Section 1: 10-Q (10-Q)

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2020

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

Commission File Number: 001-39036

ALERUS FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	**45-0375407**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
401 Demers Avenue **Grand Forks, ND**	**58201**
(Address of principal executive offices)	(Zip Code)

(701) 795-3200
(Registrant's telephone number, including area code)

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

Title of each class	Trading symbol	Name of each exchange on which registered
Common Stock, par value $1.00 per share	ALRS	The Nasdaq Stock Market LLC

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

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

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

Large accelerated filer ☐	Accelerated filer ☐	Non-accelerated filer ☒	Smalle Emergi

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 Act). Yes ☐ No ☒

The number of shares of the registrant's common stock outstanding at July 31, 2020 was 17,120,656.

Alerus Financial Corporation and Subsidiaries

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PART 1. FINANCIAL INFORMATION

Item 1 - Financial Statements

Alerus Financial Corporation and Subsidiaries

Consolidated Balance Sheets (Unaudited)

(dollars and shares in thousands, except per share data)		June 30, 2020
Assets		
Cash and cash equivalents	$	210,437
Investment securities, at fair value		
Available-for-sale		393,727
Equity		—
Loans held for sale		101,751
Loans		2,034,197
Allowance for loan losses		(27,256)
Net loans		2,006,941
Land, premises and equipment, net		20,709
Operating lease right-of-use assets		8,746
Accrued interest receivable		7,975
Bank-owned life insurance		31,959
Goodwill		27,329
Other intangible assets		16,411
Servicing rights		2,891
Deferred income taxes, net		8,810
Other assets		37,771
Total assets	$	2,875,457
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	$	700,892
Interest-bearing		1,752,261
Total deposits		2,453,153
Long-term debt		58,754
Operating lease liabilities		9,254
Accrued expenses and other liabilities		48,564
Total liabilities		2,569,725
Stockholders' equity		
Preferred stock, $1 par value, 2,000,000 shares authorized: 0 issued and outstanding		—
Common stock, $1 par value, 30,000,000 shares authorized: 17,120,466 and 17,049,551 issued and outstanding		17,120
Additional paid-in capital		89,313
Retained earnings		189,528
Accumulated other comprehensive income (loss)		9,771
Total stockholders' equity		305,732
Total liabilities and stockholders' equity	$	2,875,457

See accompanying notes to consolidated financial statements (unaudited)

Alerus Financial Corporation and Subsidiaries

Consolidated Statements of Income (Unaudited)

	Three months ended June 30,		Six montl June
(dollars and shares in thousands, except per share data)	2020	2019	2020
Interest Income			
Loans, including fees	$ 21,372	$ 21,712	$ 41,914
Investment securities			
Taxable	1,765	1,338	3,524
Exempt from federal income taxes	239	211	474
Other	130	217	700
Total interest income	23,506	23,478	46,612
Interest Expense			
Deposits	2,558	3,548	5,950
Short-term borrowings	—	735	—
Long-term debt	857	904	1,734
Total interest expense	3,415	5,187	7,684
Net interest income	20,091	18,291	38,928
Provision for loan losses	3,500	1,797	6,000
Net interest income after provision for loan losses	16,591	16,494	32,928
Noninterest Income			
Retirement and benefit services	13,710	15,776	29,930
Wealth management	4,112	3,878	8,158
Mortgage banking	17,546	7,035	22,591
Service charges on deposit accounts	297	430	720
Net gains (losses) on investment securities	1,294	182	1,294
Other	1,271	2,683	2,726
Total noninterest income	38,230	29,984	65,419
Noninterest Expense			
Compensation	21,213	18,143	39,944
Employee taxes and benefits	4,747	5,160	10,055
Occupancy and equipment expense	2,869	2,641	5,624
Business services, software and technology expense	4,520	4,022	8,964
Intangible amortization expense	991	1,050	1,981
Professional fees and assessments	1,160	1,029	2,200
Marketing and business development	549	707	1,159
Supplies and postage	675	663	1,378
Travel	51	398	312
Mortgage and lending expenses	1,192	769	2,235
Other	1,767	679	2,608
Total noninterest expense	39,734	35,261	76,460
Income before income taxes	15,087	11,217	21,887
Income tax expense	3,613	2,869	5,050
Net income	$ 11,474	$ 8,348	$ 16,837
Per Common Share Data			
Basic earnings per common share	$ 0.66	$ 0.60	$ 0.97
Diluted earnings per common share	$ 0.65	$ 0.59	$ 0.95
Dividends declared per common share	$ 0.15	$ 0.14	$ 0.30
Average common shares outstanding	17,111	13,810	17,091
Diluted average common shares outstanding	17,445	14,100	17,425

See accompanying notes to consolidated financial statements (unaudited)

Alerus Financial Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income (Unaudited)

	Three months ended June 30,		Six montl June	
(dollars in thousands)	**2020**	**2019**	**2020**	
Net Income	$ 11,474	$ 8,348	$ 16,837	
Other Comprehensive Income (Loss), Net of Tax				
Unrealized gains (losses) on available-for-sale securities	4,794	3,929	11,753	
Reclassification adjustment for losses (gains) realized in income	(1,294)	(176)	(1,294)	
Total other comprehensive income (loss), before tax	3,500	3,753	10,459	
Income tax expense (benefit) related to items of other comprehensive income	878	942	2,624	
Other comprehensive income (loss), net of tax	2,622	2,811	7,835	
Total comprehensive income	$ 14,096	$ 11,159	$ 24,672	

See accompanying notes to consolidated financial statements (unaudited)

Alerus Financial Corporation and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

	Three months ended June 30, 2020				
(dollars and shares in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	ESOP-Owned Shares
Balance as of March 31, 2020	$ 17,106	$ 88,703	$ 180,650	$ 7,149	$ —
Net income	—	—	11,474	—	—
Other comprehensive income (loss)	—	—	—	2,622	—
Common stock repurchased	—	—	—	—	—
Common stock dividends	—	—	(2,596)	—	—
Stock-based compensation expense	14	610	—	—	—
Vesting of restricted stock	—	—	—	—	—
Balance as of June 30, 2020	$ 17,120	$ 89,313	$ 189,528	$ 9,771	$ —

	Six months ended June 30, 2020				
(dollars and shares in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	ESOP-Owned Shares
Balance as of December 31, 2019	$ 17,050	$ 88,650	$ 178,092	$ 1,936	$ —
Net income	—	—	16,837	—	—
Other comprehensive income (loss)	—	—	—	7,835	—
Common stock repurchased	(15)	(111)	(210)	—	—
Common stock dividends	—	—	(5,191)	—	—
Share-based compensation expense	14	845	—	—	—
Vesting of restricted stock	71	(71)	—	—	—
Balance as of June 30, 2020	$ 17,120	$ 89,313	$ 189,528	$ 9,771	$ —

	Three months ended June 30, 2019				
(dollars and shares in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	ESOP-Owned Shares
Balance as of March 31, 2019	$ 13,801	$ 28,045	$ 163,429	$ (1,326)	$ (34,494)
Net income	—	—	8,348	—	—
Other comprehensive income (loss)	—	—	—	2,811	—
Common stock repurchased	(1)	(2)	(14)	—	—
Common stock dividends	—	—	(1,975)	—	—
Net change in fair value of ESOP shares	—	—	—	—	—
Stock-based compensation expense	13	636	—	—	—
Vesting of restricted stock	3	(3)	—	—	—
Balance as of June 30, 2019	$ 13,816	$ 28,676	$ 169,788	$ 1,485	$ (34,494)

See accompanying notes to consolidated financial statements (unaudited)

(dollars and shares in thousands)	Six months ended June 30, 2019 Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	ESOP-Owned Shares
Balance as of December 31, 2018	$ 13,775	$ 27,743	$ 159,037	$ (3,601)	$ (34,494)
Net income	—	—	14,784	—	—
Other comprehensive income (loss)	—	—	—	5,086	—
Common stock repurchased	(5)	(16)	(85)	—	—
Common stock dividends	—	—	(3,948)	—	—
Net change in fair value of ESOP shares	—	—	—	—	—
Share-based compensation expense	13	982	—	—	—
Vesting of restricted stock	33	(33)	—	—	—
Balance as of June 30, 2019	$ 13,816	$ 28,676	$ 169,788	$ 1,485	$ (34,494)

See accompanying notes to consolidated financial statements (unaudited)

Alerus Financial Corporation and Subsidiaries

Consolidated Statements of Cash Flows (Unaudited)

(dollars in thousands)	Six month June 2020
Operating Activities	
Net income	$ 16,837
Adjustments to reconcile net income to net cash provided (used) by operating activities	
Deferred income taxes	(3,543)
Provision for loan losses	6,000
Depreciation and amortization	4,313
Amortization and accretion of premiums/discounts on investment securities	684
Amortization of operating lease right-of-use assets	(12)
Stock-based compensation	859
Increase in value of bank-owned life insurance	(393)
Realized loss (gain) on sale of branch	—
Realized loss (gain) on derivative instruments	(1,010)
Realized loss (gain) on loans sold	(19,099)
Realized loss (gain) on sale of foreclosed assets	(19)
Realized loss (gain) on sale of investment securities	(1,294)
Realized loss (gain) on servicing rights	558
Net change in:	
Securities held for trading	—
Loans held for sale	(34,934)
Accrued interest receivable	(424)
Other assets	(2,295)
Accrued expenses and other liabilities	11,079
Net cash provided (used) by operating activities	(22,693)
Investing Activities	
Proceeds from sales or calls of investment securities available-for-sale	39,505
Proceeds from maturities of investment securities available-for-sale	22,266
Purchases of investment securities available-for-sale	(134,079)
Net (increase) decrease in equity securities	2,808
Net (increase) decrease in loans	(315,888)
Proceeds from sale of branch	—
Purchases of premises and equipment	(1,998)
Proceeds from sales of foreclosed assets	303
Net cash provided (used) by investing activities	(387,083)
Financing Activities	
Net increase (decrease) in deposits	481,837
Net increase (decrease) in short-term borrowings	—
Repayments of long-term debt	(103)
Cash dividends paid on common stock	(5,191)
Repurchase of common stock	(336)
Net cash provided (used) by financing activities	476,207
Net change in cash and cash equivalents	66,431
Cash and cash equivalents at beginning of period	144,006
Cash and cash equivalents at end of period	$ 210,437

See accompanying notes to consolidated financial statements (unaudited)

Supplemental Cash Flow Disclosures	Six month June : 2020
Cash paid for:	
Interest	$ 7,923
Income taxes	618
Non-cash information	
Loan collateral transferred to foreclosed assets	302
Unrealized gain (loss) on investment securities available-for-sale	7,835
Initial recognition of operating lease right-of-use assets	—
Initial recognition of operating lease liabilities	—
Right-of-use assets obtained in exchange for new operating leases	1,531

See accompanying notes to consolidated financial statements (unaudited)

Alerus Financial Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

NOTE 1 Significant Accounting Policies

Organization

Alerus Financial Corporation, or the Company, is a financial holding company organized under the laws of the state of Delaware. The Company and its subsidiaries operate as a diversified financial services company headquartered in Grand Forks, North Dakota. Through its subsidiary, Alerus Financial, National Association, or the Bank, the Company provides innovative and comprehensive financial solutions to businesses and consumers through four distinct business lines—banking, retirement and benefit services, wealth management, and mortgage.

Initial Public Offering

On September 17, 2019, the Company sold 2,860,000 shares of common stock in its initial public offering. On September 25, 2019, the Company sold an additional 429,000 shares of common stock pursuant to the exercise in full, by the underwriters, of their option to purchase additional shares. The aggregate offering price for the shares sold by the Company was $69.1 million, and after deducting $4.7 million of underwriting discounts and $1.6 million of offering expenses paid to third parties, the Company received total net proceeds of $62.8 million.

Basis of Presentation

The accompanying unaudited consolidated financial statements and notes thereto of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC, and conform to practices within the banking industry and include all of the information and disclosures required by generally accepted accounting principles in the United States of America, or GAAP, for interim financial reporting. The accompanying unaudited consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) that are necessary for a fair presentation of financial results for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results for the full year or any other period. The Company has also evaluated all subsequent events for potential recognition and disclosure through the date of the filing of this Quarterly Report on Form 10-Q. These interim unaudited financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto as of and for the year ended December 31, 2019, included in the Company’s Annual Report on Form 10-K filed with the SEC on March 26, 2020.

Principles of Consolidation

The accompanying unaudited consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. The Company’s principal operating subsidiary is the Bank.

In the normal course of business, the Company may enter into a transaction with a variable interest entity, or VIE. VIE’s are legal entities whose investors lack the ability to make decisions about the entity’s activities, or whose equity investors do not have the right to receive the residual returns of the entity. The applicable accounting guidance requires the Company to perform ongoing quantitative and qualitative analysis to determine whether it must consolidate any VIE. The Company does not have any ownership interest in, or exert any control, over any VIE, and thus no VIE’s are included in the consolidated financial statements.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term include the valuation of investment securities, determination of the allowance for loan losses, valuation of reporting units for the purpose of testing goodwill and other intangible assets for impairment, valuation of deferred tax assets, and fair values of financial instruments.

Reclassifications

Certain items previously reported have been reclassified to conform to the current period's reporting format. Such reclassifications did not affect net income or stockholders' equity.

Other Information

On March 11, 2020, the World Health Organization declared the spread of Coronavirus Disease 2019, or COVID-19, a worldwide pandemic. The COVID-19 pandemic is having significant effects on global markets, supply chains, businesses, and communities. Specific to the Company, COVID-19 has impacted various parts of its 2020 operations and financial results, including, but not limited to, additional loan loss reserves, costs for emergency preparedness, or potential shortages of personnel. Management believes the Company is taking appropriate actions to mitigate, to the extent possible, the negative impact. However, the full impact of COVID-19 is currently unknown and cannot be reasonably estimated as the events are continuing to unfold as the year progresses.

In March 2020, various regulatory agencies, including the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, or the agencies, issued an interagency statement on loan modifications and reporting for financial institutions working with customers affected by COVID-19. The interagency statement was effective immediately and impacted accounting for loan modifications. Under Accounting Standards Codification 310-40, "Receivables – Troubled Debt Restructurings by Creditors," or ASC 310-40, a restructuring of debt constitutes a troubled debt restructuring, or TDR, if the creditor for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The agencies confirmed with the staff of the Financial Accounting Standards Boards, or FASB, that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not to be considered TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented. This interagency guidance is expected to have a material impact on the Company's financial statements for disclosure of the impact to date.

Emerging Growth Company

The Company qualifies as an "emerging growth company" under the Jumpstart Our Business Startups Act of 2012, or the JOBS Act, and may take advantage of certain exemptions from various reporting requirements that are applicable to public companies that are not emerging growth companies, including, but not limited to, not being required to comply with the auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act, reduced disclosure obligations regarding executive compensation in periodic reports and proxy statements, and exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved. In addition, even if the Company complies with the greater obligations of public companies that are not emerging growth companies, the Company may avail itself of the reduced requirements applicable to emerging growth companies from time to time in the future, so long as the Company is an emerging growth company. The Company will continue to be an emerging growth company until the earliest to occur of: (1) the end of the fiscal year following the fifth anniversary of the date of the first sale of common equity securities under the Company's Registration Statement on Form S-1, which was declared effective by the SEC on September 12, 2019; (2) the last day of the fiscal year in which the Company has $1.07 billion or more in annual revenues; (3) the date on which the Company is deemed to be a "large accelerated filer" under the Securities Exchange Act of 1934, as amended, or the "Exchange Act"; or (4) the date on which the Company has, during the previous three-year period, issued publicly or privately, more than $1.0 billion in non-convertible debt securities.

Section 107 of the JOBS Act provides that an emerging growth company can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act of 1933 for complying with new or revised accounting standards. As an emerging growth company, the Company can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. The Company elected to take advantage of the benefits of this extended transition period.

NOTE 2 Recent Accounting Pronouncements

The following FASB Accounting Standards Updates, or ASUs, are divided into pronouncements which have been adopted by the Company since January 1, 2020, and those which are not yet effective and have been evaluated or are currently being evaluated by management as of June 30, 2020.

Adopted Pronouncements

In January 2017, the FASB issued ASU No. 2017-04, Simplifying the Test for Goodwill Impairment. This ASU removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. Under the amended guidance, a goodwill impairment charge will now be recognized for the amount by which the carrying value of a reporting unit exceeds its estimated fair value, not to exceed the carrying amount of goodwill. For public business entities that are US Securities and Exchange Commission filers, ASU 2017-04, is effective for interim and annual reporting periods beginning after December 15, 2019. The Company adopted ASU 2017-04 effective January 1, 2020, and the new guidance did not have an impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement. This ASU eliminates, adds, and modifies certain disclosure requirements for estimated fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the estimated fair value hierarchy, but will be required to disclose the range and weighted-average used to develop significant unobservable inputs for Level 3 estimated fair value measurements. ASU 2018-13 is effective for all entities interim and annual reporting periods beginning after December 15, 2019. The Company adopted ASU 2018-13 effective January 1, 2020, and the revised disclosure requirements did not have a material impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU 2018-15, Intangibles – Goodwill and Other – Internal Use Software (Subtopic 350-40) – Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract. ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by these amendments. ASU 2018-15 was effective for the Company on January 1, 2020, and did not have a material impact on the Company's consolidated financial statements.

Pronouncements Not Yet Effective

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU requires a new impairment model known as the current expected credit loss, or CECL, which significantly changes the way impairment of financial instruments is recognized by requiring immediate recognition of estimated credit losses expected to occur over the remaining life of financial instruments. The main provisions of ASU 2016-13 include (1) replacing the "incurred cost" approach under GAAP with an "expected loss" model for instruments measured at amortized cost, (2) requiring entities to record an allowance for credit losses related to available-for-sale debt securities rather than a direct write-down of the carrying amount of the investments, as is required by the other-than-temporary impairment model under current GAAP, and (3) a simplified accounting model for purchase credit-impaired debt securities and loans. In November 2019, the FASB issued ASU No. 2019-10, Financial Instruments – Credit Losses (Topic 326). This update amends the effective date of ASU No. 2016-13 for certain entities, including private companies and smaller reporting companies, until fiscal years beginning after December 15, 2022, including interim periods within those fiscal periods. Early adoption is permitted.

As an emerging growth company, the Company can take advantage of this delay and plans to adopt the standard with the amended effective date. The Company does not plan to early adopt this standard but continues to work through implementation. The Company continues collecting and retaining loan and credit data and evaluating various loss estimation models. While we currently cannot reasonably estimate the impact of adopting this standard, we expect the impact will be influenced by the composition, characteristics, and quality of our loan portfolio, as well as the general economic conditions and forecasts as of the adoption date.

In April 2019, the FASB issued ASU 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, which affects a variety of topics in the Codification and applies to all reporting entities within the scope of the affected accounting guidance. The Company will consider these clarifications and improvements in determining the appropriate adoption of ASU 2019-04.

In May 2019, the FASB issued ASU 2019-05, Targeted Transition Relief to provide entities with an option to irrevocably elect the fair value option applied on an instrument-by-instrument basis for eligible instruments. In November 2019, the FASB Issued ASU 2019-10, which amends the effective date of this ASU for certain entities, including private companies and smaller reporting companies until after December 15, 2022, including interim periods within those fiscal years. As an emerging growth company, the Company can take advantage of this delay and plans to adopt the standard with the amended effective date. This update is not expected to have a significant impact on the Company's consolidated financial statements.

In December 2019, the FASB issued ASU 2019-12, Income Taxes (Topic 740), which simplifies accounting for income taxes by removing certain exceptions to the general principles in Topic 740. The amendments also improve consistent application of and simplify GAAP for the areas of Topic 740 by clarifying and amending existing guidance. This guidance is effective for fiscal years, and interim periods within those fiscal years beginning after December 15, 2020, for public business entities. For private companies and smaller reporting companies, this guidance is effective for fiscal years, and interim periods within those fiscal years beginning after December 15, 2021. As an emerging growth company, the Company can take advantage of this later effective date. Early adoption of the amendments is permitted, including adoption in any interim period for which financial statements have not yet been issued. Depending on the amendment, adoption may be applied on the retrospective, modified retrospective, or prospective basis. The Company is currently reviewing the provisions of this new pronouncement, but does not expect adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In January 2020, the FASB issued ASU 2020-01, Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) – Clarifying the Interactions between Topic 321, Topic 323, and Topic 815. The ASU is based on a consensus of the Emerging Issues Task Force and is expected to increase comparability in accounting for these transactions. ASU 2016-01 made targeted improvements to accounting for financial instruments, including providing an entity the ability to measure certain equity securities without a readily determinable fair value at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Among other topics, the amendments clarify that an entity should consider observable transactions that require it to either apply or discontinue the equity method of accounting. For public business entities, the amendments in the ASU are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoptions is permitted. The Company does not expect the adoption of ASU 2020-01 to have a material impact on its consolidated financial statements.

In March 2020, the FASB issued ASU 2020-03. Codification Improvements to Financial Instruments. This ASU represents changes to clarify or improve the Accounting Standards Codification, or ASC, related to seven topics. The amendments make the ASC easier to understand and easier to apply by eliminating inconsistencies and providing clarifications. Issues 1, 2, 3, 4, and 5 are conforming amendments and for public business entities effective upon the issuance of the standard. Issues 6 and 7 are amendments that affect the guidance in ASU 2016-13. The Company will consider these clarifications and improvements in determining the appropriate adoption of ASU 2016-13.

