used to determine if there is a need for a specific allowance or charge-off. If the loan is determined to be cash flow dependent, the allowance is measured based on the present value of expected future cash flows discounted at the loan’s pre-modification effective interest rate.

The following tables present loans by class modified as TDRs that occurred during the three and nine month periods ending September 30, 2018, and September 30, 2017:

Troubled Debt Restructurings	Loans Modified as a TDR for the Three Months Ended September 30, 2018 (\$ in thousands)		Loans Modified as a TDR for the Nine Months Ended September 30, 2018 (\$ in thousands)	
	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	2	\$ 149	14	\$ 770
1-4 Family Non Owner Occupied	1	29	3	170
Multi Family	0	-	0	-
CRE Owner Occupied	4	335	11	1,849
CRE Non Owner Occupied	0	-	1	44
Agriculture Land	0	-	0	-
Other CRE	0	-	0	-
Commercial Working Capital	0	-	5	2,823
Commercial Other	1	66	1	66
Home Equity and Improvement	5	123	7	123
Consumer Finance	4	10	4	10
Total	17	\$ 712	46	\$ 5,855

The loans described above decreased the allowance for loan and lease losses (“ALLL”) by \$39,000 in the three month period ending September 30, 2018 and decreased the ALLL by \$60,000 in the nine month period ending September 30, 2018.

Troubled Debt Restructurings	Loans Modified as a TDR for the Three Months Ended September 30, 2017 (\$ in thousands)		Loans Modified as a TDR for the Nine Months Ended September 30, 2017 (\$ in thousands)	
	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)

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	Loans	(\$ of	Loans	(\$ of
	period	period	period	period
	end)	end)	end)	end)
1-4 Family Owner Occupied	10	\$ 420	18	\$ 923
1-4 Family Non Owner Occupied	0	-	3	104
Multi Family	0	-	0	-
CRE Owner Occupied	0	-	1	116
CRE Non Owner Occupied	0	-	0	-
Agriculture Land	3	280	5	1,731
Other CRE	0	-	2	165
Commercial Working Capital	2	345	7	2,396
Commercial Other	1	47	5	3,511
Home Equity and Improvement	2	72	4	150
Consumer Finance	1	7	3	10
Total	19	\$ 1,171	48	\$ 9,106

The loans described above decreased the ALLL by \$5,000 in the three month period ending September 30, 2017 and decreased the ALLL by \$29,000 in the nine month period ending September 30, 2017.

Of the 2018 modifications, four were made a TDR due to terming out lines of credit, 18 were made TDR due to advancing or renewing money to a watch list credit, one loan made a TDR due to a reduction of the interest rate, 13 were made a TDR due to bankruptcy and 10 were made a TDR because the current debt was refinanced due to maturity or for payment relief.

The following tables present loans by class modified as TDRs for which there was a payment default within twelve months following the modification during the three and nine month periods ended September 30, 2018, and September 30, 2017:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	(\$ in thousands)		(\$ in thousands)	
Troubled Debt Restructurings That Subsequently Defaulted	Number of Loans	Recorded Investment (as of period end)	Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	0	\$ -	0	\$ -
1-4 Family Non Owner Occupied	0	-	0	-
CRE Owner Occupied	0	-	0	-
CRE Non Owner Occupied	0	-	0	-
Agriculture Land	0	-	0	-
Other CRE	0	-	0	-
Commercial Working Capital or Other	3	\$ 2,644	3	2,644
Commercial Other	1	30	2	226
Home Equity and Improvement	1	61	1	61
Consumer Finance	0	-	0	-
Total	5	\$ 2,735	6	\$ 2,931

The TDRs that subsequently defaulted described above had no effect on the ALLL for the three and nine month period ended September 30, 2018.

	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2017
	(\$ in thousands)	

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Troubled Debt Restructurings That Subsequently Defaulted	Number of Loans	Recorded Investment (as of period end)	(\$ in thousands)	
			Number of Loans	Recorded Investment (as of period end)
1-4 Family Owner Occupied	0	\$ -	0	\$ -
1-4 Family Non Owner Occupied	0	-	0	-
CRE Owner Occupied	0	-	0	-
CRE Non Owner Occupied	0	-	0	-
Agriculture Land	0	-	0	-
Other CRE	0	-	0	-
Commercial Working Capital or Other	0	-	1	225
Commercial Other	0	-	0	-
Home Equity and Improvement	0	-	0	-
Consumer Finance	0	-	0	-
Total	0	\$ -	1	\$ 225

The TDRs that subsequently defaulted described above had no effect on the ALLL for the three and nine month periods ended September 30, 2017.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed on the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification.

Credit Quality Indicators

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are analyzed individually by classifying the loans as to credit risk. This analysis includes all non-homogeneous loans, such as commercial and commercial real estate loans and certain homogenous mortgage, home equity and consumer loans. This analysis is performed on a quarterly basis. First Defiance uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

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

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Not Graded. Loans classified as not graded are generally smaller balance residential real estate, home equity and consumer installment loans which are originated primarily by using an automated underwriting system. These loans are monitored based on their delinquency status and are evaluated individually only if they are seriously delinquent.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of September 30, 2018, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows (In Thousands):

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Class	Pass	Special Mention	Substandard	Doubtful	Not Graded	Total
1-4 Family Owner Occupied	\$9,157	\$92	\$ 3,469	\$ -	\$183,606	\$196,324
1-4 Family Non Owner Occupied	106,173	971	3,167	-	7,152	117,463
Total 1-4 Family Real Estate	115,330	1,063	6,636	-	190,758	313,787
Multi-Family Residential Real Estate	268,568	-	2,192	-	108	270,868
CRE Owner Occupied	397,700	6,030	9,707	-	94	413,531
CRE Non Owner Occupied	495,282	5,840	2,551	-	-	503,673
Agriculture Land	110,548	4,193	15,361	-	-	130,102
Other CRE	46,819	151	1,293	-	1,072	49,335
Total Commercial Real Estate	1,050,349	16,214	28,912	-	1,166	1,096,641
Construction	111,374	467	-	-	18,675	130,516
Commercial Working Capital	198,315	7,454	10,230	-	-	215,999
Commercial Other	263,539	8,309	3,616	-	-	275,464
Total Commercial	461,854	15,763	13,846	-	-	491,463
Home Equity and Home Improvement	-	-	605	-	129,577	130,182
Consumer Finance	-	-	155	-	32,326	32,481
Total Loans	\$2,007,475	\$33,507	\$ 52,346	\$ -	\$372,610	\$2,465,938

As of December 31, 2017, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows (In Thousands):

Class	Pass	Special Mention	Substandard	Doubtful	Not Graded	Total
Residential Owner Occupied	\$7,534	\$99	\$ 2,367	\$ -	\$168,220	\$178,220
Residential Non Owner Occupied	85,802	935	3,835	-	6,564	97,136
Total 1-4 Family Real Estate	93,336	1,034	6,202	-	174,784	275,356
Multi-Family Residential Real Estate	242,969	2,503	2,819	-	111	248,402
CRE Owner Occupied	370,613	10,432	13,575	-	156	394,776
CRE Non Owner Occupied	395,264	3,464	5,444	-	-	404,172
Agriculture Land	114,776	2,639	14,816	-	-	132,231
Other CRE	56,133	165	1,788	-	915	59,001
Total Commercial Real Estate	936,786	16,700	35,623	-	1,071	990,180
Construction	125,519	1,254	-	-	22,401	149,174
Commercial Working Capital	222,526	7,605	5,743	-	-	235,874
Commercial Other	280,013	3,443	8,598	-	-	292,054
Total Commercial	502,539	11,048	14,341	-	-	527,928
Home Equity and Home Improvement	-	-	600	-	135,674	136,274
Consumer Finance	-	-	82	-	29,093	29,175
Total Loans	\$1,901,149	\$32,539	\$ 59,667	\$ -	\$363,134	\$2,356,489

The Company has purchased loans, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The outstanding balance of those loans is as follows (In Thousands):

	September 30, 2018	December 31, 2017
1-4 Family Residential Real Estate	\$ 1,053	\$ 1,154
Multi-Family Residential Real Estate	303	309
Commercial Real Estate Loans	910	2,921
Commercial	227	407
Consumer	-	2
Total Outstanding Balance	\$ 2,493	\$ 4,793
Recorded Investment, net of allowance of \$0	\$ 2,341	\$ 3,828

Accretable yield, or income expected to be collected, is as follows:

	2018	2017
Balance at January 1	\$804	\$-
New Loans Purchased	-	1,018
Accretion of Income	(115)	(163)
Reclassification from Non-accretable	-	-
Charge-off of Accretable Yield	(197)	(8)
Balance at September 30	\$492	\$847

For those purchased loans disclosed above, the Company did not increase the allowance for loan losses during the three or nine months ended September 30, 2018 or 2017. No allowances for loan losses were reversed during the same period.

Contractually required payments receivable of loans purchased with evidence of credit deterioration during the period ended September 30, 2017, using information as of the date of acquisition are included in the table below. There were no such loans purchased during the period ended September 30, 2018. (In Thousands)

1-4 Family Residential Real Estate	\$ 1,720
Commercial Real Estate	4,724
Commercial	785
Consumer	4
Total	\$7,233

Cash Flows Expected to be Collected at Acquisition	\$5,721
Fair Value of Acquired Loans at Acquisition	\$4,703

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled \$642,000 as of September 30, 2018 and \$626,000 as of December 31, 2017.

9. Mortgage Banking

Net revenues from the sales and servicing of mortgage loans consisted of the following:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
	2018	2017	2018	2017
	(In Thousands)			
Gain from sale of mortgage loans	\$1,280	\$1,200	\$3,744	\$3,577
Mortgage loans servicing revenue (expense):				
Mortgage loans servicing revenue	929	911	2,806	2,769
Amortization of mortgage servicing rights	(340)	(386)	(1,009)	(1,101)
Mortgage servicing rights valuation adjustments	8	(27)	91	21
	597	498	1,888	1,689
Net revenue from sale and servicing of mortgage loans	\$1,877	\$1,698	\$5,632	\$5,266

The unpaid principal balance of residential mortgage loans serviced for third parties was \$1.41 billion at September 30, 2018 and \$1.39 billion at December 31, 2017.

Activity for capitalized mortgage servicing rights and the related valuation allowance follows for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
	2018	2017	2018	2017
	(In Thousands)			
Mortgage servicing assets:				
Balance at beginning of period	\$10,297	\$10,154	\$10,240	\$10,117
Loans sold, servicing retained	438	426	1,164	1,178
Amortization	(340)	(386)	(1,009)	(1,101)
Carrying value before valuation allowance at end of period	10,395	10,194	10,395	10,194
Valuation allowance:				
Balance at beginning of period	(349)	(474)	(432)	(522)
Impairment recovery (charges)	8	(27)	91	21

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Balance at end of period	(341)	(501)	(341)	(501)
Net carrying value of MSR at end of period	\$10,054	\$9,693	\$10,054	\$9,693
Fair value of MSR at end of period	\$10,558	\$9,750	\$10,558	\$9,750

Amortization of mortgage servicing rights is computed based on payments and payoffs of the related mortgage loans serviced. Estimates of future amortization expense are not easily estimable.

The Company has established an accrual for secondary market buy-back activity. A liability of \$43,000 was accrued at both September 30, 2018, and December 31, 2017, respectively. There was no expense or credit recognized related to the accrual in the three and nine months ended September 30, 2018, while a credit of \$34,000 and \$131,000 was recognized in the three and nine months ended September 30, 2017.

