Bank of Marin Bancorp
Form 10-K
March 15, 2019
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2018

OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572

Bank of Marin Bancorp
(Exact name of Registrant as specified in its charter)

California	20-8859754
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
504 Redwood Boulevard, Suite 100, Novato, CA	94947
(Address of principal executive office)	(Zip Code)

Registrant's telephone number, including area code: (415) 763-4520

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

None

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

Common Stock, No Par Value, and attached Share Purchase Rights	NASDAQ Capital Market
(Title of each class)	(Name of each exchange on which registered)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes o No x

Note - checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under these sections.

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K.
x

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 o		Accelerated filer x
Non-accelerated filer o	(Do not check if a smaller reporting company)	Smaller reporting company x
Emerging growth company o		

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.
o

Indicate by check mark if the registrant is a shell company, as defined in Rule 12b-2 of the Exchange Act.
Yes o No x

As of June 29, 2018, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting common equity held by non-affiliates, based upon the closing price per share of the registrant's common stock as reported by the NASDAQ, was approximately $546 million. For the purpose of this response, directors and certain officers of the Registrant are considered affiliates at that date.

As of February 28, 2019, there were 13,806,416 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on May 14, 2019 are incorporated by reference into Part III.

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PART I

Forward-Looking Statements

This discussion of financial results includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the "1933 Act") and Section 21E of the Securities Exchange Act of 1934, as amended, (the "1934 Act"). Those sections of the 1933 Act and 1934 Act provide a "safe harbor" for forward-looking statements to encourage companies to provide prospective information about their financial performance so long as they provide meaningful, cautionary statements identifying important factors that could cause actual results to differ significantly from projected results.

Our forward-looking statements include descriptions of plans or objectives of Management for future operations, products or services, and forecasts of revenues, earnings or other measures of economic performance. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include the words "believe," "expect," "intend," "estimate" or words of similar meaning, or future or conditional verbs preceded by "will," "would," "should," "could" or "may."

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues, that may affect our earnings in future periods. A number of factors, many of which are beyond Management’s control, could cause future results to vary materially from current Management expectations. Such factors include, but are not limited to, general economic conditions and the economic uncertainty in the United States and abroad, including changes in interest rates, deposit flows, real estate values, and expected future cash flows on loans and securities; costs or effects of acquisitions; competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation (including the Tax Cuts and Jobs Act of 2017); natural disasters (such as the recent wildfires in our area); adverse weather conditions; and other economic, competitive, governmental, regulatory and technological factors (including external fraud and cybersecurity threats) affecting our operations, pricing, products and services.

Important factors that could cause results or performance to materially differ from those expressed in our prior forward-looking statements are detailed in ITEM 1A. Risk Factors of this report. Forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

ITEM 1 BUSINESS

Bank of Marin (the “Bank”) was incorporated in August 1989, received its charter from the California Superintendent of Banks (now the California Department of Business Oversight or "DBO") and commenced operations in January 1990. The Bank is an insured bank by the Federal Deposit Insurance Corporation (“FDIC”). Bank of Marin Bancorp (“Bancorp”) was formed in 2007 and the Bank became its sole subsidiary when each share of Bank common stock was exchanged for one share of Bancorp common stock. Bancorp is listed on NASDAQ under the symbol BMRC. Upon formation of the holding company, Bancorp became subject to regulation under the Bank Holding Company Act of 1956, as amended, and reporting and examination requirements by the Board of Governors of the Federal Reserve System ("Federal Reserve"). Bancorp files periodic reports and proxy statements with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended.

References in this report to “Bancorp” mean Bank of Marin Bancorp, parent holding company for the Bank. References to “we,” “our,” “us” mean the holding company and the Bank that are consolidated for financial reporting purposes.

Virtually all of our business is conducted through Bancorp's subsidiary, Bank of Marin, which is headquartered in Novato, California. In addition to our headquarters, we operate twenty-three offices in Marin, Sonoma, San Francisco, Napa and Alameda counties, with a strong emphasis on supporting the local communities. Our customer base is made up of business and personal banking relationships from the communities near the branch office locations. Our business banking focus is on small to medium-sized businesses, professionals and not-for-profit organizations.

We offer a broad range of commercial and retail deposit and lending programs designed to meet the needs of our target markets. Our lending categories include commercial real estate loans, commercial and industrial loans, construction financing, consumer loans, and home equity lines of credit. Merchant card services are available for our

business customers. Through third-party vendors, we offer Visa® credit card programs for consumers and businesses, an American Express® credit card program, a leasing program for commercial equipment financing, prepaid business cards for handling expense reimbursements and a full suite of cash management services.

We offer a variety of personal and business checking and savings accounts, and a number of time deposit alternatives, including time certificates of deposit, Individual Retirement Accounts (“IRAs”), Health Savings Accounts ("HSA"), Certificate of Deposit Account Registry Service® ("CDARS"), Insured Cash Sweep® ("ICS"), and Demand Deposit Marketplace℠ ("DDM Sweep") accounts. CDARS, ICS and DDM Sweep accounts are networks through which we offer full FDIC insurance coverage in excess of the regulatory maximum by placing deposits in multiple banks participating in the networks. We also offer deposit options including mobile deposit, remote deposit capture, Automated Clearing House (“ACH”) services, wire transfers, and image lockbox services. A valet pick-up service is available for non-cash deposits to our professional and business clients.

Other products and services include Apple Pay®, Samsung Pay®, Google Pay®, SurePayroll®, Positive Pay (fraud detection tool), and solutions for clients with cash management needs such as Cash Vault and SafePoint.

Automated teller machines (“ATM's”) are available at most retail branch locations. Our ATM network is linked to the PLUS, CIRRUS and NYCE networks, as well as to a network of nation-wide surcharge-free ATM's called MoneyPass. We also offer our depositors 24-hour access to their accounts by telephone and through our internet and mobile banking services available to personal and business account holders.

We offer Wealth Management and Trust Services (“WMTS”), which include customized investment portfolio management, trust administration, estate settlement and custody services. We also offer 401(k) plan services to small and medium-sized businesses through a third-party vendor.

We make international banking services available to our customers indirectly through other financial institutions with whom we have correspondent banking relationships.

We hold no patents, licenses (other than licenses required by the appropriate banking regulatory agencies), franchises or concessions. The Bank has registered the service marks "The Spirit of Marin," the words “Bank of Marin,” the Bank of Marin logo, and the Bank of Marin tagline, “Committed to your business and our community” with the United States Patent & Trademark Office. In addition, Bancorp has registered the service marks for the words “Bank of Marin Bancorp” and for the Bank of Marin Bancorp logo with the United States Patent & Trademark Office. All service marks registered by Bancorp or the Bank are registered on the United States Patent & Trademark Office Principal Register.

Market Area

Our primary market area consists of Marin, San Francisco, Napa, Sonoma and Alameda counties. Our customer base is primarily made up of business, not-for-profit and personal banking relationships within these market areas.

As discussed in Note 18 to the Consolidated Financial Statements in ITEM 8 of this report, in November 2017, we expanded our presence in Napa County through the acquisition of Bank of Napa, N.A. This resulted in the addition of $302.1 million of assets and the assumption of $251.9 million of liabilities, as well as the addition of two branch offices serving the city of Napa.

We attract deposit relationships from small to medium-sized businesses, not-for-profit organizations and professionals, merchants and individuals who live and/or work in the communities comprising our market areas. As of December 31, 2018, approximately 59% of our deposits were in Marin County and southern Sonoma County, and

approximately 58% of our deposits were from businesses and 42% from individuals.

Competition

The banking business in California generally, and in our market area specifically, is highly competitive with respect to attracting both loan and deposit relationships. The increasingly competitive environment is affected by changes in regulation, interest rates, technology and product delivery systems, and consolidation among financial service providers. The banking industry is seeing strong competition for quality loans, with larger banks expanding their activities to attract businesses that are traditionally community bank customers. In all of our five counties, we have significant competition

from nationwide banks with much larger branch networks and greater financial resources, as well as credit unions and other local and regional banks. Nationwide banks have the competitive advantages of national advertising campaigns. Large commercial banks also have substantially greater lending limits and the ability to offer certain services, which are not offered directly by us. Other competitors for depositors' funds are money market mutual funds and non-bank financial institutions such as brokerage firms and insurance companies.

We differentiate ourselves from the numerous, and often larger, financial institutions in our primary market area, with a business model built on relationship banking, disciplined fundamentals and commitment to the communities we serve. The Bank's experienced professionals deliver innovative and custom financing, with a deep local market knowledge and a personal understanding of each customer's unique needs.

In Marin County, we have the third largest market share of total deposits at 10.8%, based upon FDIC deposit market share data as of June 30, 2018[1]. A significant driver of our franchise value is the growth and stability of our deposits, a low-cost funding source for our loan portfolio.

Employees

At December 31, 2018, we employed 290 full-time equivalent (“FTE”) staff. The actual number of employees, including part-time employees, at year-end 2018 included seven executive officers, 120 other corporate officers and 178 staff. None of our employees are presently represented by a union or covered by a collective bargaining agreement. We believe that our employee relations are good. We have consistently been recognized as one of the “Best Places to Work” by the North Bay Business Journal.

SUPERVISION AND REGULATION

Bank holding companies and banks are extensively regulated under both federal and state law. The following discussion summarizes certain significant laws, rules and regulations affecting Bancorp and the Bank.

Bank Holding Company Regulation

Upon formation of the bank holding company on July 1, 2007, we became subject to regulation under the Bank Holding Company Act of 1956, as amended (“BHCA”) which subjects Bancorp to Federal Reserve reporting and examination requirements. Under the Federal Reserve law and regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks. Under this requirement, we are expected to commit resources to support the Bank, including at times when we may not be in a financial position to provide such resources, and it may not be in our, or our shareholders’ or creditors’, best interests to do so. In addition, any capital loans we make to the Bank are subordinate in right of payment to depositors and to certain other indebtedness of the Bank. The BHCA regulates the activities of holding companies including acquisitions, mergers and consolidations and, together with the Gramm-Leach Bliley Act of 1999, the scope of allowable banking activities. Bancorp is also a bank holding company within the meaning of the California Financial Code. As such, Bancorp and its subsidiaries are subject to examination by, and may be required to file reports with, the DBO.

Bank Regulation

Banking regulations are primarily intended to protect consumers, depositors' funds, federal deposit insurance funds and the banking system as a whole. These regulations affect our lending practices, consumer protections, capital structure, investment practices and dividend policy.

As a state chartered bank, we are subject to regulation, supervision and examination by the DBO. We are also subject to regulation, supervision and periodic examination by the FDIC. If, as a result of an examination of the Bank, the FDIC or the DBO should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of our operations are unsatisfactory, or that we have violated any law or regulation, various remedies are available to those regulators including issuing a “cease and desist” order, monetary penalties, restitution, restricting our growth or removing officers and directors.

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[1] Source: S&P Global Market Intelligence of New York, New York

The Bank addresses the many state and federal regulations it is subject to through a comprehensive compliance program that addresses the various risks associated with these issues.

Safety and Soundness Standards (Risk Management)

The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the financial institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk management and cybersecurity are critical sources of operational risk that financial institutions are expected to address in the current environment. The Board of Directors and various sub-committees oversee Bancorp's consolidated enterprise risk management program that ensures the adequacy of policies, procedures, tolerance levels, risk measurement systems, monitoring processes, management information systems and internal controls.

Dividends

The payment of cash dividends by the Bank to Bancorp is subject to restrictions set forth in the California Financial Code (the “Code”) in addition to regulations and policy statements of the Federal Reserve. Prior to any distribution from the Bank to Bancorp, a calculation is made to ensure compliance with the provisions of the Code and to ensure that the Bank remains within capital guidelines set forth by the DBO and the FDIC. See also Note 8 to the Consolidated Financial Statements, under the heading “Dividends” in ITEM 8 of this report.

FDIC Insurance Assessments

The FDIC insures our customers' deposits to the maximum amount permitted by law, which is currently $250,000 per depositor, based on the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

Our FDIC insurance assessment base is comprised of quarterly average consolidated total assets minus average tangible equity. FDIC's assessment rates are currently between 1.5 and 40 basis points annually on the assessment base for banks in all risk categories. In deriving the risk categories, the FDIC uses a bank's capital level, supervisory ratios and other financial measures to determine a bank's ability to withstand financial stress.

Community Reinvestment Act

Congress enacted the Community Reinvestment Act (“CRA”) in 1977 to encourage financial institutions to meet the credit needs of the communities in which they are located. All banks and thrifts have a continuing and affirmative obligation, consistent with safe and sound operations, to help meet the credit needs of their entire communities, including low and moderate income neighborhoods. Regulatory agencies rate each bank's performance in assessing and meeting these credit needs. The Bank is committed to serving the credit needs of the communities in which we do

business, and it is our policy to respond to all creditworthy segments of our market. As part of its CRA commitment, the Bank maintains strong philanthropic ties to the community. We invest in affordable housing projects that help economically disadvantaged individuals and residents of low- and moderate-income census tracts, in each case consistent with our long-established prudent underwriting practices. We also donate to, invest in and volunteer with organizations that serve the communities in which we do business, especially low- and moderate-income individuals. These organizations offer educational and health programs to economically disadvantaged students and families, community development services and affordable housing programs. We offer CRA reportable small business, small farm and community development loans within our assessment areas. The CRA requires a depository institution's

primary federal regulator, in connection with its examination of the institution, to assess the institution's record in meeting CRA requirements. The regulatory agency's assessment of the institution's record is made available to the public. This record is taken into consideration when the institution establishes a new branch that accepts deposits, relocates an office, applies to merge or consolidate, or expands into other activities. The FDIC assigned a “Satisfactory” rating to its CRA performance examination completed in January 2018, which was performed under the large bank requirements.

Anti-Money-Laundering Regulations

A series of banking laws and regulations beginning with the Bank Secrecy Act in 1970 requires banks to prevent, detect, and report illicit or illegal financial activities to the federal government to prevent money laundering, international drug trafficking, and terrorism. Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, financial institutions are subject to prohibitions against specified financial transactions and account relationships, requirements regarding the Customer Identification Program, as well as enhanced due diligence and “know your customer” standards in their dealings with high risk customers, foreign financial institutions, and foreign individuals and entities. The Customer Due Diligence Rules under the Bank Secrecy Act clarify and strengthen customer due diligence requirements. These rules contain explicit customer due diligence requirements which include a new requirement to identify and verify the identity of beneficial owners of legal entity customers.

Privacy and Data Security

The Gramm-Leach Bliley Act (“GLBA”) of 1999 imposes requirements on financial institutions with respect to consumer privacy and the disclosure of non-public personal information about individuals who apply for or obtain a financial product to be used for personal, family or household purposes. The GLBA generally prohibits disclosure of consumer information to most nonaffiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers and the conditions under which an institution may disclose non-public information about a consumer to a nonaffiliated third-party. The GLBA also directs federal regulators, including the FDIC, to prescribe standards for the security of consumer information. We are subject to such standards, as well as standards for notifying consumers in the event of a security breach. We must disclose our privacy policy to consumers and permit consumers to "opt out" of having non-public customer information disclosed to third parties. We are required to have an information security program to safeguard the confidentiality and security of customer information and to ensure proper disposal of information that is no longer needed. We notify our customers when unauthorized disclosure involves sensitive customer information that may be misused.

Consumer Protection Regulations

Our lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the CRA, Home Mortgage Disclosure Act, Fair Credit Reporting Act, Fair Lending, Fair Debt Collection Practices Act, Flood Disaster Protection Act, Equal Credit Opportunity Act, the Fair Housing Act, Truth-in-Lending Act ("TILA"), the Real Estate Settlement Procedures Act ("RESPA"), and the Secure and Fair Enforcement for Mortgage Licensing Act ("SAFE"). Our deposit operations are also subject to laws and regulations that protect consumer rights including Expedited Funds Availability, Truth in Savings Act ("TISA"), and Electronic Funds Transfers. Other regulatory requirements include: the Unfair, Deceptive or Abusive Acts and Practices ("UDAAP"), Dodd-Frank Act, Right to Financial Privacy and Privacy of Consumer Financial Information. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records.

Restriction on Transactions between Bank's Affiliates

Transactions between Bancorp and the Bank are quantitatively and qualitatively restricted under Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. Section 23A places restrictions on the Bank's "covered transactions" with Bancorp, including loans and other extensions of credit, investments in the securities of, and purchases of assets from Bancorp. Section 23B requires that certain transactions, including all covered transactions, be on market terms and conditions. Federal Reserve Regulation W combines statutory restrictions on transactions between the Bank and Bancorp with Federal Reserve interpretations in an effort to simplify compliance with Sections 23A and 23B.

Capital Requirements

The Federal Reserve and the FDIC have adopted risk-based capital guidelines for bank holding companies and banks. Bancorp's ratios exceed the required minimum ratios for capital adequacy purposes and the Bank meets the definition for "well capitalized." Undercapitalized depository institutions may be subject to significant restrictions. Banks that are categorized as "critically undercapitalized" under applicable FDIC regulations are subject to dividend restrictions.

In July 2013, the federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, which became effective January 1, 2015 (subject to a phase-in period). The final rule strengthened the definition of regulatory capital, increased risk-based capital requirements, made selected changes to the calculation of risk-weighted assets, and adjusted the prompt corrective action thresholds. We were in compliance throughout the phase-in period and implemented the fully phased-in capital rules as of January 1, 2019. For additional information on our risk-based capital positions, refer to the Capital Adequacy section within ITEM 7 to Management's Discussion and Analysis and the Consolidated Financial Statements within ITEM 8 of Note 15 to this report.
In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms, which standards are commonly referred to as Basel IV. Among other things, these standards revise the Basel Committee’s standardized approach for credit risk (including the recalibration of the risk weights and the introduction of new capital requirements for certain “unconditionally cancellable commitments,” such as unused credit card lines of credit) and provides a new standardized approach for operational risk capital. Under the Basel framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing in through January 1, 2027. Under the current U.S. capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and are not applicable to the Bank. The impact of Basel IV on us will depend on how it is implemented by the federal bank regulators. See also "The Dodd-Frank Wall Street Reform and Consumer Protection Act" section in this ITEM for a discussion of a proposed joint regulatory rule relating to capital for qualifying community banking organizations such as the Bank and such proposed rule making’s impact on Basel III and IV.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act, a landmark financial reform bill comprised of voluminous new rules and restrictions on bank operations, included provisions aimed at preventing a repeat of the 2008 financial crisis and a new process for winding down failing, systemically important institutions in a manner as close to a controlled bankruptcy as possible. Among other things, the Dodd-Frank Act established new government oversight responsibilities, enhanced capital adequacy requirements for certain institutions, established consumer protection laws and regulations, and placed limitations on certain banking activities. The current Presidential Administration ("Administration") issued an executive order to consider reforming the Dodd-Frank Act in order to reduce the regulatory burden on U.S. companies, including financial institutions.
The Administration recently signed the Economic Growth, Regulatory Relief and Consumer Protection Act (the “Economic Growth Act”), which repeals or modifies certain provisions of the Dodd-Frank Act and eases regulations on all but the largest banks. The Economic Growth Act’s highlights include improving consumer access to mortgage credit, adding certain protections for consumers, including veterans and active duty military personnel, expanding credit freezes and creating an identity theft protection database. In addition, the federal banking agencies have issued a joint proposed rule whereby most qualifying community banking organizations with less than $10 billion in total consolidated assets, that meet risk-based qualifying criteria, and have a community bank leverage ratio (“CBLR”) of greater than 9 percent would be able to opt into a new community banking leverage ratio framework. Such a community banking organization would not be subject to other risk-based and leverage capital requirements (including the Basel III and Basel IV requirements) and would be considered to have met the well capitalized ratio requirements. The CBLR is determined by dividing a financial institution’s tangible equity capital by its average total

consolidated assets. The proposed rule further describes what is included in tangible equity capital and average total consolidated assets. The Bank feels that should this rule be adopted in a substantially similar format to the proposed rule, it would greatly ease the process of determining the Bank's capital requirements.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. In addition, the Economic Growth Act modifies several provisions in

the Dodd-Frank Act, but the modifications are subject to implementing regulations. Although the reforms primarily target systemically important financial service providers, the Dodd-Frank Act's influence has impacted and is expected to continue to impact smaller institutions over time. We will continue to evaluate the effect of the Dodd-Frank Act; however, in many respects, the ultimate impact of the Dodd-Frank Act will not be fully known for years, and no current assurance may be given that the Dodd-Frank Act, or any other new legislative changes, will not have a negative impact on the results of operations and financial condition of the Company and the Bank.