In March 2020, the FASB issued ASU 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting. These amendments provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying GAAP to contract modifications and hedging relationships, subject to meeting certain criteria, that reference LIBOR or another reference rate expected to be discontinued. It is intended to help stakeholders during the global market-wide reference rate transition period. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022. The Company is assessing ASU 2020-04 and its impact on the Company's transition away from LIBOR for its loan and other financial instruments.

NOTE 3 Investment Securities

The following tables present amortized cost, gross unrealized gain and losses, and fair value of the available-for-sale investment securities as of June 30, 2020 and December 31, 2019:

	June 30, 2020			
(dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. Treasury and agencies	$ 16,202	$ 66	$ (16)	$
Obligations of state and political agencies	110,676	3,477	—	
Mortgage backed securities				
Residential agency	206,146	8,595	(34)	
Commercial	27,007	940	(21)	
Asset backed securities	127	8	—	
Corporate bonds	20,524	79	(49)	
Total available-for-sale investment securities	$ 380,682	$ 13,165	$ (120)	$

	December 31, 2019			
(dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. Treasury and agencies	$ 21,246	$ 9	$ (15)	$
Obligations of state and political agencies	68,162	647	(161)	
Mortgage backed securities				
Residential agency	180,411	2,258	(131)	
Commercial	30,752	101	(168)	
Asset backed securities	139	5	—	
Corporate bonds	7,054	41	—	
Total available-for-sale investment securities	$ 307,764	$ 3,061	$ (475)	$

The following tables present unrealized losses and fair values for available-for-sale investment securities as of June 30, 2020 and December 31, 2019, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position:

	June 30, 2020				
	Less than 12 Months		Over 12 Months		To
(dollars in thousands)	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury and agencies	$ (8)	$ 4,803	$ (8)	$ 1,324	$ (16)
Obligations of state and political agencies	—	—	—	—	—
Mortgage backed securities					
Residential agency	(34)	11,903	—	—	(34)
Commercial	—	—	(21)	6,640	(21)
Asset backed securities	—	—	—	2	—
Corporate bonds	(49)	9,451	—	—	(49)
Total available-for-sale investment securities	$ (91)	$ 26,157	$ (29)	$ 7,966	$ (120)

	December 31, 2019				
	Less than 12 Months		Over 12 Months		To
(dollars in thousands)	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury and agencies	$ (5)	$ 1,740	$ (10)	$ 9,990	$ (15)
Obligations of state and political agencies	(140)	11,959	(21)	5,798	(161)
Mortgage backed securities					
Residential agency	(52)	17,131	(79)	14,036	(131)
Commercial	(116)	15,235	(52)	6,195	(168)
Asset backed securities	—	2	—	—	—
Corporate bonds	—	—	—	—	—
Total available-for-sale investment securities	$ (313)	$ 46,067	$ (162)	$ 36,019	$ (475)

For all of the above investment securities, the unrealized losses were generally due to changes in interest rates and unrealized losses were considered to be temporary as the fair value is expected to recover as the securities approach their maturity dates. The Company evaluates securities for other-than-temporary impairment, or OTTI, on a quarterly basis, at a minimum, and more frequently when economic or market concerns warrant such evaluation. In estimating OTTI losses, consideration is given to the severity and duration of the impairment; the financial condition and near-term prospects of the issuer, which for debt securities, considers external credit ratings and recent downgrades; and the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value.

For the three and six months ended June 30, 2020 and 2019, the Company did not recognize OTTI losses on its investment securities.

The following table presents amortized cost and estimated fair value of the available-for-sale investment securities as of June 30, 2020, by contractual maturity:

(dollars in thousands)	Amortized Cost
Due within one year or less	$ 18,105
Due after one year through five years	26,685
Due after five years through ten years	114,717
Due after 10 years	221,175
Total available-for-sale investment securities	$ 380,682

Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Investment securities with a total carrying value of $121.3 million and $136.2 million were pledged as of June 30, 2020 and December 31, 2019, respectively, to secure public deposits and for other purposes required or permitted by law.

Proceeds from the sale or call of available-for-sale investment securities, for the three and six months ended June 30, 2020 and 2019, are displayed in the table below:

	Three months ended June 30,		Six months en June 30,	
(dollars in thousands)	2020	2019	2020	
Proceeds	$ 35,505	$ 16,868	$ 39,505	$
Realized gains	1,294	179	1,294	
Realized losses	—	(5)	—	

As of June 30, 2020 and December 31, 2019, the carrying value of the Company's Federal Reserve stock and Federal Home Loan Bank of Des Moines, or FHLB, stock was as follows:

(dollars in thousands)	June 30, 2020	
Federal Reserve	$ 2,675	$
FHLB	3,236	

These securities can only be redeemed or sold at their par value and only to the respective issuing institution or to another member institution. The Company records these non-marketable equity securities as a component of other assets and periodically evaluates these securities for impairment. Management considers these non-marketable equity securities to be long-term investments. Accordingly, when evaluating these securities for impairment, management considers the ultimate recoverability of the par value rather than recognizing temporary declines in value.

Visa Class B Restricted Shares

In 2008, the Company received Visa Class B restricted shares as part of Visa's initial public offering. These shares are transferable only under limited circumstances until they can be converted into the publicly traded Class A common shares. This conversion will not occur until the settlement of certain litigation which will be indemnified by Visa members, including the Company. Visa funded an escrow account from its initial public offering to settle these litigation claims. Should this escrow account be insufficient to cover these litigation claims, Visa is entitled to fund additional amounts to the escrow account by reducing each member bank's Class B conversion ratio to unrestricted Class A shares. As of June 30, 2020, the conversion ratio was 1.6228. Based on the existing transfer restriction and the uncertainty of the outcome of the Visa litigation mentioned above, the 6,924 Class B shares (11,236 Class A equivalents) that the Company owned as of June 30, 2020 and December 31, 2019, are carried at a zero cost basis.

NOTE 4 Loans and Allowance for Loan Losses

The following table presents total loans outstanding, by portfolio segment, as of June 30, 2020 and December 31, 2019:

(dollars in thousands)	June 30, 2020
Commercial	
Commercial and industrial (1)	$ 794,204
Real estate construction	31,344
Commercial real estate	519,104
Total commercial	1,344,652
Consumer	
Residential real estate first mortgage	456,737
Residential real estate junior lien	154,351
Other revolving and installment	78,457
Total consumer	689,545
Total loans	$ 2,034,197

(1) Includes Paycheck Protection Program, or PPP, loans of $347.3 million at June 30, 2020.

Total loans included net deferred loan fees and costs of $10.3 million and $1.0 million at June 30, 2020 and December 31, 2019, respectively. Deferred loan fees on PPP loans were $9.6 million as of June 30, 2020.

Management monitors the credit quality of its loan portfolio on an ongoing basis. Measurement of delinquency and past due status are based on the contractual terms of each loan. Past due loans are reviewed regularly to identify loans for nonaccrual status. Loan modifications made in accordance with the Interagency Statement on Loan Modifications and Reporting for Financial Institutions are included as accruing current.

The following tables present a past due aging analysis of total loans outstanding, by portfolio segment, as of June 30, 2020 and December 31, 2019:

	June 30, 2020				
(dollars in thousands)	Accruing Current	30 - 89 Days Past Due	90 Days or More Past Due	Nonaccrual	
Commercial					
Commercial and industrial	$ 790,675	$ 662	$ —	$ 2,867	$
Real estate construction	31,344	—	—	—	
Commercial real estate	517,657	—	—	1,447	
Total commercial	1,339,676	662	—	4,314	
Consumer					
Residential real estate first mortgage	453,810	2,163	—	764	
Residential real estate junior lien	153,907	233	—	211	
Other revolving and installment	78,306	112	—	39	
Total consumer	686,023	2,508	—	1,014	
Total loans	$ 2,025,699	$ 3,170	$ —	$ 5,328	$

	December 31, 2019				
(dollars in thousands)	Accruing Current	30 - 89 Days Past Due	90 Days or More Past Due	Nonaccrual	
Commercial					
Commercial and industrial	$ 473,900	$ 382	$ —	$ 4,862	$
Real estate construction	26,251	127	—	—	
Commercial real estate	492,707	556	—	1,440	
Total commercial	992,858	1,065	—	6,302	
Consumer					
Residential real estate first mortgage	455,244	666	448	797	
Residential real estate junior lien	176,915	184	—	274	
Other revolving and installment	86,172	348	—	6	
Total consumer	718,331	1,198	448	1,077	
Total loans	$ 1,711,189	$ 2,263	$ 448	$ 7,379	$

The Company's consumer loan portfolio is primarily comprised of secured loans that are evaluated at origination on a centralized basis against standardized underwriting criteria. The Company generally does not risk rate consumer loans unless a default event such as bankruptcy or extended nonperformance takes place. Credit quality for the consumer loan portfolio is measured by delinquency rates, nonaccrual amounts and actual losses incurred.

The Company assigns a risk rating to all commercial loans, except pools of homogeneous loans, and periodically performs detailed internal and external reviews of risk rated loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by the Company's regulators. During the internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which the borrowers operate and the estimated fair values of collateral securing the loans. These credit quality indicators are used to assign a risk rating to each individual loan.

The Company's ratings are aligned to pass and criticized categories. The criticized category includes special mention, substandard, and doubtful risk ratings. The risk ratings are defined as follows:

Pass: A pass loan is a credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention: Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, this potential weakness may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard: Loans classified as substandard are not adequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. Well-defined weaknesses include a borrower's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time, or the failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company 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 repayment in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss: Loans classified as loss are considered uncollectible and charged off immediately.

The tables below present total loans outstanding, by loan portfolio segment, and risk category as of June 30, 2020 and December 31, 2019:

	June 30, 2020				
		Criticized			
(dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	
Commercial					
Commercial and industrial	$ 768,851	$ 5,886	$ 19,467	$ —	$
Real estate construction	31,087	—	257	—	
Commercial real estate	491,105	4,348	23,651	—	
Total commercial	1,291,043	10,234	43,375	—	
Consumer					
Residential real estate first mortgage	455,973	—	764	—	
Residential real estate junior lien	151,249	1,841	1,261	—	
Other revolving and installment	78,418	—	39	—	
Total consumer	685,640	1,841	2,064	—	
Total loans	$ 1,976,683	$ 12,075	$ 45,439	$ —	$

	December 31, 2019				
		Criticized			
(dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	
Commercial					
Commercial and industrial	$ 448,306	$ 9,585	$ 21,253	$ —	$
Real estate construction	25,119	282	977	—	
Commercial real estate	462,294	2,359	30,050	—	
Total commercial	935,719	12,226	52,280	—	
Consumer					
Residential real estate first mortgage	456,358	—	797	—	
Residential real estate junior lien	176,122	—	1,251	—	
Other revolving and installment	86,520	—	6	—	
Total consumer	719,000	—	2,054	—	
Total loans	$ 1,654,719	$ 12,226	$ 54,334	$ —	$

The adequacy of the allowance for loan losses is assessed at the end of each quarter. The allowance for loan losses includes a specific component related to loans that are individually evaluated for impairment and a general component related to loans that are segregated into homogeneous pools and collectively evaluated for impairment. The factors applied to these pools are an estimate of probable incurred losses based on management's evaluation of historical net losses from loans with similar characteristics, which are adjusted by management to reflect current events, trends, and conditions. The adjustments include consideration of the following: changes in lending policies and procedures, economic conditions, nature and volume of the portfolio, experience of lending management, volume and severity of past due loans, quality of the loan review system, value of underlying collateral for collateral dependent loans, concentrations, and other external factors.

The following tables present, by loan portfolio segment, a summary of the changes in the allowance for loan losses for the three and six months ended June 30, 2020 and 2019:

(dollars in thousands)	Three months ended June 30, 2020 Beginning Balance	Provision for Loan Losses	Loan Charge-offs	Loan Recoveries
Commercial				
Commercial and industrial	$ 12,901	$ 278	$ (2,703)	$ 321
Real estate construction	334	109	—	—
Commercial real estate	8,276	2,537	(865)	—
Total commercial	21,511	2,924	(3,568)	321
Consumer				
Residential real estate first mortgage	2,209	459	—	5
Residential real estate junior lien	1,025	32	(12)	57
Other revolving and installment	441	171	(86)	20
Total consumer	3,675	662	(98)	82
Unallocated	1,833	(86)	—	—
Total	$ 27,019	$ 3,500	$ (3,666)	$ 403

(dollars in thousands)	Six months ended June 30, 2020 Beginning Balance	Provision for Loan Losses	Loan Charge-offs	Loan Recoveries
Commercial				
Commercial and industrial	$ 12,270	$ 348	$ (2,735)	$ 914
Real estate construction	303	140	—	—
Commercial real estate	6,688	4,125	(865)	—
Total commercial	19,261	4,613	(3,600)	914
Consumer				
Residential real estate first mortgage	1,448	1,220	—	5
Residential real estate junior lien	671	349	(12)	94
Other revolving and installment	352	263	(153)	84
Total consumer	2,471	1,832	(165)	183
Unallocated	2,192	(445)	—	—
Total	$ 23,924	$ 6,000	$ (3,765)	$ 1,097

(dollars in thousands)	Three months ended June 30, 2019 Beginning Balance	Provision for Loan Losses	Loan Charge-offs	Loan Recoveries
Commercial				
Commercial and industrial	$ 13,815	$ 818	$ (3,166)	$ 227
Real estate construction	251	70	—	2
Commercial real estate	5,843	(228)	—	150
Total commercial	19,909	660	(3,166)	379
Consumer				
Residential real estate first mortgage	1,610	(455)	—	—
Residential real estate junior lien	761	(51)	(30)	30
Other revolving and installment	349	433	(424)	22
Total consumer	2,720	(73)	(454)	52
Unallocated	9	1,210	—	—
Total	$ 22,638	$ 1,797	$ (3,620)	$ 431

(dollars in thousands)	Six months ended June 30, 2019 Beginning Balance	Provision for Loan Losses	Loan Charge-offs	Loan Recoveries
Commercial				
Commercial and industrial	$ 12,127	$ 4,225	$ (4,951)	$ 293
Real estate construction	250	72	(1)	2
Commercial real estate	6,279	(664)	—	150
Total commercial	18,656	3,633	(4,952)	445
Consumer				
Residential real estate first mortgage	1,156	(1)	—	—
Residential real estate junior lien	805	(44)	(134)	83
Other revolving and installment	380	387	(482)	95
Total consumer	2,341	342	(616)	178
Unallocated	1,177	42	—	—
Total	$ 22,174	$ 4,017	$ (5,568)	$ 623

The following tables present the recorded investment in loans and related allowance for loan losses, by loan portfolio segment, disaggregated on the basis of the Company's impairment methodology, as of June 30, 2020 and December 31, 2019:

	June 30, 2020					
	Recorded Investment			Allowance for Loan Losses		
(dollars in thousands)	Individually Evaluated	Collectively Evaluated	Total	Individually Evaluated	Collectively Evaluated	Unallocated
Commercial						
Commercial and industrial	$ 3,644	$ 790,560	$ 794,204	$ 503	$ 10,294	$ –
Real estate construction	—	31,344	31,344	—	443	–
Commercial real estate	1,529	517,575	519,104	10	9,938	–
Total commercial	5,173	1,339,479	1,344,652	513	20,675	–
Consumer						
Residential real estate first mortgage	747	455,990	456,737	—	2,673	–
Residential real estate junior lien	260	154,091	154,351	20	1,082	–
Other revolving and installment	39	78,418	78,457	16	530	–
Total consumer	1,046	688,499	689,545	36	4,285	–
Total loans	$ 6,219	$ 2,027,978	$ 2,034,197	$ 549	$ 24,960	$ 1,74

	December 31, 2019					
	Recorded Investment			Allowance for Loan Losses		
(dollars in thousands)	Individually Evaluated	Collectively Evaluated	Total	Individually Evaluated	Collectively Evaluated	Unallocated
Commercial						
Commercial and industrial	$ 976	$ 478,168	$ 479,144	$ 189	$ 12,081	$ –
Real estate construction	—	26,378	26,378	—	303	–
Commercial real estate	5,925	488,778	494,703	2,946	3,742	–
Total commercial	6,901	993,324	1,000,225	3,135	16,126	–
Consumer						
Residential real estate first mortgage	782	456,373	457,155	—	1,448	–
Residential real estate junior lien	266	177,107	177,373	—	671	–
Other revolving and installment	5	86,521	86,526	3	349	–
Total consumer	1,053	720,001	721,054	3	2,468	–
Total loans	$ 7,954	$ 1,713,325	$ 1,721,279	$ 3,138	$ 18,594	$ 2,19

The tables below summarize key information on impaired loans. These impaired loans may have estimated losses which are included in the allowance for loan losses.

(dollars in thousands)	June 30, 2020 Recorded Investment	June 30, 2020 Unpaid Principal	June 30, 2020 Related Allowance	December 31, 2 Recorded Investment	December 31, 2 Unpaid Principal
Impaired loans with a valuation allowance					
Commercial and industrial	$ 3,020	$ 3,096	$ 503	$ 639	$ 727
Commercial real estate	199	227	10	5,718	5,823
Residential real estate junior lien	19	20	20	—	—
Other revolving and installment	35	35	16	5	6
Total impaired loans with a valuation allowance	3,273	3,378	549	6,362	6,556
Impaired loans without a valuation allowance					
Commercial and industrial	624	805	—	337	1,110
Commercial real estate	1,330	1,447	—	207	236
Residential real estate first mortgage	747	764	—	782	797
Residential real estate junior lien	241	341	—	266	372
Other revolving and installment	4	4	—	—	—
Total impaired loans without a valuation allowance	2,946	3,361	—	1,592	2,515
Total impaired loans					
Commercial and industrial	3,644	3,901	503	976	1,837
Commercial real estate	1,529	1,674	10	5,925	6,059
Residential real estate first mortgage	747	764	—	782	797
Residential real estate junior lien	260	361	20	266	372
Other revolving and installment	39	39	16	5	6
Total impaired loans	$ 6,219	$ 6,739	$ 549	$ 7,954	$ 9,071

The table below presents the average recorded investment in impaired loans and interest income for the three and six months ended June 30, 2020 and 2019:

	Three months ended June 30,		
	2020		20
(dollars in thousands)	Average Recorded Investment	Interest Income	Average Recorded Investment
Impaired loans with a valuation allowance			
Commercial and industrial	$ 4,881	$ 15	$ 2,229
Commercial real estate	200	8	1,678
Residential real estate first mortgage	—	—	—
Residential real estate junior lien	20	—	60
Other revolving and installment	35	—	9
Total impaired loans with a valuation allowance	5,136	23	3,976
Impaired loans without a valuation allowance			
Commercial and industrial	694	26	1,271
Commercial real estate	1,693	—	—
Residential real estate first mortgage	755	—	—
Residential real estate junior lien	255	3	751
Other revolving and installment	4	—	5
Total impaired loans without a valuation allowance	3,401	29	2,027
Total impaired loans			
Commercial and industrial	5,575	41	3,500
Commercial real estate	1,893	8	1,678
Residential real estate first mortgage	755	—	—
Residential real estate junior lien	275	3	811
Other revolving and installment	39	—	14
Total impaired loans	$ 8,537	$ 52	$ 6,003

	Six Months Ended June 30,		
	2020		20
(dollars in thousands)	Average Recorded Investment	Interest Income	Average Recorded Investment
Impaired loans with a valuation allowance			
Commercial and industrial	$ 4,714	$ 15	$ 1,332
Commercial real estate	203	8	1,505
Residential real estate junior lien	20	—	—
Other revolving and installment	35	—	9
Total impaired loans with a valuation allowance	4,972	23	2,846
Impaired loans without a valuation allowance			
Commercial and industrial	747	26	4,835
Real estate construction	—	—	217
Commercial real estate	1,821	—	—
Residential real estate first mortgage	761	—	—
Residential real estate junior lien	279	3	821
Other revolving and installment	5	—	13
Total impaired loans without a valuation allowance	3,613	29	5,886
Total impaired loans			
Commercial and industrial	5,461	41	6,167
Real estate construction	—	—	217
Commercial real estate	2,024	8	1,505
Residential real estate first mortgage	761	—	—
Residential real estate junior lien	299	3	821
Other revolving and installment	40	—	22
Total impaired loans	$ 8,585	$ 52	$ 8,732

Loans with a carrying value of $1.2 billion as of June 30, 2020 and $1.2 billion as of December 31, 2019, were pledged to secure public deposits, and for other purposes required or permitted by law.

Under certain circumstances, the Company will provide borrowers relief through loan restructurings. A restructuring of debt constitutes a TDR if the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. TDR concessions can include reduction of interest rates, extension of maturity dates, forgiveness of principal or interest due, or acceptance of other assets in full or partial satisfaction of the debt.