10. Deposits

A summary of deposit balances is as follows:

	September 30, 2018	December 31, 2017
	(In Thousands)	
Non-interest-bearing checking accounts	\$556,316	\$571,360
Interest-bearing checking and money market accounts	1,016,294	1,005,519
Savings deposits	293,359	302,022
Retail certificates of deposit less than \$250,000	564,379	504,912
Retail certificates of deposit greater than \$250,000	94,083	53,843
	\$2,524,431	\$2,437,656

11. Borrowings

First Defiance's debt, FHLB advances and junior subordinated debentures owed to unconsolidated subsidiary trusts are comprised of the following:

	September 30, 2018	December 31, 2017
	(In Thousands)	
FHLB Advances:		
Single maturity fixed rate advances	\$59,000	\$ 72,000
Putable advances	-	5,000
Amortizable mortgage advances	1,243	7,306
Overnight advances	40,000	-
Fair value adjustment on acquired balances	(23)	(27)
Total	\$100,220	\$ 84,279
Junior subordinated debentures owed to unconsolidated subsidiary trusts	\$36,083	\$ 36,083

In March 2007, the Company sponsored an affiliated trust, First Defiance Statutory Trust II (Trust Affiliate II) that issued \$15 million of Guaranteed Capital Trust Securities (Trust Preferred Securities). In connection with this transaction, the Company issued \$15.5 million of Junior Subordinated Deferrable Interest Debentures (Subordinated

Debentures) to Trust Affiliate II. The Company formed Trust Affiliate II for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Subordinated Debentures held by Trust Affiliate II are the sole assets of that trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company's financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate II are payable quarterly at a variable rate equal to the three-month LIBOR rate plus 1.5%. The Coupon rate payable on the Trust Preferred Securities issued by Trust Affiliate II was 3.83% as of September 30, 2018, and 3.09% as of December 31, 2017.

The Trust Preferred Securities issued by Trust Affiliate II are subject to mandatory redemption, in whole or part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures mature on June 15, 2037, but can be redeemed at the Company's option at any time now.

The Company also sponsored an affiliated trust, First Defiance Statutory Trust I (Trust Affiliate I), that issued \$20 million of Trust Preferred Securities in 2005. In connection with this transaction, the Company issued \$20.6 million of Subordinated Debentures to Trust Affiliate I. Trust Affiliate I was formed for the purpose of issuing Trust Preferred Securities to third-party investors and investing the proceeds from the sale of these capital securities solely in Subordinated Debentures of the Company. The Junior Debentures held by Trust Affiliate I are the sole assets of the trust. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company's financial statements, but rather the subordinated debentures are shown as a liability. Distributions on the Trust Preferred Securities issued by Trust Affiliate I are payable quarterly at a variable rate equal to the three-month LIBOR rate plus 1.38%. The Coupon rate payable on the Trust Preferred Securities issued by Trust Affiliate I was 3.71% and 2.97% on September 30, 2018 and December 31, 2017, respectively.

The Trust Preferred Securities issued by Trust Affiliate I are subject to mandatory redemption, in whole or in part, upon repayment of the Subordinated Debentures. The Company has entered into an agreement that fully and unconditionally guarantees the Trust Preferred Securities subject to the terms of the guarantee. The Trust Preferred Securities and Subordinated Debentures mature on December 15, 2035, but can be redeemed at the Company's option at any time now.

The subordinated debentures may be included in Tier 1 capital (with certain limitations applicable) under current regulatory guidelines and interpretations.

Interest on both issues of Trust Preferred Securities may be deferred for a period of up to five years at the option of the issuer.

Repurchase Agreements. We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor levels on a continuous basis. We may be required to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agent.

The remaining contractual maturity of the securities sold under agreements to repurchase in the consolidated balance sheets as of September 30, 2018 and December 31, 2017, is presented in the following tables.

Overnight and Continuous	Up to 30	30-90 Days	Greater than 90 Days	Total
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At September 30, 2018		Days (In Thousands)			
Repurchase agreements:					
Mortgage-backed securities – residential	\$ 3,875	\$-	\$ -	\$ -	\$3,875
Collateralized mortgage obligations	287	-	-	-	287
Total borrowings	\$ 4,162	\$-	\$ -	\$ -	\$4,162
Gross amount of recognized liabilities for repurchase agreements					\$4,162

	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater than 90 Days	Total
At December 31, 2017					
Repurchase agreements:					
Mortgage-backed securities – residential	\$ 6,599	\$-	\$ -	\$ -	\$6,599
Collateralized mortgage obligations	19,420	-	-	-	19,420
Total borrowings	\$ 26,019	\$-	\$ -	\$ -	\$26,019
Gross amount of recognized liabilities for repurchase agreements					\$26,019

12. Commitments, Guarantees and Contingent Liabilities

Loan commitments are made to accommodate the financial needs of First Federal's customers; however, there are no long-term, fixed-rate loan commitments that result in market risk. Standby letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. They primarily are issued to facilitate customers' trade transactions.

Both arrangements have credit risk, essentially the same as that involved in extending loans to customers, and are subject to the Company's normal credit policies. Collateral (e.g., securities, receivables, inventory and equipment) is obtained based on management's credit assessment of the customer.

The Company's maximum obligation to extend credit for loan commitments (unfunded loans and unused lines of credit) and standby letters of credit outstanding as of the periods stated below were as follows (In Thousands):

	September 30, 2018		December 31, 2017	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to make loans	\$43,359	\$171,337	\$42,458	\$161,778
Unused lines of credit	9,729	381,265	6,245	408,831
Standby letters of credit	-	7,256	-	7,605
Total	\$53,088	\$559,858	\$48,703	\$578,214

Commitments to make loans are generally made for periods of 60 days or less. In addition to the above commitments, First Defiance had commitments to sell \$20.0 million and \$14.9 million of loans to Freddie Mac, Fannie Mae, FHLB or BB&T Mortgage at September 30, 2018, and December 31, 2017, respectively.

13. Income Taxes

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax in the state of Indiana. The Company is no longer subject to examination by taxing authorities for years before 2013. The Company currently operates primarily in the states of Ohio and Michigan, which tax financial institutions based on their equity rather than their income.

The Tax Act reduced the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018.

14. Derivative Financial Instruments

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from its commitments to fund the loans. These mortgage banking derivatives are not designated in hedge relationships. First Federal had approximately \$19.2 million and \$14.8 million of interest rate lock commitments at September 30, 2018, and December 31, 2017, respectively. There were \$26.8 million and \$23.2 million of forward commitments for the future delivery of residential mortgage loans at September 30, 2018, and December 31, 2017, respectively.

The fair value of these mortgage banking derivatives are reflected by a derivative asset recorded in other assets in the Consolidated Statements of Financial Condition. The table below provides data about the carrying values of these derivative instruments:

	September 30, 2018		December 31, 2017		Derivative Net Carrying Value
	Assets (Liabilities)	Derivative Net Carrying Value	Assets (Liabilities)	Derivative Net Carrying Value	
Derivatives not designated as hedging instruments					
Mortgage Banking Derivatives	\$665	\$ -	\$ 609	\$ 11	\$ 598

The table below provides data about the amount of gains and losses recognized in income on derivative instruments not designated as hedging instruments:

Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
(In Thousands)			

Derivatives not designated as hedging instruments

Mortgage Banking Derivatives – Gain (Loss)	\$(111)	\$ 47	\$ 67	\$ 330
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The above amounts are included in mortgage banking income with gain on sale of mortgage loans.

15. Other Comprehensive Income

The before and after tax amounts allocated to each component of other comprehensive income (loss) are presented in the table below. Reclassification adjustments related to securities available for sale are included in gains on sale or call of securities in the accompanying consolidated condensed statements of income.

	Before Tax Amount (In Thousands)	Tax (Expense) Benefit	Net of Tax Amount
Three months ended September 30, 2018:			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$(2,058)	\$ 432	\$(1,626)
Reclassification adjustment for net gains included in net income	(76)	16	(60)
Total other comprehensive loss	\$(2,134)	\$ 448	\$(1,686)

Nine months ended September 30, 2018:			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$(6,487)	\$ 1,362	\$(5,125)
Reclassification adjustment for net gains included in net income	(76)	16	(60)
Total other comprehensive loss	\$(6,563)	\$ 1,378	\$(5,185)

	Before Tax Amount (In Thousands)	Tax (Expense) Benefit	Net of Tax Amount
Three months ended September 30, 2017:			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$(777)	\$ 272	\$(505)
Reclassification adjustment for net gains included in net income	(158)	55	(103)
Total other comprehensive loss	\$(935)	\$ 327	\$(608)

Nine months ended September 30, 2017:			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$3,383	\$ (1,183)	\$ 2,200
Reclassification adjustment for net gains included in net income	(425)	148	(277)
Total other comprehensive income	\$2,958	\$ (1,035)	\$ 1,923

Activity in accumulated other comprehensive income (loss), net of tax, was as follows:

	Securities Available For Sale	Post-retirement Benefit	Accumulated Other Comprehensive Income (Loss)
	(In Thousands)		
Balance January 1, 2018	\$601	\$ (384)	\$ 217
Other comprehensive income before reclassifications	(5,125)	-	(5,125)
Amounts reclassified from accumulated other comprehensive income	(60)	-	(60)
Net other comprehensive income during period	(5,185)	-	(5,185)
Reclassification adjustment upon adoption of ASU 2018-02	129	(82)	47
Balance September 30, 2018	\$(4,455)	\$ (466)	\$ (4,921)
Balance January 1, 2017	\$504	\$ (289)	\$ 215
Other comprehensive income before reclassifications	2,200	-	2,200
Amounts reclassified from accumulated other comprehensive income	(277)	-	(277)
Net other comprehensive income during period	1,923	-	1,923
Balance September 30, 2017	\$2,427	\$ (289)	\$ 2,138

16. Affordable Housing Projects Tax Credit Partnership

The Company makes certain equity investments in various limited partnerships that sponsor affordable housing projects utilizing the Low Income Housing Tax Credit (“LIHTC”) pursuant to Section 42 of the Internal Revenue Code. The purpose of these investments is to achieve a satisfactory return on capital, to facilitate the sale of affordable housing product offerings, and to assist in achieving goals associated with the Community Reinvestment Act. The primary activities of the limited partnerships include the identification, development, and operation of multi-family housing that is leased to qualifying residential tenants. Generally, these types of investments are funded through a combination of debt and equity.

The Company is a limited partner in each LIHTC Partnership. A separate unrelated third party is the general partner. Each limited partnership is managed by the general partner, who exercises full control over the affairs of the limited partnership. The general partner has all the rights, powers and authority granted or permitted to be granted to a general

partner of a limited partnership. Duties entrusted to the general partner of each limited partnership include, but are not limited to: investment in operating companies, company expenditures, investment of excess funds, borrowing funds, employment of agents, disposition of fund property, prepayment and refinancing of liabilities, votes and consents, contract authority, disbursement of funds, accounting methods, tax elections, bank accounts, insurance, litigation, cash reserve, and use of working capital reserve funds. Except for limited rights granted to consent to certain transactions, the limited partner(s) may not participate in the operation, management, or control of the limited partnership's business, transact any business in the limited partnership's name or have any power to sign documents for or otherwise bind the limited partnership. In addition, the general partner may only be removed by the limited partner(s) in the event the general partner fails to comply with the terms of the agreement or is negligent in performing its duties.

The general partner of each limited partnership has both the power to direct the activities which most significantly affect the performance of each partnership and the obligation to absorb losses or the right to receive benefits that could be significant to the entities. Therefore, the Company has determined that it is not the primary beneficiary of any LIHTC partnership. In January of 2014, the FASB issued ASU 2014-01 "Accounting for Investments in Qualified Affordable Housing Projects." The pronouncement permitted reporting entities to make an accounting policy election to account for these investments using the proportional amortization method if certain conditions exist. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received, and will recognize the net investment performance in the statement of income as a component of income tax expense (benefit). The Company utilized the proportional amortization method for all of its instruments. As of September 30, 2018, and December 31, 2017, the Company had \$11.5 million and \$9.2 million in qualified investments recorded in other assets and \$7.2 million and \$6.2 million in unfunded commitments recorded in other liabilities, respectively.