Notice and Approval Requirements Related to Control

Banking laws impose notice, approval and ongoing regulatory requirements on any shareholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution. These laws include the BHCA and the Change in Bank Control Act. Among other things, these laws require regulatory filings by a shareholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution or bank holding company. The determination whether an investor "controls" a depository institution is based on all of the facts and circumstances surrounding the investment. As a general matter, a party is deemed to control a depository institution or other company if the party owns or controls 25% or more of any class of voting stock. Subject to rebuttal, a party may be presumed to control a depository institution or other company if the investor owns or controls 10% or more of any class of voting stock. Ownership by family members, affiliated parties, or parties acting in concert, is typically aggregated for these purposes. If a party's ownership of the Company were to exceed certain thresholds, the investor could be deemed to "control" the Company for regulatory purposes. This could subject the investor to regulatory filings or other regulatory consequences.

In addition, except under limited circumstances, bank holding companies are prohibited from acquiring, without prior approval: 1) control of any other bank or bank holding company or all or substantially all the assets thereof; or 2) more than 5% of the voting shares of a bank or bank holding company that is not already a subsidiary.

Incentive Compensation

The Dodd-Frank Act required federal bank regulators and the Securities and Exchange Commission ("SEC") to establish joint regulations or guidelines prohibiting incentive-based payment arrangements that encourage inappropriate risks by providing an executive officer, employee, director or principal stockholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. These regulations apply to institutions having at least $1 billion in total assets. In addition, regulators must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The agencies have not finalized regulations proposed in April 2016. If adopted, the proposed regulations could place limits on the manner in which we structure our executive compensation.

The Federal Reserve reviews, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations. The Federal Reserve tailors their reviews for each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives are included in reports of examination. Deficiencies, if any, are incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Available Information

On our Internet web site, www.bankofmarin.com, we post the following filings as soon as reasonably practical after they are filed with or furnished to the Securities and Exchange Commission: Annual Report to Shareholders, Form 10-K, Proxy Statement for the Annual Meeting of Shareholders, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934. All such materials on our website are available free of charge. This website address is for information only and is not intended to be an active link, or to incorporate any website information into this document. In addition, copies of our filings are available by requesting them in writing or by phone from:

Corporate Secretary
Bank of Marin Bancorp
504 Redwood Boulevard, Suite 100
Novato, CA 94947
415-763-4523
These materials are also available at the SEC’s internet website (https://www.sec.gov).

ITEM 1A RISK FACTORS

We assume and manage a certain degree of risk in order to conduct our business. The material risks and uncertainties that Management believes may affect our business are listed below and in ITEM 7A, Quantitative and Qualitative Disclosure about Market Risk. The list is not exhaustive; additional risks and uncertainties that Management is not aware of, or focused on, or currently deems immaterial may also impair business operations. If any of the following risks, or risks that have not been identified, actually occur, our financial condition, results of operations, and stock trading price could be materially and adversely affected. We manage these risks by promoting sound corporate governance practices, which include but are not limited to, establishing policies and internal controls, and implementing internal review processes. Before making an investment decision, investors should carefully consider the risks, together with all of the other information included or incorporated by reference in this Annual Report on Form 10-K and our other filings with the SEC. This report is qualified in its entirety by these risk factors.

Earnings are Significantly Influenced by General Business and Economic Conditions

Our success depends, to a certain extent, on local, national and global economic and political conditions. Unlike larger national or other regional banks that are more geographically diversified, we provide banking and financial services to customers primarily in the State of California with particular focus on the local markets in the San Francisco Bay Area. The local economic conditions in this area have a significant impact on the demand for our products and services as well as the ability of our customers to repay loans, the value of the collateral securing loans and the stability of our deposits as our primary funding source. Economic pressure on consumers and uncertainty regarding the sustainability of economic improvements may result in changes in consumer and business spending, borrowing and saving habits, which may affect the demand for loans and other products and services we offer. Further, loan defaults that adversely affect our earnings correlate highly with deteriorating economic conditions (such as the unemployment rate), which impact our borrowers' creditworthiness. In addition, international trade disputes, inflation risks, oil price volatility, the level of U.S. debt and global economic conditions could destabilize financial markets in which we operate. Lastly, actions of the Federal Open Market Committee ("FOMC") of the Federal Reserve could cause stock market volatility, which we observed in late 2018.

Interest Rate Risk is Inherent in Our Business

Our earnings are largely dependent upon our net interest income, which is the difference between interest income earned on interest-earning assets, such as loans and securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Interest rates are sensitive to many factors outside of our control, including general economic conditions and the policies of various governmental and regulatory agencies and, in particular, the FOMC, which regulates the supply of money and credit in the United States. Changes in monetary policy, including changes in interest rates, can influence not only the interest we receive on loans and securities and interest we pay on deposits and borrowings, but can also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the duration of our securities and loan portfolios. Our portfolio of loans

and securities will generally decline in value if market interest rates increase, and increase in value if market interest rates decline. In addition, our loans and callable mortgage-backed securities are also subject to prepayment risk when interest rates fall, and the borrowers' credit risk may increase in rising rate environments. Factors such as inflation, productivity, oil prices, unemployment rates, and global demand play a role in the FOMC's consideration of future rate adjustments. In January 2019, the FOMC indicated that it will be patient with future rate hikes in light of global economic and financial uncertainties and muted inflation pressures and might plan to stop reducing the Federal Reserve’s asset holdings in late 2019.

Our net interest income is vulnerable to a falling or flat rate environment and will benefit if the prevailing market interest rates increase in the long-term. However, a rise in index rates leads to lower debt service coverage of variable rate loans if the borrower's operating cash flow does not also rise. This creates a paradox of an improving economy (leading to higher interest rates) with increased credit risk as short-term rates move up faster than the cash flow or income of the borrowers. Higher interest rates may also depress loan demand, making it more difficult for us to grow loans.

See the sections captioned “Net Interest Income” in Management's Discussion and Analysis of Financial Condition and Results of Operations in ITEM 7 and Quantitative and Qualitative Disclosures about Market Risk in ITEM 7A of this report for further discussion related to management of interest rate risk.

Banks and Bank Holding Companies are Subject to Extensive Government Regulation and Supervision

Bancorp and the Bank are subject to extensive federal and state governmental supervision, regulation and control. Holding company regulations affect the range of activities in which Bancorp is engaged. Banking regulations affect the Bank's lending practices, capital structure, investment practices, dividend policy, and compliance costs among other things. Compliance risk is the current and prospective risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards set forth by regulators. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of our clients may be ambiguous or untested. This risk exposes Bancorp and the Bank to potential fines, civil money penalties, payment of damages and the voiding of contracts. Compliance risk can lead to diminished reputation, reduced franchise value, limited business opportunities, reduced expansion potential and an inability to enforce contracts. The Bank manages these risks through its extensive compliance plan, policies and procedures. For further information on supervision and regulation, see the section captioned “SUPERVISION AND REGULATION” in ITEM 1 of this report.

Competition with Other Financial Institutions to Attract and Retain Banking Customers

We are facing significant competition for customers from other banks and financial institutions located in the markets that we serve. We compete with commercial banks, savings institutions, credit unions, non-bank financial services companies, including financial technology firms, and other financial institutions operating within or near our service areas. Some of our non-bank competitors and peer-to-peer lenders may not be subject to the same extensive regulations as we are, giving them greater flexibility in competing for business. We anticipate intense competition will continue for the coming year due to the consolidation of many financial institutions and more changes in legislation, regulation and technology. National and regional banks much larger than our size have entered our market through acquisitions and they may be able to benefit from economies of scale through their wider branch networks, more prominent national advertising campaigns, lower cost of borrowing, capital market access and sophisticated technology infrastructures. Further, intense competition for creditworthy borrowers could lead to pressure for loan rate concessions and affect our ability to generate profitable loans.

Going forward, we may see continued competition in the industry as competitors seek to expand market share in our core markets. Further, our customers may withdraw deposits to pursue alternative investment opportunities in the recent bullish equity market. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service providers. Efforts and initiatives we may undertake to retain and increase deposits, including deposit pricing, can increase our costs. Based on our current strong liquidity position, our adjustment to deposit pricing has lagged the market in a rising interest rate environment. If our customers move money into higher yielding deposits or alternative investments, we may lose a relatively inexpensive source of funds, thus increasing our funding costs through more expensive wholesale borrowings.

Activities of Our Large Borrowers and Depositors May Cause Unexpected Volatilities in Our Loan and Deposit Balances, as well as Net Interest Margin

Rising real estate values in the Bay Area market have motivated some of our borrowers to sell real estate that collateralized our loans, contributing to loan payoff activity. Payoffs of loans originated during a higher interest rate environment may be replaced by new loans with lower interest rates, causing downward pressure on our net interest margin. In addition, the top ten depositor relationships accounted for approximately 11% of our total deposit balances at December 31, 2018. The business models and cash cycles of some of our large commercial depositors may also cause short-term volatility in their deposit balances held with us. As our customers' businesses grow, the dollar value of their daily activities may also grow leading to larger fluctuations in daily balances. Any long-term decline in deposit funding would adversely affect our liquidity. For additional information on our management of deposit volatility, refer to the Liquidity section of ITEM 7, Management's Discussion and Analysis, of this report.

Negative Conditions Affecting Real Estate May Harm Our Business and Our Commercial Real Estate ("CRE") Concentration May Heighten Such Risk

Concentration of our lending activities in the California real estate sector could negatively affect our results of operations if adverse changes in our lending area occur. Although we do not offer traditional first mortgages, nor have sub-prime or Alt-A residential loans or significant amounts of securities backed by such loans in the portfolio, we are not immune to volatility in those markets. As of December 31, 2018, approximately 88% of our loans were secured by real estate, of which 67% were secured by CRE and the remaining 21% by residential real estate. Real estate valuations are influenced by demand, and demand is driven by economic factors such as employment rates and interest rates.

Loans secured by CRE include those secured by office buildings, owner-user office/warehouses, mixed-use residential/commercial properties and retail properties. There can be no assurance that the companies or properties securing our loans will generate sufficient cash flows to allow borrowers to make full and timely loan payments to us. In the event of default, the collateral value may not cover the outstanding amount due to us, especially during real estate market downturns.

Rising CRE lending concentrations may expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the CRE market. Concentration risk exists when financial institutions deploy too many assets to any one industry or segment. Concentration stemming from commercial real estate is one area of regulatory concern. The CRE Concentration Guidance provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (i) commercial real estate loans exceeding 300% of capital and increasing 50% or more in the preceding three years; or (ii) construction and land development loans exceeding 100% of capital. The CRE Concentration Guidance does not limit banks’ levels of commercial real estate lending activities, but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their commercial real estate concentrations. As of December 31, 2018, using regulatory definitions in the CRE Concentration Guidance, our CRE loans represented 340% of our total risk-based capital. We are actively working to manage our CRE concentration and we have discussed the CRE Concentration Guidance with the regulatory agencies and believe that our underwriting policies, management information systems, independent credit administration process, and monitoring of real estate loan concentrations are currently sufficient to address the CRE Concentration Guidance.

Severe Weather, Natural Disasters or Other Climate Change Related Matters Could Significantly Affect Our Business

Our primary market is located in an earthquake-prone zone in Northern California, which is also subject to other weather or disasters, such as severe rainstorms, wildfire, drought or flood. These events could interrupt our business operations unexpectedly. Climate-related physical changes and hazards could also pose credit risks for us. For example, our borrowers may have collateral properties or operations located in coastal areas at risk to rising sea levels and erosion or subject to the risk of drought in California. The properties pledged as collateral on our loan portfolio could also be damaged by tsunamis, landslides, floods, earthquakes or wildfires and thereby the recoverability of loans could be impaired. A number of factors can affect credit losses, including the extent of damage to the collateral, the extent of damage not covered by insurance, the extent to which unemployment and other economic conditions caused by the natural disaster adversely affect the ability of borrowers to repay their loans, and the cost of collection and foreclosure to us. Lastly, there could be increased insurance premiums and deductibles, or a decrease in the availability of coverage,

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due to severe weather-related losses. The ultimate outcome on our business of a natural disaster, whether or not caused by climate change, is difficult to predict.

We are Subject to Significant Credit Risk and Loan Losses May Exceed Our Allowance for Loan Losses in the Future

We maintain an allowance for loan losses, which is a reserve established through provisions for loan losses charged to expense, that represents Management's best estimate of probable losses that may be incurred within the existing portfolio of loans (the "incurred loss model"). The level of the allowance reflects Management's continuing evaluation of specific credit risks, loan loss experience, current loan portfolio quality and present economic, political and regulatory conditions. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Further, we generally rely on appraisals of the collateral or comparable sales data to determine the level of specific reserve and/or the charge-off amount on certain collateral dependent loans. Inaccurate assumptions in the appraisals or an inappropriate choice of the valuation techniques may lead to an inadequate level of specific reserve or charge-offs.

Changes in economic conditions affecting borrowers, new information regarding existing loans and their collateral, identification of additional problem loans, and other factors may require an increase in our allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs. If charge-offs in future periods exceed the allowance for loan losses or cash flows from acquired loans do not perform as expected, we will need to record additional provision for loan losses.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Under the new guidance, entities will be required to measure expected credit losses by utilizing forward-looking information to assess an entity's allowance for credit losses. The measurement of expected credit losses will be based on historical experience, current conditions and reasonable and supportable forecasts that affect the collectability of a credit over its remaining life. In addition, the ASU amends the accounting for potential credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Refer to Note 1 to the Consolidated Financial Statements in ITEM 8 for further information.

Securities May Lose Value due to Credit Quality of the Issuers

We invest in significant portions of investment securities issued by government-sponsored enterprises ("GSE"), such as Federal Home Loan Bank ("FHLB"), Federal National Mortgage Association (“FNMA”), Federal Home Loan Mortgage Corporation ("FHLMC"), and Federal Farm Credit Banks Funding Corporation. We also hold mortgage-backed securities (“MBS”) issued by FNMA and FHLMC. While we consider FNMA and FHLMC securities to have low credit risk as they carry the explicit backing of the U.S. Government due to conservatorship, they are not direct obligations of the U.S. Government. GSE debt is sponsored but not guaranteed by the federal government and carries implicit backing, whereas government agencies such as Government National Mortgage Association ("GNMA") are divisions of the government whose securities are backed by the full faith and credit of the U.S. Government.

Since 2008, both FNMA and FHLMC have been under a U.S. Government conservatorship. As a result, securities issued by FNMA and FHLMC have benefited from this government support. However, housing finance reform may be introduced to end GSE status, place FNMA and FHLMC into receivership and replace them with multiple mortgage guarantors, which could impact the fair value of our securities issued or guaranteed by these entities. Although Congress has taken steps to improve regulation and consumer protection related to the housing finance

system (e.g., Dodd-Frank Act), FNMA and FHLMC have entered their eleventh year of U.S. Government conservatorship. While Congress has considered numerous proposals to end the conservatorship, at the date of this report, its future and ultimate impact on the financial markets and our investments in GSE's are uncertain. For example, if the government support is phased-out or completely withdrawn; if the reduction in Federal Reserve's holdings of treasury and agency securities continues; or, if either FNMA or FHLMC comes under financial stress or suffers creditworthiness deterioration, the value of our investments may be significantly impacted.

While we generally seek to minimize our exposure by diversifying the geographic location of our portfolio and investing in investment grade securities, there is no guarantee that the issuers will remain financially sound or continue their payments on these debentures.

Unexpected Early Termination of Interest Rate Swap Agreements May Affect Earnings

We have entered into interest-rate swap agreements, primarily as an asset/liability risk management tool, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. These hedges allow us to offer long-term, fixed-rate loans to customers without assuming the interest rate risk of a long-term asset by swapping our fixed-rate interest stream for a floating-rate interest stream. In the event of default by the borrowers on our hedged loans, we may have to terminate these designated interest-rate swap agreements early, resulting in prepayment penalties charged by our counterparties and negatively affect our earnings.

Growth Strategy or Potential Future Acquisitions May Produce Unfavorable Outcomes

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals.

Our strategic plan also includes merger and acquisition possibilities that either enhance our market presence or have potential for improved profitability through financial management, economies of scale or expanded services, such as the Bank of Napa acquisition in 2017. We may incur significant acquisition related expenses either during the due diligence phase of acquisition targets or during integration of the acquirees. These expenses have and may continue to negatively impact our earnings prior to realizing the benefits of acquisitions. We may also be exposed to difficulties in combining the operations of acquired institutions into our own operations, which may prevent us from achieving the expected benefits from our acquisition activities. Our earnings, financial condition and prospects after the merger may affect our stock price and will depend in part on our ability to integrate the operations and management of the acquired institution while continuing to implement other aspects of our business plan. Inherent uncertainties exist in integrating the operations of an acquired institution and there is no assurance that we will be able to do so successfully. Among the issues that we could face are:

- unexpected problems with operations, personnel, technology or credit;
- loss of customers and employees of the acquiree;
- difficulty in working with the acquiree's employees and customers;
- the assimilation of the acquiree's operations, culture and personnel;
- instituting and maintaining uniform standards, controls, procedures and policies; and
- litigation risk not discovered during the due diligence period.

Undiscovered factors as a result of an acquisition could bring liabilities against us, our management and the management of the institutions we acquire. These factors could contribute to our not achieving the expected benefits from our acquisitions within desired time frames, if at all. Further, although we generally anticipate cost savings from acquisitions, we may not be able to fully realize those savings. Any cost savings may be offset by losses in revenues or other charges to earnings.

We May Not Be Able to Attract and Retain Key Employees

Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most activities engaged by us has been intense, especially in light of the recent improvement in the job market, and we

may not be able to hire skilled people or retain them. We do not have non-compete agreements with any of our senior officers. The unexpected loss of key personnel could have an unfavorable effect on our business because of the skills, knowledge of our market, years of industry experience and difficulty of promptly finding qualified replacement personnel.

Accounting Estimates and Risk Management Processes Rely on Analytical and Forecasting Models

The processes we use to estimate probable loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depends upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use for determining our probable loan losses are inadequate, the allowance for loan losses may not be sufficient to support future charge-offs. If the models we use to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

The Value of Goodwill and Other Intangible Assets May Decline in the Future

As of December 31, 2018, we had goodwill totaling $30.1 million and a core deposit intangible asset totaling $5.6 million from business acquisitions. A significant decline in expected future cash flows, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock could necessitate taking charges in the future related to the impairment of goodwill or other intangible assets. If we were to conclude that a future write-down of goodwill or other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our business, financial condition and results of operations.

We May Take Filing Positions or Follow Tax Strategies That May Be Subject to Challenge

We provide for current and deferred tax provision in our consolidated financial statements based on our results of operations, business activities and business combinations, legal structure and federal and state legislation and regulations, which is still evolving from the December 2017 enactment of the Tax Cuts and Jobs Act of 2017. We may take filing positions or follow tax strategies that are subject to interpretation of tax statutes. Our net income may be reduced if a federal, state or local authority were to assess charges for taxes that have not been provided for in our consolidated financial statements. Taxing authorities could change applicable tax laws and interpretations, challenge filing positions or assess new taxes and interest charges. If taxing authorities take any of these actions, our business, results of operations or financial condition could be significantly affected.