During the second quarter of 2020 there were no loans modified as a TDR. As of June 30, 2020, the Company executed 515 principal and interest deferrals on outstanding loan balances of $148.5 million in connection with the COVID-19 relief provided by the CARES Act. These deferrals were generally no more than 90 days in duration and were not considered TDRs in accordance with the Interagency Statement on Loan Modifications and Reporting for Financial Institutions as issued on April 7, 2020. During the first quarter of 2019, there was one loan modified as a TDR as a result of extending the amortization period. As of December 31, 2019, the carrying value of the restructured loan was $0.2 million. The loan is currently performing according to the modified terms and there was no specific reserve for loan losses allocated to the loan modified as troubled debt restructuring.

The Company does not have material commitments to lend additional funds to borrowers with loans whose terms have been modified in troubled debt restructurings or whose loans are on nonaccrual.

NOTE 5 Goodwill and Other Intangible Assets

The following table summarizes the carrying amount of goodwill, by segment, as of June 30, 2020 and December 31, 2019:

(dollars in thousands)	June 30, 2020	De
Banking	$ 20,131	$
Retirement and benefit services	7,198	
Total goodwill	$ 27,329	$

The gross carrying amount and accumulated amortization for each type of identifiable intangible asset are as follows:

	June 30, 2020			December 31, 2019	
(dollars in thousands)	Gross Carrying Amount	Accumulated Amortization	Total	Gross Carrying Amount	Accumulated Amortization
Identifiable customer intangibles	$ 31,857	$ (15,888)	$ 15,969	$ 31,857	$ (14,287)
Core deposit intangible assets	3,793	(3,351)	442	4,993	(4,172)
Total intangible assets	$ 35,650	$ (19,239)	$ 16,411	$ 36,850	$ (18,459)

Amortization of intangible assets was $1.0 million and $1.1 million for the three months ended June 30, 2020, and 2019, respectively. Amortization of intangible assets was $2.0 and $2.1 million for the six months ended June 30, 2020, and 2019, respectively.

Goodwill is evaluated for impairment on an annual basis, at a minimum, and more frequently when the economic environment warrants. The Company determined that there was no goodwill impairment as of June 30, 2020.

NOTE 6 Loan Servicing

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of loans serviced for others totaled $498.7 million and $541.9 million as of June 30, 2020 and December 31, 2019, respectively. Servicing loans for others generally consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and collection and foreclosure processing. Loan servicing income is recorded on an accrual basis and includes servicing fees from investors and certain charges collected from borrowers, such as late payment fees, and is net of fair value adjustments to capitalized mortgage servicing rights.

The following table summarizes the Company’s activity related to servicing rights for the three and six months ended June 30, 2020 and 2019:

	Three months ended June 30,		Six months June 30
(dollars in thousands)	2020	2019	2020
Balance, beginning of period	$ 3,277	$ 4,530	$ 3,845
Additions	88	34	112
Amortization	(209)	(239)	(396)
(Impairment)/Recovery	(265)	(25)	(670)
Balance, end of period	$ 2,891	$ 4,300	$ 2,891

The following is a summary of key data and assumptions used in the valuation of servicing rights as of June 30, 2020 and December 31, 2019. Increases or decreases in any one of these assumptions would result in lower or higher fair value measurements.

(dollars in thousands)		June 30, 2020	
Fair value of servicing rights	$	2,891	$
Weighted-average remaining term, years		19.9	
Prepayment speeds		22.1 %	
Discount rate		9.0 %	

NOTE 7 Leases

Substantially all of the leases in which the Company is the lessee are comprised of real estate property for offices and office equipment rentals with terms extending through 2032. Portions of certain properties are subleased for terms extending through 2024. Substantially all of the Company's leases are classified as operating leases, and therefore, were previously not recognized on the Company's consolidated financial statements. The Company has one existing finance lease for the Company's headquarters building with a lease term through 2022.

The Company elected not to include short-term leases (i.e., leases with initial terms of twelve months or less), or equipment leases (deemed immaterial) on the consolidated financial statements. The following table presents the classification of the Company's right-of-use, or ROU, assets and lease liabilities on the consolidated financial statements.

(dollars in thousands)			June 30, 2020	
Lease Right-of-Use Assets	**Classification**			
Operating lease right-of-use assets	Operating lease right-of-use assets	$	8,746	$
Finance lease right-of-use assets	Land, premises and equipment, net		260	
Total lease right-of-use assets		$	9,006	$
Lease Liabilities				
Operating lease liabilities	Operating lease liabilities	$	9,254	$
Finance lease liabilities	Long-term debt		537	
Total lease liabilities		$	9,791	$

The calculated amount of the ROU assets and lease liabilities in the table above are impacted by the length of the lease term and the discount rate used to present value the minimum lease payments. The Company's lease agreements often include one or more options to renew at the Company's discretion. If at lease inception, the Company considers the exercising of a renewal option to be reasonably certain, the Company will include the extended term in the calculation of the ROU asset and lease liability. Regarding the discount rate, Topic 842 requires the use of the rate implicit in the lease whenever this rate is readily determinable. As this rate is rarely determinable, the Company utilizes its incremental borrowing rate at lease inception, on a collateralized basis, over a similar term. For operating leases existing prior to January 1, 2019, the rate for the remaining lease term as of January 1, 2019 was used. For the Company's only finance lease, the Company utilized its incremental borrowing rate at lease inception.

	June 30, 2020	
Weighted-average remaining lease term, years		
Operating leases	5.8	
Finance leases	2.1	
Weighted-average discount rate		
Operating leases	2.8 %	
Finance leases	7.8 %	

As the Company elected, for all classes of underlying assets, not to separate lease and non-lease components and instead to account for them as a single lease component, the variable lease cost primarily represents variable

payments such as common area maintenance and utilities. Variable lease cost also includes payments for usage or maintenance of those capitalized equipment operating leases.

The following table presents lease costs and other lease information for the three and six months ending June 30, 2020 and 2019.

	Three months ended June 30,		Six mont June
(dollars in thousands)	2020	2019	2020
Lease costs			
Operating lease cost	$ 568	$ 598	$ 1,191
Variable lease cost	468	211	665
Short-term lease cost	107	260	202
Finance lease cost			
Interest on lease liabilities	11	16	23
Amortization of right-of-use assets	29	29	58
Sublease income	(52)	(68)	(118)
Net lease cost	$ 1,131	$ 1,046	$ 2,021
Other information			
Cash paid for amounts included in the measurement of lease liabilities operating cash flows from operating leases	561	597	$ 1,179
Right-of-use assets obtained in exchange for new operating lease liabilities	1,348	—	1,531
Right-of-use assets obtained in exchange for new finance lease liabilities	—	—	—

Future minimum payments for finance and operating leases with initial or remaining terms of one year or more as of June 30, 2020 were as follows:

(dollars in thousands)	Finance Leases	
Twelve months ended		
June 30, 2021	$ 251	$
June 30, 2022	251	
June 30, 2023	84	
June 30, 2024	—	
June 30, 2025	—	
Thereafter	—	
Total future minimum lease payments	$ 586	$
Amounts representing interest	(49)	
Total operating lease liabilities	$ 537	$

NOTE 8 Deposits

The components of deposits in the consolidated balance sheets as of June 30, 2020 and December 31, 2019 were as follows:

(dollars in thousands)	June 30, 2020
Noninterest-bearing	$ 700,892
Interest-bearing	
Interest-bearing demand	579,840
Savings accounts	75,973
Money market savings	892,717
Time deposits	203,731
Total interest-bearing	1,752,261
Total deposits	$ 2,453,153

NOTE 9 Short-Term Borrowings

There were no short-term borrowings outstanding as of June 30, 2020 and December 31, 2019.

The following table presents information related to short-term borrowings for the three and six months ending June 30, 2020 and 2019:

	Three months June 30,	
(dollars in thousands)	2020	
Fed funds purchased		
Balance as of end of period	$ —	$
Average daily balance	321	
Maximum month-end balance	—	
Weighted-average rate		
During period	— %	
End of period	— %	
FHLB Short-term advances		
Balance as of end of period	$ —	$
Average daily balance	—	
Maximum month-end balance	—	
Weighted-average rate		
During period	— %	
End of period	— %	

	Six months June 30	
(dollars in thousands)	2020	
Fed funds purchased		
Balance as of end of period	$ —	$
Average daily balance	161	
Maximum month-end balance	—	
Weighted-average rate		
During period	— %	
End of period	— %	
FHLB Short-term advances		
Balance as of end of period	$ —	$
Average daily balance	—	
Maximum month-end balance	—	
Weighted-average rate		
During period	— %	
End of period	— %	

NOTE 10 Long-Term Debt

Long-term debt as of June 30, 2020 and December 31, 2019 consisted of the following:

	June 30, 2020				
(dollars in thousands)	Face Value	Carrying Value	Interest Rate	Period End Interest Rate	Maturity Date
Subordinated notes payable	$ 50,000	$ 49,656	Fixed	5.75 %	12/30/2025
Junior subordinated debenture (Trust I)	4,124	3,424	Three-month LIBOR + 3.10%	3.38 %	6/26/2033
Junior subordinated debenture (Trust II)	6,186	5,137	Three-month LIBOR + 1.80%	2.11 %	9/15/2036
Finance lease liability	2,657	537	Fixed	7.81 %	10/31/2022
Total long-term debt	$ 62,967	$ 58,754			

	December 31, 2019				
(dollars in thousands)	Face Value	Carrying Value	Interest Rate	Period End Interest Rate	Maturity Date
Subordinated notes payable	$ 50,000	$ 49,625	Fixed	5.75 %	12/30/2025
Junior subordinated debenture (Trust I)	4,124	3,402	Three-month LIBOR + 3.10%	5.05 %	6/26/2033
Junior subordinated debenture (Trust II)	6,186	5,102	Three-month LIBOR + 1.80%	3.69 %	9/15/2036
Finance lease liability	2,657	640	Fixed	7.81 %	10/31/2022
Total long-term debt	$ 62,967	$ 58,769			

NOTE 11 Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, the Bank has outstanding commitment and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying consolidated financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the statements of financial condition.

As of June 30, 2020 and December 31, 2019, the following financial instruments whose contract amount represents credit risk were approximately as follows:

(dollars in thousands)	June 30, 2020
Commitments to extend credit	$ 600,269
Standby letters of credit	7,387
Total	$ 607,656

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

The Company was not required to perform on any financial guarantees and did not incur any losses on its commitments during the past two years.

The Company utilizes standby letters of credit issued by either the Federal Home Loan Bank or the Bank of North Dakota to secure public unit deposits. The Company had a $150 thousand letter of credit with the Federal Home Loan Bank as of June 30, 2020 and December 31, 2019. With the Bank of North Dakota, the Company had $15.0 million of letters of credit outstanding as of June 30, 2020 and $20.0 million as of December 31, 2019. Bank of North Dakota letters of credit were collateralized by loans pledged to the Bank of North Dakota in the amount of $248.3 million and $242.0 million as of June 30, 2020 and December 31, 2019, respectively.

NOTE 12 Share-Based Compensation

The Company has granted equity awards pursuant to the Alerus Financial Corporation 2009 Stock Plan. The awards were in the form of restricted stock or restricted stock units and are considered to represent an element of employee compensation. Compensation expense for the awards is based on the fair value of Alerus Financial Corporation common stock at the time of grant. The value of awards that are expected to vest are amortized into expense over the vesting periods. The ability to grant awards under this plan has expired.

On May 6, 2019, the Company’s stockholders approved the Alerus Financial Corporation 2019 Equity Incentive Plan. This plan allows the compensation committee the ability to grant a wide variety of equity awards, including stock options, stock appreciation rights, restricted stock, restricted stock units and cash incentive awards in such forms and amounts as it deems appropriate to accomplish the goals of the plan. Any shares subject to an award that is cancelled, forfeited, or expires prior to exercise or realization, either in full or in part, shall again become available for issuance under the plan. However, shares subject to an award shall not again be made available for issuance or delivery under the plan if such shares are (a) tendered in payment of the exercise price of a stock option, (b) delivered to, or withheld by, the Company to satisfy any tax withholding obligation, or (c) covered by a stock-settled stock appreciation right or other awards that were not issued upon the settlement of the award. Shares vest, become exercisable and contain such other terms and conditions as determined by the compensation committee and set forth in individual agreements with the participant receiving the award. The plan authorizes the issuance of up to 1,100,000 shares of common stock. As of June 30, 2020, 28,242 stock awards and 49,604 restricted stock units had been issued under the plan.

Compensation expense relating to awards under these plans was $624 thousand and $399 thousand for the three months ending June 30, 2020 and 2019, respectively. Compensation expense relating to awards under these plans was $859 thousand and $649 thousand for the six months ending June 30, 2020 and 2019, respectively.

The following tables present the activity in the stock plans for the six months ended June 30, 2020 and 2019:

	Six months ended June 30, 2020		Six months ended J	
	Awards	Weighted-Average Grant Date Fair Value	Awards	
Restricted Stock and Restricted Stock Unit Awards				
Outstanding at beginning of period	347,211	$ 18.64	337,014	$
Granted	77,846	19.53	70,617	
Vested	(86,137)	16.15	(32,837)	
Forfeited or cancelled	(5,068)	19.37	(753)	
Outstanding at end of period	333,852	$ 19.48	374,041	$

As of June 30, 2020, there was $3.58 million of unrecognized compensation expense related to non-vested awards granted under the plans. The expense is expected to be recognized over a weighted-average period of 3.56 years.

NOTE 13 Income Taxes

The components of income tax expense (benefit) for the three and six months ended June 30, 2020 and 2019 are as follows:

	Three months ended June 30,			
	2020		2019	
(dollars in thousands)	Amount	Percent of Pretax Income	Amount	
Taxes at statutory federal income tax rate	$ 3,168	21.0 %	$ 2,356	
Tax effect of:				
Tax exempt income	(127)	(0.8)	(108)	
Other	572	3.8	621	
Applicable income taxes	$ 3,613	23.9 %	$ 2,869	

	Six months ended June 30,			
	2020		2019	
(dollars in thousands)	Amount	Percent of Pretax Income	Amount	I
Taxes at statutory federal income tax rate	$ 4,596	21.0 %	$ 4,132	
Tax effect of:				
Tax exempt income	(247)	(1.1)%	(222)	
Other	701	3.2 %	983	
Applicable income taxes	$ 5,050	23.1 %	$ 4,893	

It is the opinion of management that the Company has no significant uncertain tax positions that would be subject to change upon examination.

NOTE 14 Segment Reporting

The Company determines reportable segments based on the services offered, the significance of the services offered, the significance of those services to the Company's financial statements, and management's regular review of the operating results of those services. The Company operates through four operating segments: Banking, Retirement and Benefit Services, Wealth Management, and Mortgage.

The financial information presented for each segment includes net interest income, provision for loan losses, direct noninterest income, and direct noninterest expense, before indirect allocations. Corporate Administration includes the indirect overhead and is set forth in the table below. The segment net income before taxes represents direct revenue and expense before indirect allocations and income taxes.

The following table presents key metrics related to the Company's segments for the periods presented:

	Three months ended June 30, 2020				
(dollars in thousands)	Banking	Retirement and Benefit Services	Wealth Management	Mortgage	Corporate Administration
Net interest income	$ 20,417	$ —	$ —	$ 530	$ (856)
Provision for loan losses	3,500	—	—	—	—
Noninterest income	2,857	13,710	4,112	17,546	5
Noninterest expense	11,359	9,193	2,629	8,020	8,533
Net income before taxes	$ 8,415	$ 4,517	$ 1,483	$ 10,056	$ (9,384)

(dollars in thousands)	Six months ended June 30, 2020 Banking	Retirement and Benefit Services	Wealth Management	Mortgage	Corporate Administration
Net interest income	$ 39,863	$ —	$ —	$ 798	$ (1,733)
Provision for loan losses	6,000	—	—	—	—
Noninterest income	4,731	29,930	8,158	22,591	9
Noninterest expense	24,011	17,125	4,144	13,459	17,721
Net income before taxes	$ 14,583	$ 12,805	$ 4,014	$ 9,930	$ (19,445)

(dollars in thousands)	Three months ended June 30, 2019 Banking	Retirement and Benefit Services	Wealth Management	Mortgage	Corporate Administration
Net interest income	$ 18,894	$ —	$ —	$ 305	$ (908)
Provision for loan losses	1,797	—	—	—	—
Noninterest income	1,747	15,776	3,878	7,035	1,548
Noninterest expense	10,088	8,601	2,177	5,966	8,429
Net income before taxes	$ 8,756	$ 7,175	$ 1,701	$ 1,374	$ (7,789)

(dollars in thousands)	Six months ended June 30, 2019 Banking	Retirement and Benefit Services	Wealth Management	Mortgage	Corporate Administration
Net interest income	$ 38,794	$ —	$ —	$ 434	$ (1,817)
Provision for loan losses	4,017	—	—	—	—
Noninterest income	3,578	30,835	7,489	11,604	1,552
Noninterest expense	20,080	17,591	4,101	9,928	17,075
Net income before taxes	$ 18,275	$ 13,244	$ 3,388	$ 2,110	$ (17,340)

Banking

The Banking division offers a complete line of loan, deposit, cash management, and treasury services through fifteen offices in North Dakota, Minnesota, and Arizona. These products and services are supported through web and mobile based applications. The majority of the Company's assets and liabilities are in the Banking segment's balance sheet.

Retirement and Benefit Services

Retirement and Benefit Services provides the following services nationally: recordkeeping and administration services to qualified retirement plans; ESOP trustee, recordkeeping, and administration; investment fiduciary services to retirement plans; health savings accounts, flex spending accounts, COBRA recordkeeping and administration services, and payroll to employers; and payroll and HIRS services for employers. In addition, the division operates within each of the banking markets as well as in Albert Lea, Minnesota, Lansing, Michigan, Bedford, New Hampshire, and 13 satellite offices.

Wealth Management

The Wealth Management division provides advisory and planning services, investment management, and trust and fiduciary services to clients across the Company's footprint.

Mortgage

The Mortgage division offers first and second mortgage loans through a centralized mortgage unit in Minneapolis, Minnesota as well as through the Banking office locations.

NOTE 15 Earnings Per Share

Beginning in the third quarter of 2019, the Company elected to prospectively use the two-class method in calculating earnings per share due to the restricted stock awards and restricted stock units qualifying as participating securities. Under the two-class method, earnings available to common shareholders for the period are allocated between common shareholders and participating securities according to dividends declared (or accumulated) and participating rights in undistributed earnings. Average shares of common stock for diluted net income per common share include shares to be issued upon the vesting of restricted stock awards and restricted stock units granted under the Company's share-based compensation plans.

The calculation of basic and diluted earnings per share using the two-class method for the three and six months ending June 30, 2020 is presented below:

(dollars and shares in thousands, except per share data)		**Three months ended June 30, 2020**	**S**
Net income	$	11,474	$
Dividends and undistributed earnings allocated to participating securities		200	
Net income available to common shareholders	$	11,274	$
Weighted-average common shares outstanding for basic earnings per share		17,111	
Dilutive effect of stock-based awards		334	
Weighted-average common shares outstanding for diluted earnings per share		17,445	
Earnings per common share:			
Basic earnings per common share	$	0.66	$
Diluted earnings per common share	$	0.65	$

For the three and six months ended June 30, 2019, the basic and diluted earnings per share were calculated using the treasury stock method, as presented in the table below. The Company determined that the impact to diluted earnings per share would be immaterial if calculated under the two-class method for the three and six months ended June 30, 2019.

The calculation of basic and diluted earnings per share using the treasury stock method for the three and six months ending June 30, 2019 is presented below:

(dollars and shares in thousands, except per share data)		**Three months ended June 30, 2019**	**S**
Basic:			
Net income attributable to common shareholders	$	8,348	$
Weighted-average common shares outstanding		13,810	
Basic earnings per common share	$	0.60	$
Diluted:			
Net income attributable to common shareholders	$	8,348	$
Weighted-average common shares outstanding		13,810	
Add: Dilutive effect of stock-based awards		290	
Weighted-average common shares outstanding for diluted EPS		14,100	
Diluted earnings per common share	$	0.59	$

NOTE 16 Derivative Instruments

The Company did not have any derivatives designated as hedging instruments, as of June 30, 2020 and December 31, 2019. The following table presents the amounts recorded in the Company's consolidated balance sheets, for derivatives not designated as hedging instruments, as of June 30, 2020 and December 31, 2019:

		June 30, 2020		Decembe
(dollars in thousands)		Fair Value	Notional Amount	Fair Value
Asset Derivatives	**Consolidated Balance Sheet Location**			
Interest rate lock commitments	Other assets	$ 5,936	$ 179,182	$ 1,228
Forward loan sales commitments	Other assets	1,175	34,235	393
TBA mortgage backed securities	Other assets	—	—	—
Total asset derivatives		$ 7,111	$ 213,417	$ 1,621
Liability Derivatives				
Interest rate lock commitments	Accrued expenses and other liabilities	$ —	$ —	$ —
Forward loan sales commitments	Accrued expenses and other liabilities	—	—	—
TBA mortgage backed securities	Accrued expenses and other liabilities	1,321	239,000	109
Total liability derivatives		$ 1,321	$ 239,000	$ 109

The gain (loss) recognized on derivative instruments for the three and six months ended June 30, 2020 and 2019 was as follows:

		Three months ended		Six mont
(dollars in thousands)	**Consolidated Statements of Income Location**	June 30, 2020	June 30, 2019	June 30, 2020
Interest rate lock commitments	Mortgage banking	$ 4,352	$ 492	$ 5,579
Forward loan sales commitments	Mortgage banking	117	407	783
TBA mortgage backed securities	Mortgage banking	(1,929)	(330)	(5,352)
Total gain/(loss) from derivative instruments		$ 2,540	$ 569	$ 1,010

NOTE 17 Regulatory Matters

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of common equity tier 1, tier 1, and total capital (as defined in the regulations) to risk weighted assets (as defined) and of tier 1 capital (as defined) to average assets (as defined). Management believes at June 30, 2020 and December 31, 2019, each of the Company and the Bank had met all of the capital adequacy requirements to which it is subject.