Unfunded Commitments

As of September 30, 2018, the expected payments for unfunded affordable housing commitments were as follows:

(dollars in thousands)	Amount
2018	\$ 1,205
2019	1,917
2020	1,954
2021	467
2022	338
Thereafter	1,297
Total Unfunded Commitments	\$ 7,178

The following table presents tax credits and other tax benefits recognized and amortization expense related to affordable housing for the three and nine months ended September 30, 2018 and 2017.

(dollars in thousands)	Three Months Ended September 30,	
	2018	2017
Proportional Amortization Method		
Tax credits and other tax benefits recognized	\$276	\$218
Amortization expense in federal income taxes	234	173

	Nine Months Ended September 30,	
(dollars in thousands)	2018	2017
Proportional Amortization Method		
Tax credits and other tax benefits recognized	\$785	\$640
Amortization expense in federal income taxes	703	502

There were no impairment losses of LIHTC investments for the three and nine months ended September 30, 2018 and 2017.

17. Business Combinations

Effective February 24, 2017, the Company acquired Commercial Bancshares, Inc. (“Commercial Bancshares”) and its subsidiary, The Commercial Savings Bank (“CSB”), pursuant to an Agreement and Plan of Merger (“merger agreement”), dated August 23, 2016. The acquisition was accomplished by the merger of Commercial Bancshares into First Defiance, immediately followed by the merger of CSB into First Federal. CSB operated 7 full-service banking offices in northwest and north central, Ohio and 1 commercial loan production office in central Ohio. Commercial Bancshares’ consolidated assets and equity (unaudited) as of February 24, 2017, totaled \$348.4 million and \$37.5 million, respectively. The Company accounted for the transaction under the acquisition method of accounting which means that the acquired assets and liabilities were recorded at fair value at the date of acquisition. The fair value included in these financial statements is based on final valuations.

In accordance with ASC Topic 805, Business Combinations, the Company expensed approximately \$3.7 million of direct acquisition costs, of which \$2.8 million was to settle employment and benefit agreements and for personnel expenses related to operating the new Commercial Bancshares locations. The Company recorded \$28.9 million of goodwill and \$4.9 million of intangible assets. Goodwill represents the future economic benefits arising from net assets acquired that are not individually identified and separately recognized and is primarily attributable to synergies expected to be derived from the combination of the two entities. The acquisition was consistent with the Company’s strategy to enhance and expand its presence in northwestern and north central Ohio. The acquisition offers the Company the opportunity to increase profitability by introducing existing products and services to the acquired customer base as well as add new customers in the expanded market area. The intangible assets are related to core deposits and are being amortized over 10 years on an accelerated basis. For tax purposes, goodwill totaling \$28.9 million is non-deductible. Goodwill is evaluated annually for impairment. The following table summarizes the fair value of the total consideration transferred as part of the Commercial Bancshares acquisition as well as the fair value of identifiable assets and liabilities assumed as of the effective date of the transaction.

	February 24, 2017 (In Thousands)
Cash Consideration	\$ 12,340
Equity – Dollar Value of Issued Shares	56,532
Fair Value of Total Consideration Transferred	68,872
Recognized Amounts of Identifiable Assets Acquired and Liabilities Assumed:	
Cash and Cash Equivalents	35,411
Federal Funds Sold	2,769
Securities	4,338
Loans	285,448
FHLB Stock of Cincinnati and Other Stock	2,194
Office Properties and Equipment	5,256
Intangible Assets	4,900
Bank-Owned Life Insurance	8,168
Accrued Interest Receivable and Other Assets	3,606
Deposits – Non-Interest Bearing	(56,061)
Deposits – Interest Bearing	(251,931)
Advances from FHLB	(1,403)
Accrued Interest Payable and Other Liabilities	(2,717)
Total Identifiable Net Assets	39,978
Goodwill	\$ 28,894

Under the terms of the merger agreement, Commercial Bancshares common shareholders had the opportunity to elect to receive 2.3616 shares of common stock of the Company or cash in the amount of \$51.00 for each share of Commercial Bancshares common stock, subject to adjustment as provided for in the merger agreement. Total consideration for Commercial Bancshares common shares outstanding was paid 80% in Company stock and 20% in cash. The Company issued 2,279,004 shares of its common stock and paid \$12.3 million in cash to the former shareholders of Commercial Bancshares.

On April 13, 2017, First Defiance and Corporate One Benefits Agency, Inc. (“Corporate One”) jointly announced the acquisition of Corporate One’s business by First Defiance. The total purchase price paid in cash was made up of the following: \$6.5 million was paid at closing, \$500,000 was due and paid the second quarter of 2018, and up to \$2.3 million may be due at the end of a three-year earn-out based on the compound annual growth rate of net revenue over the performance period of Corporate One, for a total purchase price of \$9.3 million. The recorded fair value of the \$2.3 million earn-out was \$1.8 million at December 31, 2017. As of December 31, 2017, total Company recorded goodwill of \$7.9 million as well as identifiable intangible assets of \$756,000 consisting of a customer relationship intangible of \$564,000 and a non-compete intangible of \$192,000. The fair value included in these financial statements is based on final valuation. Corporate One was a full-service employee benefits consulting organization founded in 1996 with offices located in Archbold, Findlay, Fostoria and Tiffin, Ohio. Corporate One consulted

employers to better manage their employee benefit programs to effectively lead them into the future. It is anticipated that the transaction will enhance employee benefit offerings and expand First Insurance's presence into adjacent markets in northwest Ohio.

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

Forward-Looking Information

Certain statements contained in this quarterly report are not statements of historical facts, including but not limited to statements that can be identified by the use of forward-looking terminology such as “may”, “will”, “expect”, “anticipate”, or “continue” or the negative thereof or other variations thereon or comparable terminology, and are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Actual results could differ materially from those indicated in such statements due to risks, uncertainties and changes with respect to a variety of market and other factors. The Company assumes no obligation to update any forward-looking statements.

Non-GAAP Financial Measures

This document contains GAAP financial measures and certain non-GAAP financial measures which are presented as management believes they are helpful in understanding the Company’s results of operations or financial position. Fully taxable-equivalent (“FTE”) is an adjustment to net interest income to reflect tax-exempt income on an equivalent before-tax basis. The following tables present a reconciliation of non-GAAP measures to their respective GAAP measures for the three and nine months ended September 30, 2018 and 2017.

Non-GAAP Financial Measures – Net Interest Income on an FTE basis, Net Interest Margin and Efficiency Ratio

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In Thousands)			
Net interest income (GAAP)	\$27,529	\$25,007	\$79,763	\$71,284
Add: FTE adjustment	257	476	746	1,432
Net interest income on a FTE basis (1)	\$27,786	\$25,483	\$80,509	\$72,716
Non-interest income-less securities gains/losses (2)	9,846	9,337	30,763	29,759
Non-interest expense (3)	22,286	20,440	68,202	64,211
Average interest-earning assets net of average Unrealized gains/losses on securities (4)	2,757,967	2,585,980	2,713,659	2,508,254

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Average interest-earning assets	2,754,561	2,590,463	2,710,998	2,511,469
Average unrealized gains/losses on securities	(3,406)	4,483	(2,661)	3,215

Ratios:

Net interest margin (1) / (4)	4.00	%	3.91	%	3.97	%	3.88	%
Efficiency ratio (3) / (1) + (2)	59.22	%	58.70	%	61.29	%	62.66	%

Critical Accounting Policies

First Defiance has established various accounting policies which govern the application of GAAP in the preparation of its financial statements. The significant accounting policies of First Defiance are described in the footnotes to the consolidated financial statements included in the Company's 2017 Form 10-K. Certain accounting policies involve significant judgments and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. Those policies which are identified and discussed in detail in the Company's 2017 Form 10-K include the Allowance for Loan Losses, Goodwill, and the Valuation of Mortgage Servicing Rights. There have been no material changes in assumptions or judgments relative to those critical policies during the first nine months of 2018.

General

First Defiance Financial Corp. ("First Defiance" or the "Company") is a unitary thrift holding company that conducts business through its wholly owned subsidiaries, First Federal Bank of the Midwest ("First Federal"), First Insurance Group of the Midwest, Inc. ("First Insurance") and First Defiance Risk Management Inc. ("First Defiance Risk Management").

On June 22, 2018, the Company announced a stock split in the form of a share distribution of one common share for each of the Company's authorized and outstanding common shares. The stock split was distributed on July 12, 2018, to shareholders of record as of July 2, 2018. All share and per share data in this Quarterly Report on Form 10-Q has been adjusted and is reflective of the stock split.

First Federal is a federally chartered stock savings bank headquartered in Defiance, Ohio. It conducts operations through thirty-six full-service banking center offices in Allen, Defiance, Fulton, Hancock, Henry, Lucas, Marion, Ottawa, Paulding, Putnam, Seneca, Williams, Wood, and Wyandot counties in northwest and central Ohio, three full-service banking center offices in Allen County in northeast Indiana, five full-service banking center offices in Lenawee County in southeast Michigan and one commercial loan production office in Ann Arbor, Michigan that was opened late in the fourth quarter of 2017.

First Federal provides a broad range of financial services including checking accounts, savings accounts, certificates of deposit, real estate mortgage loans, commercial loans, consumer loans, home equity loans and trust and wealth management services through its extensive branch network.

First Insurance is a wholly owned subsidiary of First Defiance. First Insurance is an insurance agency that conducts business through offices located in the Archbold, Bowling Green, Bryan, Defiance, Findlay, Fostoria, Lima, Sylvania, and Tiffin, Ohio areas. The Maumee and Oregon offices were consolidated into a new office in Sylvania, Ohio in January 2018. First Insurance offers property and casualty insurance, life insurance and group health insurance.

First Defiance Risk Management is a wholly owned insurance company subsidiary of the Company to insure the Company and its subsidiaries against certain risks unique to the operations of the Company and for which insurance may not be currently available or economically feasible in today's insurance marketplace. First Defiance Risk Management pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves. First Defiance Risk Management was incorporated on December 20, 2012.

Regulation - First Defiance is subject to regulation, examination and oversight by the Federal Reserve Board (“Federal Reserve”). First Federal is subject to regulation, examination and oversight by the Office of the Comptroller of the Currency (“OCC”). Because the Federal Deposit Insurance Corporation (“FDIC”) insures First Federal’s deposits, First Federal is also subject to examination and regulation by the FDIC. In addition, First Federal is subject to regulations of the Consumer Financial Protection Bureau (the “CFPB”), which was established by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and has broad powers to adopt and enforce consumer protection regulations. First Defiance and First Federal must file periodic reports with the Federal Reserve and the OCC, and examinations are conducted periodically by the Federal Reserve, the OCC and the FDIC to determine whether First Defiance and First Federal are in compliance with various regulatory requirements and are operating in a safe and sound manner.

First Defiance is also subject to various Ohio laws that restrict takeover bids, tender offers and control-share acquisitions involving public companies that have significant ties to Ohio.

Regulatory Capital Requirements - The federal banking regulators have adopted risk-based capital guidelines for financial institutions and their holding companies, designed to absorb losses. The guidelines provide a systematic analytical framework, which makes regulatory capital requirements sensitive to differences in risk profiles among banking organizations, takes off-balance sheet exposures expressly into account in evaluating capital adequacy and minimizes disincentives to holding liquid, low-risk assets. Capital levels as measured by these standards are also used to categorize financial institutions for purposes of certain prompt corrective action regulatory provisions.