The Financial Services Industry is Undergoing Rapid Technological Changes and, As a Result, We Have a Continuing Need to Stay Current with Those Changes to Compete Effectively and Increase Our Efficiencies. We May Not Have the Resources to Implement New Technology to Stay Current with These Changes

The financial services industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to providing better client service, the effective use of technology increases efficiency and reduces operational costs. Our future success will depend in part upon our ability to use technology to provide products and services that will satisfy client demands securely and cost-effectively. In connection with implementing new technology enhancements and/or products, we may experience operational challenges (e.g. human error, system error, incompatibility) which could result in us not fully realizing the anticipated benefits from such new technology or require us to incur significant costs to remedy any such challenges in a timely manner.

Risks Associated with Cybersecurity Could Negatively Affect Our Earnings and Reputation

Our business requires the secure management of sensitive client and bank information. We work diligently to implement security measures that intend to make our communications and information systems safe to conduct business. Cyber threats such as social engineering, ransomware, and phishing emails are more prevalent now than ever before. These incidents include intentional and unintentional events that may present threats designed to disrupt operations, corrupt data, release sensitive information or cause denial-of-service attacks. A cybersecurity breach of systems operated by the Bank, merchants, vendors, customers, or externally publicized breaches of other financial institutions may significantly harm our reputation, result in a loss of customer business, subject us to regulatory scrutiny, or expose us to civil litigation and financial liability. While we have systems and procedures designed to prevent security breaches,

we cannot be certain that advances in criminal capabilities, physical system or network break-ins or inappropriate access will not compromise or breach the technology protecting our networks or proprietary client information. If a material security breach were to occur, the Bank has policies and procedures in place to ensure timely disclosure.

We Rely on Third-Party Vendors for Important Aspects of Our Operation

We depend on the accuracy and completeness of information and systems provided by certain key vendors, including but not limited to data processing, payroll processing, technology support, investment safekeeping and accounting. For example, we outsource core processing to Fidelity Information Services ("FIS") and wire processing to Finastra, which are leading financial services solution providers that allow us access to competitive technology offerings without having to invest in their development. Our ability to operate, as well as our financial condition and results of operations, could be negatively affected in the event of an interruption of an information system, an undetected error, a cyber-breach, or in the event of a natural disaster whereby certain vendors are unable to maintain business continuity.

Bancorp Relies on Dividends from the Bank to Pay Cash Dividends to Shareholders

Bancorp is a separate legal entity from its subsidiary, the Bank. Bancorp receives substantially all of its cash stream from the Bank in the form of dividends, which is Bancorp's principal source of funds to pay cash dividends to Bancorp's common shareholders, service subordinated debt, and cover operational expenses of the holding company. Various federal and state laws and regulations limit the amount of dividends that the Bank may pay to Bancorp. In the event that the Bank is unable to pay dividends to Bancorp, Bancorp may not be able to pay dividends to its shareholders or pay interest on the subordinated debentures. As a result, it could have an adverse effect on Bancorp's stock price and investment value.

Federal law would prohibit capital distributions from the Bank, with limited exceptions, if the Bank were categorized as "undercapitalized" under applicable Federal Reserve or FDIC regulations. In addition, as a California bank, Bank of Marin is subject to state law restrictions on the payment of dividends. For further information on the distribution limit from the Bank to Bancorp, see the section captioned “Bank Regulation” in ITEM 1 above and “Dividends” in Note 8 to the Consolidated Financial Statements in ITEM 8 of this report.

The Trading Volume of Bancorp's Common Stock is Less than That of Other, Larger Financial Services Companies

Our common stock is listed on the NASDAQ Capital Market exchange. Our trading volume is less than that of nationwide or larger regional financial institutions. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence of willing buyers and sellers of common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the low trading volume of our common stock, significant trades of our stock in a given time, or the expectations of these trades, could cause volatility in the stock price.

The Small to Medium-sized Businesses that we Lend to may have Fewer Resources to Weather Adverse Business Developments, which may Impair a Borrower's Ability to Repay a Loan, and such Impairment could Adversely Affect our Results of Operations and Financial Condition

We focus our business development and marketing strategy primarily on small to medium-sized businesses. Small to medium-sized businesses frequently have smaller market shares than their competition, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience substantial volatility in operating results, any of which may impair a borrower's ability to repay a loan. In addition, the success of a small and medium-sized business often depends on the management talents and efforts of one or two people or a

small group of people, and the death, disability or resignation of one or more of these people could adversely affect the business and its ability to repay its loan. If general economic conditions negatively affect the California markets in which we operate and small to medium-sized businesses are adversely affected or our borrowers are otherwise affected by adverse business developments, our business, financial condition and results of operations may be negatively affected.

A Lack of Liquidity could Adversely Affect our Operations and Jeopardize our Business, Financial Condition and Results of Operations

Liquidity is essential to our business. We rely on our ability to generate deposits and effectively manage the repayment and maturity schedules of our loans and investment securities, respectively, to ensure that we have adequate liquidity to fund our operations. An inability to raise funds through deposits, borrowings, securities sales, Federal Home Loan Bank advances, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our most important source of funds consists of deposits. Deposit balances can decrease when customers perceive alternative investments as providing a better risk/return trade-off. If customers move money out of bank deposits and into other investments, then we would lose a relatively low-cost source of funds, increasing our funding costs and reducing our net interest income and net income.

Other primary sources of funds consist of cash flows from operations, investment maturities and sales, loan repayments, and proceeds from the issuance and sale of any equity and debt securities to investors. Additional liquidity is provided by the ability to borrow from the Federal Reserve Bank of San Francisco and the Federal Home Loan Bank and our ability to raise brokered deposits. We also may borrow funds from third-party lenders, such as other financial institutions. Our access to funding sources in amounts adequate to finance or capitalize our activities, or on terms that are acceptable to us, could be impaired by factors that affect us directly or the bank or non-bank financial services industries or the economy in general, such as disruptions in the financial markets or negative views and expectations about the prospects for the bank or non-bank financial services industries.

Based on experience, we believe that our deposit accounts are relatively stable sources of funds. If we increase interest rates paid to retain deposits, our earnings may be adversely affected, which could have an adverse effect on our business, financial condition and results of operations.

Any decline in available funding could adversely affect our ability to originate loans, invest in securities, meet our expenses, and pay dividends to our shareholders or fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, financial condition and results of operations.

Changes to, or Elimination of, London Interbank Offered Rate ("LIBOR") Could Adversely Affect our Financial Instruments with Interest Rates Currently Indexed to LIBOR

In 2017, the Financial Conduct Authority of the United Kingdom (the "FCA") announced its intention to cease sustaining LIBOR after 2021. While the FCA came to an agreement with panel banks to continue receiving submissions to LIBOR until the end of 2021, it is not possible to predict whether and how credible LIBOR will be as an acceptable market benchmark. The FCA is encouraging due diligence and implementation of alternative rates prior to the phase out of LIBOR. While there is no consensus on what rate or rates may become accepted alternatives to LIBOR, the Alternative Reference Rates Committee ("ARRC"), a steering committee comprised of U.S. financial market participants, selected by the Federal Reserve Bank of New York, began to publish the Secured Overnight Financing Rate ("SOFR") as an alternative to LIBOR. SOFR is a broad measure of the cost of overnight borrowings collateralized by Treasury securities selected by the ARRC. Hence, SOFR is a risk-free rate, while LIBOR is a risk-based rate. Therefore, a spread adjustment is required and will most likely be recommended by a relevant governmental body (such as ARRC). Such language has yet to be published and it is unknown to us whether during the transition period, banks like us will be permitted to retain LIBOR as a reference rate, be required to amend contracts to reference SOFR without economic impact (market, legal and documentation costs), or be allowed to amend the definition of LIBOR through a specific grandfathering protocol.

We have floating rate loans and investment securities, interest rate swap agreements and subordinated debentures whose interest rates are indexed to LIBOR that mature after December 31, 2021. The transition from LIBOR could create additional costs as well as economic and reputation risk. We cannot predict any unfavorable effect the chosen alternative index may have on financial instruments currently indexed to LIBOR.

ITEM 1B UNRESOLVED STAFF COMMENTS

None

ITEM 2 PROPERTIES

We lease our corporate headquarters building in Novato, California, which houses loan production, operations, Wealth Management & Trust and administration. We lease branch and office facilities within our primary market areas in the cities of Corte Madera, San Rafael, Novato, Sausalito, Mill Valley, Tiburon, Greenbrae, Petaluma, Santa Rosa, Healdsburg, Sonoma, Napa, San Francisco, Alameda, Oakland, and Walnut Creek. For additional information on properties, see Notes 4 and 12 to the Consolidated Financial Statements included in ITEM 8 of this report.

ITEM 3 LEGAL PROCEEDINGS

Bancorp may be party to legal actions that arise from time to time as part of the normal course of business. Bancorp's Management is not aware of any pending legal proceedings to which either it or the Bank may be a party or has recently been a party that will have a material adverse effect on the financial condition or results of operations of Bancorp or the Bank.

The Bank is responsible for its proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks in connection with lawsuits related to anti-trust charges and interchange fees. Because Visa funded a litigation escrow account to insulate member banks from financial liability, we do not expect to make any cash settlement payments as a result of Visa's litigation. For further details, see Note 12 to the Consolidated Financial Statements in ITEM 8 of this report.

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5 MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information and Holders

Bancorp common stock trades on the NASDAQ Capital Market under the symbol BMRC. On October 22, 2018, Bancorp announced a two-for-one stock split, which occurred on November 27, 2018. All share and per share data have been adjusted to reflect the stock split effective November 27, 2018. At February 28, 2019, 13,806,416 shares of Bancorp's common stock, no par value, were outstanding and held by approximately 2,900 holders of record and beneficial owners.

Five-Year Stock Price Performance Graph

The following graph, compiled by S&P Global Market Intelligence of New York, New York, shows a comparison of cumulative total shareholder return on our common stock during the five fiscal years ended December 31, 2018 compared to the Russell 2000 Stock index and the SNL Bank $1B - $5B Index. The comparison assumes the investment of $100 in our common stock on December 31, 2013 and the reinvestment of all dividends. The graph represents past performance and does not indicate future performance. In addition, total return performance results vary depending on the length of the performance period.

	2013	2014	2015	2016	2017	2018
Bank of Marin Bancorp (BMRC)	100.00	123.34	127.50	169.97	168.53	207.70
Russell 2000 Index	100.00	104.89	100.26	121.63	139.44	124.09
SNL Bank $1B - $5B Index [1]	100.00	104.56	117.04	168.38	179.51	157.27

Source: S&P Global Market Intelligence

[1] Includes all major exchange (NYSE, NYSE MKT, and Nasdaq) banks in S&P Global's coverage universe with $1 billion to $5 billion in assets as of the most recent available financial data.

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Shareholder Rights Agreement

On July 6, 2017, Bancorp executed a shareholder rights agreement (“Rights Agreement”), which is designed to discourage takeovers that involve abusive tactics or do not provide fair value to shareholders. For further information, see Note 8 to the Consolidated Financial Statements, under the heading “Preferred Stock and Shareholder Rights Plan” in ITEM 8 of this report.

Securities Authorized for Issuance under Equity Compensation Plans

The following table summarizes information as of December 31, 2018, with respect to equity compensation plans. All plans have been approved by the shareholders.

	Shares to be issued upon exercise of outstanding options[1]	Weighted average exercise price of outstanding options	Shares remaining available for future issuance [2]
Equity compensation plans approved by shareholders	425,700	$ 25.01	1,262,182

[1] Represents shares of common stock issuable upon exercise of outstanding options under the Bank of Marin Bancorp 2017 Equity Plan and 2007 Equity Plan.
[2] Represents remaining shares of common stock available for future grants under the 2017 Equity Plan and the 2010 Director Stock Plan, excluding 425,700 shares to be issued upon exercise of outstanding options and 383,870 shares available to be issued under the Employee Stock Purchase Plan.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

On April 23, 2018, Bancorp announced that its Board of Directors approved a Share Repurchase Program under which Bancorp may repurchase up to $25.0 million of its outstanding common stock through May 1, 2019. From April 23, 2018 to December 31, 2018, Bancorp repurchased 171,217 shares at an average price of $40.92 and a total cost of $7.0 million. The following table reflects purchases under the Share Repurchase Program for the periods presented. For further information, see Note 8 to the Consolidated Financial Statements, under the heading “Share Repurchase Program” in ITEM 8 of this report.

(in thousands, except per share data) Period	Total Number of Shares Purchased [1]	Average Price Paid per Share [1]	Total Number of Shares Purchased as Part of Publicly Announced Programs [1]	Approximate Dollar Value That May yet Be Purchased Under the Program
April 23-30, 2018	—	$ —	—	$ 25,000
May 1-31, 2018	2,796	37.03	2,796	24,896
June 1-30, 2018	—	—	—	24,896
July 1-31, 2018	—	—	—	24,896
August 1-31, 2018	8,888	44.43	8,888	24,501
September 1-30, 2018	24,202	42.99	24,202	23,460
October 1-30, 2018	29,890	40.68	29,890	22,244
November 1-30, 2018	34,754	42.10	34,754	20,779
December 1-31, 2018	70,687	39.44	70,687	17,988

Total	171,217	$ 40.92	171,217

[1] Share and per share data have been adjusted to reflect the two-for-one stock split effective November 27, 2018.

ITEM 6 SELECTED FINANCIAL DATA

The following data has been derived from the audited consolidated financial statements of Bank of Marin Bancorp. For additional information, refer to ITEM 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, and ITEM 8, Financial Statements and Supplementary Data.

	At December 31,				
(in thousands)	2018	2017	2016	2015	2014
Selected financial condition data:					
Total assets	$2,520,892	$2,468,154	$2,023,493	$2,031,134	$1,787,130
Loans, net	1,748,043	1,663,246	1,471,174	1,436,299	1,348,252
Deposits	2,174,840	2,148,670	1,772,700	1,728,226	1,551,619
Borrowings	9,640	5,739	5,586	72,395	20,185
Stockholders' equity	316,407	297,025	230,563	214,473	200,026
	For the Years Ended December 31,				
(dollars in thousands, except per share data)	2018	2017	2016	2015	2014
Selected operating data:					
Net interest income	$91,544	$74,852	$73,161	$67,187	$70,441
Provision for (reversal of) loan losses	—	500	(1,850)	500	750
Non-interest income	10,139	8,268	9,161	9,193	9,041
Non-interest expense [1]	58,266	53,782	47,692	46,949	47,263
Net income [1]	32,622	15,976	23,134	18,441	19,771
Net income per common share:[6]					
Basic	$2.35	$1.29	$1.90	$1.55	$1.68
Diluted	$2.33	$1.27	$1.89	$1.52	$1.65
	At or for the Years Ended December 31,				
	2018	2017	2016	2015	2014
Performance and other financial ratios:					
Return on average assets	1.31%	0.75%	1.15%	0.98%	1.08%
Return on average equity	10.73%	6.49%	10.23%	8.84%	10.31%
Tax-equivalent net interest margin [2]	3.90%	3.80%	3.91%	3.83%	4.13%
Efficiency ratio	57.30%	64.70%	57.93%	61.47%	59.46%
Loan-to-deposit ratio	81.10%	78.14%	83.86%	83.97%	87.87%
Cash dividend payout ratio on common stock [3]	27.23%	43.41%	26.84%	29.03%	23.81%
Cash dividends per common share [6]	$0.64	$0.56	$0.51	$0.45	$0.40
Asset quality ratios:					
Allowance for loan losses to total loans	0.90%	0.94%	1.04%	1.03%	1.11%
Allowance for loan losses to non-performing loans [4]	22.71x	38.88x	106.5x	6.88x	1.61x
Non-performing loans to total loans [4]	0.04%	0.02%	0.01%	0.15%	0.69%
Capital ratios:					
Equity to total assets ratio	12.55%	12.03%	11.39%	10.60%	11.20%
Tangible common equity to tangible assets [5]					
Total capital (to risk-weighted assets)	14.93%	14.91%	14.32%	13.37%	13.94%
Tier 1 capital (to risk-weighted assets)	14.10%	14.04%	13.37%	12.44%	12.87%
Tier 1 capital (to average assets)	11.54%	12.13%	11.39%	10.67%	10.62%
Common equity Tier 1 capital (to risk-weighted assets)	13.98%	13.75%	13.07%	12.16%	N/A
Other data:					
Number of full service offices	23	23	20	20	21

Full time equivalent employees	290	291	262	259	260

[1] 2018, 2017 and 2014 included $962 thousand, $2.2 million, $746 thousand, respectively, in merger-related expenses.
[2] Tax-equivalent net interest margin is computed by dividing taxable equivalent net interest income, which is adjusted for taxable equivalent income on tax-exempt loans and securities based on federal statutory rate of 21% in 2018 and 35% in years prior to 2018, by total average interest-earning assets.
[3] Calculated as dividends on common shares divided by basic net income per common share.
[4] Non-performing loans include loans on non-accrual status and loans past due 90 days or more and still accruing interest.
[5] Tangible common equity to tangible assets is considered to be a meaningful non-GAAP financial measure of capital adequacy and is useful for investors to assess Bancorp's ability to absorb potential losses. Tangible common equity includes common stock, retained earnings and unrealized gains (losses) on available-for sale securities, net of tax, less goodwill and intangible assets of $281 million, $260 million, $222 million, $205 million, and $190 million at December 31, 2018, 2017, 2016, 2015, and 2014, respectively. Tangible assets exclude goodwill and intangible assets.
[6] Share and per share data have been adjusted to reflect the two-for-one stock split effective November 27, 2018.

ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of financial condition as of December 31, 2018 and 2017 and results of operations for each of the years in the two-year period ended December 31, 2018 should be read in conjunction with our consolidated financial statements and related notes thereto, included in Part II ITEM 8 of this report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances. All share and per share data have been adjusted to reflect the stock split effective November 27, 2018.

Forward-Looking Statements

The disclosures set forth in this item are qualified by important factors detailed in Part I captioned Forward-Looking Statements and ITEM 1A captioned Risk Factors of this report and other cautionary statements set forth elsewhere in the report.

Critical Accounting Policies and Estimates

Critical accounting policies are those that are both very important to the portrayal of our financial condition and results of operations and require Management's most difficult, subjective, or complex judgments, often because of the need to make estimates about the effect of matters that are inherently uncertain and imprecise.

Management has determined the following four accounting policies to be critical:

Allowance for Loan Losses: For information regarding our ALLL methodology, the related provision for loan losses, risks related to asset quality and lending activity, see ITEM 1A - Risk Factors, the Allowance for Loan Losses section in ITEM 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations, and Note 1 - Summary of Significant Accounting Policies and Note 3 - Loans and Allowance for Loan Losses in ITEM 8 - Financial Statements and Supplementary Data of this Form 10 K.

Other-than-temporary Impairment of Investment Securities: For information regarding our investment securities, investment activity, and related risks, see ITEM 1A - Risk Factors, Note 1 - Summary of Significant Accounting Policies and Note 2 - Investment Securities in ITEM 8 - Financial Statements and Supplementary Data of this Form 10-K.

Accounting for Income Taxes: For information on our tax assets and liabilities, and related provision for income taxes, see Note 1 - Summary of Significant Accounting Policies and Note 11 - Income Taxes in ITEM 8 - Financial Statements and Supplementary Data of this Form 10-K.

Fair Value Measurements: For information on our use of fair value measurements and our related valuation methodologies, see Note 1 - Summary of Significant Accounting Policies and Note 9 - Fair Value of Assets and Liabilities in ITEM 8 - Financial Statements and Supplementary Data of this Form 10-K.

Executive Summary

Annual earnings were $32.6 million in 2018 compared to $16.0 million in 2017. Diluted earnings were $2.33 per share for the year ended December 31, 2018, compared to $1.27 per share in the same period of 2017.