The following table presents the Company’s and the Bank’s actual capital amounts and ratios as of June 30, 2020 and December 31, 2019:

	June 30, 2020				
	Actual		Requirements for Capital Adequacy Purposes		Minim Well Ca Under Correctiv
(dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount
Common equity tier 1 capital to risk weighted assets					
Consolidated	$ 254,047	12.58 %	$ 90,888	4.50 %	$ N/A
Bank	241,940	11.99 %	90,814	4.50 %	131,176
Tier 1 capital to risk weighted assets					.
Consolidated	262,298	12.99 %	121,184	6.00 %	N/A
Bank	241,940	11.99 %	121,086	6.00 %	161,448
Total capital to risk weighted assets					
Consolidated	337,225	16.70 %	161,578	8.00 %	N/A
Bank	267,191	13.24 %	161,448	8.00 %	201,810
Tier 1 capital to average assets					
Consolidated	262,298	9.75 %	107,620	4.00 %	N/A
Bank	241,940	9.00 %	107,531	4.00 %	134,414

	December 31, 2019				
	Actual		Requirements for Capital Adequacy Purposes		Minim Well Ca Under Correctiv
(dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount
Common equity tier 1 capital to risk weighted assets					
Consolidated	$ 239,672	12.48 %	$ 86,452	4.50 %	$ N/A
Bank	228,512	11.91 %	86,362	4.50 %	124,745
Tier 1 capital to risk weighted assets					.
Consolidated	247,866	12.90 %	115,270	6.00 %	N/A
Bank	228,512	11.91 %	115,149	6.00 %	153,532
Total capital to risk weighted assets					
Consolidated	321,415	16.73 %	153,693	8.00 %	N/A
Bank	252,436	13.15 %	153,532	8.00 %	191,915
Tier 1 capital to average assets					
Consolidated	247,866	11.05 %	91,504	4.00 %	N/A
Bank	228,512	10.20 %	89,615	4.00 %	112,018

The Bank is subject to certain restrictions on the amount of dividends that it may pay without prior regulatory approval. The Company and the Bank are subject to the rules of the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act rules. The rules included the implementation of a 2.5 percent capital conservation buffer that is added to the minimum requirements for capital adequacy purposes. A banking organization with a conservation buffer of less than the required amount will be subject to the limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At June 30, 2020, the ratios for the Company and the Bank were sufficient to meet the conservation buffer. In addition, the Company must adhere to various U.S. Department of Housing and Urban Development, or HUD, regulatory guidelines including required minimum capital and liquidity to maintain their Federal Housing Administration approval status. Failure to comply with the HUD guidelines could result in withdrawal of this certification. As of June 30, 2020, and December 31, 2019, the Company was in compliance with HUD guidelines.

NOTE 18 Fair Value of Assets and Liabilities

The Company categorizes its assets and liabilities measured at estimated fair value into a three level hierarchy based on the priority of the inputs to the valuation technique used to determine estimated fair value. The estimated fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used in the determination of the estimated fair value

measurement fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the estimated fair value measurement. Assets and liabilities valued at estimated fair value are categorized based on the following inputs to the valuation techniques as follows:

Level 1—Inputs that utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that an entity has the ability to access.

Level 2—Inputs that include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Estimated fair values for these instruments are estimated using pricing models, quoted prices of investment securities with similar characteristics, or discounted cash flows.

Level 3—Inputs that are unobservable inputs for the asset or liability, which are typically based on an entity's own assumptions, as there is little, if any, related market activity. Subsequent to initial recognition, the Company may re-measure the carrying value of assets and liabilities measured on a nonrecurring basis to estimated fair value. Adjustments to estimated fair value usually result when certain assets are impaired. Such assets are written down from their carrying amounts to their estimated fair value.

Professional standards allow entities the irrevocable option to elect to measure certain financial instruments and other items at estimated fair value for the initial and subsequent measurement on an instrument-by-instrument basis. The Company adopted the policy to value certain financial instruments at estimated fair value. The Company has not elected to measure any existing financial instruments at estimated fair value; however, it may elect to measure newly acquired financial instruments at estimated fair value in the future.

Recurring Basis

The Company uses estimated fair value measurements to record estimated fair value adjustments to certain assets and liabilities and to determine estimated fair value disclosures.

The following tables present the balances of the assets and liabilities measured at estimated fair value on a recurring basis as of June 30, 2020 and December 31, 2019:

	June 30, 2020			
(dollars in thousands)	Level 1	Level 2	Level 3	
Available-for-sale and securities				
U.S. treasury and government agencies	$ —	$ 16,252	$ —	$
Obligations of state and political agencies	—	114,153	—	
Mortgage backed securities				
Residential agency	—	214,707	—	
Commercial	—	27,926	—	
Asset backed securities	—	135	—	
Corporate bonds	—	20,554	—	
Total available-for-sale securities	$ —	$ 393,727	$ —	$
Other assets				
Derivatives	$ —	$ 7,111	$ —	$
Other liabilities				
Derivatives	$ —	$ 1,321	$ —	$

(dollars in thousands)	December 31, 2019 Level 1	Level 2	Level 3
Available-for-sale and equity securities			
U.S. treasury and government agencies	$ —	$ 21,240	$ —
Obligations of state and political agencies	—	68,648	—
Mortgage backed securities			
Residential agency	—	182,538	—
Commercial	—	30,685	—
Asset backed securities	—	144	—
Corporate bonds	—	7,095	—
Equity securities	2,808	—	—
Total available-for-sale and equity securities	$ 2,808	$ 310,350	$ —
Other assets			
Derivatives	$ —	$ 1,621	$ —
Other liabilities			
Derivatives	$ —	$ 109	$ —

The following is a description of the valuation methodologies used for instruments measured at estimated fair value on a recurring basis, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Investment Securities

When available, the Company uses quoted market prices to determine the estimated fair value of investment securities; such items are classified in Level 1 of the estimated fair value hierarchy. For the Company's investment securities for which quoted prices are not available for identical investment securities in an active market, the Company determines estimated fair value utilizing vendors who apply matrix pricing for similar bonds for which no prices are observable or may compile prices from various sources. These models are primarily industry-standard models that consider various assumptions, including time value, yield curve, volatility factors, prepayment speeds, default rates, loss severity, current market, and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace. Estimated fair values from these models are verified, where possible, against quoted prices for recent trading activity of assets with similar characteristics to the security being valued. Such methods are generally classified as Level 2. However, when prices from independent sources vary, cannot be obtained, or cannot be corroborated, a security is generally classified as Level 3.

Derivatives

All of the Company's derivatives are traded in over-the-counter markets where quoted market prices are not readily available. For these derivatives, estimated fair value is measured using internally developed models that use primarily market observable inputs, such as yield curves and option volatilities, and accordingly, classify as Level 2. Examples of Level 2 derivatives are basic interest rate swaps and forward contracts.

Nonrecurring Basis

Certain assets are measured at estimated fair value on a nonrecurring basis. These assets are not measured at estimated fair value on an ongoing basis; however, they are subject to estimated fair value adjustments in certain circumstances, such as when there is evidence of impairment or a change in the amount of previously recognized impairment.

Net impairment related to nonrecurring estimated fair value measurements of certain assets as of June 30, 2020 and December 31, 2019 consisted of the following:

	June 30, 2020			
(dollars in thousands)	Level 2	Level 3	Total	
Loans held for sale	$ 101,751	$ —	$ 101,751	$
Impaired loans	—	5,670	5,670	
Foreclosed assets	—	26	26	
Servicing rights	—	2,891	2,891	

	December 31, 2019			
(dollars in thousands)	Level 2	Level 3	Total	
Loans held for sale	$ 46,846	$ —	$ 46,846	$
Impaired loans	—	4,816	4,816	
Foreclosed assets	—	8	8	
Servicing rights	—	3,845	3,845	

Loans Held for Sale

Loans originated and held for sale are carried at the lower of cost or estimated fair value. The Company obtains quotes or bids on these loans directly from purchasing financial institutions. Typically these quotes include a premium on the sale and thus these quotes indicate estimated fair value of the held for sale loans is greater than cost.

Impairment losses for loans held for sale that are carried at the lower of cost or estimated fair value, represent additional net write-downs during the period to record these loans at the lower of cost or estimated fair value, subsequent to their initial classification as loans held for sale.

The valuation techniques and significant unobservable inputs used to measure Level 3 estimated fair values as of June 30, 2020, and December 31, 2019, were as follows:

(dollars in thousands)			June 30, 2020	
Asset Type	**Valuation Technique**	**Unobservable Input**	**Fair Value**	**Range**
Impaired loans	Appraisal value	Property specific adjustment	$ 5,670	N/A
Foreclosed assets	Appraisal value	Property specific adjustment	26	N/A
Servicing rights	Discounted cash flows	Prepayment speed assumptions	2,891	268-425
		Discount rate		9.0 %

(dollars in thousands)			December 31, 2019	
Asset Type	**Valuation Technique**	**Unobservable Input**	**Fair Value**	**Range**
Impaired loans	Appraisal value	Property specific adjustment	$ 4,816	N/A
Foreclosed assets	Appraisal value	Property specific adjustment	8	N/A
Servicing rights	Discounted cash flows	Prepayment speed assumptions	3,845	123-267
		Discount rate		9.4 %

Disclosure of estimated fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the consolidated balance sheets. In cases in which quoted market prices are not available, estimated fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimate of future cash flows. In that regard, the derived estimated fair value estimates cannot be substantiated by comparison to

independent markets and, in many cases could not be realized in immediate settlement of the instruments. Certain financial instruments, with an estimated fair value that is not practicable to estimate and all non-financial instruments, are excluded from the disclosure requirements. Accordingly, the aggregate estimated fair value amounts presented do not necessarily represent the underlying value of the Company.

The following disclosures represent financial instruments in which the ending balances, as of June 30, 2020 and December 31, 2019, were not carried at estimated fair value in their entirety on the consolidated balance sheets.

Cash and Cash Equivalents and Accrued Interest

The carrying amounts reported in the consolidated balance sheets approximate those assets and liabilities estimated fair values.

Loans

For variable-rate loans that reprice frequently and with no significant change in credit risk, estimated fair values are based on carrying values. The estimated fair values of other loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Bank-Owned Life Insurance

Bank-owned life insurance is carried at the amount due upon surrender of the policy, which is also the estimated fair value. This amount was provided by the insurance companies based on the terms of the underlying insurance contract.

Deposits

The estimated fair values of demand deposits are, by definition, equal to the amount payable on demand at the consolidated balance sheet date. The estimated fair values of fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies current incremental interest rates being offered on certificates of deposit to a schedule of aggregated expected monthly maturities of the outstanding certificates of deposit.

Short-Term Borrowings and Long-Term Debt

For variable-rate borrowings that reprice frequently, estimated fair values are based on carrying values. The estimated fair value of fixed-rate borrowings are estimated using discounted cash flow analysis, based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

Off-Balance Sheet Credit-Related Commitments

Off-balance sheet credit related commitments are generally of short-term nature. The contract amount of such commitments approximates their estimated fair value since the commitments are comprised primarily of unfunded loan commitments which are generally priced at market at the time of funding.

The estimated fair values, and related carrying or notional amounts, of the Company’s financial instruments are as follows:

(dollars in thousands)	June 30, 2020 Carrying Amount	Estimated Fair Value Level 1	Level 2	Level 3
Financial Assets				
Cash and cash equivalents	$ 210,437	$ 210,437	$ —	$ —
Loans	2,006,941	—	—	2,035,211
Accrued interest receivable	7,975	7,975	—	—
Bank-owned life insurance	31,959	—	31,959	—
Financial Liabilities				
Noninterest-bearing deposits	$ 700,892	$ —	$ 700,892	$ —
Interest-bearing deposits	1,548,530	—	1,548,530	—
Time deposits	203,731	—	—	205,086
Long-term debt	58,754	—	56,670	—
Accrued interest payable	799	799	—	—

(dollars in thousands)	December 31, 2019 Carrying Amount	Estimated Fair Value Level 1	Level 2	Level 3
Financial Assets				
Cash and cash equivalents	$ 144,006	$ 144,006	$ —	$ —
Loans	1,697,355	—	—	1,693,824
Accrued interest receivable	7,551	7,551	—	—
Bank-owned life insurance	31,566	—	31,566	—
Financial Liabilities				
Noninterest-bearing deposits	$ 577,704	$ —	$ 577,704	$ —
Interest-bearing deposits	1,197,530	—	1,197,530	—
Time deposits	196,082	—	—	196,182
Long-term debt	58,769	—	58,239	—
Accrued interest payable	1,038	1,038	—	—

NOTE 19 COVID-19 Pandemic Response

On March 27, 2020, President Trump signed into Law the Coronavirus Aid Relief and Economic Security Act, or CARES Act, which established a $2.0 trillion economic stimulus package, including cash payments to individuals, supplemental unemployment insurance benefits and a $349 billion loan program administered through the U.S. Small Business Administration, or SBA, referred to as the PPP. Under the PPP, small businesses, sole proprietorships, independent contractors, and self-employed individuals may apply for loans from existing SBA lenders and other approved regulated lenders that enroll in the program, subject to numerous limitations and eligibility criteria. The Bank is participating as a lender in the PPP. In addition, the CARES Act provides financial institutions the option to temporarily suspend certain requirements under GAAP related to TDRs for a limited period of time to account for the effects of COVID-19. See “Note 4 Loans and Allowance for Loan Losses” for additional discussion regarding TDRs.

On April 2, 2020, the SBA issued an interim final rule, announcing the implementation of sections 1102 and 1106 of the CARES Act. Section 1102 of the CARES Act temporarily added a new program, the PPP, to the SBA’s 7(a) Loan Program. Section 1106 of the CARES Act provides for forgiveness of up to the full principal amount of qualifying loans guaranteed under the PPP. The PPP and loan forgiveness are intended to provide economic relief to small businesses nationwide adversely impacted by COVID-19.

As an SBA-Certified Preferred lender we were delegated the authority as part of the CARES Act to make PPP SBA-guaranteed financing available to eligible borrowers. As of June 30, 2020, we had assisted over 1,580 new and existing clients secure approximately $362.7 million of PPP financing. The SBA pays a processing fee based on the balance of the financing outstanding at the time of final disbursement. The processing fees were as follows: five percent for loans of not more than $350 thousand, three percent for loans of more than $350 thousand and less than $2 million,

and one percent for loans of at least $2 million. Net processing fees in the amount of $11.0 million are being deferred and recognized as interest income on a level yield method over the life of the respective loans.

On April 7, 2020, the Board of Governors of the Federal Reserve System, or FRB, authorized each of the Federal Reserve Banks to establish the Payment Protection Program Lending Facility, or PPPL Facility, pursuant to section 13(3) of the Federal Reserve Act. Under the PPPL Facility, each of the Federal Reserve Banks will extend non-recourse loans to eligible financial institutions to fund loans guaranteed by the SBA under the PPP established by the CARES Act.

On April 15, 2020, we executed a PPPL Facility Agreement with the Federal Reserve Bank of Minneapolis. The PPP loans guaranteed by the SBA are eligible to serve as collateral for the PPPL Facility. The PPPL Facility will provide us with additional liquidity to facilitate lending to small businesses under the PPP. As of June 30, 2020, we have not had a need to utilize the PPPL Facility.

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

General

The following discussion explains our financial condition and results of operations as of and for the three and six months ended June 30, 2020 and 2019. Annualized results for this interim period may not be indicative of results for the full year or future periods. The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes presented elsewhere in this report and the Company's Annual Report on Form 10-K for the year ended December 31, 2019, filed with the Securities and Exchange Commission on March 26, 2020.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, statements concerning plans, estimates, calculations, forecasts and projections with respect to the anticipated future performance of Alerus Financial Corporation. These statements are often, but not always, identified by words such as "may", "might", "should", "could", "predict", "potential", "believe", "expect", "continue", "will", "anticipate", "seek", "estimate", "intend", "plan", "projection", "would", "annualized", "target" and "outlook", or the negative version of those words or other comparable words of a future or forward-looking nature. Examples of forward-looking statements include, among others, statements we make regarding our projected growth, anticipated future financial performance, financial condition, credit quality and management's long-term performance goals and the future plans and prospects of Alerus Financial Corporation.

Forward-looking statements are neither historical facts nor assurances of future performance. Instead, they are based only on our current beliefs, expectations and assumptions regarding the future of our business, future plans and strategies, projections, anticipated events and trends, the economy and other future conditions. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict and many of which are outside of our control. Our actual results and financial condition may differ materially from those indicated in the forward-looking statements. Therefore, you should not rely on any of these forward-looking statements. Important factors that could cause our actual results and financial condition to differ materially from those indicated in the forward-looking statements include, among others, the following:

- the effects of the COVID-19 pandemic, including its effects on the economic environment, our clients and our operations, as well as any changes to federal, state, or local governmer or orders in connection with the pandemic;
- our ability to successfully manage credit risk and maintain an adequate level of allowance for loan losses;
- new or revised accounting standards, including as a result of the future implementation of the new Current Expected Credit Loss standard;
- business and economic conditions generally and in the financial services industry, nationally and within our market areas;
- the overall health of the local and national real estate market;
- concentrations within our loan portfolio;
- the level of nonperforming assets on our balance sheet;
- our ability to implement our organic and acquisition growth strategies;

- the impact of economic or market conditions on our fee-based services;
- our ability to continue to grow our retirement and benefit services business;
- our ability to continue to originate a sufficient volume of residential mortgages;
- our ability to manage mortgage pipeline risk;
- the occurrence of fraudulent activity, breaches or failures of our information security controls or cybersecurity-related incidents;
- interruptions involving our information technology and telecommunications systems or third-party servicers;
- potential losses incurred in connection with mortgage loan repurchases;
- the composition of our executive management team and our ability to attract and retain key personnel;
- rapid technological change in the financial services industry;
- increased competition in the financial services industry;
- our ability to successfully manage liquidity risk;
- the effectiveness of our risk management framework;
- the commencement and outcome of litigation and other legal proceedings and regulatory actions against us or to which we may become subject;
- potential impairment to the goodwill we recorded in connection with our past acquisitions;
- the extensive regulatory framework that applies to us;
- the impact of recent and future legislative and regulatory changes;
- interest rate risks associated with our business;
- fluctuations in the values of the securities held in our securities portfolio;
- governmental monetary, trade and fiscal policies;
- severe weather, natural disasters, widespread disease or pandemics, such as the COVID-19 pandemic, acts of war or terrorism, or other adverse external events;
- any material weaknesses in our internal control over financial reporting;
- our success at managing the risks involved in the foregoing items; and
- any other risks described in the “Risk Factors” section of this report and in other reports filed by Alerus Financial Corporation with the Securities and Exchange Commission.

Any forward-looking statement made by us in this report is based only on information currently available to us and speaks only as of the date on which it is made. We undertake no obligation to publicly update any forward-looking statement, whether written or oral, that may be made from time to time, whether as a result of new information, future developments or otherwise.

Overview

We are a diversified financial services company headquartered in Grand Forks, North Dakota. Through our subsidiary, Alerus Financial, National Association, or the Bank, we provide innovative and comprehensive financial solutions to businesses and consumers through four distinct business lines—banking, retirement and benefit services, wealth management and mortgage. These solutions are delivered through a relationship-oriented primary point of contact along with responsive and client-friendly technology.

Our business model produces historically strong financial performance and a diversified revenue stream, which has helped us establish a brand and culture yielding both a loyal client base and passionate and dedicated employees. We generate a majority of our overall revenue from noninterest income, which is driven primarily by our retirement and benefit services, wealth management and mortgage business lines. The remainder of our revenue consists of net interest income, which we derive from offering our traditional banking products and services.

Critical Accounting Policies

Our consolidated financial statements are prepared based on the application of accounting policies generally accepted in the United States, or GAAP. The preparation of our consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates are based upon historical experience and on various other assumptions that management believes are reasonable under current circumstances. These estimates form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates under different assumptions or conditions. The estimates and judgments that management believes have the most effect on the Company's reported financial position and results of operations are set forth in Note 1 – Significant Accounting Policies of the Notes to the Consolidated Statements, included in our Annual Report on Form 10-K for the year ended December 31, 2019. There have been no significant changes in critical accounting policies or the assumptions and judgments utilized in applying these policies since December 31, 2019.