In July 2013, the United States banking regulators issued final new capital rules applicable to smaller banking organizations which also implement certain provisions of the Dodd-Frank Act. The new minimum capital requirements became effective on January 1, 2015, whereas a new capital conservation buffer and deductions from common equity capital phase in from January 1, 2016, through January 1, 2019, and most deductions from common equity tier 1 capital are being phased in from January 1, 2015, through January 1, 2019.

The rules include (a) a minimum common equity Tier 1 (“CET1”) capital ratio of 4.5%, (b) a minimum Tier 1 capital ratio of 6.0%, (c) a minimum total capital ratio of 8.0%, and (d) a minimum leverage ratio of 4%.

Common equity for the CET1 capital ratio includes common stock (plus related surplus) and retained earnings, plus limited amounts of minority interests in the form of common stock, less the majority of certain regulatory deductions.

Tier 1 capital includes common equity as defined for the CET1 capital ratio, plus certain non-cumulative preferred stock and related surplus, cumulative preferred stock and related surplus and trust preferred securities that have been

grandfathered (but which are not permitted going forward), and limited amounts of minority interests in the form of additional Tier 1 capital instruments, less certain deductions.

Tier 2 capital, which can be included in the total capital ratio, includes certain capital instruments (such as subordinated debt) and limited amounts of the allowance for loan and lease losses (“ALLL”), subject to new eligibility criteria, less applicable deductions.

The deductions from CET1 capital include goodwill and other intangibles, certain deferred tax assets, mortgage-servicing assets above certain levels, gains on sale in connection with a securitization, investments in a banking organization’s own capital instruments and investments in the capital of unconsolidated financial institutions (above certain levels).

Under the guidelines, capital is compared to the relative risk related to the balance sheet. To derive the risk included in the balance sheet, one of several risk weights is applied to different balance sheet and off-balance sheet assets, primarily based on the relative credit risk of the counterparty. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The rules also place restrictions on the payment of capital distributions, including dividends, and certain discretionary bonus payments to executive officers if the company does not hold a capital conservation buffer of greater than 2.5% composed of CET1 capital above its minimum risk-based capital requirements, or if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% at the beginning of the quarter. The capital conservation buffer phases in through January 1, 2019, and is currently 1.875%.

The federal banking agencies have established a system of “prompt corrective action” to resolve certain problems of undercapitalized banks. This system is based on five capital level categories for insured depository institutions: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “critically undercapitalized.” The federal banking agencies may (or in some cases must) take certain supervisory actions depending upon a bank’s capital level. For example, the banking agencies must appoint a receiver or conservator for a bank within 90 days after it becomes “critically undercapitalized” unless the bank’s primary regulator determines, with the concurrence of the FDIC, that other action would better achieve regulatory purposes. Banking operations otherwise may be significantly affected depending on a bank’s capital category. For example, a bank that is not “well capitalized” generally is prohibited from accepting brokered deposits and offering interest rates on deposits higher than the prevailing rate in its market, and the holding company of any undercapitalized depository institution must guarantee, in part, specific aspects of the bank’s capital plan for the plan to be acceptable.

Effective January 1, 2015, in order to be “well-capitalized,” a financial institution must have a CET1 capital ratio of 6.5%, a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital of at least 8% and a leverage ratio of at least 5%, and the institution must not be subject to any written agreement, order, capital directive or prompt corrective action directive to meet and maintain a specific capital level for any capital measure. As of September 30, 2018, First Federal met the ratio requirements in effect to be deemed “well-capitalized.”

Deposit Insurance - The FDIC maintains the Depositors Insurance Fund (“DIF”), which insures the deposit accounts of First Federal to the maximum amount provided by law. The general insurance limit is \$250,000 per separately insured depositor. This insurance is backed by the full faith and credit of the United States government.

The FDIC assesses deposit insurance premiums on each insured institution quarterly based on risk characteristics of the institution. The FDIC may also impose a special assessment in an emergency situation.

Pursuant to the Dodd-Frank Act, the FDIC has established 2.0% as the designated reserve ratio (“DRR”), which is the ratio of the DIF to insured deposits of the total industry. In March 2016, the FDIC adopted final rules designed to meet the statutory minimum DRR of 1.35% by September 30, 2020, the deadline imposed by the Dodd-Frank Act. The Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets of less than \$10 billion of the increase in the statutory minimum DRR to 1.35% from the former statutory minimum of 1.15%. The FDIC’s rules reduced assessment rates on all banks but imposed a surcharge on banks with assets of \$10 billion or more until the DRR reaches 1.35% and provide assessment credits to banks with assets of less than \$10 billion for the portion of their assessments that contribute to the increase of the DRR to 1.35%. The rules also changed the method to determine risk-based assessment rates for established banks with less than \$10 billion in assets to better ensure that banks taking on greater risks pay more for deposit insurance than less risky banks.

In addition, all institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by the Financing Corporation, a mixed-ownership government corporation established to recapitalize a predecessor to the DIF. These assessments will continue until the Financing Corporation bonds mature in 2019.

As insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, federally-insured institutions. It also may prohibit any federally-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to take enforcement actions against insured institutions. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged or is engaging in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or written agreement entered into with the FDIC.

Business Strategy - First Defiance’s primary objective is to be a high-performing community focused financial institution, well regarded in its market areas. First Defiance accomplishes this through emphasis on local decision making and empowering its employees with tools and knowledge to serve its customers’ needs. First Defiance believes in a “Customer First” philosophy that is strengthened by its Trusted Advisor initiative. First Defiance also has a tagline of “Better Together” as an indication of its commitment to local, responsive, personalized service. First Defiance believes this strategy results in greater customer loyalty and profitability through core relationships. First Defiance is focused on diversification of revenue sources and increased market penetration in areas where the growth potential exists for a balance between acquisition and organic growth. The primary elements of First Defiance’s business strategy are commercial banking, consumer banking, including the origination and sale of single-family residential loans, enhancement of fee income, wealth management and insurance sales, each united by a strong customer service culture throughout the organization.

Commercial and Commercial Real Estate Lending - Commercial and commercial real estate lending have been an ongoing focus and a major component of First Federal's success. First Federal provides primarily commercial real estate and commercial business loans with an emphasis on owner-occupied commercial real estate and commercial business lending, including a focus on the deposit balances that accompany these relationships. First Federal's client base tends to be small to middle market customers with annual gross revenues generally between \$1 million and \$50 million. First Federal's focus is also on securing multiple guarantors in addition to collateral where possible. These customers require First Federal to have a high degree of knowledge and understanding of their business in order to provide them with solutions to meet their financial needs. First Federal's "Customer First" philosophy and culture complements this need of its clients. First Federal believes this personal service model differentiates First Federal from its competitors, particularly the larger regional institutions. First Federal offers a wide variety of products to support commercial clients including remote deposit capture and other cash management services. First Federal also believes that the small business customer is a strong market for First Federal. First Federal participates in many of the Small Business Administration ("SBA") lending programs and implemented a program targeting the small business customer. Maintaining a diversified portfolio with an emphasis on monitoring industry concentrations and reacting to changes in the credit characteristics of industries is an ongoing focus.

Consumer Banking - First Federal offers customers a full range of deposit and investment products including demand, checking, money market, certificates of deposits, Certificate of Deposit Account Registry Service ("CDARS") and savings accounts. First Federal offers a full range of investment products through the wealth management department and a wide variety of consumer loan products, including residential mortgage loans, home equity loans, and installment loans. First Federal also offers online banking services, which include mobile banking, People Pay ("P2P") and online bill pay.

Fee Income Development - Generation of fee income and the diversification of revenue sources are accomplished through the mortgage banking operation, First Insurance and the wealth management department as First Defiance seeks to reduce reliance on retail transaction fee income.

Deposit Growth - First Federal's focus has been to grow core deposits with an emphasis on total relationship banking with both our retail and commercial customers. First Federal has initiated a pricing strategy that considers the whole relationship of the customer. First Federal will continue to focus on increasing its market share in the communities it serves by providing quality products with extraordinary customer service, business development strategies and branch expansion. First Federal will look to grow its footprint in areas believed to further complement its overall market share and complement its strategy of being a high-performing community bank.

Asset Quality - Maintaining a strong credit culture is of the utmost importance to First Federal. First Federal has maintained a strong credit approval and review process that has allowed the Company to maintain a credit quality standard that balances the return with the risks of industry concentrations and loan types. First Federal is primarily a collateral lender with an emphasis on cash flow performance, while obtaining additional support from personal guarantees and secondary sources of repayment. First Federal has directed its attention to loan types and markets that

it knows well and in which it has historically been successful. First Federal strives to have loan relationships that are well diversified in both size and industry, and monitors the overall trends in the portfolio to maintain its industry and loan type concentration targets. First Federal maintains a problem loan remediation process that focuses on detection and resolution. First Federal maintains a strong process of internal control that subjects the loan portfolio to periodic internal reviews as well as independent third-party loan review.

Expansion Opportunities - First Defiance believes it is well positioned to take advantage of acquisitions or other business expansion opportunities in its market areas. First Defiance believes it has a track record of successfully accomplishing both acquisitions and de novo branching in its market area. This track record puts the Company in a solid position to enter or expand its business. First Defiance will continue to be disciplined as well as opportunistic in its approach to future acquisitions and de novo branching with a focus on its primary geographic market area, which it knows well, and has been competing in for a long period of time, as well as surrounding market areas.

Investments - First Defiance invests in U.S. Treasury and federal government agency obligations, obligations of municipal and other political subdivisions, mortgage-backed securities which are issued by federal agencies, corporate bonds, and collateralized mortgage obligations (“CMOs”) and real estate mortgage investment conduits (“REMICs”). Management determines the appropriate classification of all such securities at the time of purchase in accordance with FASB ASC Topic 320, Investments –Debt and Equity Securities.

Securities are classified as held-to-maturity when First Defiance has the positive intent and ability to hold the security to maturity. Held-to-maturity securities are stated at amortized cost and had a recorded value of \$603,000 at September 30, 2018. Securities not classified as held-to-maturity are classified as available-for-sale, which are stated at fair value and had a recorded value of \$283.0 million at September 30, 2018. The available-for-sale portfolio included obligations of U.S. federal government corporations and agencies (\$2.5 million), certain municipal obligations (\$100.2 million), CMOs/REMICs (\$100.8 million), corporate bonds (\$13.1 million), and mortgage backed securities (\$66.5 million).

In accordance with ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income.

Lending - In order to properly assess the collateral dependent loans included in its loan portfolio, the Company has established policies regarding the monitoring of the collateral underlying such loans. The Company requires an appraisal that is less than one year old for all new collateral dependent real estate loans, and all renewed collateral dependent real estate loans where significant new money is extended. The appraisal process is handled by the Company’s Credit Department, which selects the appraiser and orders the appraisal. First Defiance’s loan policy prohibits the account officer from talking or communicating with the appraiser to ensure that the appraiser is not influenced by the account officer in any way in making their determination of value.

First Federal generally does not require updated appraisals for performing loans unless significant new money is requested by the borrower.

When a collateral dependent loan is downgraded to classified status, First Federal reviews the most current appraisal on file and, if necessary, based on First Federal's assessment of the appraisal, such as age, market, etc., First Federal will discount this amount to a more appropriate current value based on inputs from lenders and realtors. This amount may then be discounted further by First Federal's estimation of the carrying and selling costs. In most instances, if the appraisal is more than twelve to fifteen months old, a new appraisal may be required. Finally, First Federal assesses whether there is any collateral short fall, taking into consideration guarantor support and liquidity, and determines if a charge off is necessary.