The following are highlights of operating and financial performance for the year ended December 31, 2018:

- In 2018, we expanded our footprint in the East Bay and strengthened our team in Sonoma County. We added key people to open a new commercial banking office in Walnut Creek and enhanced our presence in our Santa Rosa market.
- The Bank achieved loan growth of $84.9 million, or 5.1% in 2018, to $1,763.9 million at December 31, 2018, from $1,679.0 million at December 31, 2017.
- Strong credit quality remains a cornerstone of the Bank's consistent performance. Non-accrual loans represented 0.04% of the Bank's loan portfolio as of December 31, 2018. There was no provision for loan losses recorded in 2018 due to continuing high credit quality.
- Deposits grew by $26.1 million to $2,174.8 million at December 31, 2018, compared to $2,148.7 million at December 31, 2017. Non-interest bearing deposits grew by $51.9 million in 2018 and made up 49% of total deposits at year-end. For the full year 2018, cost of total deposits remained low at 0.10% despite the higher interest rate environment, compared to 0.07% in 2017.
- Net interest income totaled $91.5 million and $74.9 million in 2018 and 2017, respectively. The increase of $16.6 million in 2018 was primarily due to a $337.7 million increase in average earning assets. Additionally, higher yields on loans, investment securities and interest-bearing cash positively impacted interest income. The tax-equivalent net interest margin increased to 3.90% in 2018 compared to 3.80% in 2017 for the same reasons, despite the 0.04% negative impact from the early redemption of a subordinated debenture.
- Pre-tax net income in 2018 was $43.4 million, up $14.6 million, or 50.6% over 2017 pretax net income of $28.8 million. Higher average balances and yields on both loans and investment securities favorably impacted earnings in the current year.
- The efficiency ratio was 57.3% in 2018, down from 64.7% in 2017.
- For the year ended December 31, 2018, return on assets was 1.31% and return on equity was 10.73%.
- All capital ratios exceed regulatory requirements. The total risk-based capital ratio for Bancorp was 14.9% at both December 31, 2018 and December 31, 2017.
- On April 23, 2018, Bancorp announced that its Board of Directors approved a Share Repurchase Program under which Bancorp may repurchase up to $25.0 million of its outstanding common stock through May 1, 2019. During 2018, Bancorp repurchased 171,217 shares for a total amount of $7.0 million.
- On October 22, 2018, Bancorp announced a two-for-one stock split, which occurred on November 27, 2018.
- The Board of Directors declared a cash dividend of $0.19 per share on January 25, 2019, a $0.015 increase from the prior quarter. This was the 55th consecutive quarterly dividend paid by Bank of Marin Bancorp. Since August 2005, Bancorp's average annual dividend growth rate has been 10.2%. The cash dividend was paid on February 15, 2019 to shareholders of record at the close of business on February 8, 2019.

Looking forward into the new year, with a low cost and stable deposit base, solid opportunities for loan growth, and our unwavering commitment to relationship banking, we are well-positioned to carry our successful performance into 2019. We have ample liquidity and capital to support organic growth and acquisitions in coming years. Acquisitions remain a component of our strategic plan and we will continue to evaluate merger and acquisition opportunities that fit with our culture and add value for our shareholders. Our disciplined credit culture and relationship-focused banking

continue to be critical components of our success.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the difference between the interest earned on loans, investments and other interest-earning assets and the interest expense incurred on deposits and other interest-bearing liabilities. Net interest income is affected by changes in general market interest rates and by changes in the amounts and composition of interest-earning assets and interest-bearing liabilities. Interest rate changes can create fluctuations in net interest income and/or margin due to an imbalance in the timing of repricing or maturity of assets or liabilities. We manage interest rate risk exposure with the goal of minimizing the effect of interest rate volatility on net interest income.

Net interest margin is expressed as net interest income divided by average interest-earning assets. Net interest rate spread is the difference between the average rate earned on total interest-earning assets and the average rate incurred on total interest-bearing liabilities. Both of these measures are reported on a taxable-equivalent basis. Net interest margin is the higher of the two because it reflects interest income earned on assets funded with non-interest-bearing sources of funds, which include demand deposits and stockholders' equity.

The following table compares interest income, average interest-earning assets, interest expense, and average interest-bearing liabilities for the periods presented. The table also presents net interest income, net interest margin and net interest rate spread for the years indicated.

Table 1 Average Statements of Condition and Analysis of Net Interest Income

	Year ended December 31, 2018			Year ended December 31, 2017		
(dollars in thousands; unaudited)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Assets						
Interest-bearing due from banks [1]	$78,185	$1,461	1.84 %	$80,351	$995	1.22%
Investment securities [2, 3]	566,883	14,512	2.56 %	419,873	9,732	2.32%
Loans [1, 3, 4]	1,704,390	80,406	4.65 %	1,511,503	68,562	4.47%
Total interest-earning assets [1]	2,349,458	96,379	4.05 %	2,011,727	79,289	3.89%
Cash and non-interest-bearing due from banks	41,595			42,511		
Bank premises and equipment, net	8,021			8,411		
Interest receivable and other assets, net	86,709			63,301		
Total assets	$2,485,783			$2,125,950		
Liabilities and Stockholders' Equity						
Interest-bearing transaction accounts	$143,706	$226	0.16 %	$105,544	$108	0.10%
Savings accounts	178,907	72	0.04 %	167,190	66	0.04%
Money market accounts	612,372	1,355	0.22 %	542,592	555	0.10%
Time accounts, including CDARS	137,339	542	0.39 %	146,069	576	0.39%
FHLB and overnight borrowings [1]	105	2	2.03 %	1	—	1.75%
Subordinated debentures [1]	5,025	1,339	26.29%	5,664	439	7.65%
Total interest-bearing liabilities	1,077,454	3,536	0.33 %	967,060	1,744	0.18%
Demand accounts	1,085,870			899,289		
Interest payable and other liabilities	18,514			13,506		
Stockholders' equity	303,945			246,095		
Total liabilities & stockholders' equity	$2,485,783			$2,125,950		
Tax-equivalent net interest income/margin [1]		$92,843	3.90 %		$77,545	3.80%
Reported net interest income/margin [1]		$91,544	3.84 %		$74,852	3.67%

Tax-equivalent net interest rate spread	3.72 %	3.71%

[1] Interest income/expense is divided by actual number of days in the period times 360 days to correspond to stated interest rate terms, where applicable.
[2] Yields on available-for-sale securities are calculated based on amortized cost balances rather than fair value, as changes in fair value are reflected as a component of stockholders' equity. Investment security interest is earned on 30/360 day basis monthly.
[3] Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the federal statutory rate of 21% in 2018 and 35% in 2017.
[4] Average balances on loans outstanding include non-performing loans. The amortized portion of net loan origination fees is included in interest income on loans, representing an adjustment to the yield.

Table 2 Analysis of Changes in Net Interest Income

The following table presents the effects of changes in average balances (volume) or changes in average rates on tax-equivalent net interest income for the years indicated. Volume variances are equal to the increase or decrease in average balances multiplied by prior period rates. Rate variances are equal to the increase or decrease in rates multiplied by prior period average balances. Mix variances are attributable to the change in yields or rates multiplied by the change in average balances.

	2018 compared to 2017			
(in thousands, unaudited)	Volume	Yield/Rate	Mix	Total
Interest-bearing due from banks	$(27)	$ 507	$(14)	$466
Investment securities [1]	3,408	1,016	356	4,780
Loans [1]	8,749	2,745	350	11,844
Total interest-earning assets	12,130	4,268	692	17,090
Interest-bearing transaction accounts	39	58	21	118
Savings accounts	5	1	—	6
Money market accounts	71	645	84	800
Time accounts, including CDARS	(34)	2	(2)	(34)
FHLB borrowings and overnight borrowings	2	—	—	2
Subordinated debentures	(50)	1,070	(120)	900
Total interest-bearing liabilities	33	1,776	(17)	1,792
	$12,097	$ 2,492	$709	$15,298

[1] Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the federal statutory rate of 21% in 2018 and 35% in 2017.

2018 Compared to 2017

Net interest income totaled $91.5 million and $74.9 million in 2018 and 2017, respectively. The increase of $16.6 million, or 22.2% in 2018 was primarily due to a $337.7 million, or 16.8%, increase in average earning assets and higher average yields across all earning asset categories, partially offset by $916 thousand in accelerated discount accretion from the early redemption of one high-rate subordinated debenture assumed in the NorCal Community Bancorp acquisition. This transaction removed a high cost source of borrowing and the Bank will benefit from reduced interest expense going forward. While we do not plan to redeem the remaining subordinated debenture in the short-term, we may early redeem it in the future depending on changes in rates and our capital position. The tax-equivalent net interest margin increased ten basis points to 3.90% in 2018 compared to 3.80% in 2017 for the same reasons, despite the 0.04% negative impact from the early redemption of a subordinated debenture.

The yield on average interest-earning assets increased sixteen basis points in 2018 compared to 2017. The loan portfolio as a percentage of average interest-earning assets, decreased to 72.5% in 2018, from 75.1% in 2017. Investment securities increased to 24.1% of average interest-earning assets in 2018, compared to 20.9% in 2017.

Market Interest Rates

Market interest rates are, in part, based on the target federal funds interest rate (the interest rate banks charge each other for short-term borrowings) implemented by the Federal Reserve Open Market Committee ("FOMC"). Actions by the FOMC to increase the target federal funds rate by 25 basis points in December 2015, December 2016, March 2017, June 2017, December 2017, March 2018, June 2018, September 2018 and December 2018 have positively impacted yields on our rate sensitive interest-earning assets. The increase in December 2018, to the current target range for the federal funds rate of 2.25% to 2.50%, was the ninth rate hike since 2008. If interest rates continue to rise,

we anticipate that our net interest income will increase over time. While short-term interest rates have risen and improved the Bank's yields on prime-rate adjustable assets, the yield curve flattened in 2018 with less movement in longer-term rates that influence pricing for fixed-rate lending activities. In its January 2019 meeting, the FOMC indicated that it will be patient with future rate hikes in light of global economic and financial uncertainties and muted inflation pressures and might plan to stop reducing the Federal Reserve's asset holdings in late 2019.

Impact of Acquired Loans on Net Interest Margin

Early payoffs or prepayments of our acquired loans with significant unamortized purchase discount/premium could result in volatility in our net interest margin. Accretions and gains on payoffs of purchased loans are recorded in interest income. As our acquired loans from prior acquisitions continue to pay off, we expect accretion income from these loans to continue to decline. The positive affect on our net interest margin during the past two years was as follows:

	Years ended December 31,			
	2018		2017	
(dollars in thousands; unaudited)	Dollar Amount	Basis point affect on net interest margin	Dollar Amount	Basis point affect on net interest margin
Accretion on purchased credit impaired ("PCI") loans	$320	1 bps	$331	2 bps
Accretion on non-PCI loans	$487	2 bps	$571	3 bps
Gains on payoffs of PCI loans	$135	1 bps	$184	1 bps

Provision for Loan Losses

Management assesses the adequacy of the allowance for loan losses quarterly based on several factors including growth of the loan portfolio, analysis of probable losses in the portfolio, historical loss experience and the current economic climate. Actual losses on loans are charged against the allowance, and the allowance is increased by loss recoveries and provisions for loan losses charged to expense. For further discussion, see Note 1 to the Consolidated Financial Statements in ITEM 8 of this report.

We recorded no provision for loan losses in 2018, compared to $500 thousand in 2017. The allowance for loan losses was 0.90% and 0.94% of loans at December 31, 2018 and 2017, respectively. The lack of a provision for loan losses in 2018 and the decrease in the allowance ratio was primarily due to a $15.3 million decrease in classified loans, resulting from two borrowing relationships whose risk grades were upgraded from substandard to special mention in the second quarter of 2018. This reduction was offset by general allowances resulting from loan growth, refinement of certain loan concentration qualitative factors, and an increase in specific reserves for impaired loans. The allowance for loan losses excluding acquired loans was 0.98% and 1.06% of loans at December 31, 2018 and 2017, respectively. Net recoveries totaled $54 thousand in 2018, compared to net charge-offs of $175 thousand in 2017. The 2017 net charge-offs were primarily related to one unsecured commercial loan. See the section captioned "Allowance for Loan Losses" below for further analysis of the provision for loan losses.

Non-interest Income

The table below details the components of non-interest income.
Table 3 Components of Non-Interest Income

	Years ended		2018 compared to 2017	
	December 31,		Amount	Percent
(dollars in thousands; unaudited)	2018	2017	Increase (Decrease)	Increase (Decrease)
Service charges on deposit accounts	$1,891	$1,784	$107	6.0 %
Wealth Management and Trust Services	1,919	2,090	(171)	(8.2)%
Debit card interchange fees	1,561	1,531	30	2.0 %
Merchant interchange fees	378	398	(20)	(5.0)%
Earnings on bank-owned life insurance	913	845	68	8.0 %

Dividends on FHLB stock	959	766	193	25.2	%
Gains (losses) on investment securities, net	876	(185)	1,061	573.5	%
Other income	1,642	1,039	603	58.0	%
Total non-interest income	$10,139	$8,268	$1,871	22.6	%

2018 Compared to 2017

Non-interest income totaled $10.1 million and $8.3 million in 2018 and 2017, respectively. The increase compared to the prior year primarily relates to a $180 thousand Federal Home Loan Bank special dividend, a $442 thousand increase in deposit network income (included in other income) and a $956 thousand pre-tax gain on the sale of 6,500 shares of Visa Inc. Class B restricted common stock, partially offset by $79 thousand in net losses from the sale of available-for-sale investment securities. The Bank sold less than half of its Visa Inc. position to realize recent appreciation in market prices and hedge against market volatility. Currently, we do not intend to sell our remaining shares of Visa Inc. Class B stock, but will consider future sales depending on the resolution of the related Visa litigation (as discussed in Note 12 to the Consolidated Financial Statements in ITEM 8 of this report) and equity market volatility.

Non-interest Expense

The table below details the components of non-interest expense.
Table 4 Components of Non-Interest Expense

	Years ended		2018 compared to 2017	
	December 31,		Amount	Percent
(dollars in thousands; unaudited)	2018	2017	Increase (Decrease)	Increase (Decrease)
Salaries and related benefits	$33,335	$29,958	$3,377	11.3 %
Occupancy and equipment	5,976	5,472	504	9.2 %
Depreciation and amortization	2,143	1,941	202	10.4 %
FDIC insurance	756	666	90	13.5 %
Data processing	4,358	4,906	(548)	(11.2)%
Professional services	3,317	2,858	459	16.1 %
Directors' expense	700	720	(20)	(2.8)%
Information technology	1,023	769	254	33.0 %
Provision for losses on off-balance sheet commitments	—	57	(57)	(100.0)%
Other non-interest expense:				
Advertising	666	567	99	17.5 %
Amortization of core deposit intangible	921	528	393	74.4 %
Other expense	5,071	5,340	(269)	(5.0)%
Total other non-interest expense	6,658	6,435	223	3.5 %
Total non-interest expense	$58,266	$53,782	$4,484	8.3 %

2018 Compared to 2017

In 2018, non-interest expense increased by $4.5 million to $58.3 million. The increase primarily relates to $3.4 million in higher salaries and benefits due to additional personnel (including former Bank of Napa employees), annual merit increases, higher employee insurance and stock based compensation awards reaching retirement eligibility. We expect salaries and benefits to increase in 2019 as we fill certain commercial banking positions. The number of average FTE employees totaled 289 in 2018 and 269 in 2017. The increase in non-interest expense also relates to $1.0 million in consulting expenses related to core processing contract negotiations, higher core deposit intangible amortization and acquisition-related rent. These increases were partially offset by decreases in acquisition-related legal, professional and data processing expenses. Going forward, we expect certain data processing costs to decrease as a result of the contract negotiations. However, these cost savings will be partially offset during the first two quarters of 2019 with additional expenses associated with the implementation of a new mobile banking platform. In addition, for the Bank

of Napa acquisition, we do not expect to incur any additional acquisition-related expenses in 2019.

Provision for Income Taxes

The provision for income taxes totaled $10.8 million at an effective tax rate of 24.9% in 2018, compared to $12.9 million at an effective tax rate of 44.6% in 2017. The decrease in both the provision for income taxes and the effective tax rate from the prior year reflects the reduction in the federal corporate income tax rate from 35% to 21% related to the enactment of the Tax Cuts and Jobs Act of 2017 that was signed into law on December 22, 2017 and became effective January 1, 2018. The 2017 provision for income taxes included a $3.0 million write-down of net deferred tax assets which accounted for 10.5 percentage points of the 2017 effective tax rate of 44.6%. In addition, certain acquisition-

related expenses incurred in 2017 were not deductible for tax purposes and added 0.8 percentage points to the 2017 effective tax rate. The resulting reduction in the federal statutory rate was partially offset by the effect of the higher level of pre-tax income in 2018 and elimination or reductions to the deductibility of certain meals, entertainment, parking and transportation expenses due to the Tax Cuts and Jobs Act of 2017. Income tax provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on tax exempt loans and municipal securities, BOLI, and low-income housing tax credits) as well as transactions with discrete tax effects (such as the exercise of non-qualified stock options, the disqualifying dispositions of incentive stock options and vesting of restricted stock awards). Additional fluctuations in the effective rate from period to period are due to the relationship of net permanent differences to income before tax.

The Tax Cuts and Jobs Act of 2017 includes numerous uncertainties, which will likely require the issuance of new regulations or other interpretive guidance for clarification. Although we believe our assumptions, judgments and estimates are reasonable, changes in tax laws and their interpretation could significantly affect the amounts provided for income taxes in our consolidated financial statements. Going forward, certain provisions of the Tax Cuts and Jobs Act of 2017 may have an unfavorable impact on our tax expenses, including but not limited to 1) the elimination of the exception for performance-based executive compensation resulting in our inability to deduct executive compensation exceeding $1.0 million, and 2) clarification of the definition of a covered employee for excessive employee compensation purposes.

We file a consolidated return in the U.S. Federal tax jurisdiction and a combined return in the State of California tax jurisdiction. There were no ongoing federal or state income tax examinations at the issuance of this report. At December 31, 2018 and 2017, neither the Bank nor Bancorp had accruals for interest or penalties related to unrecognized tax benefits.

FINANCIAL CONDITION

Our assets increased $52.7 million from December 31, 2017 to December 31, 2018. Deposits increased by $26.1 million and loan growth for 2018 was $84.9 million.

Investment Securities

We maintain an investment securities portfolio to provide liquidity and to generate earnings on funds that have not been loaned to customers. Management determines the maturities and types of securities to be purchased based on liquidity, the interest rate risk position, and the desire to attain a reasonable investment yield balanced with risk exposure. Table 5 shows the composition of the debt securities portfolio by expected maturity at December 31, 2018 and 2017. Expected maturities differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties. We estimate and update expected maturity dates regularly based on current and historical prepayment speeds. The weighted average life of the investment portfolio at December 31, 2018 and 2017 was approximately five years.

Table 5 Investment Securities

December 31, 2018	Within 1 Year		1-5 Years		5-10 Years		After 10 Years		Total		
(dollars in thousands; unaudited)	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Fair Value	Aver Yield
Held-to-maturity:											
State and municipal[3]	$7,557	3.78 %	$3,554	4.93 %	$—	— %	$—	— %	$11,111	$11,216	4.14
MBS/CMOs issued by U.S. government agencies	—	—	39,929	2.16	83,461	2.53	22,705	2.51	146,095	142,678	2.43
Total held-to-maturity	7,557	3.78	43,483	2.38	83,461	2.53	22,705	2.51	157,206	153,894	2.55
Available-for-sale:											
MBS/CMOs issued by U.S. government agencies	5,927	1.73	135,077	2.51	139,882	3.10	—	—	280,886	278,403	2.79
SBA-backed securities	—	—	2,372	2.77	48,351	2.99	—	—	50,723	50,781	2.98
State and municipal[3]	13,954	1.86	26,640	2.46	37,080	2.56	1,372	4.01	79,046	77,960	2.43
Debentures of government sponsored agencies	—	—	41,460	2.68	11,496	3.35	—	—	52,956	53,018	2.82
Privately issued CMOs	193	3.63	102	4.43	—	—	—	—	295	297	3.91
Corporate bonds	501	2.01	1,503	3.93	—	—	—	—	2,004	2,005	3.45
Total available-for-sale	20,575	1.85	207,154	2.55	236,809	3.01	1,372	4.01	465,910	462,464	2.76
Total	$28,132	2.36 %	$250,637	2.52 %	$320,270	2.88 %	$24,077	2.59 %	$623,116	$616,358	2.70

December 31, 2017	Within 1 Year		1-5 Years		5-10 Years		After 10 Years		Total		
(dollars in thousands; unaudited)	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Average Yield[2]	Amortized Cost[1]	Fair Value	Aver Yield
Held-to-maturity:											
State and municipal[3]	$7,606	4.64 %	$11,293	4.02 %	$747	5.18 %	$—	— %	$19,646	$19,998	4.31
MBS/CMOs issued by U.S. government agencies	—	—	26,245	2.18	101,291	2.26	3,850	2.64	131,386	131,034	2.26
	7,606	4.64	37,538	2.74	102,038	2.28	3,850	2.64	151,032	151,032	2.52

Total held-to-maturity															
Available-for-sale:															
MBS/CMOs issued by U.S. government agencies	800	1.81		118,125	2.19		45,739	2.54		24,702	2.75		189,366	188,061	2.34
SBA-backed securities	167	5.23		1,759	2.12		22,554	2.57		1,499	3.09		25,979	25,982	2.59
State and municipal[3]	7,192	1.84		51,832	2.09		36,984	2.39		2,019	4.53		98,027	97,491	2.24
Debentures of government sponsored agencies	1,495	1.55		11,445	2.06		—	—		—	—		12,940	12,938	2.00
Privately issued CMOs	121	3.35		1,311	2.53		—	—		—	—		1,432	1,431	2.60
Corporate bonds	4,531	1.94		2,010	2.88		—	—		—	—		6,541	6,564	2.23
Total available-for-sale	14,306	1.89		186,482	2.16		105,277	2.50		28,220	2.90		334,285	332,467	2.32
Total	$21,912	2.84	%	$224,020	2.26	%	$207,315	2.39	%	$32,070	2.87	%	$485,317	$483,499	2.38

[1] Book value reflects cost, adjusted for accumulated amortization and accretion.