The JOBS Act permits the Company an extended transition period for complying with new or revised accounting standards affecting public companies. The Company has elected to take advantage of this extended transition period, which means that the financial statements included in this report, as well as any financial statements filed in the future, will not be subject to all new or revised accounting standards generally applicable to public companies for the transition period for so long as the Company remains an emerging growth company or until the Company affirmatively and irrevocably opts out of the extended transition period under the JOBS Act.

Recent Developments

Impact of COVID-19

The progression of the COVID-19 pandemic in the United States began to have an adverse impact on our financial condition and results of operations as of and for the three and six months ended June 30, 2020, and is expected to have a complex and significant adverse impact on the economy, the banking industry and our Company in future fiscal periods, all subject to a high degree of uncertainty.

Effects on Our Market Areas. Our primary banking market areas are the states of North Dakota, Minnesota, and Arizona. Our retirement and benefit services business serves clients in all 50 states. We offer retirement and benefit services at all of our banking offices located in our three primary market areas. In addition, we operate two retirement and benefits services offices in Minnesota, two in Michigan and one in New Hampshire.

In Minnesota, the Governor ordered individuals to stay at home and non-essential businesses to cease all activities, in each case subject to limited exceptions. This order went into effect on March 28, 2020, and was in effect until May 18, 2020. They have now implemented a four phase stay safe plan to reopen businesses in the area. Similarly, in Arizona, the Governor recently ordered individuals to stay at home and non-essential businesses to cease all activities, in each case subject to limited exceptions. This order went into effect on March 31, 2020, and expired on May 15, 2020, and the Governor announced new guidance for protecting businesses and their customers as they reopen. Due to a resurgence in cases in the state of Arizona there have been subsequent orders issued to restrict large gatherings as well as certain restrictions placed on bars and restaurants. In North Dakota, the Governor has not issued an order requiring individuals to stay at home, but placed certain restrictions on bars, restaurants and gyms. These orders have been lifted and North Dakota is now working toward a “Smart Restart” program to encourage businesses to open safely and take precautions to slow the spread of COVID-19. In response to these orders, the Bank has been serving its customers through its drive-up windows at various branch locations and through online and mobile banking. The Bank is also permitting certain visits to its branches on a limited basis and by appointment only. In North Dakota, certain offices have re-opened for business with safeguards in place that materially comply with CDC guidance.

Each state has experienced a dramatic and sudden increase in unemployment levels as a result of the curtailment of business activities. According to data released by the U.S. Department of Labor, initial claims for unemployment insurance have spiked in recent months in each of the states in our banking markets, a trend we expect to continue for the foreseeable future until restrictions are lifted. To date, many of the public health and economic effects of COVID-19 have been concentrated in the largest U.S. cities, such as New York, but we anticipate that similar effects will occur on a more delayed basis in smaller cities and communities, where many our banking operations are focused.

Policy and Regulatory Developments. Federal, state and local governments and regulatory authorities have enacted and issued a range of policy responses to the COVID-19 pandemic, including the following:

- The Federal Reserve decreased the range for the Federal Funds Target Rate by 0.50% on March 3, 2020, and by another 1.0% on March 16, 2020, reaching a current range of 0.0 – 0.2

- On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief and Economic Security Act, or CARES Act, which established a $2.0 trillion economic stimulus pacl payments to individuals, supplemental unemployment insurance benefits and a $349 billion loan program administered through the U.S. Small Business Administration, or SBA, refe paycheck protection program, or PPP. Under the PPP, small businesses, sole proprietorships, independent contractors and self-employed individuals may apply for loans from existi other approved regulated lenders that enroll in the program, subject to numerous limitations and eligibility criteria. The Bank is participating as a lender in the PPP. On or about April notified lenders that the $349 billion earmarked for the PPP was exhausted. On April 24, 2020, an additional $310 billion in funding for PPP loans was authorized, with such funds avai beginning on April 27, 2020. In addition, the CARES Act provides financial institutions the option to temporarily suspend certain requirements under GAAP related to TDRs for a lim to account for the effects of COVID-19. See “NOTE 4 Loans and Allowance for Loan Losses” for additional discussion regarding TDRs.

- On April 7, 2020, federal banking regulators issued a revised Interagency Statement on Loan Modifications and Reporting for Financial Institutions, which, among other things, enco institutions to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the effects of COVID-19, and stated that institution need to categorize COVID-19-related modifications as TDRs and that the agencies will not direct supervised institutions to automatically categorize all COVID-19 related loan modifi See “NOTE 4 Loans and Allowance for Loan Losses” for additional discussion regarding TDRs.

- On April 9, 2020, the Federal Reserve announced additional measures aimed at supporting small and midsized business, as well as state and local governments impacted by COVID-1 Reserve announced the Main Street Business Lending Program, which establishes two new loan facilities intended

to facilitate lending to small and midsized businesses: (1) the Main Street New Loan Facility, or MSNLF, and (2) the Main Street Expanded Loan Facility, or MSELF. MSNLF loans ar loans originated on or after April 8, 2020, while MSELF loans are provided as upsized tranches of existing loans originated before April 8, 2020. The combined size of the program wil billion. The program is designed for businesses with up to 10,000 employees or $2.5 billion in 2019 revenues. To obtain a loan, borrowers must confirm that they are seeking financia COVID-19 and that they will not use proceeds from the loan to pay off debt. The Federal Reserve also stated that it would provide additional funding to banks offering PPP loans to businesses. Lenders participating in the PPP will be able to exclude loans financed by the facility from their leverage ratio. In addition, the Federal Reserve created a Municipal Liquic support state and local governments with up to $500 billion in lending, with the Treasury Department backing $35 billion for the facility using funds appropriated by the CARES Act. make short-term financing available to cities with a population of more than one million or counties with a population of greater than two million. The Federal Reserve expanded botl its Primary and Secondary Market Corporate Credit Facilities to support up to $750 billion in credit to corporate debt issuers. This will allow companies that were investment grade b COVID-19 but then subsequently downgraded after March 22, 2020 to gain access to the facility. Finally, the Federal Reserve announced that its Term Asset-Backed Securities Loan scaled up in scope to include the triple A-rated tranche of commercial mortgage-backed securities and newly issued collateralized loan obligations. The size of the facility is $100 billi

- In addition to the policy responses described above, the federal bank regulatory agencies, along with their state counterparts, have issued a stream of guidance in response to the C and have taken a number of unprecedented steps to help banks navigate the pandemic and mitigate its impact. These include, without limitation: requiring banks to focus on busine pandemic planning; adding pandemic scenarios to stress testing; encouraging bank use of capital buffers and reserves in lending programs; permitting certain regulatory reporting e margin requirements on swaps; permitting certain otherwise prohibited investments in investment funds; issuing guidance to encourage banks to work with customers affected by tl encourage loan workouts; and providing credit under the Community Reinvestment Act, or CRA, for certain pandemic-related loans, investments and public service. Moreover, beca social distancing measures, the agencies have revamped the manner in which they conduct periodic examinations of their regulated institutions, including making greater use of off-s Federal Reserve also issued guidance encouraging banking institutions to utilize their discount window for loans and intraday credit extended by their Reserve Banks to help house businesses impacted by the pandemic and announced numerous funding facilities. The FDIC has also acted to mitigate the deposit insurance assessment effects of participating in t PPPL Facility and Money Market Mutual Fund Liquidity Facility.

Effects on Our Business. We currently expect that the COVID-19 pandemic and the specific developments referred to above will continue to have a significant impact on our business. In particular, we anticipate that a significant portion of the Bank's borrowers in the retail, restaurants, and hospitality industries will continue to endure significant economic distress, which could cause them to draw on their existing lines of credit and could adversely affect their ability and willingness to repay existing indebtedness, and is expected to adversely impact the value of collateral. These developments, together with economic conditions generally, are also expected to impact our commercial real estate portfolio, particularly with respect to real estate with exposure to these industries, our consumer loan business and loan portfolio, and the value of certain collateral securing our loans. In addition, we expect to see decreases in our total assets under administration and assets under management and a decrease in mortgage loan originations. As a result, we anticipate that our financial condition, capital levels and results of operations will be significantly and adversely affected, as described in this Management's Discussion and Analysis of Financial Condition and Results of Operations.

Our Response. We have taken numerous steps in response to the COVID-19 pandemic, including the following:

- First and foremost, we have prioritized the safety, health and well-being of our employees, clients and communities. We have implemented a work from home policy and certain of ou closed. We continue to effectively serve our clients in all markets; virtually, digitally, via drive-thru and in-person as

conditions allow. Our work place strategy includes various phases of expanding service to clients, reopening offices, and determining long-term work arrangements for employees. T
allows us to incrementally expand in-person services to clients and provides flexibility between markets based on local conditions, guidelines, and restrictions.

- We are offering payment deferrals and interest only payment options for consumer, small business, and commercial customers for initial terms of up to 90 days. We are offering payr mortgage customers for initial terms of up to 90 days. As of June 30, 2020, we had executed 515 loan deferrals on outstanding balances of $148.5 million.

- The Business Continuity Planning COVID-19 Response team and Alerus leadership teams meet regularly to manage the Company's response to the pandemic and the effect on our addition, a cross functional task force team meets regularly to address specific issues such as employee and client communications, facilities, reopening offices, and long-term work Risk Committee of the Board meets regularly with management to receive updates on the Company's response and discuss the effect on our business.

- We are participating in the SBA's PPP. As of June 30, 2020, we had assisted 1,580 borrowers receive approval for funding of $362.7 million in PPP loans.

- In addition, as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2019, we will not be permitted to make capital distributions (including dividends and re or pay discretionary bonuses to executive officers without restriction if we do not maintain 2.5% in Common Equity Tier 1 Capital attributable to a capital conservation buffer.

Shareholder Dividend and Stock Repurchases

On May 12, 2020, the Company's Board of Directors declared a quarterly cash dividend of $0.15 per share. This dividend was paid out on July 10, 2020, to stockholders of record at the close of business on June 15, 2020.

On July 23, 2020, the Company's Board of Directors declared a quarterly cash dividend of $0.15 per common share. This dividend is payable on October 9, 2020, to stockholders of record as of the close of business on September 18, 2020.

Although the Board of Directors is closely monitoring the impacts of the COVID-19 pandemic, it is the current expectation and intent of the Board of Directors to continue with a quarterly cash dividend.

We currently do not have an authorized stock repurchase program, but the Company does repurchase shares to pay withholding taxes on the vesting of restricted stock awards and units.

Operating Results Overview

The following table summarizes key financial results as of and for the periods indicated:

(dollars and shares in thousands, except per share data)	Three months ended June 30, 2020	March 31, 2020	June 30, 2019	Six months e June 30, 2020	
Performance Ratios					
Return on average total assets	1.68 %	0.89 %	1.52 %	1.31 %	
Return on average common equity	15.30 %	7.32 %	15.82 %	11.35 %	
Return on average tangible common equity (1)	18.88 %	9.76 %	21.94 %	14.39 %	
Noninterest income as a % of revenue	65.55 %	59.07 %	62.11 %	62.69 %	
Net interest margin (taxable-equivalent basis) (1)	3.14 %	3.35 %	3.62 %	3.24 %	
Efficiency ratio (1)	66.31 %	77.47 %	70.74 %	71.23 %	
Net charge-offs/(recoveries) to average loans	0.66 %	(0.14)%	0.74 %	0.29 %	
Dividend payout ratio	23.08 %	50.00 %	23.73 %	31.58 %	
Per Common Share					
Earnings per common share - basic (2)	$ 0.66	$ 0.31	$ 0.60	$ 0.97	$
Earnings per common share - diluted (2)	$ 0.65	$ 0.30	$ 0.59	$ 0.95	$
Dividends declared per common share	$ 0.15	$ 0.15	$ 0.14	$ 0.30	$
Tangible book value per common share (1)	$ 15.30	$ 14.55	$ 12.02		
Average common shares outstanding - basic	17,111	17,070	13,810	17,091	
Average common shares outstanding - diluted	17,445	17,405	14,100	17,425	
Other Data					
Retirement and benefit services assets under administration/management	$ 30,093,095	$ 27,718,026	$ 30,369,847		
Wealth management assets under administration/management	2,957,213	2,746,052	2,744,438		
Mortgage originations	431,638	228,568	246,115	$ 660,206	$

(1) Represents a non-GAAP financial measure. See "Non-GAAP to GAAP Reconciliations and Calculation of Non-GAAP Financial Measures."
(2) Earnings per share calculated using the two-class method beginning in the third quarter of 2019.

Selected Financial Data

The following tables summarize selected financial data as of and for the periods indicated:

(dollars in thousands)	Three months ended June 30, 2020	March 31, 2020	June 30, 2019	Six mont June 30, 2020
Selected Average Balance Sheet Data				
Loans	$ 1,986,028	$ 1,731,593	$ 1,724,080	$ 1,858,810
Investment securities	369,247	337,160	255,502	353,203
Assets	2,740,330	2,419,665	2,200,795	2,579,995
Deposits	2,329,192	2,026,261	1,777,003	2,177,726
Short-term borrowings	321	—	115,892	161
Long-term debt	58,747	58,755	58,808	58,751
Stockholders' equity	301,719	294,727	211,653	298,221

(dollars in thousands)		June 30, 2020		March 31, 2020		December 31, 2019	
Selected Period End Balance Sheet Data							
Loans	$	2,034,197	$	1,758,277	$	1,721,279	$
Allowance for loan losses		(27,256)		(27,019)		(23,924)	
Investment securities		393,727		354,149		313,158	
Assets		2,875,457		2,512,078		2,356,878	
Deposits		2,453,153		2,121,514		1,971,316	
Long-term debt		58,754		58,762		58,769	
Total stockholders’ equity		305,732		293,608		285,728	

	Three months ended						Six mont	
(dollars in thousands)		June 30, 2020		March 31, 2020		June 30, 2019		June 30, 2020
Selected Income Statement Data								
Net interest income	$	20,091	$	18,837	$	18,291	$	38,928
Provision for loan losses		3,500		2,500		1,797		6,000
Noninterest income		38,230		27,189		29,984		65,419
Noninterest expense		39,734		36,726		35,261		76,460
Income before income taxes		15,087		6,800		11,217		21,887
Income tax expense		3,613		1,437		2,869		5,050
Net income	$	11,474	$	5,363	$	8,348	$	16,837

Non-GAAP to GAAP Reconciliations and Calculation of Non-GAAP Financial Measures

In addition to the results presented in accordance with GAAP, we routinely supplement our evaluation with an analysis of certain non-GAAP financial measures. These non-GAAP financial measures include the ratio of tangible common equity to tangible assets, tangible book value per common share, return on average tangible common equity, net interest margin (tax-equivalent), and the efficiency ratio. Management uses these non-GAAP financial measures in its analysis of its performance, and believes financial analysts and others frequently use these measures, and other similar measures, to evaluate capital adequacy. Management calculates: (i) tangible common equity as total common stockholders' equity less goodwill and other intangible assets; (ii) tangible common equity per share as tangible common equity divided by shares of common stock outstanding; (iii) tangible assets as total assets, less goodwill and other intangible assets; (iv) return on average tangible common equity as net income adjusted for intangible amortization net of tax, divided by average tangible common equity; (v) net interest margin (tax-equivalent) as net interest income plus a tax-equivalent adjustment, divided by average earning assets; and (vi) efficiency ratio as noninterest expense less intangible amortization expense, divided by net interest income plus noninterest income plus a tax-equivalent adjustment.

The following tables present these non-GAAP financial measures along with the most directly comparable financial measures calculated in accordance with GAAP for the periods indicated.

	June 30, 2020	March 31, 2020	December 31, 2019
Tangible common equity to tangible assets			
Total common stockholders' equity	$ 305,732	$ 293,608	$ 285,728
Less: Goodwill	27,329	27,329	27,329
Less: Other intangible assets	16,411	17,401	18,391
Tangible common equity (a)	261,992	248,878	240,008
Total assets	2,875,457	2,512,078	2,356,878
Less: Goodwill	27,329	27,329	27,329
Less: Other intangible assets	16,411	17,401	18,391
Tangible assets (b)	2,831,717	2,467,348	2,311,158
Tangible common equity to tangible assets (a)/(b)	9.25 %	10.09 %	10.38 %
Tangible book value per common share			
Total common stockholders' equity	$ 305,732	$ 293,608	$ 285,728
Less: Goodwill	27,329	27,329	27,329
Less: Other intangible assets	16,411	17,401	18,391
Tangible common equity (c)	261,992	248,878	240,008
Total common shares issued and outstanding (d)	17,120	17,106	17,050
Tangible book value per common share (c)/(d)	$ 15.30	$ 14.55	$ 14.08

	Three months ended			Six months enc
	June 30, 2020	March 31, 2020	June 30, 2019	June 30, 2020
Return on average tangible common equity				
Net income	$ 11,474	$ 5,363	$ 8,348	$ 16,837
Add: Intangible amortization expense (net of tax)	783	782	830	1,565
Net income, excluding intangible amortization (e)	12,257	6,145	9,178	18,402
Average total equity	301,719	294,727	211,653	298,221
Less: Average goodwill	27,329	27,329	27,329	27,329
Less: Average other intangible assets (net of tax)	13,345	14,128	16,498	13,737
Average tangible common equity (f)	261,045	253,270	167,826	257,155
Return on average tangible common equity (e)/(f)	18.88 %	9.76 %	21.94 %	14.39 %
Net interest margin (tax-equivalent)				
Net interest income	$ 20,091	$ 18,837	$ 18,291	$ 38,928
Tax-equivalent adjustment	109	100	84	209
Tax-equivalent net interest income (g)	20,200	18,937	18,375	39,137
Average earning assets (h)	2,584,037	2,271,004	2,037,604	2,427,519
Net interest margin (tax-equivalent) (g)/(h)	3.14 %	3.35 %	3.62 %	3.24 %
Efficiency ratio				
Noninterest expense	$ 39,734	$ 36,726	$ 35,261	$ 76,460
Less: Intangible amortization expense	991	990	1,050	1,981
Adjusted noninterest expense (i)	38,743	35,736	34,211	74,479
Net interest income	20,091	18,837	18,291	38,928
Noninterest income	38,230	27,189	29,984	65,419
Tax-equivalent adjustment	109	100	84	209
Total tax-equivalent revenue (j)	58,430	46,126	48,359	104,556
Efficiency ratio (i)/(j)	66.31 %	77.47 %	70.74 %	71.23 %

Discussion and Analysis of Results of Operations

Net Income

Net income for the three months ended June 30, 2020 was $11.5 million, or $0.65 per diluted common share, compared to $8.3 million, or $0.59 per diluted common share, for the three months ended June 30, 2019. The increase of $3.2 million in net income was primarily due to an increase of $8.2 million in noninterest income and a $1.8 million increase in net interest income partially offset by an increase of $4.5 million in noninterest expense and a $1.7 million increase in provision expense. The increase in noninterest income was primarily attributable to mortgage banking from an increase of $8.8 million in realized gains on the sale of loans primarily due to an increase in mortgages originations. The increase in noninterest expense was primarily attributable to increases in compensation expenses also driven by an increase in mortgage originations.

Net income for the six months ended June 30, 2020 was $16.8 million, or $0.95 per diluted common share, compared to $14.8 million, or $1.05 per diluted common share, for the six months ended June 30, 2019. The increase of $2.0 million was due to increases of $10.4 million in noninterest income and $1.5 million in net interest income partially offset by an increase of $7.7 million in noninterest expense. The increase in noninterest income was primarily due to an $11.0 million increase in mortgage banking revenue as a result of an increase of $13.0 million in realized gains on sales of loans held for sale and an increase in mortgage originations, partially offset by a decrease in other noninterest income. The increase in noninterest expense was driven by an increase in compensation expense which was primarily a result of the increase in mortgage originations.

Net Interest Income

Net interest income is the difference between interest income and yield-related fees earned on assets and interest expense paid on liabilities. Net interest margin is the difference between the yield on interest earning assets and the cost of interest-bearing liabilities as a percentage of interest earning assets. Net interest margin is presented on a tax-equivalent basis, which means that tax-free interest income has been adjusted to a pre-tax-equivalent income, assuming a federal income tax rate of 21% for the three and six months ended June 30, 2020 and 2019.

In response to the COVID-19 pandemic, the Federal Reserve decreased the targeted federal funds rate by a total of 150 basis points in March 2020. This decrease impacts the comparability of net interest income between 2019 and 2020. We anticipate that our interest income will be significantly and adversely affected in future periods as a result of the COVID-19 pandemic, including as a result of the effects of lower interest rates.

Net interest income for the three months ended June 30, 2020 was $20.1 million, an increase of $1.8 million from $18.3 million for the three months ended June 30, 2019. The three months ended June 30, 2020 included a $1.8 million decrease in interest expense compared to the same period in 2019 and a $28 thousand increase in interest income. The decrease in interest expense was primarily driven by a decrease of $1.0 million in deposit interest expense and a decrease of $735 thousand in interest expense on short-term borrowings. The decrease in deposit interest expense for the three months ended June 30, 2020, compared to the same period 2019 was driven primarily by a 47 basis point reduction in average rate paid on interest-bearing deposits. The decrease in interest expense on short-term borrowings for the three months ended June 30, 2020, was primarily due to a $115.6 million decrease in the average balance in short-term borrowings. The increase in interest income was primarily driven by a $455 thousand increase in interest income from investment securities, offset by a $340 thousand decrease in interest and fees on loans. Interest and fees on loans decreased overall excluding the increase of $2.1 million in interest income on PPP loans.