When a collateral dependent loan moves to non-performing status, First Federal generally gets a new third party appraisal and charges the loan down appropriately based upon the new appraisal and an estimate of costs to liquidate the collateral. All properties that are moved into the Other Real Estate Owned ("OREO") category are supported by current appraisals, and the OREO is carried at the lower of cost or fair value, which is determined based on appraised value less First Federal's estimate of the liquidation costs.

First Federal does not adjust any appraisals upward without written documentation of this valuation change from the appraiser. When setting reserves and charge-offs on classified loans, appraisal values may be discounted downward based upon First Federal's experience with liquidating similar properties.

All loans over 90 days past due and/or on non-accrual are classified as non-performing loans. Non-performing status automatically occurs in the month in which the 90 day delinquency occurs.

As stated above, once a collateral dependent loan is identified as non-performing, First Federal generally gets an appraisal.

Appraisals are received within approximately 60 days after they are requested. The First Federal Loan Loss Reserve Committee reviews the amount of each new appraisal and makes any necessary charge-off decisions at its meeting prior to the end of each quarter.

Any partially charged-off collateral dependent loans are considered non-performing, and as such, would need to show an extended period of time with satisfactory payment performance as well as cash flow coverage capability supported by current financial statements before First Federal will consider an upgrade to performing status. First Federal may consider moving the loan to accruing status after approximately six months of satisfactory payment performance.

For loans where First Federal determines that an updated appraisal is not necessary, other means are used to verify the value of the real estate, such as recent sales of similar properties on which First Federal had loans as well as calls to appraisers, brokers, realtors and investors. First Federal monitors and tracks its loan to value quarterly to determine accuracy and any necessary charge-offs. Based on these results, changes may occur in the processes used.

Loan modifications constitute a troubled debt restructuring (“TDR”) if First Federal for economic or legal reasons related to the borrower’s financial difficulties grants a concession to the borrower that it would not otherwise consider. For loans that are considered TDRs, First Federal either computes the present value of expected future cash flows discounted at the original loan’s effective interest rate or it may measure impairment based on the fair value of the collateral. For those loans measured for impairment utilizing the present value of future cash flows method, any discount is carried as a reserve in the ALLL. For those loans measured for impairment utilizing the fair value of the collateral, any shortfall is charged off.

Earnings - The profitability of First Defiance is primarily dependent on its net interest income and non-interest income. Net interest income is the difference between interest income on interest-earning assets, principally loans and securities, and interest expense on interest-bearing deposits, Federal Home Loan Bank of Cincinnati (“FHLB”) advances, and other borrowings. The Company’s non-interest income is mainly derived from service fees and other charges, mortgage banking income, and insurance commissions. First Defiance’s earnings also depend on the provision for loan losses, non-interest expenses (such as employee compensation and benefits, occupancy and equipment expense, deposit insurance premiums, and miscellaneous other expenses) and federal income tax expense.

Changes in Financial Condition

At September 30, 2018, First Defiance's total assets, deposits and stockholders’ equity amounted to \$3.10 billion, \$2.52 billion and \$393.5 million, respectively, compared to \$2.99 billion, \$2.44 billion and \$373.3 million, respectively, at December 31, 2017.

Net loans receivable (excluding loans held for sale) increased \$106.7 million to \$2.43 billion. The variance in loans receivable between September 30, 2018, and December 31, 2017 includes an increase of \$126.3 million in commercial real estate loans, \$38.4 million in residential real estate loans, and \$3.3 million increase in consumer loans. That growth was partially offset by a \$18.4 million decrease in construction loans, a \$36.7 decrease in commercial loans, and a \$6.2 million decrease in home equity and improvement loans.

The investment securities portfolio increased \$22.3 million to \$283.6 million at September 30, 2018 from \$261.3 million at December 31, 2017. The increase is mainly a result of \$51.5 million of securities being purchased during the period. This was offset by \$19.9 million of securities maturing or being called in the period, \$1.9 million in the sale of securities and \$0.9 million in amortization. Lastly, there was a \$6.6 million decrease in the market value of available-for-sale securities during the period ended September 30, 2018.

Deposits increased from \$2.44 billion at December 31, 2017, to \$2.52 billion as of September 30, 2018. Interest bearing demand and money market deposits increased \$10.8 million to \$1.02 billion and retail time deposits increased \$99.7 million to \$658.5 million. Non-interest bearing demand deposits decreased \$15.0 million to \$556.3 million and savings deposits decreased \$8.7 million to \$293.4 million.

Stockholders' equity increased from \$373.3 million at December 31, 2017, to \$393.5 million at September 30, 2018. The increase in stockholders' equity was primarily the result of recording net income of \$34.2 million. This was offset by \$9.6 million of common stock dividends being paid in the first nine months of 2018 and \$5.2 million other comprehensive loss.

Average Balances, Net Interest Income and Yields Earned and Rates Paid

The following table presents for the periods indicated the total dollar amount of interest from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in thousands of dollars and rates, and the net interest margin. The table reports interest income from tax-exempt loans and investment on a fully tax-equivalent basis. All average balances are based upon daily balances (dollars in thousands).

	Three Months Ended September 30,						
	2018			2017			
	Average Balance	Interest(1)	Yield/ Rate(2)		Average Balance	Interest(1)	Yield/ Rate(2)
Interest-earning assets:							
Loans receivable	\$2,403,932	\$ 29,397	4.85 %		\$2,251,071	\$ 26,025	4.59 %
Securities (3)	286,507	2,308	3.16		259,310	2,114	3.29
Interest bearing deposits	49,734	275	2.19		64,090	209	1.29
FHLB stock	14,388	240	6.62		15,992	209	5.18
Total interest-earning assets	2,754,561	32,220	4.63		2,590,463	28,557	4.38
Non-interest-earning assets	304,664				316,332		
Total assets	\$3,059,225				\$2,906,795		
Interest-bearing liabilities:							
Deposits	\$1,955,518	\$ 3,753	0.76 %		\$1,818,670	\$ 2,391	0.52 %
FHLB advances and other	77,719	342	1.75		104,648	431	1.63
Subordinated debentures	36,196	334	3.66		36,158	239	2.62
Securities sold under repurchase agreements	5,431	5	0.37		28,182	13	0.18
Total interest-bearing liabilities	2,074,864	4,434	0.85		1,987,658	3,074	0.61
Non-interest bearing deposits	558,190	-			520,147	-	
Total including non-interest bearing demand deposits	2,633,054	4,434	0.67		2,507,805	3,074	0.49
Other non-interest-bearing liabilities	36,810				35,378		
Total liabilities	2,669,864				2,543,183		
Stockholders' equity	389,361				363,612		
Total liabilities and stock- holders' equity	\$3,059,225				\$2,906,795		
Net interest income; interest rate spread		\$ 27,786	3.78 %			\$ 25,483	3.77 %
Net interest margin (4)			4.00 %				3.91 %
Average interest-earning assets to average interest-bearing liabilities			133 %				130 %

- Interest on certain tax-exempt loans and securities is not taxable for federal income tax purposes. In order to
- (1) compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a pre-tax equivalent amount based on the marginal corporate federal income tax rate of 21% for the period in 2018 and 35% for the period in 2017.
 - (2) Annualized
 - (3) Securities yield is annualized interest income divided by the average balance of securities, excluding average unrealized gains/losses. See Non-GAAP Financial Measure discussion for further details.
 - (4) Net interest margin is net interest income divided by average interest-earning assets. See Non-GAAP Financial Measure discussion for further details.

	Nine Months Ended September 30,					
	2018			2017		
	Average	Yield/		Average	Yield/	
	Balance	Interest	Rate	Balance	Interest	Rate
		(1)	(2)		(1)	(2)
Interest-earning assets:						
Loans receivable	\$2,352,514	\$83,633	4.75 %	\$2,171,733	\$73,415	4.52 %
Securities (3)	276,745	6,637	3.21	257,924	6,475	3.40
Interest bearing deposits	66,283	945	1.91	66,299	555	1.12
FHLB stock	15,456	698	6.04	15,513	562	4.84
Total interest-earning assets	2,710,998	91,913	4.53	2,511,469	81,007	4.32
Non-interest-earning assets	307,634			301,091		
Total assets	\$3,018,632			\$2,812,560		
Interest-bearing liabilities:						
Deposits	\$1,925,972	\$9,508	0.66 %	\$1,743,769	\$6,357	0.49 %
FHLB advances	74,634	943	1.69	104,616	1,211	1.55
Subordinated debentures	36,195	934	3.45	36,155	682	2.51
Securities sold under repurchase agreements	10,185	19	0.25	27,484	41	0.20
Total interest-bearing liabilities	2,046,986	11,404	0.74	1,912,024	8,291	0.58
Non-interest bearing deposits	552,554	-		521,161	-	
Total including non-interest bearing demand deposits	2,599,540	11,404	0.59	2,433,185	8,291	0.46
Other non-interest-bearing liabilities	37,586			34,183		
Total liabilities	2,637,126			2,467,368		
Stockholders' equity	381,506			345,192		
Total liabilities and stock-holders' equity	\$3,018,632			\$2,812,560		
Net interest income; interest rate spread		\$80,509	3.79 %		\$72,716	3.74 %
Net interest margin (4)			3.97 %			3.88 %
Average interest-earning assets to average interest-bearing liabilities			132 %			131 %

Interest on certain tax-exempt loans and securities is not taxable for Federal income tax purposes. In order to compare the tax-exempt yields on these assets to taxable yields, the interest earned on these assets is adjusted to a pre-tax equivalent amount based on the marginal corporate federal income tax rate of 21% for the period in 2018 and 35% for the period in 2017.

(2) Annualized

(3) Securities yield is annualized interest income divided by the average balance of securities, excluding average unrealized gains/losses. See Non-GAAP Financial Measure discussion for further details.

(4) Net interest margin is net interest income divided by average interest-earning assets. See Non-GAAP Financial Measure discussion for further details.

Results of Operations

Three Months Ended September 30, 2018 and 2017

On a consolidated basis, First Defiance's net income for the quarter ended September 30, 2018, was \$11.3 million compared to net income of \$9.4 million for the comparable period in 2017. On a per share basis, basic and diluted earnings per common share for the three months ended September 30, 2018, were both \$0.55, compared to basic and diluted earnings per common share of \$0.46 for the quarter ended September 30, 2017.

Net Interest Income

First Defiance's net interest income is determined by its interest rate spread (i.e., the difference between the yields on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities.

Net interest income was \$27.5 million for the quarter ended September 30, 2018, up from \$25.0 million for the same period in 2017. The tax-equivalent net interest margin was 4.00% for the quarter ended September 30, 2018, an increase from 3.91% for the same period in 2017. The increase in margin between the 2018 and 2017 third quarters was primarily a result of the rate hikes over the past year coupled with growth on interest-earning assets outpacing growth of interest-bearing liabilities. The yield on interest-earning assets was 4.63% for the quarter ended September 30, 2018, up 25 basis points from 4.38% for the same period in 2017. The cost of interest-bearing liabilities between the two periods increased 24 basis points to 0.85% in the third quarter of 2018 from 0.61% in the same period in 2017.

Total interest income increased \$3.9 million to \$32.0 million for the quarter ended September 30, 2018, from \$28.1 million for the quarter ended September 30, 2017. This was primarily due to continued loan growth and an increase in interest rates. Income from loans increased to \$29.4 million for the quarter ended September 30, 2018, compared to \$26.0 million for the same period in 2017 due to average loan growth of \$152.9 million. The increase in the loan portfolio yield to 4.85% at September 30, 2018 from 4.59% at September 30, 2017, was due mainly to increasing interest rates. The investment interest income increased \$389,000 in the third quarter of 2018 to \$2.1 million; however, the yield dropped 13 basis points to 3.16% at September 30, 2018, compared to 3.29% at September 30, 2017. The decline in investment yield is primarily attributable to the reinvestment of matured securities at lower yields. Income from interest-bearing deposits and FHLB stock increased to \$275,000 and \$240,000, respectively, in the third quarter of 2018 compared to \$209,000 and \$209,000 for the same period in 2017 due to increased interest rates.