[2] Weighted average calculation is based on amortized cost of securities.

[3] Yields on tax-exempt municipal bonds are presented on a taxable equivalent basis, using federal tax rate of 21%.

The amortized cost of our investment securities portfolio increased $137.8 million or 28.4% during 2018. We purchased $237.9 million in securities in 2018, including $2.0 million designated as held-to-maturity and $235.9 million designated as available-for-sale to provide flexibility for liquidity and interest rate risk management. These purchases were partially offset by $80.6 million of paydowns, calls and maturities, and $17.1 million of sales during 2018. Sales of securities were mainly due to changes in tax law resulting in less favorable yields on these tax exempt municipal securities.

During 2018, we purchased $99.1 million in collateralized mortgage obligations ("CMOs"), $55.6 million in mortgage pass-through securities, $41.5 million in debentures of government sponsored agencies, $35.6 million in Small Business Administration ("SBA") backed securities, and $6.0 million in obligations of state and political subdivisions. We consider agency debentures, mortgage-backed securities, and CMOs issued by U.S. government sponsored entities to have low credit risk as they carry the credit support of the U.S. federal government. The debentures, CMOs and MBS issued by U.S. government sponsored agencies, state and municipal securities, SBA-backed securities, and corporate bonds, made up 77%, 14.5%, 8.1% and 0.3% of the portfolio at December 31, 2018, compared to 68.8%, 24.2%, 5.4% and

1.4%, respectively at December 31, 2017. See the discussion in the section captioned "Securities May Lose Value due to Credit Quality of the Issuers" in ITEM 1A Risk Factors above.

At December 31, 2018, distribution of our investment in obligations of state and political subdivisions was as follows:

	December 31, 2018			December 31, 2017		
(dollars in thousands; unaudited)	Amortized Cost	Fair Value	% of state and municipal securities	Amortized Cost	Fair Value	% of state and municipal securities
Within California:						
General obligation bonds	$14,438	$14,418	16.0 %	$19,634	$19,678	16.7 %
Revenue bonds	7,109	7,108	7.9	11,660	11,776	9.9
Tax allocation bonds	4,541	4,601	5.0	6,099	6,234	5.2
Total within California	26,088	26,127	28.9	37,393	37,688	31.8
Outside California:						
General obligation bonds	56,186	55,199	62.3	68,890	68,454	58.5
Revenue bonds	7,883	7,850	8.8	11,390	11,346	9.7
Total outside California	64,069	63,049	71.1	80,280	79,800	68.2
Total obligations of state and political subdivisions	$90,157	$89,176	100.0 %	$117,673	$117,488	100.0 %

The portion of the portfolio outside the state of California is distributed among 23 states. The largest concentrations outside California are in Texas (18%), Washington (10%), and Minnesota (9%). Revenue bonds, both within and outside California, primarily consisted of bonds issued for essential services (such as transportation, infrastructure, public services, education and utilities).

Investments in states, municipalities and political subdivisions are subject to an initial pre-purchase credit assessment and ongoing monitoring. Key considerations include:

- The soundness of a municipality's budgetary position and stability of its tax revenues
- Debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority of the issuer
- Local demographics/economics including unemployment data, largest local taxpayers and employers, income indices and home values
- For revenue bonds, the source and strength of revenue for municipal authorities including obligors' financial condition and reserve levels, annual debt service and debt coverage ratio, and credit enhancement (such as insurer's strength)
- Credit ratings by major credit rating agencies

Loans

Table 6 Loans Outstanding by Type at December 31

(in thousands; unaudited)	2018	2017	2016	2015	2014
Commercial loans	$230,739	$235,835	$218,615	$219,452	$210,223
Real estate					
Commercial owner-occupied	313,277	300,963	247,713	242,309	230,605
Commercial investor	873,410	822,984	724,228	715,879	673,499
Construction	76,423	63,828	74,809	65,495	48,413
Home equity	124,696	132,467	117,207	112,300	110,788
Other residential	117,847	95,526	78,549	73,134	73,035
Installment and other consumer loans	27,472	27,410	25,495	22,639	16,788
Total loans	1,763,864	1,679,013	1,486,616	1,451,208	1,363,351
Allowance for loan losses	(15,821)	(15,767)	(15,442)	(14,999)	(15,099)

Total net loans	$1,748,043	$1,663,246	$1,471,174	$1,436,209	$1,348,252

New organic loan volume totaled approximately $239.4 million in 2018, compared to approximately $173.1 million in 2017. Loan originations were partially offset by payoffs totaling $157.3 million in 2018 and $132.5 million in 2017.

Payoffs to total loans of 8.9% and 7.9% in 2018 and 2017, respectively, were below our anticipated 10% annual payoff rate, but do not change our expectations for future payoffs. Approximately 88% and 87% of our outstanding loans were secured by real estate at December 31, 2018 and 2017, respectively. Also, see ITEM 1A, Risk Factors, regarding our loan concentration risk.

The following table summarizes our commercial real estate loan portfolio by the geographic location in which the property is located as of December 31, 2018 and 2017.

Table 7 Commercial Real Estate Loans Outstanding by Geographic Location

	December 31, 2018			December 31, 2017		
(dollars in thousands; unaudited)	Amount	% of Commercial real estate loans		Amount	% of Commercial real estate loans	
Marin	$342,163	28.8	%	$341,827	30.4	%
Sonoma	177,087	14.9		167,014	14.9	
Napa	168,394	14.2		151,778	13.5	
Alameda	167,170	14.1		143,939	12.8	
San Francisco	155,863	13.1		150,376	13.4	
Contra Costa	41,986	3.5		42,093	3.7	
San Mateo	23,919	2.0		20,481	1.8	
Solano	17,503	1.5		18,071	1.6	
El Dorado	13,274	1.1		13,860	1.2	
Sacramento	10,759	0.9		11,030	1.0	
Other	68,569	5.9		63,478	5.7	
Total	$1,186,687	100.0	%	$1,123,947	100.0	%

Commercial real estate loans increased by $62.7 million in 2018 and $152.0 million in 2017. The increase in 2018 was primarily in Sonoma, Napa, Alameda and San Francisco counties. The increase in 2017 included $92.3 million from the Bank of Napa acquisition, as well as lending activities in Marin and Alameda Counties. Of the commercial real estate loans at December 31, 2018, 74% were non-owner occupied and 26% were owner occupied. Almost the entire commercial real estate loan portfolio is comprised of term loans for which the primary source of repayment is the operating cash flow from the leasing activities of the real estate collateral. Originated loans are subject to our conservative credit underwriting standards and both the acquired and originated loans are actively managed.

We occasionally provide interest-only term loans to borrowers who exhibit strong financial capacity and/or for commercial real estate loans during the occupancy stabilization period. These interest-only term loans must meet our stringent underwriting standards and are generally short-term in nature, usually less than two years. In addition, we may make interest-only concessions in a modified troubled debt restructuring ("TDR"). At December 31, 2018 and 2017, approximately 2.9% and 2.0%, respectively, of our total loans contained an interest-only feature as part of the loan terms. All of these loans were current with their payments as of December 31, 2018. Except for two TDR loans to one borrowing relationship totaling $7.0 million as of December 31, 2018, all were considered to have low credit risk (graded "Pass").

The following table shows an analysis of construction loans by type and location as of December 31, 2018 and 2017.

Table 8 Construction Loans Outstanding by Type and Geographic Location

(dollars in thousands; unaudited)	December 31, 2018		December 31, 2017	
Construction loans by type	Amount	% of Construction Loans	Amount	% of Construction Loans
Commercial real estate	$30,603	40.0 %	$20,935	32.8 %
Apartments and multifamily	23,583	30.9	14,878	23.3
1-4 Single family residential	15,760	20.6	22,780	35.7
Land - improved	4,046	5.3	3,668	5.7
Land - unimproved	2,431	3.2	1,567	2.5
Total	$76,423	100.0 %	$63,828	100.0 %

(dollars in thousands; unaudited)	December 31, 2018		December 31, 2017	
Construction loans by geographic location	Amount	% of Construction Loans	Amount	% of Construction Loans
San Francisco	$20,764	27.2 %	$21,664	33.9 %
Marin	14,665	19.2	9,750	15.3
Sonoma	14,241	18.6	4,683	7.3
Alameda	11,411	14.9	7,783	12.2
San Mateo	5,110	6.7	3,495	5.5
Napa	3,988	5.2	12,072	18.9
Riverside	2,688	3.5	2,969	4.7
Other	3,556	4.7	1,412	2.2
Total	$76,423	100.0 %	$63,828	100.0 %

Construction loans increased by $12.6 million in 2018 and decreased by $11.0 million in 2017. The increase in 2018 was primarily due to new construction projects, partially offset by payoffs related to completed construction projects. The $8.1 million decrease in Napa construction loans primarily resulted from the successful completion of three projects and one completed project that converted to a commercial real estate term loan. The improving economy resulted in a number of new financing opportunities for existing and new customers who had successfully completed construction projects in the past.

The following table presents the maturity distribution of our commercial and construction loans as of December 31, 2018 based on their contractual maturity dates and does not include scheduled payments or potential prepayments.

Table 9A Commercial and Construction Loan Maturity Distribution

(in thousands; unaudited)	Due within 1 year	Due after 1 but within 5 years	Due after 5 years	Total
Maturity distribution:				
Commercial	$69,335	$105,464	$55,940	$230,739
Construction	47,427	14,957	14,039	76,423
Total	$116,762	$120,421	$69,979	$307,162

The following table shows the mix of variable-rate loans to fixed-rate loans for commercial and construction loans. The large majority of the variable-rate loans are tied to independent indices (such as the Wall Street Journal Prime Rate or a Treasury Constant Maturity Rate). Most loans with original terms of more than five years have provisions for the fixed rates to reset, or convert to variable rates, after three, five or seven years. These loans are included in variable-rate balances below.

Table 9B Commercial and Construction Loan Interest Rate Sensitivity

(in thousands; unaudited)	Fixed	Variable	Total
Commercial	$116,796	$113,943	$230,739
Construction	20,416	56,007	76,423
Total	$137,212	$169,950	$307,162

Allowance for Loan Losses

Credit risk is inherent in the business of lending. As a result, we maintain an allowance for loan losses to absorb probable losses in our loan portfolio through a provision for loan losses charged against earnings. All specifically identifiable and quantifiable losses are charged off against the allowance. The balance of our allowance for loan losses is Management's best estimate of the remaining probable losses in the portfolio. The ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the real estate market, changes in interest rates and economic and political environments. Based on the current conditions of the loan portfolio, Management believes that the $15.8 million allowance for loan losses at December 31, 2018 is adequate to absorb losses in our loan portfolio, but provides no assurance that adverse economic conditions or other circumstances will not result in increased losses in the portfolio.

The Components of the Allowance for Loan Losses

As stated in Note 1 to the Consolidated Financial Statements in ITEM 8 of this report, the overall allowance consists of 1) specific allowances for individually identified impaired loans ("ASC 310-10") and 2) general allowances for pools of loans ("ASC 450-20"), which incorporate quantitative (e.g., historical loan loss rates) and qualitative risk factors (e.g., portfolio growth and trends, credit concentrations, economic and regulatory factors, etc.).

The first component, specific allowances, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Management evaluates these loans individually for impairment. Management considers an originated loan to be impaired when it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement. For PCI loans, specific allowances are established to account for credit deterioration subsequent to acquisition if we have probable decreases in cash flows expected to be collected. For loans determined to be impaired, the extent of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate at origination (for originated loans), based on the loan's observable market price, or based on the fair value of the collateral if the loan is collateral dependent or if foreclosure is imminent. Generally, with problem credits that are collateral dependent, we obtain appraisals of the collateral at least annually. We may obtain appraisals more frequently if we believe the collateral is subject to market volatility, if a specific event has occurred to the collateral, or if we believe foreclosure is imminent. Impaired loan balances decreased to $15.0 million at December 31, 2018 from $16.9 million at December 31, 2017. The specific allowance for impaired loans increased to $778 thousand at December 31, 2018 from $513 thousand at December 31, 2017. The decrease in impaired loan balances primarily relates to $2.2 million in payoffs and paydowns, two loans totaling $247 thousand removed from troubled debt status, partially offset by $611 thousand in loans downgraded to impaired status during 2018. The increase in reserves for impaired loans was primarily due to two unsecured commercial loans that became impaired during 2018.

The second component is an estimate of the probable inherent losses in each loan pool with similar risk characteristics. This analysis encompasses the entire loan portfolio, excluding individually identified impaired loans and acquired loans whose purchase discount has not been fully accreted. Under our allowance model, loans are evaluated on a pool basis by federal regulatory reporting codes ("CALL codes" or "segments"), which are further delineated by assigned credit risk ratings, as described in Note 3 to the Consolidated Financial Statements in ITEM 8 of this report. At December 31, 2018 and 2017, the allowance allocated for the second component totaled $15.0

million and $15.3 million, respectively. The decrease in the general allowance was primarily attributed to reserves for two large non-impaired substandard classified borrowing relationships that were upgraded to special mention, partially offset by allowances related to loan growth and the refinement of certain loan concentration qualitative risk factors, as previously discussed in the section entitled Provision for Loan Losses.

Table 10 shows the allocation of the allowance by loan type as well as the percentage of total loans in each of the same loan types.

Table 10 Allocation of Allowance for Loan Losses

(dollars in thousands; unaudited)	December 31, 2018		December 31, 2017		December 31, 2016		December 31, 2015		December 31, 2014	
	Allowance balance allocation	Loans as a percent of total loans	Allowance balance allocation	Loans as a percent of total loans	Allowance balance allocation	Loans as a percent of total loans	Allowance balance allocation	Loans as a percent of total loans	Allowance balance allocation	Loans as a percent of total loans
Commercial loans	$2,436	13.1 %	$3,654	14.0 %	$3,248	14.7 %	$3,023	15.1 %	$2,837	15.4 %
Real Estate:										
Commercial, owner-occupied	2,407	17.8	2,294	17.9	1,753	16.7	2,249	16.7	1,924	16.9
Commercial, investor	7,703	49.5	6,475	49.1	6,320	48.7	6,178	49.4	6,672	49.4
Construction	756	4.3	681	3.8	781	5.0	724	4.5	839	3.6
Home Equity	915	7.1	1,031	7.9	973	7.9	910	7.7	859	8.1
Other residential	800	6.7	536	5.7	454	5.3	394	5.0	433	5.4
Installment and other consumer	310	1.5	378	1.6	372	1.7	425	1.6	566	1.2
Unallocated allowance	494	N/A	718	N/A	1,541	N/A	1,096	N/A	969	N/A
Total allowance for loan losses	$15,821		$15,767		$15,442		$14,999		$15,099	
Total percent		100.0 %		100.0 %		100.0 %		100.0 %		100.0 %

Table 11 shows the activity in the allowance for loan losses for each of the years in the five-year period ended December 31, 2018.

Table 11 Allowance for Loan Losses

(dollars in thousands; unaudited)	2018	2017	2016	2015	2014
Beginning balance	$15,767	$15,442	$14,999	$15,099	$14,224
Provision for (reversal of) loan losses	—	500	(1,850)	500	750
Loans charged-off:					
Commercial	(3)	(289)	(11)	(5)	(66)
Real Estate:					
Commercial, owner occupied	—	—	(20)	—	—
Commercial, investor	—	—	—	—	—
Construction	—	—	—	(839)	(204)
Home equity	—	—	—	—	—
Other residential	—	—	—	—	—
Installment and other consumer	(2)	(4)	(5)	(20)	(7)
Total loans charged-off	(5)	(293)	(36)	(864)	(277)
Loans recovered:					
Commercial	17	111	143	236	168
Real Estate:					

Commercial, owner occupied	—	—	—	—	5
Commercial, investor	—	—	2,156	23	45
Construction	—	—	—	—	96
Home equity	—	—	3	3	3
Other residential	—	—	—	—	—
Installment and other consumer	42	7	27	2	85
Total loans recovered	59	118	2,329	264	402
Net loans recovered (charged-off)	54	(175)	2,293	(600)	125
Ending balance	$15,821	$15,767	$15,442	$14,999	$15,099
Total loans outstanding at end of year, before deducting allowance for loan losses	$1,763,864	$1,679,013	$1,486,616	$1,451,208	$1,363,351
Average total loans outstanding during year	$1,704,390	$1,511,503	$1,452,357	$1,354,564	$1,317,794
Ratio of allowance for loan losses to total loans at end of year	0.90%	0.94%	1.04%	1.03%	1.11%
Net recoveries (charge-offs) to average loans	0.003%	(0.01)%	0.16%	(0.04)%	0.01%
Ratio of allowance for loan losses to net recoveries (charge-offs)	29,298.1%	(9,009.7)%	673.4%	(2,499.8)%	12,079.2%

Net recoveries totaled $54 thousand in 2018, compared to net charge-offs of $175 thousand in 2017. The 2017 net charge-offs were primarily related to one unsecured commercial loan. The percentage of net recoveries (charge-offs) to average loans was 0.003% in 2018, compared to (0.01)% in 2017.

Table 12 shows non-performing assets and impaired loans for each of the years in the five-year period ended December 31, 2018.

Table 12 Non-performing Assets and Impaired Loans

(dollars in thousands; unaudited)	2018	2017	2016	2015	2014
Non-accrual loans:					
Commercial	$319	$—	$—	$21	$—
Real Estate:					
Commercial, owner-occupied	—	—	—	—	1,403
Commercial, investor	—	—	—	1,903	2,429
Construction	—	—	—	1	5,134
Home equity	313	406	91	171	280
Other residential	—	—	—	—	—
Installment and other consumer	65	—	54	83	104
Total non-accrual loans	697	406	145	2,179	9,350
Other real estate owned[1]	—	—	408	421	461
Total non-performing assets	$697	$406	$553	$2,600	$9,811
Accruing restructured loans:[2]					
Commercial	$1,506	$2,165	$2,207	$4,562	$3,584
Real Estate:					
Commercial, owner-occupied	6,993	6,999	6,993	6,993	7,056
Commercial, investor	1,821	2,171	2,256	513	524
Construction	2,688	2,969	3,245	3,237	550
Home equity	251	347	625	388	414
Other residential	462	1,148	1,965	2,011	2,045
Installment and other consumer	620	721	877	1,168	1,689
Total accruing restructured loans	14,341	16,520	18,168	18,872	15,862
Accreting impaired PCI loans:[3]					
Commercial real estate	—	—	—	—	—
Commercial	—	—	—	137	—
Construction	—	—	—	—	11
Total accreting impaired PCI loans	—	—	—	137	11
Total non-accrual loans (from above)	697	406	145	2,179	9,350
Total impaired loans	$15,038	$16,926	$18,313	$21,188	$25,223
Allowance for loan losses to non-accrual loans at period end	2,270 %	3,883 %	10,650 %	688 %	162 %
Non-accrual loans to total loans	0.04 %	0.02 %	0.01 %	0.15 %	0.69 %

[1] Other real estate owned decreased in 2017 from the sale of two properties obtained from a bank acquisition in 2013.
[2] Excludes TDR loans on non-accrual status.
[3] The expected cash flows on these PCI loans declined post-acquisition, but continued to accrete interest based on the expected cash flows.