Net interest income for the six months ended June 30, 2020 was $38.9 million, an increase of $1.5 million from $37.4 million for the six months ended June 30, 2019. The increase in net interest income was primarily driven by a decrease of $1.7 million in interest expense partially offset by a decrease of $176 thousand in interest income. The decrease in interest expense was driven by a decrease of $1.3 million in interest expense on short-term borrowings. The decrease in interest income was primarily driven by a $1.4 million decrease in interest and fees on loans. The decrease in interest expense on short-term borrowings was due to a $99.5 million decrease in the average balance on short-term borrowings. The decrease in interest and fees on loans was primarily driven by a 54 basis point decrease in the average

yield on total loans. Interest and fees on loans decreased overall excluding the increase of $2.1 million increase in interest income on PPP loans.

Our net interest margin (on a fully tax-equivalent, or FTE, basis) for the three months ended June 30, 2020 was 3.14%, compared to 3.62% for the same period in 2019. The net interest margin excluding PPP loans would have been 3.16% for the three months ended June 30, 2020. The decrease in net interest margin from the second quarter of 2019 was due to a 96 basis point lower average earning asset yield partially offset by a 60 basis point decrease in the average rate on interest-bearing liabilities. The decrease in the average earning asset yield was primarily due to a 2.08% decrease in the average yield earned on interest-bearing deposits with banks and a 75 basis point decrease in the average yield on total loans. The decline in loan yield was primarily due to PPP loan balances which averaged $273.8 million during the quarter with a yield of 3.01%. Commercial and industrial loans, excluding PPP loans, averaged $466.0 million during the quarter with a yield of 4.78%, a decrease of 75 basis points compared to the three months ended June 30, 2019. The decrease in the average rate on total interest-bearing deposits was primarily due to a 69 basis point decrease in the average rate on money market and savings deposits and a $115.6 million dollar decrease in the average balance on short-term borrowings.

Our net interest margin (FTE) for the six months ended June 30, 2020 was 3.24%, compared to 3.74% for the same period in 2019. The net interest margin excluding PPP loans would have been 3.44% for the six months ended June 30, 2020. The decrease in net interest margin was primarily attributable to a 79 basis point decrease on the average earning asset yield partially offset by a 34 basis point decrease in the average rate on interest-bearing liabilities. The decrease in the average earning asset yield was primarily the result of a 1.63% decrease in the average yield on interest-bearing deposits with banks as well as a 54 basis point reduction in the average yield on total loans. The decline in loan yield was primarily due to PPP loan balances which averaged $136.9 million for the six months ended June 30, 2020 with a yield of 3.01%. Commercial and industrial loans, excluding PPP loans, averaged $472.6 million with a yield of 5.02%, a decrease of 51 basis points compared to the six months ended June 30, 2019.The decrease in average rate on interest-bearing liabilities was the result of a 34 basis point decrease in the average rate on money market and savings deposits and a $99.5 million decrease in the average balance on short-term borrowings

As a result of the recent reductions in the target federal funds interest rate, as well as the impact of the COVID-19 pandemic and related future loan charge-offs that we expect to incur, we expect that our net interest income and net interest margin FTE will decrease significantly in future periods. These decreases will be offset by the processing fees received from PPP financing, which fees are being deferred and recognized as an adjustment to interest income over the life of the loans.

The following tables present average balance sheet information, interest income, interest expense and the corresponding average yields on assets, and average yields earned and rates paid for the three and six months ended June 30, 2020 and 2019. We derived these yields and rates by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. Average loan balances include loans that have been placed on nonaccrual, while interest previously accrued on these loans is reversed against interest income. In these tables, adjustments are made to the yields on tax-exempt assets in order to present tax-exempt income and fully taxable income on a comparable basis.

	Three months ended June 30,				
	2020			2019	
(dollars in thousands)	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense
Interest Earning Assets					
Interest-bearing deposits with banks	$ 153,197	$ 62	0.16 %	$ 14,476	$ 81
Investment securities (1)	369,247	2,068	2.25 %	255,502	1,605
Loans held for sale	69,606	465	2.69 %	33,078	280
Loans					
Commercial:					
Commercial and industrial	739,816	7,582	4.12 %	485,645	6,698
Real estate construction	31,660	353	4.48 %	32,985	469
Commercial real estate	513,497	5,508	4.31 %	480,429	5,904
Total commercial	1,284,973	13,443	4.21 %	999,059	13,071
Consumer					
Residential real estate first mortgage	459,789	4,681	4.09 %	444,280	4,619
Residential real estate junior lien	163,345	1,944	4.79 %	187,054	2,690
Other revolving and installment	77,921	884	4.56 %	93,687	1,080
Total consumer	701,055	7,509	4.31 %	725,021	8,389
Total loans (1)	1,986,028	20,952	4.24 %	1,724,080	21,460
Federal Reserve/FHLB Stock	5,959	68	4.59 %	10,468	136
Total interest earning assets	2,584,037	23,615	3.68 %	2,037,604	23,562
Noninterest earning assets	156,293			163,191	
Total assets	$ 2,740,330			$ 2,200,795	
Interest-Bearing Liabilities					
Interest-bearing demand deposits	$ 534,733	$ 405	0.30 %	$ 425,260	$ 486
Money market and savings deposits	900,812	1,504	0.67 %	694,474	2,357
Time deposits	201,147	649	1.30 %	178,401	705
Short-term borrowings	321	—	— %	115,892	735
Long-term debt	58,747	857	5.87 %	58,808	904
Total interest-bearing liabilities	1,695,760	3,415	0.81 %	1,472,835	5,187
Noninterest-Bearing Liabilities and Stockholders' Equity					
Noninterest-bearing deposits	692,500			478,868	
Other noninterest-bearing liabilities	50,351			37,439	
Stockholders' equity	301,719			211,653	
Total liabilities and stockholders' equity	$ 2,740,330			$ 2,200,795	
Net interest income		$ 20,200			$ 18,375
Net interest rate spread			2.87 %		
Net interest rate margin (2)			3.14 %		

	Six months ended June 30,				
	2020			2019	
(dollars in thousands)	Average Balance	Interest Income/ Expense	Average Yield/ Rate	Average Balance	Interest Income/ Expense
Interest Earning Assets					
Interest-bearing deposits with banks	$ 158,274	$ 564	0.72 %	$ 12,865	$ 150
Investment securities (1)	353,203	4,124	2.35 %	255,060	3,223
Loans held for sale	51,372	719	2.81 %	23,079	386
Loans					
Commercial:					
Commercial and industrial	609,553	13,854	4.57 %	485,533	13,310
Real estate construction	29,191	687	4.73 %	32,079	905
Commercial real estate	510,831	11,331	4.46 %	480,135	11,728
Total commercial	1,149,575	25,872	4.53 %	997,747	25,943
Consumer					
Residential real estate first mortgage	460,258	9,380	4.10 %	447,006	9,425
Residential real estate junior lien	168,390	4,172	4.98 %	188,076	5,417
Other revolving and installment	80,587	1,854	4.63 %	95,044	2,169
Total consumer	709,235	15,406	4.37 %	730,126	17,011
Total loans (1)	1,858,810	41,278	4.47 %	1,727,873	42,954
Federal Reserve/FHLB Stock	5,860	136	4.67 %	9,808	252
Total interest earning assets	2,427,519	46,821	3.88 %	2,028,685	46,965
Noninterest earning assets	152,476			161,761	
Total assets	$ 2,579,995			$ 2,190,446	
Interest-Bearing Liabilities					
Interest-bearing demand deposits	$ 496,880	$ 933	0.38 %	$ 422,309	$ 893
Money market and savings deposits	852,325	3,582	0.85 %	689,508	4,057
Time deposits	200,117	1,435	1.44 %	181,990	1,347
Short-term borrowings	161	—	— %	99,702	1,265
Long-term debt	58,751	1,734	5.94 %	58,810	1,816
Total interest-bearing liabilities	1,608,234	7,684	0.96 %	1,452,319	9,378
Noninterest-Bearing Liabilities and Stockholders' Equity					
Noninterest-bearing deposits	628,404			494,136	
Other noninterest-bearing liabilities	45,136			38,206	
Stockholders' equity	298,221			205,785	
Total liabilities and stockholders' equity	$ 2,579,995			$ 2,190,446	
Net interest income		$ 39,137			$ 37,587
Net interest rate spread			2.92 %		
Net interest margin on FTE basis (2)			3.24 %		

(1) Taxable equivalent adjustment was calculated utilizing a marginal income tax rate of 21.0 percent.

(2) Represents a non-GAAP financial measure. See "Non-GAAP to GAAP Reconciliations and Calculation of Non-GAAP Financial Measures."

Interest Rates and Operating Interest Differential

Increases and decreases in interest income and interest expense result from changes in average balances (volume) of interest earning assets and interest-bearing liabilities, as well as changes in average interest rates. The following table shows the effect that these factors had on the interest earned on our interest earning assets and the interest incurred on our interest-bearing liabilities. The effect of changes in volume is determined by multiplying the

change in volume by the previous period’s average rate. Similarly, the effect of rate changes is calculated by multiplying the change in average rate by the previous period’s volume.

	Three Months Ended June 30, 2020 Compared with Three Months Ended June 30, 2019			Six months ended June 3 Compared with Six months ended June 3	
	Change due to:		Interest	Change due to:	
(tax-equivalent basis, dollars in thousands)	Volume	Rate	Variance	Volume	Rate
Interest earning assets					
Interest-bearing deposits with banks	$ 773	$ (792)	$ (19)	$ 1,699	$ (1,285)
Investment securities	713	(250)	463	1,244	(343)
Loans held for sale	309	(124)	185	474	(141)
Loans					
Commercial:					
Commercial and industrial	3,495	(2,611)	884	3,410	(2,866)
Real estate construction	(19)	(97)	(116)	(82)	(136)
Commercial real estate	405	(801)	(396)	753	(1,150)
Total commercial	3,881	(3,509)	372	4,081	(4,152)
Consumer					
Residential real estate first mortgage	161	(99)	62	280	(325)
Residential real estate junior lien	(340)	(406)	(746)	(569)	(676)
Other revolving and installment	(181)	(15)	(196)	(331)	16
Total consumer	(360)	(520)	(880)	(620)	(985)
Total loans	3,521	(4,029)	(508)	3,461	(5,137)
Federal Reserve/FHLB Stock	(58)	(10)	(68)	(102)	(14)
Total interest income	5,258	(5,205)	53	6,776	(6,920)
Interest-bearing liabilities					
Interest-bearing demand deposits	125	(206)	(81)	159	(119)
Money market and savings deposits	698	(1,551)	(853)	963	(1,438)
Time deposits	90	(146)	(56)	134	(46)
Short-term borrowings	(730)	(5)	(735)	(1,267)	2
Long-term debt	(1)	(46)	(47)	(2)	(80)
Total interest expense	182	(1,954)	(1,772)	(13)	(1,681)
Change in net interest income	$ 5,076	$ (3,251)	$ 1,825	$ 6,789	$ (5,239)

Provision for Loan Losses

The provision for loan losses is based upon our allowance methodology and is a charge to income that, in our judgment, is required to maintain an adequate allowance for incurred loan losses at each period-end. In assessing the adequacy of the allowance, management considers the size and quality of the loan portfolio measured against prevailing economic conditions, regulatory guidelines, and historical loan loss experience. However, there is no assurance that loan credit losses will not exceed the allowance, and any growth in the loan portfolio and the uncertainty of the general economy may require additional provisions in future periods.

We recorded a provision for loan losses of $3.5 million for the three months ended June 30, 2020, a $1.7 million increase compared to the $1.8 recorded for the three months ended June 30, 2019. The increase in provision expense was primarily due to allocations of reserves for the economic uncertainties related to COVID-19. We expect the provision for loan losses could increase in future periods based on our belief that the credit quality of our loan portfolio may decline, and loan defaults may increase, as a result of COVID-19.

We recorded a provision for loan losses of $6.0 million for the six months ended June 30, 2020, a $2.0 million increase compared to the $4.0 million for the six months ended June 30, 2019. The increase in provision expense was primarily due to allocations of reserves for the economic uncertainties related to COVID-19.

Noninterest Income

Our noninterest income is generated from four primary sources: (1) retirement and benefit services; (2) wealth management; (3) mortgage banking; and (4) other general banking services.

The following table presents our noninterest income for the three and six months ended June 30, 2020 and 2019.

	Three months ended June 30,		Six mont June
(dollars in thousands)	2020	2019	2020
Retirement and benefit services	$ 13,710	$ 15,776	$ 29,930
Wealth management	4,112	3,878	8,158
Mortgage banking	17,546	7,035	22,591
Service charges on deposit accounts	297	430	720
Net gains (losses) on investment securities	1,294	182	1,294
Other	1,271	2,683	2,726
Total noninterest income	$ 38,230	$ 29,984	$ 65,419
Noninterest income as a % of revenue	65.55 %	62.11 %	62.69 %

Total noninterest income for the three months ended June 30, 2020 was $38.2 million, an increase of $8.2 million, or 27.5%, compared to $30.0 million for the three months ended June 30, 2019. The increase in noninterest income was primarily due to an increase of $10.5 million in mortgage banking revenue and a $1.1 million increase in net gains and losses on investment securities revenue, partially offset by a $2.1 million decrease in retirement and benefit services revenue. Mortgage banking revenue increased primarily due to a $185.5 million increase in mortgage originations compared to the three months ended June 30, 2019. The increase in net gains and losses on investment securities increased due to sales in the portfolio during the second quarter of 2020. Retirement and benefit services revenue decreased primarily due to a $2.4 million decrease in asset based fees as a result of a decline in assets under administration/management and a continued transition away from revenue sharing.

Total noninterest income for the six months ended June 30, 2020 was $65.4 million, an increase of $10.3 million or 18.8%, compared to $55.1 million for the six months ended June 30, 2019. The increase in noninterest income was primarily driven by an increase of $11.0 million in mortgage banking, partially offset by a $1.2 million decrease in other noninterest income. Mortgage banking revenue increased as mortgage originations increased from $371.7 million for the six months ended June 30, 2019 to $660.2 million for the six months ended June 30, 2020. Other noninterest income decreased $1.4 million in the second quarter of 2020 due to a $1.5 million gain on the sale of a branch in 2019.

We anticipate that our noninterest income will be significantly adversely affected in future periods as a result of the COVID-19 pandemic and the related decline in global economic conditions and significant volatility in the global stock markets. We expect retirement and benefit services asset based revenue will be adversely affected by reduced assets under administration and assets under management, waived transaction and participant related fees, and a decline in ESOP transaction fees. We expect wealth management asset based revenue will be adversely affected by reduced assets under administration and assets under management and we also expect increased unemployment and recessionary concerns will adversely affect mortgage originations and mortgage banking revenue in future periods.

Noninterest income as a percentage of total operating revenue, which consists of net interest income plus noninterest income, was 65.6% for the three months ending June 30, 2020, compared to 62.1% for the three months ending June 30, 2019. The increase was due to noninterest income increasing by 27.5% while net interest income increased only 9.8%.

Noninterest income as a percentage of total operating revenue was 62.7% for the six months ending June 30, 2020, compared to 59.5% for the six months ending June 30, 2019. The increase was due to noninterest income increasing by 18.8% while net interest income increased only 4.1%.

See “NOTE 14 Segment Reporting” for additional discussion regarding our business lines.

Noninterest Expense

The following table presents noninterest expense for the three and six months ended June 30, 2020 and 2019.

	Three months ended June 30,		Six m J
(dollars in thousands)	2020	2019	2020
Compensation	$ 21,213	$ 18,143	$ 39,94
Employee taxes and benefits	4,747	5,160	10,05
Occupancy and equipment expense	2,869	2,641	5,62
Business services, software and technology expense	4,520	4,022	8,96
Intangible amortization expense	991	1,050	1,98
Professional fees and assessments	1,160	1,029	2,20
Marketing and business development	549	707	1,15
Supplies and postage	675	663	1,37
Travel	51	398	31
Mortgage and lending expenses	1,192	769	2,23
Other	1,767	679	2,60
Total noninterest expense	$ 39,734	$ 35,261	$ 76,46

Total noninterest expense for the three months ended June 30, 2020 was $39.7 million, an increase of $4.4 million, or 12.7%, compared to $35.3 million for the three months ended June 30, 2019. The increase in noninterest expense was driven by increases of $3.1 million in compensation expenses, $1.1 million in other noninterest expense, $498 thousand in business services, software and technology expense, and $423 thousand in mortgage and lending expenses. Increases in compensation and mortgage and lending expenses were a direct result of increases in mortgage originations. The increase in other noninterest expense was a result of a $1.0 million increase in the provision for unfunded commitments.

Total noninterest expense for the six months ended June 30, 2020 was $76.5 million, an increase of $7.7 million, or 11.2%, compared to $68.8 million for the six months ended June 30, 2019. The increase in noninterest expense was due to increases of $5.0 million in compensation expense, $1.4 million in other noninterest expense, $1.1 in business services, software and technology expense, and $1.0 million in mortgage and lending expenses. The increases in compensation and mortgage and lending expenses were a result of increased mortgage originations for the six months ended June 30, 2020 compared to 2019. The increase in other noninterest expense was primarily due to a $1.5 million increase in the provision for unfunded commitments. The increase in business services, software and technology expense was due to our continued investment in software related and technology related to our “One Alerus” initiative.

Income Tax Expense

Income tax expense is an estimate based on the amount we expect to owe the respective taxing authorities, plus the impact of deferred tax items. Accrued taxes represent the net estimated amount due, or to be received from, taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions, taking into account statutory, judicial, and regulatory guidance in the context of our tax position. If the final resolution of taxes payable differs from our estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

For the three months ended June 30, 2020, we recognized income tax expense of $3.6 million on $15.1 million of pre-tax income, resulting in an effective tax rate of 23.9%, compared to income tax expense of $2.9 million on $11.2 million of pre-tax income for the three months ended June 30, 2019, resulting in an effective tax rate of 25.6%. The decrease in the effective tax rate was primarily due to additional tax benefits from non-taxable income for the three months ended June 30, 2020, as compared to the same period in 2019.

For the six months ended June 30, 2020, we recognized income tax expense of $5.1 million on $21.9 million of pre-tax income, resulting in an effective tax rate of 23.1%, compared to income tax expense of $4.9 million on $19.7 million of pre-tax income for the six months ended June 30, 2019, resulting in an effective tax rate of 24.9%. The decrease in the effective tax rate was primarily due to additional tax benefits from share-based compensation for the six-months ended June 30, 2020, as compared to the same period in 2019.

Financial Condition

Overview

Total assets were $2.9 billion as of June 30, 2020, an increase of $518.6 million, or 22.0%, as compared to December 31, 2019. The increase in total assets was primarily due to increases of $347.3 million in PPP loans, $83.4 million in available-for-sale investments, $54.9 million in loans held for sale, and $7.8 million in other assets.

Loans

The loan portfolio represents a broad range of borrowers comprised of commercial and industrial, commercial real estate, residential real estate, and consumer financing loans. The goal of the overall portfolio mix is to diversify with approximately one third of the portfolio in each of the commercial and industrial, commercial real estate, and residential real estate categories. As of June 30, 2020, the portfolio mix was 39.0% commercial and industrial, 25.5% commercial real estate, 30.1% residential real estate and 5.4% other categories. Commercial and industrial loans included $347.3 million of PPP loans as of June 30, 2020. Excluding PPP loans, the commercial and industrial loan portfolio group represents 26.5% of total loans.

The following table presents the composition of total loans outstanding by portfolio segment as of June 30, 2020 and December 31, 2019:

	June 30, 2020		December 31, 2019		Ch
(dollars in thousands)	Balance	Percent of Portfolio	Balance	Percent of Portfolio	Amount
Commercial					
Commercial and industrial (1)	$ 794,204	39.0 %	$ 479,144	27.8 %	$ 315,060
Real estate construction	31,344	1.5 %	26,378	1.5 %	4,966
Commercial real estate	519,104	25.5 %	494,703	28.8 %	24,401
Total commercial	1,344,652	66.0 %	1,000,225	58.1 %	344,427
Consumer					
Residential real estate first mortgage	456,737	22.5 %	457,155	26.6 %	(418
Residential real estate junior lien	154,351	7.6 %	177,373	10.3 %	(23,022
Other revolving and installment	78,457	3.9 %	86,526	5.0 %	(8,069
Total consumer	689,545	34.0 %	721,054	41.9 %	(31,509
Total loans	$ 2,034,197	100.0 %	$ 1,721,279	100.0 %	$ 312,918

(1) Includes PPP loans of $347.3 million at June 30, 2020.

Total loans outstanding were $2.03 billion as of June 30, 2020, an increase of $312.9 million, or 18.2%, from December 31, 2019. The increase was primarily due to increases of $315.1 in commercial and industrial loans and $24.4 million in our commercial real estate loan portfolio, partially offset by a $31.5 million decrease in our consumer loan portfolio. The increase in commercial and industrial loans was due to an increase of $347.3 million in net PPP loans, offset by a decrease in $25.3 million due to a 7.86% decrease in operating line utilization.