Interest expense increased by \$1.3 million in the third quarter of 2018 compared to the same period in 2017, to \$4.4 million from \$3.1 million. The cost of interest-bearing liabilities increased 24 basis points from 0.61% at September 30, 2017 to 0.85% at September 30, 2018. Interest expense related to interest-bearing deposits was \$3.8 million in the third quarter of 2018 compared to \$2.4 million for the same period in 2017. Interest expense recognized by the Company related to FHLB advances was \$342,000 in the third quarter of 2018 compared to \$431,000 for the same period in 2017 as decreased volumes offset the increase in interest rates. Expenses on subordinated debentures and notes payable were \$334,000 and \$5,000, respectively, in the third quarter of 2018 compared to \$239,000 and \$13,000 respectively for the same period in 2017.

Allowance for Loan and Lease Losses (“ALLL”)

The ALLL represents management’s assessment of the estimated probable incurred credit losses in the loan portfolio at each balance sheet date. Management analyzes the adequacy of the ALLL regularly through reviews of the loan portfolio. Consideration is given to economic conditions, changes in interest rates and the effect of such changes on collateral values and borrower’s ability to pay, changes in the composition of the loan portfolio and trends in past due and non-performing loan balances. The ALLL is a material estimate that is susceptible to significant fluctuation and is established through a provision for loan losses based on management’s evaluation of the inherent risk in the loan portfolio. In addition to extensive in-house loan monitoring procedures, the Company utilizes an outside party to conduct an independent loan review of commercial loan and commercial real estate loan relationships. The Company’s goal is to have approximately 55% to 60% of the portfolio reviewed annually. This includes all relationships over \$5.0 million with new exposure greater than \$2.0 million and a sample of other relationships greater than \$5.0 million; loan relationships between \$1.0 million and \$5.0 million with new exposure greater than \$750,000 and a sample of other relationships between \$1.0 million and \$5.0 million; and a sample of relationships less than \$1.0 million. Management utilizes the results of this outside loan review to assess the effectiveness of its internal loan grading system as well as to assist in the assessment of the overall adequacy of the ALLL associated with these types of loans.

The ALLL is made up of two basic components. The first component of the allowance for loan loss is the specific reserve in which the Company sets aside reserves based on the analysis of individual impaired credits. In establishing specific reserves, the Company analyzes all substandard, doubtful and loss graded loans quarterly and makes judgments about the risk of loss based on the cash flow of the borrower, the value of any collateral and the financial strength of any guarantors. If the loan is impaired and cash flow dependent, then a specific reserve is established for the discount on the net present value of expected future cash flows. If the loan is impaired and collateral dependent, then any shortfall is usually charged off. The Company also considers the impacts of any SBA or Farm Service Agency (“FSA”) guarantees. The specific reserve portion of the ALLL was \$662,000 at September 30, 2018, and \$758,000 at December 31, 2017.

The second component is a general reserve, which is used to record loan loss reserves for groups of homogenous loans in which the Company estimates the potential losses incurred in the portfolio based on quantitative and qualitative factors. For purposes of the general reserve analysis, the loan portfolio is stratified into nine different loan pools based on loan type to allocate historic loss experience. The loss experience factor is then applied to the non-impaired loan portfolio. The Company utilizes a loss migration measurement for each loan portfolio segment with differentiation between loan risk grades in calculating the general reserve component for non-impaired loans. The Company’s historical loss calculation uses an average of all four-year loss migration periods to the present beginning with data from the second quarter 2011. Management believes this provides a precise calculation of historical losses by incorporating more data points for the average loss ratio and including periods that provide a more complete coverage of the full business cycle. Management believes that capturing the risk grade changes and cumulative losses over the life cycle of a loan more accurately depicts management’s estimate of historical losses as well as being more reflective of the ongoing risks in the loan portfolio.

The quantitative general allowance increased \$100,000 to \$6.1 million at September 30, 2018, from \$6.0 million at December 31, 2017.

In addition to the quantitative analysis, a qualitative analysis is performed each quarter to provide additional general reserves on the non-impaired loan portfolio for various factors. The overall qualitative factors are based on nine sub-factors. The nine sub-factors have been aggregated into three qualitative factors: economic, environment and risk.

ECONOMIC

- 1) Changes in international, national and local economic business conditions and developments, including the condition of various market segments.
- 2) Changes in the value of underlying collateral for collateral dependent loans.

ENVIRONMENT

- 3) Changes in the nature and volume in the loan portfolio.
- 4) The existence and effect of any concentrations of credit and changes in the level of such concentrations.
- 5) Changes in lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices.
- 6) Changes in the quality and breadth of the loan review process.
- 7) Changes in the experience, ability and depth of lending management and staff.

RISK

- 8) Changes in the trends of the volume and severity of delinquent and classified loans, and changes in the volume of non-accrual loans, TDRs, and other loan modifications.
- 9) Changes in the political and regulatory environment.

The qualitative analysis at September 30, 2018, indicated a general reserve of \$20.9 million compared with \$20.0 million at December 31, 2017, an increase of \$900,000. Management reviewed the overall economic, environmental and risk factors and determined that it was appropriate to make adjustments to these sub-factors based on that review.

The economic factors for all loan segments decreased in the first nine months of 2018 due to strengthening trends in the U.S. economy particularly unemployment rates which decreased in all markets.

The environmental factors for all loan segments, but particularly the commercial real estate and commercial loan segments increased in the first nine months of 2018 due to an increase in credit concentrations and an increase in the mix of lending in First Federal's defined metro markets.

The risk factors for all loan segments, but particularly the commercial loan segment, were decreased in the first nine months of 2018 due to favorable trends in the levels of non-performing loans and classified assets.

First Defiance's general reserve percentages for main loan segments not otherwise classified ranged from 0.47% for construction loans to 1.51% for home equity and improvement loans at September 30, 2018.

As a result of the quantitative and qualitative analyses, along with the change in specific reserves and the increase in net charge-offs in the quarter, the Company's provision for loan losses for the third quarter of 2018 was \$1.4 million compared to \$462,000 for the same period in 2017. The ALLL was \$27.6 million at September 30, 2018 and \$26.7 million at December 31, 2017. The allowance for loans losses represented 1.13% of loans, net of undisbursed loan funds and deferred fees and costs, at September 30, 2018 and 1.14% at December 31, 2017. In management's opinion, the overall ALLL of \$27.6 million as of September 30, 2018, is adequate to cover probable incurred losses.

Management also assesses the value of real estate owned as of the end of each accounting period and recognizes write-downs to the value of that real estate in the income statement if conditions dictate. In the three and nine month periods ended September 30, 2018, there were \$8,000 and \$552,000, respectively of write-downs of real estate held for sale. Management believes that the values recorded at September 30, 2018, for real estate owned and repossessed assets represent the realizable value of such assets.

Total classified loans decreased to \$51.9 million at September 30, 2018, compared to \$59.4 million at December 31, 2017, a decrease of \$7.5 million due to payoffs and an upgrade of a classified relationship during the second quarter.

First Defiance's ratio of ALLL to non-performing loans was 132.1% at September 30, 2018, compared with 86.9% at December 31, 2017. Management monitors collateral values of all loans included on the watch list that are collateral dependent and believes that allowances for those loans at September 30, 2018, are appropriate. Of the \$20.9 million in non-accrual loans at September 30, 2018, \$12.2 million or 58.2% are less than 90 days past due.

At September 30, 2018, First Defiance had total non-performing assets of \$22.6 million, compared to \$32.2 million at December 31, 2017. Non-performing assets include loans that are on non-accrual, OREO and other assets held for sale. Non-performing assets at September 30, 2018, and December 31, 2017, by category were as follows:

Table 1 – Nonperforming Asset

	September 30, 2018	December 31, 2017		
	(In Thousands)			
Non-performing loans:				
One to four family residential real estate	\$3,512	\$ 3,037		
Non-residential and multi-family residential real estate	11,692	18,219		
Commercial	5,129	8,841		
Construction	-	-		
Home equity and improvement	562	590		
Consumer finance	34	28		
Total non-performing loans	20,929	30,715		
Real estate owned	1,676	1,532		
Total repossessed assets	\$1,676	1,532		
Total Nonperforming assets	\$22,605	\$ 32,247		
TDR loans, accruing	\$12,611	\$ 13,770		
Total nonperforming assets as a percentage of total assets	0.73	%	1.08	%
Total nonperforming loans as a percentage of total loans*	0.85	%	1.31	%
Total nonperforming assets as a percentage of total loans plus REO*	0.92	%	1.37	%
ALLL as a percent of total nonperforming assets	122.27	%	82.75	%

* Total loans are net of undisbursed loan funds and deferred fees and costs.

Non-performing loans in the commercial loan category represented 1.05% of the total loans in that category at September 30, 2018, compared to 1.68% for the same category at December 31, 2017. Non-performing loans in the non-residential and multi-family residential real estate loan category were 0.86% of the total loans in this category at September 30, 2018, compared to 1.47% at December 31, 2017. Non-performing loans in the residential loan category represented 1.12% of the total loans in that category at September 30, 2018, compared to 1.10% for the same category at December 31, 2017.

First Federal's Asset Review Committee meets monthly to review the status of work-out strategies for all criticized relationships, which include all non-accrual loans. Based on such factors as anticipated collateral values in liquidation scenarios, cash flow projections, assessment of net worth of guarantors and all other factors which may mitigate risk of loss, the Asset Review Committee makes recommendations regarding proposed charge-offs which are approved by the Loan Loss Reserve Committee.

The following table details net charge-offs and nonaccrual loans by loan type.

Table 2 – Net Charge-offs and Non-Accruals by Loan Type

	For the Nine Months Ended September 30, 2018			As of September 30, 2018		
	Net Charge-offs			Nonaccrual Loans		
	Charge-offs (Recovery)	% of Total Net Charge-offs		Loans	% of Total Non- Accrual Loans	
	(In Thousands)			(In Thousands)		
Residential	\$145	(57.54)	)%	\$3,512	16.78	%
Construction	-	0.00	%	-	0.00	%
Commercial real estate	925	(367.06)	)%	11,692	55.87	%
Commercial	(1,491)	591.67	%	5,129	24.51	%
Consumer	107	(42.47)	)%	34	0.16	%
Home equity and improvement	62	(24.60)	)%	562	2.68	%
Total	\$(252)	100.00	%	\$20,929	100.00	%

	For the Nine Months Ended September 30, 2017			As of September 30, 2017		
	Net Charge-offs			Nonaccrual Loans		
	Charge-offs (Recovery)	% of Total Net Charge-offs		Loans	% of Total Non- Accrual Loans	
	(In Thousands)			(In Thousands)		
Residential	\$9	0.41	%	\$3,368	11.55	%
Construction	-	0.00	%	-	0.00	%
Commercial real estate	148	6.80	%	17,110	58.69	%
Commercial	1,864	85.58	%	8,070	27.69	%
Consumer	29	1.33	%	59	0.20	%
Home equity and improvement	128	5.88	%	545	1.87	%
Total	\$2,178	100.00	%	\$29,152	100.00	%

Table 3 – ALLL Activity

	For the Quarter Ended				
	3rd 2018	2nd 2018	1st 2018	4th 2017	3rd 2017
	(In Thousands)				
Allowance at beginning of period	\$27,321	\$27,267	\$26,683	\$26,341	\$25,915
Provision (credit) for loan losses	1,376	423	(1,095)	314	462
Charge-offs:					
Residential	136	78	16	170	60
Commercial real estate	1,048	254	55	29	-
Commercial	528	84	97	210	64
Consumer finance	25	72	31	27	20
Home equity and improvement	36	41	117	55	92
Total charge-offs	1,773	529	316	491	236
Recoveries	715	160	1,995	519	200
Net charge-offs	1,058	369	(1,679)	(28)	36
Ending allowance	\$27,639	\$27,321	\$27,267	\$26,683	\$26,341

The following table sets forth information concerning the allocation of First Federal's ALLL by loan categories at the dates indicated.