The decrease in total impaired loans from 2017 to 2018 primarily relates to payoffs, paydowns, and two loans that were removed from TDR status. The decrease in total impaired loans from 2016 to 2017 primarily relates to payoffs and paydowns, and the charge-off of an unsecured commercial loan mentioned above, which were partially offset by

an increase in non-accrual loans. The decrease in total impaired loans from 2015 to 2016 primarily relates to the resolution and payoff of a commercial real estate credit. The decrease in total impaired loans from 2014 to 2015 primarily relates to a previously non-accrual loan that returned to accrual status, the payoff of a commercial real estate loan, and the sale of a land development loan.

Total accruing TDR loans, whose contractual terms were restructured in a manner that granted a concession to a borrower experiencing financial difficulties, totaled $14.3 million and $16.5 million as of December 31, 2018 and 2017, respectively. The decreases from 2017 to 2018 and from 2016 to 2017 primarily relate to the same changes mentioned above. The decrease from 2015 to 2016 primarily relates to loan payoffs and paydowns, net of loans modified as

TDRs during 2016. The decrease from 2014 to 2015 primarily relates to five loans that were removed from TDR designation, one sold TDR loan and payoffs and paydowns of several other TDR loans. For more information, refer to Note 3 to the Consolidated Financial Statements in ITEM 8, under “Troubled Debt Restructuring."

Other Assets

BOLI totaled $39.0 million at December 31, 2018, compared to $38.1 million at December 31, 2017, and is recorded in other assets. The increase of $913 thousand is due to an increase in the cash surrender value of the BOLI policies.

Other assets also included net deferred tax assets of $10.4 million and $8.8 million at December 31, 2018 and 2017, respectively. Deferred tax assets consist primarily of tax benefits expected to be realized in future periods related to temporary differences such as allowance for loan losses and off-balance sheet credit commitments, net operating loss carryforwards, deferred compensation plan and salary continuation plan, and net unrealized losses on available-for-sale securities. The increase in 2018 primarily relates to increases in accrued but unpaid expenses, state franchise taxes, and net unrealized losses on available-for-sale securities. Management believes deferred tax assets will be realizable due to our consistent record of earnings and the expectation that earnings will continue at a level adequate to realize such benefits. Therefore, no valuation allowance was established as of December 31, 2018 or 2017. For additional information, refer to Note 11 to the Consolidated Financial Statements in ITEM 8 of this report.

In addition, we held $11.1 million of FHLB stock recorded at cost in other assets at December 31, 2018 and 2017, respectively. The FHLB paid $959 thousand and $766 thousand in cash dividends in 2018 and 2017, respectively. FHLB dividends in 2018 include a special dividend of $180 thousand. For additional information, refer to Note 2 to the Consolidated Financial Statements in ITEM 8 of this report.

Deposits

Deposits grew $26.1 million, to $2,174.8 million at December 31, 2018, compared to $2,148.7 million at December 31, 2017. Non-interest bearing deposits grew by $51.9 million in 2018 and made up 49% of total deposits at year end. No individual customer accounted for more than 5% of deposits. Also, see ITEM 1A, Risk Factors, for a discussion of risks associated with volatility due to activity of our large deposit customers.

Table 13 Distribution of Average Deposits

Table 13 shows the relative composition of our average deposits for 2018 and 2017. For average rates paid on deposits, refer to Table 1 in ITEM 7- Management's Discussion and Analysis of Financial Condition and Results of Operations.

	Years ended December 31,					
	2018			2017		
(dollars in thousands; unaudited)	Amount	Percent		Amount	Percent	
Non-interest bearing [1]	$1,085,870	50.3	%	$899,289	48.3	%
Interest bearing transaction	143,706	6.7		105,544	5.6	
Savings	178,907	8.3		167,190	9.0	
Money market [1]	612,372	28.4		542,592	29.2	
Time deposits, including CDARS:						
Less than $100,000	37,468	1.7		35,136	1.9	
$100,000 or more	99,871	4.6		110,933	6.0	
Total time deposits	137,339	6.3		146,069	7.9	
Total average deposits	$2,158,194	100.0	%	$1,860,684	100.0	%

[1] Because we changed the types of deposits placed in the Demand Deposit Marketplace SM ("DDM") network between 2018 and 2017, DDM balances consisted of non-interest bearing deposits in 2018, whereas in 2017 DDM balances consisted of money market deposits. In addition, money market balances included Insured Cash Sweep® ("ICS") in both 2018 and 2017. DDM and ICS balances are discussed in Note 6 to the Consolidated Financial Statements in ITEM 8 of this report.

Table 14 Maturities of Time Deposits of $100,000 or more at December 31

Table 14 below shows the maturity groupings for time deposits of $100,000 or more at December 31, 2018 and 2017.

	December 31,	
(in thousands; unaudited)	2018	2017
Three months or less	$25,512	$36,669
Over three months through six months	13,201	20,617
Over six months through twelve months	13,997	22,638
Over twelve months	29,834	40,481
Total	$82,544	$120,405

Borrowings

As of December 31, 2018 and 2017, respectively, we had $629.4 million and $538.9 million in secured lines of credit with FHLB and $69.7 million and $52.1 million with the Federal Reserve Bank of San Francisco (“FRBSF”). We also had $92.0 million and $100.4 million (including $8.4 million assumed from Bank of Napa) in unsecured lines with correspondent banks to cover any short or long-term borrowing needs at December 31, 2018 and 2017, respectively.

FHLB overnight borrowings were $7.0 million at a rate of 2.56% on December 31, 2018. There were no borrowings at December 31, 2017. At December 31, 2018 and 2017, respectively, $629.4 million and $538.9 million remained available for borrowing from the FHLB. The FRBSF and correspondent bank lines were not utilized at December 31, 2018 and 2017.

As part of a bank acquisition in 2013, we assumed two subordinated debentures due to the NorCal Community Bancorp Trusts I and II at fair values totaling $5.0 million at the acquisition date, which are being accreted up to the contractual values totaling $8.2 million over the remaining terms of the debentures. On October 7, 2018, Bancorp redeemed in full the subordinated debentures due to NorCal Community Bancorp Trust I. The subordinated debentures had been accreted up to $2.6 million and $5.7 million as of December 31, 2018 and 2017, respectively.

For additional information, see Note 7 to the Consolidated Financial Statements in ITEM 8 of this report.

Deferred Compensation Obligations

We maintain a non-qualified, unfunded deferred compensation plan for certain key management personnel. Under this plan, participating employees may defer compensation, which will entitle them to receive certain payments for up to fifteen years commencing upon retirement, death, disability or termination of employment. The participating employee may elect to receive payments over periods not to exceed fifteen years. At December 31, 2018 and 2017, our aggregate payment obligations under this plan totaled $3.8 million and $3.4 million, respectively.

We established a Salary Continuation Plan ("Plan") on January 1, 2011 to provide a percentage of salary continuation benefits to a select group of Executive Management upon retirement at age sixty-five and reduced benefits upon early retirement. At December 31, 2018 and 2017, our liability under the Salary Continuation Plan was $2.7 million and $2.5 million, respectively, and is recorded in interest payable and other liabilities in the Consolidated Statements of Condition. The Plan is unfunded and non-qualified for tax purposes and for purposes of Title I of the Employee Retirement Income Security Act of 1974.

For additional information, see Note 10 to the Consolidated Financial Statements in ITEM 8 of this report.

Table 15 Off-Balance Sheet Arrangements, Commitments and Contractual Obligations

We make commitments to extend credit in the normal course of business to meet the financing needs of our customers. For additional information, see Note 16 to the Consolidated Financial Statements in ITEM 8 of this report.

	Payments due by period				
(in thousands; unaudited)	<1 year	1-3 years	4-5 years	>5 years	Total
Operating leases	$4,206	$5,807	$2,248	$1,938	$14,199
Subordinated debentures	—	—	—	4,124	4,124
Certificates of deposit	76,880	28,077	12,202	23	117,182
Other long term liabilities (salary continuation payments)[1]	28	122	304	1,473	1,927
Total	$81,114	$34,006	$14,754	$7,558	$137,432

[1] Represents future benefit payments under executive salary continuation agreements assumed from the Bank of Napa acquisition whereby participants begin receiving payments upon reaching retirement age. Amounts exclude future benefit payment obligations totaling $4.2 million under Bank of Marin executive salary continuation agreements whereby participants will begin receiving payments upon reaching retirement age and fulfilling their service requirements. For additional information, see Note 10 to the Consolidated Financial Statements in ITEM 8 of this report.

The contractual amount of loan commitments not reflected on the consolidated statements of condition was $491.3 million and $453.2 million at December 31, 2018 and 2017, respectively.

As permitted or required under California law and to the maximum extent allowable under that law, we have certain obligations to indemnify our current and former officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. These indemnification obligations are valid as long as the director or officer acted in good faith and in a manner the person reasonably believed to be in, or not opposed to, our best interests, and with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful. The maximum potential amount of future payments we could be required to make under these indemnification obligations is unlimited; however, we have a director and officer insurance policy that mitigates our exposure and enables us to recover a portion of any future amounts paid. As we believe the possibility of potential claims to be remote and any amounts under the indemnifications would be covered by the insurance policy, we have not recorded an indemnification obligation.

Capital Adequacy

As discussed in Note 15 to the Consolidated Financial Statements in ITEM 8 of this report, the Bank's capital ratios were above regulatory guidelines to be considered "well capitalized" and Bancorp's ratios exceeded the required minimum ratios for capital adequacy purposes. For further discussion of bank capital requirements and the potential effect of the recently proposed capital rules under the Economic Growth, Regulatory Relief and Consumer Protection Act, refer to the SUPERVISION AND REGULATION section in ITEM 1 of this report.

The Bank's total risk-based capital ratio decreased from 14.7% at December 31, 2017 to 14.0% at December 31, 2018, primarily due to $36.7 million in dividends paid to Bancorp to cover the Share Repurchase Program described below, quarterly common stock dividends, and operating costs, partially offset by the Bank's $34.5 million 2018 in net income. Additionally, the Bank's total risk-weighted assets increased by $117.5 million to $2.0 billion at December 31, 2018. Bancorp's total risk-based capital ratio was 14.9% at both December 31, 2017 and 2018. Bancorp's 2017 Tier 1 capital included NorCal Community Bancorp Trusts I and II which are not included at the Bank level. On October 7, 2018, Bancorp redeemed in full the subordinated debentures due to NorCal Community Bancorp Trust I. The redemption reduced Bancorp's total risk-based capital ratio by approximately 18 basis points.

On April 23, 2018, Bancorp announced that its Board of Directors approved a Share Repurchase Program under which Bancorp may repurchase up to $25.0 million of its outstanding common stock through May 1, 2019. During 2018, Bancorp repurchased 171,217 shares for a total amount of $7.0 million. Our Share Repurchase Program may affect future capital levels. We expect to maintain strong capital levels and do not expect that we will be required to raise additional capital in 2019. Our anticipated sources of capital in 2019 include future earnings and shares issued under the stock-based compensation program.

Liquidity

The goal of liquidity management is to provide adequate funds to meet loan demand and to fund operating activities and deposit withdrawals. We accomplish this goal by maintaining an appropriate level of liquid assets and formal lines of credit with the FHLB, FRBSF and correspondent banks that enable us to borrow funds as discussed in Note 7 to the Consolidated Financial Statement in ITEM 8 of this report. Our Asset Liability Management Committee ("ALCO"), which is comprised of independent Bank directors and the Bank's Chief Executive Officer, is responsible for approving and monitoring our liquidity targets and strategies. ALCO has adopted a contingency funding plan that provides early detection of potential liquidity issues in the market or the Bank and institutes prompt responses that may prevent or alleviate a potential liquidity crisis. Management monitors liquidity daily and regularly adjusts our position based on current and future liquidity needs. We also have relationships with third-party deposit networks and can adjust the placement of our deposits via reciprocal or one-way sales as part of our cash management strategy.

We obtain funds from the repayment and maturity of loans, deposit inflows, investment security maturities and paydowns, federal funds purchases, FHLB advances, other borrowings, and cash flow from operations. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of certificates of deposit, repayment of borrowings, and dividends to common stockholders.

The most significant factor in our daily liquidity position has been the level of customer deposits. We attract and retain new deposits, which depends upon the variety and effectiveness of our customer account products, service and convenience, and rates paid to customers, as well as our financial strength. The cash cycles of some of our large commercial depositors may cause short-term fluctuations in their deposit balances held with us.

At December 31, 2018 our liquid assets, which included unencumbered available-for-sale securities and cash, totaled $433.2 million, a decrease of $68.7 million from December 31, 2017. Our cash and cash equivalents decreased $169.3 million from December 31, 2017. Significant uses of liquidity during 2018 were $237.9 million in investment securities purchased, $84.6 million in loan originations and advances, net of repayments, $8.9 million in cash dividends paid on common stock to our shareholders, $6.9 million in common stock repurchases, and a $4.1 million repayment of a subordinated debenture. Significant sources of liquidity during 2018 included $98.5 million in paydowns, maturities and sales of investment securities, $42.1 million in net cash provided by operating activities, an increase in deposits of $26.2 million, and a $7.0 million overnight borrowing outstanding at year-end. Refer to the Consolidated Statement of Cash Flows in this Form 10-K for additional information on our sources and uses of liquidity. Management anticipates that our current strong liquidity position and core deposit base will provide adequate liquidity to fund our operations.

Undrawn credit commitments, as discussed in Note 16 to the Consolidated Financial Statements in ITEM 8 of this report, totaled $491.3 million at December 31, 2018. We expect to fund these commitments to the extent utilized primarily through the repayment of existing loans, deposit growth and liquid assets. Over the next twelve months, $76.9 million of time deposits will mature. We expect to replace these funds with new deposits. Our emphasis on local deposits, combined with our liquid investment portfolio, provides a very stable funding base.

Since Bancorp is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to Bancorp without advance regulatory approval is restricted to the lesser of the Bank’s retained earnings or the amount of the Bank’s net profits from the previous three fiscal years less the amount of dividends paid during that period. The primary uses of funds for Bancorp are shareholder dividends and ordinary operating expenses. Bancorp held $19.1 million of cash at December 31, 2018. In January 2019, Bancorp obtained a dividend distribution from the Bank totaling $10.4 million, which is deemed sufficient to cover Bancorp's operational needs, share repurchases, and cash dividends to shareholders through the end of 2019. Management anticipates that there will be sufficient earnings at the

Bank to provide dividends to Bancorp to meet its funding requirements for the foreseeable future.

ITEM 7A. Quantitative and Qualitative Disclosure about Market Risk

Market risk is defined as the risk of loss arising from an adverse change in the market value (or prices) of financial instruments. A significant form of market risk is interest rate risk, which is inherent in our investment, borrowing, lending and deposit gathering activities. The Bank manages interest rate sensitivity to minimize the exposure of our net interest margin, earnings, and capital to changes in interest rates. Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities.

Over time, we expect our net interest margin to increase if rates go up, primarily due to adjustable rate loans, our significant and stable non-interest bearing deposit base and our cash earning the Federal Funds rate.

To mitigate interest rate risk, the structure of the Consolidated Statement of Condition is managed with the objective of correlating the effects of interest rate changes on loans and investments with those of deposits and borrowings. The asset liability management policy sets limits on the acceptable amount of change to net interest income and economic value of equity in different interest rate environments.

From time to time, we enter into interest rate swap contracts to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. See Note 14 to the Consolidated Financial Statements in ITEM 8 of this report.

ALCO and the Board of Directors review our exposure to interest rate risk at least quarterly. We use simulation models to measure interest rate risk and to evaluate strategies to improve profitability. A simplified static statement of condition is prepared on a quarterly basis as a starting point, using instrument level data of our actual loans, investments, borrowings and deposits as inputs. If potential changes to net equity value and net interest income resulting from hypothetical interest rate changes are not within the limits established by the Board of Directors, Management may adjust the asset and liability mix to bring the risk position within approved limits or take other actions. At December 31, 2018, interest rate risk was within policy guidelines established by ALCO and the Board.

One set of interest rates modeled and evaluated against flat interest rates is a series of immediate parallel shifts in the yield curve. These are provided in the following table as an example rather than an expectation of likely interest rate movements.

Table 16 Effect of Interest Rate Change on Net Interest Income (NII)

Immediate Changes in Interest Rates (in basis points)	Estimated Change in NII in Year 1 (as percent of NII)	Estimated Change in NII in Year 2 (as percent of NII)
up 400	(4.7)%	3.8%
up 300	(3.3)%	3.3%
up 200	(2.0)%	2.6%
up 100	(0.8)%	2.0%
down 100	(4.5)%	(8.2)%
down 200	(8.6)%	(17.1)%

Interest rate sensitivity is a function of the repricing characteristics of our assets and liabilities. The Bank runs a combination of scenarios and sensitivities in its attempt to capture the range of interest rate risk including the simulations mentioned above. As with any simulation model or other method of measuring interest rate risk, limitations are inherent in the process and dependent on assumptions. For example, if we choose to pay interest on certain business deposits that are currently non-interest bearing, causing these deposits to become rate sensitive in the future, we would become less asset sensitive than the model currently indicates. Assets and liabilities may react differently to changes in market interest rates in terms of both timing and responsiveness to market rate movements. For instance, banks have experienced significant growth in deposit balances, particularly in non-interest bearing

demand deposits. Deposit balance run-off may increase in a rising interest rate environment. If the deposit run-off differs from the assumptions, the sensitivity analysis will change. Another important deposit modeling assumption is the amount by which interest-bearing deposit rates will increase or decrease when market interest rates increase or decrease. This deposit repricing sensitivity is known as the beta, and it represents the expected amount by which our deposit rates will change for a given change in short-term market rates. Further, the actual rates and timing of prepayments on loans and investment

securities, and the behavior of depositors, could vary significantly from the assumptions applied in the various scenarios. Lastly, changes in U.S. Treasury rates accompanied by a change in the shape of the yield curve could produce different results from those presented in the table. Accordingly, the results presented should not be relied upon as indicative of actual results in the event of changing market interest rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors
Bank of Marin Bancorp

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated statements of condition of Bank of Marin Bancorp and subsidiary (the "Company") as of December 31, 2018 and 2017, the related consolidated statements of comprehensive income, changes in stockholders' equity and cash flows for each of the two years in the period ended December 31, 2018, and the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017, and the consolidated results of its operations and its cash flows for each of the two years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by COSO.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the consolidated financial statements.
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Moss Adams LLP
San Francisco, California
March 14, 2019

We have served as the Company's auditor since 2004.

March 14, 2019

Management's Report on Internal Control over Financial Reporting

Management of Bank of Marin Bancorp and subsidiary, (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles ("GAAP"). The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and board of directors; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Management conducted an assessment of the effectiveness of internal control over financial reporting as of December 31, 2018, utilizing the framework established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, Management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2018.

The Company's independent registered public accounting firm, Moss Adams LLP, has issued an attestation report on our internal control over financial reporting, which appears on the previous page.