Consistent with regulatory guidance urging banks to work with borrowers during this unprecedented situation and as outlined in the CARES Act, the Company offered a payment deferral program for its lending clients that are adversely affected by COVID-19. These deferrals were generally no more than 90 days in duration. As of June 30, 2020, the Company had executed 515 of these deferrals on outstanding loan balances of $148.5 million. In accordance with the Interagency Statement on Loan Modifications and Reporting for Financial institutions as issued on April 7, 2020, these

short-term deferrals were not considered TDRs. See “NOTE 4 Loans and Allowance for Loan Losses” to the consolidated financial statements for additional information regarding TDRs.

We anticipate that loan growth will slow down in the future for our commercial and industrial, commercial real estate, residential real estate, and consumer loan portfolios as a result of COVID-19 and the related decline in economic conditions in our market areas.

The following table presents the maturities and types of interest rates for the loan portfolio as of June 30, 2020.

	June 30, 2020		
(dollars in thousands)	One year or less	After one but within five years	After five years
Commercial			
Commercial and industrial	$ 148,788	$ 586,709	$ 58,707
Real estate construction	4,589	15,766	10,989
Commercial real estate	46,844	219,872	252,388
Total commercial	200,221	822,347	322,084
Consumer			
Residential real estate first mortgage	20,224	18,971	417,542
Residential real estate junior lien	18,563	60,280	75,508
Other revolving and installment	11,219	56,162	11,076
Total consumer	50,006	135,413	504,126
Total loans	$ 250,227	$ 957,760	$ 826,210
Sensitivity of loans to changes in interest rates			
Fixed interest rates		$ 836,252	$ 361,697
Floating interest rates		121,508	464,513
Total		$ 957,760	$ 826,210

As of June 30, 2020, 62.1% of the loan portfolio bore interest at fixed rates and 37.9% at floating rates. The expected life of our loan portfolio will differ from contractual maturities because borrowers may have the right to curtail or prepay their loans with or without penalties. Consequently, the table above includes information limited to contractual maturities of the underlying loans.

Asset Quality

Our strategy for credit risk management includes well-defined, centralized credit policies; uniform underwriting criteria; and ongoing risk monitoring and review processes for all commercial and consumer credit exposures. The strategy also emphasizes diversification on a geographic, industry, and client level; regular credit examinations; and management reviews of loans experiencing deterioration of credit quality. We strive to identify potential problem loans early, take necessary charge-offs promptly, and maintain adequate reserve levels for probable loan losses inherent in the portfolio. Management performs ongoing, internal reviews of any problem credits and continually assesses the adequacy of the allowance. We utilize an internal lending division, Special Credit Services, to develop and implement strategies for the management of individual nonperforming loans.

Credit Quality Indicators

Loans are assigned a risk rating and grouped into categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The risk ratings are aligned to pass and criticized categories. The criticized categories include special mention, substandard, and doubtful risk ratings.

See "NOTE 4 Loans and Allowance for Loan Losses" to the consolidated financial statements for a definition of each of the risk ratings.

The table below presents criticized loans outstanding by loan portfolio segment as of June 30, 2020 and December 31, 2019:

(dollars in thousands)	June 30, 2020	De
Commercial		
Commercial and industrial	$ 25,353	$
Real estate construction	257	
Commercial real estate	27,999	
Total commercial	53,609	
Consumer		
Residential real estate first mortgage	764	
Residential real estate junior lien	3,102	
Other revolving and installment	39	
Total consumer	3,905	
Total loans	$ 57,514	$
Criticized loans as a percent of total loans	2.83 %	

The following table presents information regarding nonperforming assets as of June 30, 2020 and December 31, 2019:

(dollars in thousands)	June 30, 2020	De
Nonaccrual loans	$ 5,328	$
Accruing loans 90+ days past due	—	
Total nonperforming loans	5,328	
OREO and repossessed assets	26	
Total nonperforming assets	5,354	
Total restructured accruing loans	893	
Total nonperforming assets and restructured accruing loans	$ 6,247	$
Nonperforming loans to total loans	0.26 %	
Nonperforming assets to total assets	0.19 %	
Allowance for loan losses to nonperforming loans	512 %	

The ratio of nonperforming loans to total loans at June 30, 2020 was 0.26%, and if PPP loans were excluded, this ratio would have been 0.32%. Nonperforming assets as a percentage of total assets was 0.19% at June 30, 2020. Excluding PPP loans, nonperforming assets as a percentage of total assets would have been 0.21%

Interest income lost on nonaccrual loans approximated $159 thousand and $20 thousand for the three months ended June 30, 2020 and 2019, respectively. There was no interest income included in net interest income related to nonaccrual loans for the three months ended June 30, 2020 and 2019.

Interest income lost on nonaccrual loans approximated $314 thousand and $147 thousand for the six months ended June 30, 2020 and 2019, respectively. There was no interest income included in net interest income related to nonaccrual loans for the six months ended June 30, 2020 and 2019.

Allowance for Loan Losses

The allowance for loan losses represents management's estimate of incurred credit losses inherent in the loan portfolio at the balance sheet date. The allowance for loan losses is maintained at a level management believes is sufficient to absorb incurred losses in the loan portfolio given the conditions at the time. Management determines the adequacy of the allowance based on periodic evaluations of the loan portfolio, after consideration of risk characteristics of the loans and prevailing and anticipated economic and other conditions. A risk system, consisting of multiple grading

categories for each portfolio class, is utilized as an analytical tool to assess risk and appropriate reserves. In addition to the risk system, management further evaluates risk characteristics of the loan portfolio under current and anticipated economic conditions and considers such factors as the financial condition of the borrower, past and expected loss experience, and other factors which management feels deserve recognition in establishing an appropriate reserve. These estimates are reviewed at least quarterly, and, as adjustments become necessary, they are recognized in the periods in which they become known. These evaluations are inherently subjective as they require management to make material estimates, all of which may be susceptible to significant change.

The following table presents, by loan type, the changes in the allowance for loan losses for the periods presented.

	Three months ended June 30,		Six months enc June 30,	
(dollars in thousands)	2020	2019	2020	
Balance—beginning of period	$ 27,019	$ 22,638	$ 23,924	$
Commercial loan charge-offs				
Commercial and Industrial	(2,703)	(3,166)	(2,735)	
Real estate construction	—	—	—	
Commercial real estate	(865)	—	(865)	
Total commercial loan charge-offs	(3,568)	(3,166)	(3,600)	
Consumer loan charge-offs				
Residential real estate first mortgage	—	—	—	
Residential real estate junior lien	(12)	(30)	(12)	
Other revolving and installment	(86)	(424)	(153)	
Total consumer loan charge-offs	(98)	(454)	(165)	
Total loan charge-offs	(3,666)	(3,620)	(3,765)	
Commercial loan recoveries				
Commercial and Industrial	321	227	914	
Real estate construction	—	2	—	
Commercial real estate	—	150	—	
Total commercial recoveries	321	379	914	
Consumer loan recoveries				
Residential real estate first mortgage	5	—	5	
Residential real estate junior lien	57	30	94	
Other revolving and installment	20	22	84	
Total consumer loan recoveries	82	52	183	
Total loan recoveries	403	431	1,097	
Net loan charge-offs (recoveries)	3,263	3,189	2,668	
Commercial loan provision				
Commercial and Industrial	278	818	348	
Real estate construction	109	70	140	
Commercial real estate	2,537	(228)	4,125	
Total commercial loan provision	2,924	660	4,613	
Consumer loan provision				
Residential real estate first mortgage	459	(455)	1,220	
Residential real estate junior lien	32	(51)	349	
Other revolving and installment	171	433	263	
Total consumer loan provision	662	(73)	1,832	
Unallocated provision expense	(86)	1,210	(445)	
Total loan loss provision	3,500	1,797	6,000	
Balance—end of period	$ 27,256	$ 21,246	$ 27,256	$
Total loans	$ 2,034,197	$ 1,713,452	$ 2,034,197	$
Average total loans	1,986,028	1,724,080	1,858,810	
Allowance for loan losses to total loans	1.34 %	1.24 %	1.34 %	
Net charge-offs/(recoveries) to average total loans (annualized)	0.66 %	0.74 %	0.29 %	

The allowance for loan losses was $27.3 million as of June 30, 2020, compared to $23.9 million as of December 31, 2019. The $3.4 million increase in the allowance for loan losses was due to additional provision for loan losses of $6.0 million, partially offset by net charge-offs of $2.6 million. The increase in provision expense was primarily due to allocations of reserves for the economic uncertainties related to COVID-19. As of June 30, 2020, the allowance for loan losses represented 1.34% of total loans. Excluding PPP loans, the ratio of allowance for loan losses to total loans increased 23 basis points to 1.62% at June 30, 2020, compared to 1.39% as of December 31, 2019. At June 30, 2020, the ratio of net charge-offs to average total loans was 0.66%, and if PPP loans were excluded, the ratio was 11 basis points higher at 0.77%.

Based on current economic indicators, the Company increased the economic factors within the allowance for loan losses evaluation. We expect that the allowance for loan losses as a percent of total loans may increase in future periods based on our belief that the credit quality of our loan portfolio may decline, and loan defaults may increase, as a result of COVID-19.

The following table presents the allocation of the allowance for loan losses as of the dates presented.

	June 30, 2020		December 31, 201
(dollars in thousands)	Allocated Allowance	Percentage of loans to total loans	Allocated Allowance
Commercial and industrial	$ 10,797	39.0 %	$ 12,270
Real estate construction	443	1.5 %	303
Commercial real estate	9,948	25.5 %	6,688
Residential real estate first mortgage	2,673	22.5 %	1,448
Residential real estate junior lien	1,102	7.6 %	671
Other revolving and installment	546	3.9 %	352
Unallocated	1,747	— %	2,192
Total loans	$ 27,256	100.0 %	$ 23,924

In the ordinary course of business, we enter into commitments to extend credit, including commitments under credit arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded. A reserve for unfunded commitments is established using historical loss data and utilization assumptions. This reserve is located in accrued expenses and other liabilities on the Consolidated Balance Sheets. The reserve for unfunded commitments was $2.0 million as of June 30, 2020, an increase of $1.0 million, as compared to December 31, 2019.

Loans Held for Sale

Loans held for sale represent loans to consumers for the purchase or refinance of a residence that we have originated and intend to sell into the secondary market. Loans held for sale were $101.8 million as of June 30, 2020, an increase of $54.9 million, as compared to December 31, 2019. The increase in loans held for sale was primarily due to increased mortgage originations through June and investor pipeline capacity. Mortgage loan originations totaled $431.6 million for the three months ended June 30, 2020 compared to $261.3 million for the three months ended December 31, 2019.

Investment Securities

The composition of our investment securities portfolio reflects our investment strategy of maintaining an appropriate level of liquidity for normal operations while providing an additional source of revenue. The investment portfolio also provides a balance to interest rate risk and credit risk in other categories of the balance sheet, while providing a vehicle for the investment of available funds, furnishing liquidity, and supplying securities to pledge as collateral.

The following table presents the fair value composition of our investment securities portfolio as of June 30, 2020 and December 31, 2019:

(dollars in thousands)	June 30, 2020 Balance	June 30, 2020 Percent of Portfolio	December 31, 2019 Balance	December 31, 2019 Percent of Portfolio	Chang Amount
Available-for-sale					
U.S. Treasury and agencies	$ 16,252	4.1 %	$ 21,240	6.8 %	$ (4,988)
Obligations of state and political agencies	114,153	29.0 %	68,648	21.9 %	45,505
Mortgage backed securities					
Residential Agency	214,707	54.6 %	182,538	58.3 %	32,169
Commercial	27,926	7.1 %	30,685	9.8 %	(2,759)
Asset backed securities	135	— %	144	— %	(9)
Corporate bonds	20,554	5.2 %	7,095	2.3 %	13,459
Total available-for-sale	393,727	100.0 %	310,350	99.1 %	83,377
Equity	—	- %	2,808	0.9 %	(2,808)
Total investment securities	$ 393,727	100.0 %	$ 313,158	100.0 %	$ 80,569

The securities available-for-sale presented in the following table are reported at fair value and by contractual maturity as of June 30, 2020. Actual timing may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Additionally, residential mortgage backed securities and collateralized mortgage obligations receive monthly principal payments, which are not reflected below. The yields below are calculated on a tax-equivalent basis.

	Maturity as of June 30, 2020						
	One year or less		One to five years		Five to ten years		After t
(dollars in thousands)	Fair Value	Average Yield	Fair Value	Average Yield	Fair Value	Average Yield	Fair Value
Available-for-sale							
U.S. Treasury and agencies	$ 10,066	1.52 %	$ —	— %	$ 1,622	0.92 %	$ 4,564
Obligations of state and political agencies	2,086	1.49 %	21,906	1.54 %	53,000	1.93 %	37,161
Mortgage backed securities							
Residential Agency	2	2.84 %	2,663	2.35 %	45,637	2.56 %	166,405
Commercial	—	— %	1,752	2.83 %	6,505	2.35 %	19,669
Asset backed securities	—	— %	—	— %	—	— %	135
Corporate bonds	6,081	2.57 %	1,002	2.63 %	11,480	4.92 %	1,991
Total available-for-sale	$ 18,235	1.87 %	$ 27,323	1.75 %	$ 118,244	2.51 %	$ 229,925

Deposits

Total deposits were $2.45 billion as of June 30, 2020, an increase of $481.8 million, or 24.4%, as compared to December 31, 2019. The increase in total deposits was due to an increase in interest-bearing deposits of $358.6 million and a $123.2 million increase in noninterest-bearing deposits. The increase in deposits was primarily due to higher customer balances resulting from PPP loans and the uncertain economic environment. The increase in interest-bearing deposits included an $89.7 million increase in synergistic deposits from our retirement and benefit services and wealth management segments. In addition, health savings account, or HSA, deposits were $128.6 million as of June 30, 2020, an increase of $8.8 million, or 7.4%, from December 31, 2019. Noninterest-bearing deposits as a percent of total deposits was 28.6% and 29.3% as of June 30, 2020 and December 31, 2019, respectively. Total deposits represented 95.5% of total liabilities as of June 30, 2020.

We expect that deposit levels will generally decrease in future periods as a result of the distressed economic conditions in our market areas as a result of the COVID-19 pandemic and as clients continue to utilize funds received from PPP loans.

The following table presents the composition of our deposit portfolio as of June 30, 2020 and December 31, 2019:

	June 30, 2020		December 31, 2019		C
(dollars in thousands)	Balance	Percent of Portfolio	Balance	Percent of Portfolio	Amount
Noninterest-bearing demand	$ 700,892	28.6 %	$ 577,704	29.3 %	$ 123,
Interest-bearing demand	579,840	23.6 %	458,689	23.3 %	121,
Money market and savings	968,690	39.5 %	738,841	37.5 %	229,
Time deposits	203,731	8.3 %	196,082	9.9 %	7,
Total deposits	$ 2,453,153	100.0 %	$ 1,971,316	100.0 %	$ 481,

The following table presents the average balances and rates of our deposit portfolio for the three months ended June 30, 2020 and 2019:

	Three months ended June 30, 2020		Three months end June 30, 2019
(dollars in thousands)	Average Balance	Average Rate	Average Balance
Noninterest-bearing demand	$ 692,500	— %	$ 478,868
Interest-bearing demand	534,733	0.30 %	425,260
Money market and savings	900,812	0.67 %	694,474
Time deposits	201,147	1.30 %	178,401
Total deposits	$ 2,329,192	0.44 %	$ 1,777,003

The following table presents the contractual maturity of time deposits, including certificate of deposit account registry services and IRA deposits of $100 thousand and over, that were outstanding, as of the dates presented:

(dollars in thousands)	
Maturing in:	
3 months or less	$
3 months to 6 months	
6 months to 1 year	
1 year or greater	
Total	$

Borrowings

Borrowings as of June 30, 2020 and December 31, 2019 were as follows:

	June 30, 2020		December 31, 2019		Chan
(dollars in thousands)	Balance	Percent of Portfolio	Balance	Percent of Portfolio	Amount
Subordinated notes	$ 49,656	84.5 %	$ 49,625	84.4 %	$ 31
Junior subordinated debentures	8,561	14.6 %	8,504	14.5 %	57
Finance lease liability	537	0.9 %	640	1.1 %	(103)
Total borrowed funds	$ 58,754	100.0 %	$ 58,769	100.0 %	$ (15)

Capital Resources

Stockholders' equity is influenced primarily by earnings, dividends, the Company's sales and repurchases of its common stock and changes in accumulated other comprehensive income caused primarily by fluctuations in unrealized gains or losses, net of taxes, on available-for-sale securities.

Stockholders' equity increased $20.0 million to $305.7 million as of June 30, 2020, compared to $285.7 million as of December 31, 2019. The increase in stockholders' equity was primarily impacted by $16.8 million of net income

for the six months ended June 30, 2020, and an increase of $7.8 million of accumulated other comprehensive income. These increases were partially offset by $5.2 million in dividends declared on common stock. Tangible common equity to tangible assets, a non-GAAP financial measure, decreased to 9.25% as of June 30, 2020, from 10.38% as of December 31, 2019. Tangible common equity to tangible assets would have been 10.55% as of June 30, 2020, if PPP loans were excluded.

We strive to maintain an adequate capital base to support our activities in a safe and sound manner while at the same time attempting to maximize stockholder value. Capital adequacy is assessed against the risk inherent in our balance sheet, recognizing that unexpected loss is the common denominator of risk and that common equity has the greatest capacity to absorb unexpected loss.

We are subject to various regulatory capital requirements both at the Company and at the Bank level. Failure to meet minimum capital requirements could result in certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have an adverse material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines must be met that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting policies. We have consistently maintained regulatory capital ratios at or above the well-capitalized standards.

At June 30, 2020 and December 31, 2019, we met all the capital adequacy requirements to which we were subject. The table below presents the Company's and the Bank's regulatory capital ratios as of June 30, 2020 and December 31, 2019:

Capital Ratios	**June 30, 2020**	**D**
Alerus Financial Corporation		
Common equity tier 1 capital to risk weighted assets	12.58 %	
Tier 1 capital to risk weighted assets	12.99 %	
Total capital to risk weighted assets	16.70 %	
Tier 1 capital to average assets	9.75 %	
Tangible common equity to tangible assets (1)	9.25 %	
Alerus Financial, National Association		
Common equity tier 1 capital to risk weighted assets	11.99 %	
Tier 1 capital to risk weighted assets	11.99 %	
Total capital to risk weighted assets	13.24 %	
Tier 1 capital to average assets	9.00 %	

(1)Represents a non-GAAP financial measure. See "Non-GAAP to GAAP Reconciliations and Calculation of Non-GAAP Financial Measures."

The capital ratios for the Company and the Bank, as of June 30, 2020, as shown in the above tables, were at levels above the regulatory minimums to be considered "well capitalized". See "Note 17 Regulatory Matters" to the consolidated financial statements for additional information

Contractual Obligations and Off-Balance Sheet Arrangements

Contractual Obligations

In the ordinary course of our operations, we enter into certain contractual obligations. The following table presents our contractual obligations by maturity as of June 30, 2020.

	June 30, 2020				
(dollars in thousands)	Less than one year	One to three years	Three to five years	Over five years	
Operating lease obligations	$ 2,293	$ 4,066	$ 1,993	$ 1,913	$
Time deposits	172,598	18,410	6,620	6,103	
Subordinated notes payable	—	—	—	49,656	
Junior subordinated debenture (Trust I)	—	—	—	3,424	
Junior subordinated debenture (Trust II)	—	—	—	5,137	
Finance lease liability	251	335	—	—	
Total contractual obligations	$ 175,142	$ 22,811	$ 8,613	$ 66,233	$

Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments consist primarily of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. These commitments consist principally of unused commercial and consumer credit lines. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of an underlying contract with a third party. The credit risks associated with commitments to extend credit and standby letters of credit are essentially the same as that involved with extending loans to customers and are subject to normal credit policies. Collateral may be required based on management's assessment of the customer's creditworthiness. The fair value of these commitments is considered immaterial for disclosure purposes.

A summary of the contractual amounts of our exposure to off-balance sheet agreements as of June 30, 2020 and December 31, 2019, is as follows:

(dollars in thousands)	June 30, 2020
Commitments to extend credit	$ 600,269
Standby letters of credit	7,387
Total	$ 607,656

Liquidity

Liquidity management is the process by which we manage the flow of funds necessary to meet our financial commitments on a timely basis and at a reasonable cost and to take advantage of earnings enhancement opportunities. These financial commitments include withdrawals by depositors, credit commitments to borrowers, expenses of our operations, and capital expenditures. Liquidity is monitored and closely managed by our asset and liability committee, or the ALCO, a group of senior officers from the finance, enterprise risk management, deposit, investment, treasury, and lending areas. It is the ALCO's responsibility to ensure we have the necessary level of funds available for normal operations as well as maintain a contingency funding policy to ensure that potential liquidity stress events are planned for, quickly identified, and management has plans in place to respond. The ALCO has created policies which establish limits and require measurements to monitor liquidity trends, including modeling and management reporting that identifies the amounts and costs of all available funding sources.