Table 4 – ALLL Allocation by Loan Category

	September 30, 2018		June 30, 2018		March 31, 2018		December 31, 2017		September 30, 2017	
	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category	Amount	Percent of total loans by category
(Dollars In Thousands)										
Residential	\$2,824	12.04 %	\$2,682	12.18 %	\$2,534	11.15 %	\$2,532	11.14 %	\$2,538	11.33 %
Construction	615	10.54 %	737	11.25 %	667	10.19 %	647	10.76 %	578	10.23 %
Commercial real estate	14,680	52.39 %	14,166	50.85 %	13,756	51.88 %	13,056	50.10 %	12,774	50.38 %
Commercial	7,161	18.81 %	7,455	19.39 %	7,838	20.25 %	7,965	21.33 %	8,025	21.32 %
Consumer	288	1.25 %	249	1.18 %	263	1.13 %	228	1.18 %	241	1.21 %
Home equity and improvement	2,071	4.97 %	2,032	5.15 %	2,209	5.40 %	2,255	5.49 %	2,185	5.53 %
	\$27,639	100.00%	\$27,321	100.00%	\$27,267	100.00%	\$26,683	100.00%	\$26,341	100.00%

Key Asset Quality Ratio Trends

Table 5 – Key Asset Quality Ratio Trends

	3rd Qtr 2018	2nd Qtr 2018	1st Qtr 2018	4th Qtr 2017	3rd Qtr 2017
Allowance for loan losses / loans*	1.13 %	1.15 %	1.16 %	1.14 %	1.16 %
Allowance for loan losses / non-performing assets	122.27%	135.69%	92.86%	82.75%	88.74%
Allowance for loan losses / non-performing loans	132.06%	148.97%	97.64%	86.87%	90.36%
Non-performing assets / loans plus OREO*	0.92 %	0.84 %	1.24 %	1.37 %	1.30 %
Non-performing assets / total assets	0.73 %	0.66 %	0.97 %	1.08 %	1.01 %
Net charge-offs / average loans (annualized)	0.18 %	0.06 %	(0.29)%	0.00 %	0.01 %

* Total loans are net of undisbursed funds and deferred fees and costs.

Non-Interest Income.

Total non-interest income increased \$427,000 in the third quarter of 2018 to \$9.9 million from \$9.5 million for the same period in 2017. The third quarter of 2018 had \$76,000 in net gains or losses from the sale of securities, while the third quarter 2017 included gains of \$158,000 from the sale of securities.

Service Fees. Service fees and other charges increased by \$182,000 or 5.8% in the third quarter of 2018 compared to the same period in 2017. This is due mainly to growth in the number of loan and deposit accounts in 2018 compared to 2017.

Overdrawn balances, net of an allowance for losses, are reflected as loans on First Defiance's balance sheet. The fees charged for this service are established based both on the return of processing costs plus a profit, and on the level of fees charged by competitors in the Company's market area for similar services. These fees are considered to be compensation for providing a service to the customer and therefore deemed to be non-interest income rather than interest income. Fee income recorded for the quarters ending September 30, 2018 and 2017 related to the overdraft privilege product, net of adjustments to the allowance for uncollectible overdrafts, was \$686,000 and \$641,000, respectively. Accounts charged off are included in non-interest expense. The allowance for uncollectible overdrafts was \$21,000 at September 30, 2018, \$24,000 at December 31, 2017, and \$19,000 at September 30, 2017.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans was \$1.9 million in the third quarter of 2018, up from \$1.7 million in the third quarter of 2017. Gains from the sale of mortgage loans were \$1.3 million in the third quarter of 2018, up from \$1.2 million in the third quarter of 2017. Mortgage loan servicing revenue was \$929,000 in the third quarter of 2018, up slightly from \$911,000 in the third quarter of 2017. First Defiance had a positive change in the valuation adjustment in mortgage servicing assets of \$8,000 in the third quarter of 2018 compared with a negative adjustment of \$27,000 in the third quarter of 2017.

Insurance Commission Income. Income from the sale of insurance products increased \$172,000 or 5.6% to \$3.3 million in the third quarter of 2018, up from \$3.1 million in the third quarter of 2017.

Non-Interest Expense.

Non-interest expense increased \$1.8 million to \$22.3 million for the third quarter of 2018 compared to \$20.4 million for the same period in 2017. The increase is mainly attributable to the increase in compensation and benefits of \$1.1 million further explained in the section below.

Compensation and Benefits. Compensation and benefits increased to \$12.9 million in the third quarter of 2018, compared to \$11.8 million in the third quarter of 2017. The increase in compensation and benefits versus the prior year reflects merit increases, additional increases to minimum pay levels, and increases to staff to achieve the overall growth strategies.

Occupancy. Occupancy expense increased by \$194,000 to \$2.2 million for the quarter ended September 30, 2018, compared to the same period in 2017. This can be attributed to continued growth strategies and newly signed leases in metro markets.

Data Processing. Data processing expense increased \$287,000 to \$2.2 million in the third quarter of 2018 compared to \$1.9 million for the third quarter of 2017.

Other Non-Interest Expenses. Other non-interest expense of \$4.0 million in the third quarter of 2018 increased from \$3.7 million in the second quarter of 2017. Other expenses in the third quarter 2018 include an increase in advertising in certain markets as well as an increase in management consulting expenses.

The efficiency ratio, considering tax equivalent interest income and excluding securities gains and losses, for the third quarter of 2018 was 59.22% compared to 58.70% for the third quarter of 2017.

Nine Months Ended September 30, 2018 and 2017

On a consolidated basis, First Defiance's net income for the nine months ended September 30, 2018 was \$34.2 million compared to income of \$22.9 million for the same period in 2017. On a per share basis, basic and diluted earnings per common share for the nine months ended September 30, 2018 were \$1.68 and \$1.67, respectively, compared to basic and diluted earnings per common share of \$1.15 and \$1.15, respectively, for the same period in 2017.

The first nine months of 2018 includes the results from the operations of the Commercial Savings Bank ("CSB") acquisition completed on February 24, 2017 and the Corporate One Benefits Agency, Inc. ("Corporate One") acquisition completed on April 1, 2017. In addition, the first nine months of 2017 includes merger and conversion expenses related to the acquisitions of \$3.9 million, which had an after tax impact of \$2.8 million, or \$0.14 per diluted share.

Net Interest Income

Net interest income was \$79.8 million for the first nine months of 2018 compared with \$71.3 million in the first nine months of 2017. Average interest-earning assets increased to \$2.71 billion in the first nine months of 2018 compared to \$2.51 billion in the first nine months of 2017.

For the nine month period ended September 30, 2018, total interest income was \$91.2 million compared to \$79.6 million for the same period in 2017. Interest expense increased by \$3.1 million to \$11.4 million for the nine months ended September 30, 2018 compared to \$8.3 million for the same period in 2017.

Net interest margin for the first nine months of 2018 was 3.97%, up 9 basis points from the 3.88% margin reported in the nine month period ended September 30, 2017.

Provision for Loan Losses

The provision for loan losses was \$704,000 for the nine months ended September 30, 2018, compared to \$2.6 million expense during the nine months ended September 30, 2017. Charge-offs for the first nine months of 2018 were \$2.6 million and recoveries of previously charged off loans totaled \$2.9 million for net recoveries of \$252,000. By comparison, \$3.0 million of charge-offs were recorded in the same period of 2017 and \$780,000 of recoveries were realized for net charge-offs of \$2.2 million.

Non-Interest Income

Total non-interest income increased \$655,000 to \$30.8 million for the nine months ended September 30, 2018 from \$30.2 million recognized for the same period in 2017.

Service Fees. Service fees and other charges were \$9.8 million for the first nine months of 2018, up from \$9.1 million for the same period in 2017. This is mainly due to the increased loan and deposit base year over year.

Mortgage Banking Activity. Total revenue from the sale and servicing of mortgage loans increased \$366,000 to \$5.6 million for the nine months ended September 30, 2018 from \$5.3 million for the same period in 2017. Gains realized from the sale of mortgage loans increased \$167,000 to \$3.7 million for the first nine months of 2018 from \$3.6 million for the same period in 2017. Mortgage loan servicing revenue increased slightly to \$2.8 million in the first nine months of 2018 from \$2.77 million for the same period in 2017. The Company recorded a positive valuation adjustment of \$91,000 in the first nine months of 2018 compared to a positive adjustment of \$21,000 in the first nine months of 2017.

Insurance Commission Income. Income from the sale of insurance and investment products was \$11.0 million in the first nine months of 2018, an increase of \$1.2 million from \$9.8 million in the first nine months of 2017. The increase is primarily due to added commissions from the Corporate One merger completed on April 1, 2017.

Bank-Owned Life Insurance. Income from bank-owned life insurance was \$1.4 million in the first nine months of 2018, a decrease of \$1.3 million from \$2.7 million in the same period of 2017. In February 2017, the Company surrendered an underperforming BOLI policy, recorded a tax penalty of \$1.7 million (recorded in income tax expense), and purchased a new BOLI policy receiving a \$1.5 million enhancement value gain.

Non-Interest Expense

Non-interest expense was \$68.2 million for the first nine months of 2018, up \$4.0 million from \$64.2 million for the same period in 2017.

Compensation and Benefits. Compensation and benefits increased to \$39.0 million for the nine months ended September 30, 2018, compared to \$37.6 million for the same period in 2017. The increase is mainly related to merit increases, additional increases to minimum pay levels, higher incentive compensation, increases to staff related to growth strategies, and increased personnel expenses related to operating the new CSB and Corporate One locations.

Occupancy. Occupancy expense increased by \$500,000 to \$6.3 million for the nine months ended September 30, 2018, compared \$5.8 million in the same period in 2017. This can be attributed to continued growth strategies and newly signed leases in metro markets.

Data Processing. Data processing expense increased \$517,000 to \$6.3 million in the first nine months of 2018 compared to \$5.8 million for the first nine months of 2017 due to strategic spending initiatives.

Other Non-Interest Expenses. Other non-interest expenses increased \$1.5 million to \$13.2 million for the first nine months of 2018 from \$11.7 million for the same period in 2017. The increase in other non-interest expense is primarily due to an OREO write-down of \$544,000 and other miscellaneous expense increases over the previous year comparative period.

The efficiency ratio for the first nine months of 2018 was 61.29% compared to 62.66% for the same period in 2017.

Income Taxes.

The Tax Cuts and Jobs Act was enacted on December 22, 2017, establishing a new, flat corporate federal statutory income tax rate of 21% effective January 1, 2018.

First Defiance computes federal income tax expense in accordance with ASC Topic 740, Subtopic 942, which resulted in an effective tax rate of 18.09% for the nine months ended September 30, 2018 compared to 33.95% for the same period in 2017. The tax rate for 2018 is lower than the statutory 21% tax rate for the Company mainly because of investments in tax-exempt securities. The earnings on tax-exempt securities are not subject to federal income tax.

Liquidity

As a regulated financial institution, First Federal is required to maintain appropriate levels of “liquid” assets to meet short-term funding requirements.

First Defiance had \$33.0 million of cash provided by operating activities during the first nine months of 2018. The Company's cash provided by operating activities resulted from the origination of loans held for sale and net income mostly offset by the proceeds on the sale of loans.