/s/ Russell A. Colombo
Russell A. Colombo, President and Chief Executive Officer

/s/ Tani Girton
Tani Girton, EVP and Chief Financial Officer

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CONDITION
December 31, 2018 and 2017

(in thousands, except share data)	2018	2017
Assets		
Cash and due from banks	$34,221	$203,545
Investment securities		
Held-to-maturity, at amortized cost	157,206	151,032
Available-for-sale, at fair value	462,464	332,467
Total investment securities	619,670	483,499
Loans, net of allowance for loan losses of $15,821 and $15,767 at December 31, 2018 and 2017, respectively	1,748,043	1,663,246
Bank premises and equipment, net	7,376	8,612
Goodwill	30,140	30,140
Core deposit intangible	5,571	6,492
Interest receivable and other assets	75,871	72,620
Total assets	$2,520,892	$2,468,154
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest bearing	$1,066,051	$1,014,103
Interest bearing		
Transaction accounts	133,403	169,195
Savings accounts	178,429	178,473
Money market accounts	679,775	626,783
Time accounts	117,182	160,116
Total deposits	2,174,840	2,148,670
Federal Home Loan Bank borrowing	7,000	—
Subordinated debentures	2,640	5,739
Interest payable and other liabilities	20,005	16,720
Total liabilities	2,204,485	2,171,129
Stockholders' Equity		
Preferred stock, no par value, Authorized - 5,000,000 shares, none issued	—	—
Common stock, no par value, Authorized - 30,000,000 shares; Issued and outstanding - 13,844,353 and 13,843,084 at December 31, 2018 and 2017, respectively	140,565	143,967
Retained earnings	179,944	155,544
Accumulated other comprehensive loss, net	(4,102)	(2,486)
Total stockholders' equity	316,407	297,025
Total liabilities and stockholders' equity	$2,520,892	$2,468,154

The accompanying notes are an integral part of these consolidated financial statements.

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years ended December 31, 2018 and 2017 (in thousands, except per share amounts)	2018	2017
Interest income		
Interest and fees on loans	$79,527	$66,799
Interest on investment securities	14,092	8,802
Interest on federal funds sold and due from banks	1,461	995
Total interest income	95,080	76,596
Interest expense		
Interest on interest-bearing transaction accounts	226	108
Interest on savings accounts	72	66
Interest on money market accounts	1,355	555
Interest on time accounts	542	576
Interest on FHLB and overnight borrowings	2	—
Interest on subordinated debentures	1,339	439
Total interest expense	3,536	1,744
Net interest income	91,544	74,852
Provision for loan losses	—	500
Net interest income after provision for loan losses	91,544	74,352
Non-interest income		
Service charges on deposit accounts	1,891	1,784
Wealth Management and Trust Services	1,919	2,090
Debit card interchange fees, net	1,561	1,531
Merchant interchange fees, net	378	398
Earnings on bank-owned life Insurance	913	845
Dividends on FHLB stock	959	766
Gains (losses) on investment securities, net	876	(185)
Other income	1,642	1,039
Total non-interest income	10,139	8,268
Non-interest expense		
Salaries and related benefits	33,335	29,958
Occupancy and equipment	5,976	5,472
Depreciation and amortization	2,143	1,941
Federal Deposit Insurance Corporation insurance	756	666
Data processing	4,358	4,906
Professional services	3,317	2,858
Directors' expense	700	720
Information technology	1,023	769
Provision for losses on off-balance sheet commitments	—	57
Other expense	6,658	6,435
Total non-interest expense	58,266	53,782
Income before provision for income taxes	43,417	28,838
Provision for income taxes	10,795	12,862
Net income	$32,622	$15,976
Net income per common share:[1]		
Basic	$2.35	$1.29
Diluted	$2.33	$1.27

Weighted average shares:[1]		
Basic	13,864	12,392
Diluted	14,029	12,545
Comprehensive income:		
Net income	$32,622	$15,976
Other comprehensive (loss) income:		
Change in net unrealized gain or loss on available-for-sale securities	(1,707)	3,671
Reclassification adjustment for losses on available-for-sale securities in net income	79	185
Net unrealized loss on securities transferred from available-for-sale to held-to-maturity	(278)	(3,036)
Amortization of net unrealized losses on securities transferred from available-for-sale to held-to-maturity	516	426
Subtotal	(1,390)	1,246
Deferred tax (benefit) expense	(412)	439
Other comprehensive (loss) income, net of tax	(978)	807
Comprehensive income	$31,644	$16,783

[1] Share and per share data have been adjusted to reflect the two-for-one stock split effective November 27, 2018.

The accompanying notes are an integral part of these consolidated financial statements.

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BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years ended December 31, 2018 and 2017

(in thousands, except share data)	Common Stock Shares[1]	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Loss ("AOCL"), Net of Taxes	Total
Balance at December 31, 2016	12,254,628	$87,392	$146,464	$ (3,293)	$230,563
Net income	—	—	15,976	—	15,976
Other comprehensive income	—	—	—	807	807
Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings	18,532	28	—	—	28
Stock issued under employee stock purchase plan	1,024	32	—	—	32
Stock issued under employee stock ownership plan (" ESOP")	59,094	1,850	—	—	1,850
Restricted stock granted	32,460	—	—	—	—
Stock-based compensation - stock options	—	529	—	—	529
Stock-based compensation - restricted stock	—	742	—	—	742
Cash dividends paid on common stock ($.56 per share[1])	—	—	(6,896)	—	(6,896)
Stock purchased by directors under director stock plan	1,062	35	—	—	35
Stock issued in payment of director fees	5,756	188	—	—	188
Stock and stock options issued to Bank of Napa shareholders (net of payment for fractional shares of $14 thousand)	1,470,528	53,171	—	—	53,171
Balance at December 31, 2017	13,843,084	$143,967	$155,544	$ (2,486)	$297,025
Net income	—	—	32,622	—	32,622
Other comprehensive loss	—	—	—	(978)	(978)
Reclassification of stranded tax effects in AOCI	—	—	638	(638)	—
Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings	111,714	538	—	—	538
Stock issued under employee stock purchase plan	1,036	39	—	—	39
Stock issued under ESOP	29,600	1,173	—	—	1,173
Restricted stock granted	37,040	—	—	—	—
Restricted stock surrendered for tax withholdings upon vesting	(1,316)	(45)	—	—	(45)
Restricted stock forfeited / cancelled	(12,056)	—	—	—	—
Stock-based compensation - stock options	—	651	—	—	651
Stock-based compensation - restricted stock	—	1,013	—	—	1,013
Cash dividends paid on common stock ($.64 per share[1])	—	—	(8,860)	—	(8,860)
Stock purchased by directors under director stock plan	998	37	—	—	37
Stock issued in payment of director fees	5,470	204	—	—	204
Stock repurchased, net of commissions	(171,217)	(7,012)	—	—	(7,012)
Balance at December 31, 2018	13,844,353	$140,565	$179,944	$ (4,102)	$316,407

[1] Share and per share data have been adjusted to reflect the two-for-one stock split effective November 27, 2018.

The accompanying notes are an integral part of these consolidated financial statements.

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2018 and 2017

(in thousands)	2018	2017
Cash Flows from Operating Activities:		
Net income	$32,622	$15,976
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	—	500
Provision for losses on off-balance sheet commitments	—	57
Write-down of deferred tax assets, net	—	3,017
Noncash contribution expense to employee stock ownership plan	1,173	1,152
Noncash director compensation expense-common stock	227	197
Stock-based compensation expense	1,664	1,271
Amortization of core deposit intangible	921	529
Amortization of investment security premiums, net of accretion of discounts	2,695	2,912
Accretion of discount on acquired loans	(807)	(902)
Accretion of discount on subordinated debentures	1,025	153
Net amortization of deferred loan origination costs/fees	183	65
Gain on sale of other real estate owned	—	(6)
(Gain) loss on sale of investment securities	(876)	185
Depreciation and amortization	2,143	1,941
Earnings on bank owned life insurance policies	(913)	(845)
Net change in operating assets and liabilities:		
Deferred rent and other rent-related expenses	(382)	(12)
Interest receivable and other assets	1,148	(278)
Interest payable and other liabilities	1,284	1,035
Net cash provided by operating activities	42,107	26,947
Cash Flows from Investing Activities:		
Purchase of held-to-maturity securities	(1,988)	(4,497)
Purchase of available-for-sale securities	(235,873)	(118,666)
Proceeds from sale of available-for-sale securities	16,972	55,408
Proceeds from paydowns/maturities of held-to-maturity securities	22,891	26,333
Proceeds from paydowns/maturities of available-for-sale securities	57,662	48,559
Proceeds from sale of Visa Inc. Class B restricted common stock	956	—
Loans originated and principal collected, net	(84,598)	(57,181)
Purchase of premises and equipment	(907)	(1,434)
Proceeds from sale of other real estate owned	—	414
Cash acquired from the Bank of Napa acquisition	—	59,779
Cash paid for low income housing investment	(418)	(902)
Net cash (used in) provided by investing activities	(225,303)	7,813
Cash Flows from Financing Activities:		
Net increase in deposits	26,170	126,084
Proceeds from stock options exercised	591	88
Payment of tax withholding for stock options exercised and vesting of restricted stock	(99)	(60)
Federal Home Loan Bank borrowings	7,000	—
Repayment of subordinated debenture including execution costs	(4,137)	—
Cash dividends paid on common stock	(8,860)	(6,896)
Stock repurchased, net of commissions	(6,869)	—
Proceeds from stock issued under employee and director stock purchase plans and ESOP	76	765
Net cash provided by financing activities	13,872	119,981

Net (decrease) increase in cash and cash equivalents	(169,324)	154,741
Cash and cash equivalents at beginning of period	203,545	48,804
Cash and cash equivalents at end of period	$34,221	$203,545
Supplemental disclosure of cash flow items, non-cash investing and financing activities:		
Cash paid in interest	$2,599	$1,535
Cash paid in income taxes	$8,380	$9,761
Change in unrealized gain on available-for-sale securities	$(1,707)	$3,671
Amortization of net unrealized losses on securities transferred from available-for-sale to held-to-maturity	$516	$426
Stock issued to ESOP	$1,173	$1,152
Stock issued in payment of director fees	$204	$188
Subscription in low income housing tax credit investment	$3,000	$—
Repurchase of stock not yet settled	$143	$—
Securities transferred from available-for-sale to held-to-maturity	$27,422	$128,965
Acquisition: Merger consideration - stock and stock options issued to the Bank of Napa shareholders	$—	$53,185
Fair value of assets acquired, excluding cash acquired	$—	$245,342
Fair value of liabilities assumed	$—	$251,938

The accompanying notes are an integral part of these consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Summary of Significant Accounting Policies

Basis of Presentation: The consolidated financial statements include the accounts of Bank of Marin Bancorp (“Bancorp”), a bank holding company, and its wholly-owned bank subsidiary, Bank of Marin (the “Bank”), a California state-chartered commercial bank. References to “we,” “our,” “us” mean Bancorp and the Bank that are consolidated for financial reporting purposes. All material intercompany transactions have been eliminated. We evaluated subsequent events through the date of filing with the Securities and Exchange Commission (“SEC”) and determined that there were no subsequent events that require additional recognition or disclosure.

The NorCal Community Bancorp Trusts I and II, respectively (the "Trusts"), were formed for the sole purpose of issuing trust preferred securities. Bancorp is not considered the primary beneficiary of the Trusts (variable interest entities), therefore the Trusts are not consolidated in our consolidated financial statements, but rather the subordinated debentures are shown as a liability on our consolidated statements of condition. Bancorp's investment in the securities of the Trusts is accounted for under the equity method and is included in interest receivable and other assets on the consolidated statements of condition. Refer to Note 7, Borrowings, for detail on the early redemption on October 7, 2018 of one subordinated debenture due to NorCal Community Bancorp Trust I.

Nature of Operations: Bancorp, headquartered in Novato, CA, conducts business primarily through its wholly-owned subsidiary, the Bank, which provides a wide range of financial services to customers who are predominantly professionals, small and middle-market businesses, and individuals who work and/or reside in Marin, Sonoma, Napa, San Francisco and Alameda counties. Besides its headquarters located in Novato, CA, the Bank operates ten branches in Marin County, three in Napa County, one in San Francisco, six in Sonoma County and three in Alameda County. Our accounting and reporting policies conform to generally accepted accounting principles, general practice, and regulatory guidance within the banking industry. A summary of our significant policies follows.

Cash and Cash Equivalents include cash, due from banks, federal funds sold and other short-term investments with maturities of less than three months at the time of purchase.

Investment Securities are classified as "held-to-maturity," "trading securities" or "available-for-sale." Investments classified as held-to-maturity are those that we have the ability and intent to hold until maturity and are reported at cost, adjusted for the amortization or accretion of premiums or discounts. Investments held for resale in anticipation of short-term market movements are classified as trading securities and are reported at fair value, with unrealized gains and losses included in earnings. Investments that are neither held-to-maturity nor trading are classified as available-for-sale and are reported at fair value. Unrealized gains and losses for available-for-sale securities, net of related taxes, are reported as a separate component of comprehensive income and included in stockholders' equity until realized. For discussion of our methodology in determining fair value, see Note 9, Fair Value of Assets and Liabilities.

Securities transferred from the available-for-sale category to the held-to-maturity category are recorded at fair value at the date of transfer. Unrealized holding gains or losses associated with the transfer of securities from available-for-sale to held-to-maturity are included in the balance of accumulated other comprehensive income (loss), net of tax, in the consolidated balance sheets. These unrealized holding gains or losses are amortized over the remaining life of the securities as yield adjustments in a manner consistent with the amortization or accretion of the original purchase premium or discount on the associated security.

At each financial statement date, we assess whether declines in the fair values of held-to-maturity and available-for-sale securities below their costs are deemed to be other-than-temporary. We consider, among other

things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) our intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value. Evidence evaluated includes, but is not limited to, the remaining payment terms of the instrument and economic factors that are relevant to the collectability of the instrument, such as: current prepayment speeds, the current financial condition of the issuer(s), industry analyst reports, credit ratings, credit default rates, interest rate trends, the quality of any credit enhancement and the value of any underlying collateral.

For each security in an unrealized loss position ("impaired security"), we assess whether we intend to sell the security or if it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If we intend to sell the security or it is more likely than not we will be required to sell the security before recovery of its amortized cost basis, the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date is recognized against earnings.

For impaired securities that are not intended for sale and will not be required to be sold prior to recovery of our amortized cost basis, we determine if the impairment has a credit loss component. For both held-to-maturity and available-for-sale securities, if the amount of cash flows expected to be collected are less than the amortized cost, then other-than-temporary impairment shall be considered to have occurred and the credit loss component is recognized against earnings as the difference between present value of the expected future cash flows and the amortized cost. In determining the present value of the expected cash flows, we discount the expected cash flows at the effective interest rate implicit in the security at the date of purchase. The remaining difference between the fair value and the amortized basis is deemed to be due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

For held-to-maturity securities, if there is no credit loss component, no impairment is recognized. The portion of other-than-temporary impairment recognized in other comprehensive income for credit impaired debt securities classified as held-to-maturity is accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. For certain callable debt securities purchased at a premium, we amortize the premium to the earliest call date.

Dividend and interest income are recognized when earned. Realized gains and losses on the sale of securities and credit losses related to other-than-temporary impairment on available-for-sale and held-to-maturity securities are included in non-interest income as gains (losses) on investment securities, net. The specific identification method is used to calculate realized gains and losses on sales of securities.

Originated Loans are reported at the principal amount outstanding net of deferred fees (costs), charge-offs and the allowance for loan losses ("ALLL"). Interest income is accrued daily using the simple interest method. Loan origination fees and commitment fees, offset by certain direct loan origination costs, are deferred and amortized as yield adjustments over the contractual lives of the related loans. Loans are placed on non-accrual status when Management believes that there is substantial doubt as to the collection of principal or interest, generally when they become contractually past due by ninety days or more with respect to principal or interest, except for loans that are well-secured and in the process of collection. When loans are placed on non-accrual status, any accrued but uncollected interest is reversed from current-period interest income. We may return non-accrual loans to accrual status when one of the following occurs:

- The borrower has resumed paying the full amount of the principal and interest and we are satisfied with the borrower's financial position. In order to meet this test, we must have received repayment of all past due principal and interest, unless the amounts contractually due are reasonably assured of repayment within a reasonable period of time, and there has been a sustained period of repayment performance (generally, six consecutive monthly payments), according to the original contractual terms or modified terms for loans whose contractual terms have been restructured in a manner which grants a concession to a borrower experiencing financial difficulties ("troubled debt restructuring").
- The loan has become well secured and is in the process of collection.

Loan Charge-Off Policy: For all loan types excluding overdraft accounts, we generally make a charge-off determination at or before 90 days past due. A collateral-dependent loan is partially charged down to the fair value of collateral securing it if: (1) it is deemed uncollectable, or (2) it has been classified as a loss by either our internal loan review process or external examiners. A non-collateral-dependent loan is partially charged down to its net realizable value under the same circumstances. Overdraft accounts are generally charged off when they exceed 60 days past due.

Acquired Loans: Acquired loans are recorded at their estimated fair values at the acquisition date in accordance with Accounting Standards Code ("ASC") 805, Business Combinations, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded for acquired loans as of the acquisition date.

We estimated the fair value of acquired loans at the acquisition date based on a discounted cash flow methodology that considered factors including the type of loan and related collateral, risk classification, fixed or variable interest rate, term of loan, whether or not the loan was amortizing, and current discount rates. Loans, except for purchased credit impaired ("PCI") loans, were grouped together according to similar risk characteristics and treated in the aggregate when applying various valuation techniques. Expected cash flows incorporated our best estimate of key assumptions at the time, such as property values, default rates, loss severity and prepayment speeds. Discount rates were based on market rates for new originations of comparable loans, where available, and included adjustments for liquidity factors. To the extent comparable market rates were not readily available, a discount rate was derived based on the assumptions of market participants' cost of funds, servicing costs and return requirements for comparable risk assets. In either case, the discount rate did not include a factor for credit losses, as that had been considered in estimating the cash flows. The process of calculating fair values of acquired loans, including estimates of losses expected to be incurred over the estimated remaining lives of the loans at acquisition date and ongoing updates to Management's expectation of future cash flows, requires significant subjective judgments and assumptions. The economic environment and lack of market liquidity and transparency are factors that have influenced, and may continue to affect, these assumptions and estimates.

We acquired loans with evidence of significant credit quality deterioration subsequent to their origination and for which it was probable, at acquisition, that we would be unable to collect all contractually required payments. Management applied significant subjective judgment in determining which loans were PCI loans. Evidence of credit quality deterioration as of the purchase date may include data such as past due and non-accrual status, risk grades and charge-off history.

The difference between the undiscounted expected cash flows expected to be collected and the fair value at the acquisition date ("accretable difference") is accreted into interest income at a level yield of return over the estimated remaining life of the PCI loan, provided that the timing and amount of future cash flows is reasonably estimable. The accretable yield is affected by:

- Changes in interest rate indices for variable rate loans – Expected future cash flows are based on the variable rates in effect at the time of the regular evaluations of cash flows expected to be collected;

- Changes in prepayment assumptions – Prepayments affect the estimated life of the loans which may change the amount of interest income, and possibly principal, expected to be collected; and

- Changes in the expected principal and interest payments over the estimated life – Updates to expected cash flows are driven by the credit outlook and actions taken with borrowers. Changes in expected future cash flows from loan modifications are included in the regular evaluations of cash flows expected to be collected.

The cash flows expected to be collected are updated each quarter based on current assumptions regarding default rates, loss severities, and other factors that are reflective of current financial conditions of the borrowers and the market conditions. Probable decreases in expected cash flows after acquisition result in impairment recorded as a specific allowance for loan losses or a charge-off to the allowance. Impairment is calculated as the present value of the expected future cash flows on the PCI loan, discounted at the loan's effective interest rate implicit in the loan.

The nonaccretable difference on the date of acquisition is defined as the difference between the contractually required payments and the cash flows expected to be collected, considering the result of prepayments, and is not recorded.

For purposes of accounting for the PCI loans from past business combinations, we elected not to apply the pooling method but to account for these loans individually. Disposals of loans, which may include sales of loans to third parties, receipt of payments in full by the borrower, or foreclosure of the collateral, result in removal of the loan from the PCI loan portfolio at its carrying amount. If a PCI loan pays off earlier than expected, a gain is recorded as interest income when the payoff amount exceeds the recorded investment.