As of June 30, 2020, we had on balance sheet liquidity of $354.6 million, compared to $250.7 million as of December 31, 2019. On balance sheet liquidity includes total due from banks, federal funds sold, interest-bearing deposits with banks, unencumbered securities available-for-sale, and over collateralized securities pledging positions.

The Bank is a member of the FHLB, which provides short- and long-term funding to its members through advances collateralized by real estate related assets and other select collateral, most typically in the form of debt securities. The actual borrowing capacity is contingent on the amount of collateral available to be pledged to the FHLB. As of June 30, 2020, we had no outstanding fed funds purchased from the FHLB and $580.2 million of collateral pledged to the FHLB. Based on this collateral, we were eligible to borrow up to $579.9 million from the FHLB. In addition, we can borrow up to $102.0 million through the unsecured lines of credit we have established with four other banks.

In addition, because the Bank is "well capitalized," we can accept wholesale deposits up to 20.0% of total assets based on current policy limits. Management believed that we had adequate resources to fund all of our commitments as of June 30, 2020 and December 31, 2019.

Our primary sources of liquidity include liquid assets, as well as unencumbered securities that can be used to collateralize additional funding.

Though remote, the possibility of a funding crisis exists at all financial institutions. The economic impact of COVID-19 could place increased demand on our liquidity if we experience significant credit deterioration and as we meet borrowers' needs. Accordingly, management has addressed this issue by formulating a liquidity contingency plan, which has been reviewed and approved by both the Bank's board of directors and the ALCO. The plan addresses the actions that we would take in response to both a short-term and long-term funding crisis.

A short-term funding crisis would most likely result from a shock to the financial system, either internal or external, which disrupts orderly short-term funding operations. Such a crisis would likely be temporary in nature and would not involve a change in credit ratings. A long-term funding crisis would most likely be the result of both external and internal factors and would most likely result in drastic credit deterioration. Management believes that both potential circumstances have been fully addressed through detailed action plans and the establishment of trigger points for monitoring such events.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates. Interest-rate risk is the risk to earnings and equity value arising from changes in market interest rates and arises in the normal course of business to the extent that there is a divergence between the amount of interest-earning assets and the amount of interest-bearing liabilities that are prepaid/withdrawn, re-price, or mature in specified periods. We seek to achieve consistent growth in net interest income and equity while managing volatility arising from shifts in market interest rates. The ALCO oversees market risk management, monitoring risk measures, limits, and policy guidelines for managing the amount of interest rate risk and its effect on net interest income and capital. The Bank's board of directors approves policy limits with respect to interest rate risk.

Interest Rate Risk

Interest rate risk management is an active process that encompasses monitoring loan and deposit flows complemented by investment and funding activities. Effective interest rate risk management begins with understanding the dynamic characteristics of assets and liabilities and determining the appropriate interest rate risk position given business activities, management objectives, market expectations and ALCO policy limits and guidelines.

Interest rate risk can come in a variety of forms, including repricing risk, basis risk, yield curve risk and option risk. Repricing risk is the risk of adverse consequences from a change in interest rates that arises because of differences in the timing of when those interest rate changes impact our assets and liabilities. Basis risk is the risk of adverse consequence resulting from unequal change in the spread between two or more rates for different instruments with the same maturity. Yield curve risk is the risk of adverse consequences resulting from unequal changes in the spread between two or more rates for different maturities for the same or different instruments. Option risk in financial instruments arises from embedded options such as options provided to borrowers to make unscheduled loan

prepayments, options provided to debt issuers to exercise call options prior to maturity, and depositor options to make withdrawals and early redemptions.

Management regularly reviews our exposure to changes in interest rates. Among the factors considered are changes in the mix of interest-earning assets and interest-bearing liabilities, interest rate spreads and repricing periods. The ALCO reviews, on at least a quarterly basis, the interest rate risk position.

The interest-rate risk position is measured and monitored at the Bank using net interest income simulation models and economic value of equity sensitivity analysis that capture both short-term and long-term interest-rate risk exposure.

Modeling the sensitivity of net interest income and the economic value of equity to changes in market interest rates is highly dependent on numerous assumptions incorporated into the modeling process. The models used for these measurements rely on estimates of the potential impact that changes in interest rates may have on the value and prepayment speeds on all components of our loan portfolio, investment portfolio, as well as embedded options and cash flows of other assets and liabilities. Balance sheet growth assumptions are also included in the simulation modeling process. The analysis provides a framework as to what our overall sensitivity position is as of our most recent reported position and the impact that potential changes in interest rates may have on net interest income and the economic value of our equity.

Net interest income simulation involves forecasting net interest income under a variety of interest rate scenarios including instantaneous shocks.

The estimated impact on our net interest income as of June 30, 2020 and December 31, 2019, assuming immediate parallel moves in interest rates is presented in the table below.

	June 30, 2020		December 31,
	Following 12 months	Following 24 months	Following 12 months
+400 basis points	4.1 %	−3.1 %	5.5 %
+300 basis points	2.8 %	−5.9 %	4.2 %
+200 basis points	1.6 %	−8.8 %	2.9 %
+100 basis points	0.4 %	−11.8 %	1.5 %
−100 basis points	1.3 %	−15.7 %	−5.4 %
−200 basis points	N/A %	N/A %	N/A %

Management strategies may impact future reporting periods, as actual results may differ from simulated results due to the timing, magnitude, and frequency of interest rate changes, the difference between actual experience, and the characteristics assumed, as well as changes in market conditions. Market based prepayment speeds are factored into the analysis for loan and securities portfolios. Rate sensitivity for transactional deposit accounts is modeled based on both historical experience and external industry studies.

Management uses economic value of equity sensitivity analysis to understand the impact of interest rate changes on long-term cash flows, income, and capital. Economic value of equity is based on discounting the cash flows for all balance sheet instruments under different interest rate scenarios. Deposit premiums are based on external industry studies and utilizing historical experience.

The table below presents the change in the economic value of equity as of June 30, 2020 and December 31, 2019, assuming immediate parallel shifts in interest rates.

	June 30, 2020	D
+400 basis points	17.0 %	
+300 basis points	15.7 %	
+200 basis points	13.1 %	
+100 basis points	9.0 %	
−100 basis points	−48.1 %	
−200 basis points	N/A %	

Operational Risk

Operational risk is the risk of loss due to human behavior, inadequate or failed internal systems and controls, and external influences such as market conditions, fraudulent activities, disasters, and security risks. Management continuously strives to strengthen its system of internal controls, enterprise risk management, operating processes and employee awareness to assess the impact on earnings and capital and to improve the oversight of our operational risk.

Compliance Risk

Compliance risk represents the risk of regulatory sanctions, reputational impact or financial loss resulting from failure to comply with rules and regulations issued by the various banking agencies and standards of good banking practice. Activities which may expose us to compliance risk include, but are not limited to, those dealing with the prevention of money laundering, privacy and data protection, community reinvestment initiatives, fair lending challenges resulting from the expansion of our banking center network, employment and tax matters.

Strategic and/or Reputation Risk

Strategic and/or reputation risk represents the risk of loss due to impairment of reputation, failure to fully develop and execute business plans, failure to assess current and new opportunities in business, markets and products, and any other event not identified in the defined risk types mentioned previously. Mitigation of the various risk elements that represent strategic and/or reputation risk is achieved through initiatives to help management better understand and report on various risks, including those related to the development of new products and business initiatives.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company’s management, including our President and Chief Executive Officer and our Chief Financial Officer, have evaluated the effectiveness of our “disclosure controls and procedures” (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, or the “Exchange Act”), as of the end of the period covered by this report. Based on such evaluation, our President and Chief Executive Officer and our Chief Financial Officer have concluded that, as of the end of such period, the Company’s disclosure controls and procedures were effective as of that date to provide reasonable assurance that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to the Company’s management, including its President and Chief Executive Officer and its Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company’s internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1 – Legal Proceedings

There are no material pending legal proceedings, other than ordinary routine litigation incidental to the business of the Company or its subsidiaries, to which we or any of our subsidiaries is a party or to which our property is the subject. The Company does not know of any proceeding contemplated by a governmental authority against the Company or any of its subsidiaries.

Item 1A – Risk Factors

In addition to the risk factors set forth under Part I, Item 1A “Risk Factors” in the Company’s Form 10-K for the fiscal year ended December 31, 2019, the following risk factors apply to the Company:

The outbreak of Coronavirus Disease 2019, or COVID-19, has led to an economic recession and other severe disruptions to the U.S. economy and has adversely impacted certain industries in which our clients operate and impaired their ability to fulfill their financial obligations to us. As a result, we are starting to see the impact from COVID-19 on our business, and we believe that it will be significant, adverse, and potentially material.

Currently, COVID-19 is spreading through the United States and the world. The spread of COVID-19 has caused severe disruptions to the U.S. economy at large, and for small businesses, in particular, which has disrupted our operations. We are starting to see the impact from COVID-19 on our business, and we believe that it will be significant, adverse, and potentially material. The responses on the part of the U.S. and global governments and populations have created a recessionary environment, reduced economic activity, and caused significant volatility in the global stock markets. We expect that we will experience significant disruptions across our business due to these effects, leading to decreased earnings and significant loan defaults and slowdowns in our loan collections. We expect retirement and benefit services and wealth management asset based revenue will be adversely affected by reduced assets under administration and assets under management, and we also expect increased unemployment and recessionary concerns will adversely affect mortgage originations and mortgage banking revenue in future periods.

The outbreak of COVID-19 has resulted in a decline in our clients’ businesses, a decrease in consumer confidence, an increase in unemployment, and a disruption in the services provided by our vendors. Continued disruptions to our clients’ businesses could result in increased risk of delinquencies, defaults, foreclosures, and losses on our loans and declines in assets under management and wealth management revenues, negatively impact regional economic conditions, result in declines in local loan demand, liquidity of loan guarantors, the value of loan collateral (particularly in real estate), loan originations, and deposit availability and negatively impact the implementation of our growth strategy. Although the U.S. government has introduced a number of programs designed to soften the impact of COVID-19 on small businesses, once these programs expire, our borrowers may not be able to satisfy their financial obligations to us.

In addition, COVID-19 has impacted and likely will continue to impact the financial ability of businesses and consumers to borrow money, which would negatively impact loan volumes. Certain of our borrowers are in, or have exposure to, the retail, restaurant, and hospitality industries and are located in areas that are, or were, quarantined or under stay-at-home orders, and COVID-19 may also have an adverse effect on our commercial real estate portfolio, particularly with respect to real estate with exposure to these industries, and consumer loan portfolios. Any new or prolonged quarantine or stay-at-home orders would have a negative adverse impact on these borrowers and their revenue streams, which consequently impacts their ability to meet their financial obligations to us and could result in loan defaults.

As a result of the COVID-19 pandemic we may experience adverse financial consequences due to a number of other factors, including but not limited to:

- a further and sustained decline in our stock price or the occurrence of what management would deem to be a triggering event that could, under certain circumstances, cause man

impairment testing on our goodwill and other intangible assets that could result in an impairment charge being recorded for that period, and adversely impact our results of oper ability of the Bank to pay dividends to us;

- the negative effect on earnings resulting from the Bank modifying loans and agreeing to loan payment deferrals due to the COVID-19 crisis;
- increased demand on our liquidity as we meet borrowers' needs, experience significant credit deterioration, and cover expenses related to our business continuity plan;
- the potential for reduced liquidity and its negative affect on our capital and leverage ratios;
- increased cyber and payment fraud risk due to increased online and remote activity; and
- other operational failures due to changes in our normal business practices because of the pandemic and governmental actions to contain it.

Overall, we believe that the economic impact from COVID-19 will be severe and could have a material and adverse impact on our business and result in significant losses in our loan portfolio, all of which would adversely and materially impact our earnings and capital. Even after the COVID-19 pandemic has subsided, we may continue to experience materially adverse impacts to our business as a result of the global economic impact of the COVID-19 pandemic, including the availability of credit, adverse impacts on liquidity and any recession that has occurred or may occur in the future. There are no comparable recent events that provide guidance as to the effect the spread of COVID-19 as a global pandemic may have, and, as a result, the ultimate impact of the pandemic is highly uncertain and subject to change.

The U.S. government and banking regulators, including the Federal Reserve, have taken a number of unprecedented actions in response to the COVID-19 pandemic, which could ultimately have a material adverse effect on our business and results of operations

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief and Economic Security Act, or CARES Act, which established a $2.0 trillion economic stimulus package, including cash payments to individuals, supplemental unemployment insurance benefits and a $349 billion loan program administered through the SBA referred to as the PPP. In addition to implementing the programs contemplated by the CARES Act, the federal bank regulatory agencies have issued a steady stream of guidance in response to the COVID-19 pandemic and have taken a number of unprecedented steps to help banks navigate the pandemic and mitigate its impact. These include, without limitation:

- requiring banks to focus on business continuity and pandemic planning;
- adding pandemic scenarios to stress testing;
- encouraging bank use of capital conservation buffers and reserves in lending programs;
- permitting certain regulatory reporting extensions;
- reducing margin requirements on swaps;
- permitting certain otherwise prohibited investments in investment funds;
- issuing guidance to encourage banks to work with customers affected by the pandemic and encourage loan workouts; and
- providing credit under the CRA for certain pandemic-related loans, investments, and public service.

The COVID-19 pandemic has significantly affected the financial markets and the Federal Reserve has taken a number of actions in response. In March 2020, the Federal Reserve dramatically reduced the target federal funds rate and announced a $700 billion quantitative easing program in response to the expected economic downturn caused by the COVID-19 pandemic. In addition, the Federal Reserve reduced the interest that it pays on excess reserves. We expect that these reductions in interest rates, especially if prolonged, could adversely affect our net interest income and margins and our profitability. The Federal Reserve also launched the Main Street Lending Program, which will offer deferred interest on four-year loans to small and mid-sized businesses. The full impact of the COVID-19 pandemic on our business activities as a result of new government and regulatory laws, policies, programs, and guidelines, as well as market reactions to such activities, remains uncertain but may ultimately have a material adverse effect on our business and results of operations.

COVID-19 has disrupted banking and other financial activities in the areas in which we operate and could potentially create widespread business continuity issues for us.

The COVID-19 pandemic has negatively impacted the ability of our employees and clients to engage in banking and other financial transactions in the geographic areas in which we operate and could create widespread business continuity issues for us. We also could be adversely affected if key personnel or a significant number of employees were to become unavailable due to the effects and restrictions of an outbreak or escalation of the COVID-19 pandemic in our market areas, including because of illness, quarantines, government actions or other restrictions in connection with the COVID-19 pandemic. Although we have business continuity plans and other safeguards in place, there is no assurance that such plans and safeguards will be effective. Further, we rely upon third-party vendors to conduct business and to process, record, and monitor transactions. If any of these vendors are unable to continue to provide us with these services, it could negatively impact our ability to serve our clients.

As a participating lender in the PPP, we are subject to additional risks of litigation from our clients or other parties regarding our processing of loans for the PPP and risks that the SBA may not fund some or all PPP loan guarantees.

The CARES Act included a $349 billion loan program administered through the SBA referred to as the PPP. Under the PPP, small businesses and other entities and individuals can apply for loans from existing SBA lenders and other approved regulated lenders that enroll in the program, subject to numerous limitations and eligibility criteria. The Bank is participating as a lender in the PPP. The PPP opened on April 3, 2020; however, because of the short timeframe between the passing of the CARES Act and the opening of the PPP, there is some ambiguity in the laws, rules, and guidance regarding the operation of the PPP, which exposes us to risks relating to noncompliance with the PPP. On or about April 16, 2020, the SBA notified lenders that the $349 billion earmarked for the PPP was exhausted. On April 24, 2020, an additional $310 billion in funding for PPP loans was authorized and such funds became available for PPP loans beginning on April 27, 2020.

Since the opening of the PPP, several other larger banks have been subject to litigation regarding the process and procedures that such banks used in processing applications for the PPP and claims related to agent fees. If any such litigation is filed against us and is not resolved in a manner favorable to us, it may result in significant financial liability or adversely affect our reputation. In addition, litigation can be costly, regardless of outcome. Any financial liability, litigation costs, or reputational damage caused by the PPP related litigation could have a material adverse impact on our business, financial condition, and results of operations.

We also have credit risk on PPP loans if a determination is made by the SBA that there is a deficiency in the manner in which the loan was originated, funded, or serviced by the Bank, such as an issue with the eligibility of a borrower to receive a PPP loan, which may or may not be related to the ambiguity in the laws, rules, and guidance regarding the operation of the PPP. In the event of a loss resulting from a default on a PPP loan and a determination by the SBA that there is a deficiency in the manner in which the PPP loan was originated, funded, or serviced by us, the SBA may deny its liability under the guaranty, reduce the amount of the guaranty, or if it has already paid under the guaranty, seek recovery of any loss related to the deficiency from us.

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

Unregistered Sales of Equity Securities

None.

Use of Proceeds from Registered Securities

On September 17, 2019, the Company sold 2,860,000 shares of common stock in its initial public offering. On September 25, 2019, the Company sold 429,000 additional shares of common stock pursuant to the exercise in full by the underwriters of their option to purchase additional shares to cover over-allotments. All of the shares were sold pursuant to the Company's Registration Statement on Form S-1, as amended (File No. 333-233339), which was declared effective by the SEC on September 12, 2019. The Company's common stock is currently traded on the Nasdaq Capital Market under the symbol "ALRS".

There has been no material change in the planned use of proceeds from the initial public offering as described in the Company's prospectus filed with the SEC on September 13, 2019, pursuant to Rule 424(b)(4) under the Securities Act of 1933. From the effective date of the registration statement through June 30, 2020, the Company has maintained the net proceeds of the initial public offering on deposit with the Bank. The Bank has used the deposits of the Company to pay down short-term borrowings.

Item 3 – Defaults Upon Senior Securities

None.

Item 4 – Mine Safety Disclosures

Not Applicable.

Item 5 – Other Information

None.

Item 6 – Exhibits

Exhibit No.	Description
31.1	Chief Executive Officer's Certifications required by Rule 13(a)-14(a) – filed herewith.
31.2	Chief Financial Officer's Certifications required by Rule 13(a)-14(a) – filed herewith.
32.1	Chief Executive Officer Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – filed herewith.
32.2	Chief Financial Officer Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – filed herewith.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

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

ALERUS FINANCIAL CORPORATION

Date: August 6, 2020

By: /s/ Randy L. Newman
Name: Randy L. Newman
Title: Chairman, Chief Executive Officer and President (Principal Executive Office

Date: August 6, 2020

By: /s/ Katie A. Lorenson
Name: Katie A. Lorenson
Title: Executive Vice President and Chief Financial Officer (Principal Financial a Officer)

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Section 2: EX-31.1 (EX-31.1)

Exhibit 31.1

Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Randy L. Newman, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q (the "Report") of Alerus Financial Corporation (the "Registrant");
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in lig circumstances under which such statements were made, not misleading with respect to the period covered by this Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Report, fairly present in all material respects the financial condition, results of opera cash flows of the Registrant as of, and for, the periods presented in this Report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) ar (e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information r the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Report is being prepared;
   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure co procedures, as of the end of the period covered by this Report based on such evaluation; and
   d) Disclosed in this Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has r affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and committee of the Registrant's board of directors (or persons performing the equivalent functions):
   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Re ability to record, process, summarize and report financial information; and
   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Alerus Financial Corporation

August 6, 2020

/s/ Randy L. Newman
Randy L. Newman
Chairman, Chief Executive Officer and President
(Principal Executive Officer)

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Section 3: EX-31.2 (EX-31.2)

Exhibit 31.2

Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Katie A. Lorenson, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q (the "Report") of Alerus Financial Corporation (the "Registrant");
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in lig circumstances under which such statements were made, not misleading with respect to the period covered by this Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Report, fairly present in all material respects the financial condition, results of opera cash flows of the Registrant as of, and for, the periods presented in this Report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) ar (e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information r the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Report is being prepared;
   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure cor procedures, as of the end of the period covered by this Report based on such evaluation; and
   d) Disclosed in this Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter that has r affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and committee of the Registrant's board of directors (or persons performing the equivalent functions):
   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Re ability to record, process, summarize and report financial information; and
   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Alerus Financial Corporation

August 6, 2020

/s/ Katie A. Lorenson
Katie A. Lorenson
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

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Section 4: EX-32.1 (EX-32.1)

Exhibit 32.1

Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

I, Randy L. Newman, Chairman, President and Chief Executive Officer of Alerus Financial Corporation (the "Company") hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Quarterly Report on Form 10-Q of the Company for the quarterly period ended June 30, 2020 (the "Report") fully complies with the requirements of Sections 13(a) or 15 Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Alerus Financial Corporation

August 6, 2020

/s/ Randy L. Newman
Randy L. Newman
Chairman, Chief Executive Officer and President
(Principal Executive Officer)

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Section 5: EX-32.2 (EX-32.2)

Exhibit 32.2

Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

I, Katie A. Lorenson, Executive Vice President and Chief Financial Officer of Alerus Financial Corporation (the "Company") hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Quarterly Report on Form 10-Q of the Company for the quarterly period ended June 30, 2020 (the "Report") fully complies with the requirements of Sections 13(a) or 15 Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Alerus Financial Corporation

August 6, 2020

/s/ Katie A. Lorenson
Katie A. Lorenson
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

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