At September 30, 2018, First Federal had \$214.7 million in outstanding loan commitments and loans in process to be funded generally within the next six months and an additional \$398.3 million committed under existing consumer and commercial lines of credit and standby letters of credit. Also at that date, First Federal had commitments to sell \$20.0 million of loans held-for-sale. First Defiance believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If First Defiance requires funds beyond its internal funding capabilities, advances from the FHLB and other financial institutions are available.

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

Capital Resources

Capital is managed at First Federal and on a consolidated basis. Capital levels are maintained based on regulatory capital requirements and the economic capital required to support credit, market, liquidity and operational risks inherent in the business, as well as flexibility needed for future growth and new business opportunities.

In July 2013, the federal banking agencies approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2016, and are subject to a phase-in period through January 1, 2019, minimum requirements increased for both quantity and quality of capital held by the Company and the Bank. The rules include a new minimum CET1 capital to risk-weighted assets ratio of 4.5% and a capital conservation buffer of 0.625% of risk-weighted assets during 2016, 1.25% during the year 2017, 1.875% during the year 2018, and increasing each year until fully phased-in during 2019 at 2.50%, effectively resulting in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), which effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance sheet exposures.

The Company met each of the well capitalized ratio guidelines at September 30, 2018. The following table indicates the capital ratios for First Defiance (consolidated) and First Federal at September 30, 2018, and December 31, 2017. (In Thousands):

September 30, 2018

	Actual		Minimum Required for Adequately Capitalized		Minimum Required for Well Capitalized	
	Amount	Ratio	Amount	Ratio(1)	Amount	Ratio
CET1 Capital (to Risk-Weighted Assets) (2)						
Consolidated	\$300,186	11.06%	\$122,179	4.5	% N/A	N/A
First Federal	\$319,815	11.79%	\$122,079	4.5	% \$176,337	6.5 %
Tier 1 Capital (1)						
Consolidated	\$335,186	11.30%	\$118,659	4.0	% N/A	N/A
First Federal	\$319,815	10.81%	\$118,357	4.0	% \$147,946	5.0 %
Tier 1 Capital (to Risk Weighted Assets) (1)						
Consolidated	\$335,186	12.35%	\$162,905	6.0	% N/A	N/A
First Federal	\$319,815	11.79%	\$162,772	6.0	% \$217,030	8.0 %
Total Capital (to Risk Weighted Assets) (1)						
Consolidated	\$362,825	13.36%	\$217,206	8.0	% N/A	N/A
First Federal	\$347,454	12.81%	\$217,030	8.0	% \$271,287	10.0 %

(1) Excludes capital conservation buffer of 1.875% as of September 30, 2018.

Core capital is computed as a percentage of adjusted total assets of \$2.97 billion for consolidated and \$2.96 billion (2) for First Federal, respectively. Risk-based capital is computed as a percentage of total risk-weighted assets of \$2.72 billion for consolidated and \$2.71 billion for First Federal, respectively.

December 31, 2017

	Actual		Minimum Required for Adequately Capitalized		Minimum Required for Well Capitalized	
	Amount	Ratio	Amount	Ratio(1)	Amount	Ratio
<u>CET1 Capital (to Risk-Weighted Assets) (2)</u>						
Consolidated	\$274,832	10.43%	\$118,596	4.5	% N/A	N/A
First Federal	\$298,571	11.33%	\$118,534	4.5	% \$171,216	6.5 %
Tier 1 Capital (1)						
Consolidated	\$309,832	10.80%	\$114,773	4.0	% N/A	N/A

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First Federal	\$298,571	10.43%	\$114,539	4.0	%	\$143,173	5.0	%
Tier 1 Capital (to Risk Weighted Assets) (1)								
Consolidated	\$309,832	11.76%	\$158,128	6.0	%	N/A	N/A	
First Federal	\$298,571	11.33%	\$158,046	6.0	%	\$210,728	8.0	%
Total Capital (to Risk Weighted Assets) (1)								
Consolidated	\$336,515	12.77%	\$210,838	8.0	%	N/A	N/A	
First Federal	\$325,254	12.35%	\$210,728	8.0	%	\$263,410	10.0	%

(1) Excludes capital conservation buffer of 1.25% as of December 31, 2017.

Core capital is computed as a percentage of adjusted total assets of \$2.87 billion for consolidated and \$2.86 billion (2) for First Federal. Risk-based capital is computed as a percentage of total risk-weighted assets of \$2.64 billion for consolidated and \$2.63 billion for First Federal.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As discussed in detail in First Defiance's Annual Report on Form 10-K for the year ended December 31, 2017, First Defiance's ability to maximize net income is dependent on management's ability to plan and control net interest income through management of the pricing and mix of assets and liabilities. Because a large portion of assets and liabilities of First Defiance are monetary in nature, changes in interest rates and monetary or fiscal policy affect its financial condition and can have significant impact on the net income of the Company. First Defiance does not use off-balance sheet derivatives to enhance its risk management, nor does it engage in trading activities beyond the sale of mortgage loans.

First Defiance monitors its exposure to interest rate risk on a monthly basis through simulation analysis that measures the impact changes in interest rates can have on net interest income. The simulation technique analyzes the effect of a presumed 100 basis point shift in interest rates (which is consistent with management's estimate of the range of potential interest rate fluctuations) and takes into account prepayment speeds on amortizing financial instruments, loan and deposit volumes and rates, non-maturity deposit assumptions and capital requirements.

The table below presents, for the twelve months subsequent to September 30, 2018 and December 31, 2017, an estimate of the change in net interest income that would result from a gradual (ramp) and immediate (shock) change in interest rates, moving in a parallel fashion over the entire yield curve, relative to the measured base case scenario. Based on our net interest income simulation as of September 30, 2018, net interest income sensitivity to changes in interest rates for the twelve months subsequent to September 30, 2018, remained relatively stable for the ramp and shock compared to the sensitivity profile for the twelve months subsequent to December 31, 2017.

Net Interest Income Sensitivity Profile

(dollars in thousands)	Impact on Future Annual Net Interest Income			
	September 30, 2018		December 31, 2017	
Gradual Change in Interest Rates				
+200	\$1,545	1.36 %	\$2,354	2.18 %
+100	749	0.66 %	1,200	1.11 %
-100	(1,742)	-1.54 %	(3,033)	-2.81 %
Immediate Change in Interest Rates				
+200	\$2,953	2.60 %	\$4,821	4.47 %
+100	1,586	1.40 %	2,463	2.28 %
-100	(4,883)	-4.31 %	(6,223)	-5.77 %

To analyze the impact of changes in interest rates in a more realistic manner, non-parallel interest rate scenarios are also simulated. These non-parallel interest rate scenarios indicate that net interest income may decrease from the base case scenario should the yield curve flatten or become inverted. Conversely, if the yield curve should steepen, net interest income may increase.

The results of all the simulation scenarios are within the Company's Board mandated guidelines as of September 30, 2018, except for the down 200 basis points over the first twelve months in a dynamic and static shock balance sheet and the down 200 basis points over the cumulative 24 months in both a dynamic and static balance sheet. Management is reviewing the Board policy limits in all scenarios to determine if they are adequate and if so, any measures to be taken to bring the current results back into alignment with Board guidelines.

In addition to the simulation analysis, First Defiance also uses an economic value of equity (“EVE”) analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis generally calculates the net present value of First Federal’s assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. However, the likelihood of a decrease in rates beyond 200 basis points as of September 30, 2018, was considered to be unlikely given the current interest rate environment and, therefore, was not included in this analysis. The results of this analysis are reflected in the following tables for the nine months ended September 30, 2018, and the year-ended December 31, 2017.

September 30, 2018

Economic Value of Equity

Change in Rates	\$ Amount	\$ Change	% Change
	(Dollars in Thousands)		
+400 bp	718,064	58,359	8.85%
+ 300 bp	708,925	49,220	7.46%
+ 200 bp	695,958	36,253	5.50%
+ 100 bp	680,279	20,574	3.12%
0 bp	659,704	-	-
- 100 bp	623,802	(35,903)	(5.44)%
- 200 bp	568,249	(91,455)	(13.86)%

December 31, 2017

Economic Value of Equity

Change in Rates	\$ Amount	\$ Change	% Change
	(Dollars in Thousands)		
+400 bp	700,563	80,544	12.99%
+ 300 bp	685,883	65,864	10.62%
+ 200 bp	668,127	48,108	7.76%
+ 100 bp	647,439	27,420	4.42%
0 bp	620,019	-	-
- 100 bp	585,967	(34,052)	(5.49)%

Item 4. Controls and Procedures

Disclosure controls and procedures are controls and other procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Exchange Act, such as this report, is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, including those disclosure controls and procedures designed to ensure that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure

controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable, not absolute, assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of September 30, 2018. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

No changes occurred in the Company's internal controls over financial reporting during the quarter ended September 30, 2018, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

FIRST DEFIANCE FINANCIAL CORP.

PART II-OTHER INFORMATION

Item 1. Legal Proceedings

Neither First Defiance nor any of its subsidiaries is engaged in any legal proceedings of a material nature.

Item 1A. Risk Factors

There are no material changes from the risk factors set forth under Part I, Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

The Company had no unregistered sales of equity securities during the quarter ended September 30, 2018.

The following table provides information regarding First Defiance's purchases of its common stock during the three-month period ended September 30, 2018 (share data has been adjusted to reflect a 2-for-1 stock split on July 12, 2018):

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(1)
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	or Programs			
Beginning Balance, June 30, 2018				755,000
July 1 – July 31, 2018	-	\$ -	-	755,000
August 1 – August 31, 2018	-	-	-	755,000
September 1 – September 30, 2018	-	-	-	755,000
Total	-	\$ -	-	755,000

On January 29, 2016, the Company announced that its Board of Directors authorized another program for the (1) repurchase of up to 5% of the outstanding common shares or 900,000 shares. There is no expiration date for the repurchase program.

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit
3.1 Articles of Incorporation of First Defiance (1)

Exhibit
3.2 Amendment to Articles of Incorporation of First Defiance (2)

Exhibit
3.3 Code of Regulations of First Defiance (3)

Exhibit
31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit
31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit
32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit
32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit
101 The following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2018 is formatted in eXtensible Business Reporting Language ("XBRL"): (i) Unaudited Consolidated Condensed Statements of Financial Condition at September 30, 2018 and December 31, 2017, (ii) Unaudited Consolidated Condensed Statements of Income for the Three and Nine Months ended September 30, 2018 and 2017 (iii) Unaudited Consolidated Condensed Statements of Comprehensive Income for the Three and Nine Months ended September 30, 2018 and 2017, (iv) Unaudited Consolidated Condensed Statements of Changes in Stockholders' Equity for the Nine Months ended September 30, 2018 and 2017, (v) Unaudited Consolidated Condensed Statements of Cash Flows for the Nine Months ended September 30, 2018 and 2017 and (vi) Notes to Unaudited Consolidated Condensed Financial Statements.

(1) Incorporated by reference to the like numbered exhibit in the Registrant's Form S-3 (File No. 333-163014), filed on November 10, 2009.

(2) Incorporated by reference to Exhibit 3.1 of the Registrant's Form 8-K (File No. 000-26850), filed on June 22, 2018.

(3) Incorporated by reference to Exhibit 4.3 of the Registrant's Form S-8 POS (File No. 333-197203), filed on July 17, 2018.

FIRST DEFIANCE FINANCIAL CORP.

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.

First Defiance Financial Corp.
(Registrant)

Date: November 9, 2018 By: /s/ Donald P. Hileman
Donald P. Hileman
President and
Chief Executive Officer

Date: November 9, 2018 By: /s/ Kevin T. Thompson
Kevin T. Thompson
Executive Vice President and
Chief Financial Officer