For acquired loans not considered credit impaired ("non-PCI"), we recognize the entire fair value discount accretion as interest income, based on contractual cash flows using an effective interest rate method for term loans, and on a straight line basis for revolving lines. When a non-PCI loan is placed on non-accrual status subsequent to acquisition, accretion stops until the loan is returned to accrual status. The level of accretion on non-PCI loans varies from period to period due to maturities and early payoffs of these loans during the reporting periods. Subsequent to acquisition, if the probable and estimable losses for non-PCI loans exceed the amount of the remaining unaccreted discount, the excess is established as an allowance for loan losses. For further information regarding our acquired loans, see Note 3, Loans and Allowance for Loan Losses.

Allowance for Loan Losses is based upon estimates of loan losses and is maintained at a level considered adequate to provide for probable losses inherent in the loan portfolio. The allowance is increased by provisions for loan losses charged against earnings and reduced by charge-offs, net of recoveries.

In periodic evaluations of the adequacy of the allowance balance, Management considers current economic conditions, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, our past loan loss experience and other factors. The ALLL is based on estimates, and ultimate losses may vary from current estimates. Our Board of Directors' Asset/Liability Management Committee (“ALCO”) reviews the adequacy of the ALLL at least quarterly.

The overall allowance consists of 1) specific allowances for individually identified impaired loans ("ASC 310-10") and 2) general allowances for pools of loans ("ASC 450-20"), which incorporate quantitative (e.g., historical loan loss rates) and qualitative risk factors (e.g., portfolio growth and trends, credit concentrations, economic and regulatory factors, etc.).

The first component, specific allowances, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. Through Management's ongoing loan grading and credit monitoring process, individual loans are identified that have conditions indicating the borrower may be unable to pay all amounts due in accordance with the contractual terms. These loans are evaluated for impairment individually by Management. Management considers an originated loan to be impaired when it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement. When the fair value of the impaired loan is less than the recorded investment in the loan, the difference is recorded as an impairment through the establishment of a specific allowance. For loans determined to be impaired, the extent of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate at origination (for originated loans), based on the loan's observable market price, or based on the fair value of the collateral if the loan is collateral dependent or if foreclosure is imminent. Generally, with problem credits that are collateral dependent, we obtain appraisals of the collateral at least annually. We may obtain appraisals more frequently if we believe the collateral value is subject to market volatility, if a specific event has occurred to the collateral, or if we believe foreclosure is imminent.

The second component is an estimate of the probable inherent losses in each loan pool with similar characteristics. This analysis encompasses the entire loan portfolio, excluding individually identified impaired loans and acquired loans whose purchase discount has not been fully accreted. Under our allowance model, loans are evaluated on a pool basis by federal regulatory reporting codes ("CALL codes" or "segments"), which are further delineated by assigned credit risk ratings, as described in Note 3, Loans and Allowance for Loan Losses. Segments include the following:

- Loans secured by real estate:
  - 1-4 family residential construction loans
  - Other construction loans and all land development and other land loans
  - Secured by farmland (including residential and other improvements)

- Revolving, open-end loans secured by 1-4 family residential properties and extended under lines of credit
- Closed-end loans secured by 1-4 family residential properties, secured by first liens
- Closed-end loans secured by 1-4 family residential properties, secured by junior liens
- Secured by multifamily (5 or more) residential properties
- Loans secured by owner-occupied non-farm nonresidential properties
- Loans secured by other non-farm nonresidential properties

- Loans to finance agricultural production and other loans to farmers
- Commercial and industrial loans

- Loans to individuals for household, family and other personal expenditures (i.e., consumer loans)
- Other loans

The model determines general allowances by loan segment based on quantitative (loss history) and qualitative risk factors. The quantitative risk factor for each segment utilizes the greater result of either the historical loss method or migration analysis loss method based on loss history beginning March 2010. Qualitative internal and external risk factors include, but are not limited to, the following:

- Changes in the nature and volume of the loan portfolio
- Changes in the volume and severity of past due loans, the volume of non-accruals loans, and the volume and severity of adversely classified or graded loans
- The existence and effect of individual loan and loan segment concentrations
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere
- Changes in the experience, ability, and depth of lending management and other relevant staff
- Changes in the quality of our systematic loan review processes
- Changes in economic and business conditions, and developments that affect the collectability of the portfolio
- Changes in the value of underlying collateral, where applicable
- The effect of other external factors such as legal and regulatory requirements on the level of estimated credit losses in the portfolio
- The effect of acquisitions of other loan portfolios on our infrastructure, including risk associated with entering new geographic areas as a result of such acquisitions
- The presence of specialized lending segments in the portfolio

Under the historical loss method, quarterly loss rates are calculated for each segment by dividing annualized net charge-offs during each quarter by the quarter's average segment balances. The quarterly loss rates are averaged over the entire loss history period. Under the migration analysis method, loss rates are calculated at the risk grade and segment levels by dividing the net charge-off amount by the total segment balance at the beginning of each migration period where the charged-off loan in question was present. Migration loss rates are averaged for each risk grade and segment for the entire loss history period. For each segment, the loss rates that result in the larger of the migration loss reserves or segment historical loss reserves are applied to the current loan balances. Qualitative factors are combined with these quantitative factors at the segment level to arrive at the overall general allowances.

We establish specific allowances to account for credit deterioration for probable decreases in cash flows for PCI loans subsequent to acquisition. The estimated cash flows expected to be collected on PCI loans are updated quarterly and require the use of key assumptions and estimates based on factors such as the current economic environment, changes in collateral values, loan workout plans, changes in the probability of default, loss severities, and prepayments. Probable decreases in expected cash flows after acquisition result in impairment recorded as a specific allowance for loan losses or a charge-off to the allowance. Impairment is calculated as the present value of the expected future cash flows on the PCI loan, discounted at the loan's effective interest rate implicit in the loan.

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in local and national economic conditions, or significant changes in other assumptions, could result in a material increase in the allowance for loan losses and may adversely affect our financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

For further information regarding the allowance for loan losses, see Note 3, Loans and Allowance for Loan Losses.

Allowance for Losses on Off-Balance Sheet Commitments: We make commitments to extend credit to meet the financing needs of our customers in the form of loans or standby letters of credit. We are exposed to credit loss in the event that a decline in credit quality of the borrower leads to nonperformance. We record an allowance for losses on these off-balance sheet commitments based on estimates of probability that these commitments will be drawn upon according to the historical utilization experience of different types of commitments and expected loss severity. This allowance is included in interest payable and other liabilities on the consolidated statements of condition.

Transfers of Financial Assets: We have entered into certain loan participation agreements with other organizations. We account for these transfers of financial assets as sales when control over the transferred financial assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets and liabilities have been isolated from us, (2) the transferee has the right to pledge or exchange the assets (or beneficial interests) it received, free of conditions that constrain it from taking advantage of that right, beyond a trivial benefit and (3) we do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets. No gain or loss has been recognized by us on the sale of these participation interests in 2018 and 2017.

Premises and Equipment: Premises and equipment consist of leasehold improvements, furniture, fixtures, software and equipment and are stated at cost, less accumulated depreciation and amortization, which are calculated on a straight-line basis. Furniture and fixtures are depreciated over eight years and equipment is generally depreciated over three to twenty years. Leasehold improvements are amortized over the lesser of their estimated useful lives or the terms of the leases. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred.

Business Combinations: Business combinations are accounted for under the acquisition method of accounting in accordance with ASC 805, Business Combinations. Under the acquisition method, the acquiring entity in a business combination recognizes the acquired assets and assumed liabilities at their estimated fair values as of the date of acquisition. Any excess of the purchase price over the fair value of net assets and other identifiable intangible assets acquired is recorded as goodwill. To the extent the fair value of net assets acquired, including other identifiable assets, exceed the purchase price, a bargain purchase gain is recognized. Assets acquired and liabilities assumed from contingencies must be recognized at fair value, if the fair value can be determined during the measurement period. Results of operations of an acquired business are included in the consolidated statements of operations from the date of acquisition. Acquisition-related costs, including conversion and restructuring charges, are expensed as incurred.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. The amendments are intended to help companies evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses and provide a more robust framework to use in determining when a set of assets and activities is a business. The amendments should be applied prospectively and are effective for annual periods after December 31, 2017, including interim periods within those periods. We adopted the amendments effective January 1, 2018, which did not impact our financial condition, results of operations, or related financial statement disclosures for the periods presented.

Goodwill and Other Intangible Assets: Goodwill is determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill that arises from a business combination is periodically evaluated for impairment at the reporting unit level, at least annually. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Core deposit intangible ("CDI") represents the estimated future benefit of deposits related to an acquisition and is booked separately from the related deposits and evaluated periodically for impairment. The CDI asset is amortized on an accelerated method over its estimated useful life of ten years. At December 31, 2018, the future estimated amortization expense for the CDI arising from our past acquisitions is as follows:

(in thousands)	2019	2020	2021	2022	2023	Thereafter	Total
Core deposit intangible amortization	$887	$853	$818	$782	$719	$ 1,512	$5,571

We make a qualitative assessment of whether it is more likely than not that the fair value of a reporting unit where goodwill is assigned is less than its carrying amount. If we conclude that it is more likely than not that the fair value is more than its carrying amount, no impairment is recorded. Goodwill is tested for impairment on an interim basis if circumstances change or an event occurs between annual tests that would more likely than not reduce the fair value of the reporting unit below its carrying amount. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting units' fair value as well as positive and mitigating events. Such indicators may include, among others, significant changes in legal factors or in the general business climate, significant changes in our stock price and market capitalization, unanticipated competition, and an action or assessment by a

regulator. If the fair value of a reporting unit is less than its carrying amount, an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value is recognized. The loss recognized should not exceed the total amount of goodwill allocated to that reporting unit.

Other Real Estate Owned ("OREO"): OREO is comprised of property acquired through foreclosure, in substance repossession or acceptance of deeds-in-lieu of foreclosure when the related loan receivable is de-recognized. OREO is recorded at fair value of the collateral less estimated costs to sell, establishing a new cost basis, and subsequently accounted for at the lower of cost or fair value less estimated costs to sell. Any shortfall of collateral value from the recorded investment of the related loan is recognized as loss at the time of foreclosure and is charged against the allowance for loan losses. Fair value of collateral is generally based on an independent appraisal of the property. Revenues and expenses associated with OREO, and subsequent adjustments to the fair value of the property and to the estimated costs of disposal, are realized and reported as a component of non-interest income and expense when incurred.

Bank Owned Life Insurance ("BOLI"): The Bank owns life insurance policies on certain key current and former officers. BOLI is recorded in interest receivable and other assets on the consolidated statements of condition at the amount that can be realized under the insurance contract at period-end, which is the cash surrender value adjusted for other charges or amounts due that are probable at settlement.

Federal Home Loan Bank of San Francisco ("FHLB") Stock: The Bank is a member of the FHLB. Members are required to own a certain amount of stock based on the level of borrowings and other factors. As of December 31, 2018, our investment in FHLB stock was carried at cost, as there was no impairment or changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. As of December 31, 2017, our investment in FHLB stock was carried at cost. We periodically evaluate FHLB stock for impairment based on ultimate recovery of par value. FHLB stock is included as part of interest receivable and other assets on the consolidated statements of condition. Both cash and stock dividends are reported as non-interest income.

Investments in Low Income Housing Tax Credit Funds: We have invested in limited partnerships that were formed to develop and operate affordable housing projects for low or moderate-income tenants throughout California. Our ownership percentage in each limited partnership ranges from 1.0% to 3.5%. We account for the investments in qualified affordable housing tax credit funds using the proportional amortization method, where the initial cost of the investment is amortized in proportion to the tax credits and other tax benefits received and the net investment performance is recognized as part of income tax expense (benefit). Each of the partnerships must meet the regulatory minimum requirements for affordable housing for a minimum 15-year compliance period to fully utilize the tax credits. If the partnerships cease to qualify during the compliance period, the credit may be denied for any period in which the project is not in compliance and a portion of the credit previously taken is subject to recapture with interest. We record an impairment charge if the value of the future tax benefits is less than the carrying value of the investments.

Employee Stock Ownership Plan (“ESOP”): We recognize compensation cost for ESOP contributions when funds become committed for the purchase of Bancorp's common shares into the ESOP in the year in which the employees render service entitling them to the contribution. If we contribute stock, the compensation cost is the fair value of the shares when they are committed to be released (i.e., when the number of shares becomes known and formally approved). In 2018 and 2017, the Bank only made stock contributions to the ESOP.

Income Taxes: Income taxes reported in the consolidated financial statements are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year and we record deferred tax assets and liabilities for future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax bases using enacted tax rates in

effect for the year in which the temporary differences are expected to reverse. We record net deferred tax assets to the extent it is more likely than not that they will be realized. In evaluating our ability to recover the deferred tax assets and the need to establish a valuation allowance against the deferred tax assets, Management considers all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies. In projecting future taxable income, Management develops assumptions including the amount of future state and federal pretax operating income, the reversal of temporary differences, and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates being used to manage the underlying business. Bancorp files consolidated federal and combined state income tax returns.

We recognize the financial statement effect of a tax position when it is more likely than not, based on the technical merits and all available evidence, that the position will be sustained upon examination, including the resolution through protests, appeals or litigation processes. For tax positions that meet the more likely than not threshold, we measure and record the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with the taxing authority. The remainder of the benefits associated with tax positions taken is recorded as unrecognized tax benefits, along with any related interest and penalties. Interest and penalties related to unrecognized tax benefits are recorded in tax expense.

In deciding whether or not our tax positions taken meet the more likely than not recognition threshold, we must make judgments and interpretations about the application of inherently complex state and federal tax laws. To the extent tax authorities disagree with tax positions taken by us, our effective tax rates could be materially affected in the period of settlement with the taxing authorities. Revision of our estimate of accrued income taxes also may result from our own income tax planning, which may affect effective tax rates and results of operations for any reporting period.

We present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward, or similar tax loss or tax credit carryforward, rather than as a liability, when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) we intend to and are able to use the deferred tax asset for that purpose. Otherwise, the unrecognized tax benefit is presented as a liability instead of being netted with deferred tax assets.

Earnings per share (“EPS”) are based upon the weighted average number of common shares outstanding during each year. The following table shows: 1) weighted average basic shares, 2) potentially dilutive weighted average common shares related to stock options and unvested restricted stock awards, and 3) weighted average diluted shares. Basic EPS are calculated by dividing net income by the weighted average number of common shares outstanding during each annual period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average number of potentially dilutive common shares. The number of potentially dilutive common shares included in year-to-date diluted EPS is a year-to-date weighted average of potentially dilutive common shares included in each quarterly diluted EPS computation. In computing diluted EPS, we exclude anti-dilutive shares such as options whose exercise prices exceed the current common stock price, as they would not reduce EPS under the treasury method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of unvested restricted stock awards receive non-forfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings. Under the two-class method, the difference in EPS is nominal for these participating securities.

(in thousands, except per share data)[1]	2018	2017
Weighted average basic shares outstanding	13,864	12,392
Potentially dilutive common shares related to:		
Stock options	136	123
Unvested restricted stock awards	29	30
Weighted average diluted shares outstanding	14,029	12,545
Net income	$32,622	$15,976
Basic EPS	$2.35	$1.29
Diluted EPS	$2.33	$1.27
Weighted average anti-dilutive shares not included in the calculation of diluted EPS	44	42

[1] Share and per share data have been adjusted to reflect the two-for-one stock split effective November 27, 2018.

Share-Based Compensation: All share-based payments, including stock options and restricted stock, are recognized as stock-based compensation expense in the consolidated statements of comprehensive income based on the grant-date fair value of the award with a corresponding increase in common stock. The grant-date fair value of the award is

amortized on a straight-line basis over the requisite service period, which is generally the vesting period. The stock-based compensation expense excludes stock grants to directors as compensation for their services, which are recognized as director expenses separately based on the grant-date value of the stock. We account for forfeitures as they occur. See Note 8, Stockholders' Equity and Stock Option Plans for further discussion.

We determine the fair value of stock options at the grant date using a Black-Scholes pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying

stock, the expected dividend yield and the risk-free interest rate over the expected life of the option. The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatility is based on the historical volatility of the common stock over the most recent period that is generally commensurate with the expected life of the options. The Black-Scholes option valuation model requires the input of highly subjective assumptions, including the expected life of the stock-based award and stock price volatility. The assumptions used represent Management's best estimates based on historical information, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, the recorded stock-based compensation expense could have been materially different from that recorded in the consolidated financial statements. The fair value of restricted stock is based on the stock price on the grant date.

We record excess tax benefits resulting from the exercise of non-qualified stock options, the disqualifying disposition of incentive stock options and vesting of restricted stock awards as tax benefits in the consolidated statements of comprehensive income with a corresponding decrease to current taxes payable. In addition, we reflect excess tax benefits as an operating activity in the consolidated statements of cash flows.

Cash paid for tax withholdings when shares are surrendered in a cashless stock option exchange is classified as a financing activity in the consolidated statements of cash flows.

In May 2017, the FASB issued ASU No. 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. This ASU applies to entities that change the terms or conditions of a share-based payment award. The FASB adopted this ASU to provide clarity in what constitutes a modification and to reduce diversity in practice in applying Topic 718. In order for a change to a share-based arrangement to not require Topic 718 modification accounting treatment, all of the following must be met: no change in fair value, no change in vesting conditions and no change in the balance sheet classification of the modified award. The ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those periods. The amendments should be applied prospectively to an award modified on or after the adoption date. We adopted the requirements of this ASU effective January 1, 2018, which did not impact our financial condition, results of operation, or related financial statement disclosures.

Derivative Financial Instruments and Hedging Activities - Fair Value Hedges: All of our interest rate swap contracts are designated and qualified as fair value hedges. The terms of our interest rate swap contracts are closely aligned to the terms of the designated fixed-rate loans. The hedging relationships are tested for effectiveness on a quarterly basis. The interest rate swaps are carried on the consolidated statements of condition at their fair value in other assets (when the fair value is positive) or in other liabilities (when the fair value is negative). The changes in the fair value of the interest rate swaps are recorded in interest income. The unrealized gains or losses due to changes in fair value of the hedged fixed-rate loans are recorded as an adjustment to the hedged loans and offset in interest income. For derivative instruments executed with the same counterparty under a master netting arrangement, we do not offset fair value amounts of interest rate swaps in liability positions with the ones in asset positions.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This amendment changes both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. It is intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting and increase transparency as to the scope and results of hedging programs. The ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. We early adopted the amendments of this ASU in the second quarter of 2018, and elected to perform hedge effectiveness assessments using a qualitative approach instead of quantitative regression analysis going

forward. The adoption of this ASU had an immaterial impact to our financial results. The amendments also require additional disclosures, which are included in Note 14, Derivative Financial Instruments and Hedging Activities.

From time to time, we make firm commitments to enter into long-term fixed-rate loans with borrowers backed by yield maintenance agreements and simultaneously enter into forward interest rate swap agreements with correspondent banks to mitigate the change in fair value of the yield maintenance agreement. Prior to loan funding, yield maintenance agreements with net settlement features that meet the definition of a derivative are considered as non-designated hedges and are carried on the consolidated statements of condition at their fair value in other assets (when the fair

value is positive) or in other liabilities (when the fair value is negative). The offsetting changes in the fair value of the forward swap and the yield maintenance agreement are recorded in interest income. When the fixed-rate loans are originated, the forward swaps are designated to offset the change in fair value in the loans. Subsequent to the point of the swap designations, the fair value of the related yield maintenance agreements at the designation date was recorded in other assets and is amortized using the effective yield method over the life of the respective designated loans.

The net effect of the change in fair value of interest rate swaps, the amortization of the yield maintenance agreement and the change in the fair value of the hedged loans result in an insignificant amount of hedge ineffectiveness recognized in interest income. For further detail, see Note 14, Derivative Financial Instruments and Hedging Activities.

Revenue Recognition on Non-Financial Instruments: In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The core principle of this ASU (and all subsequent updates) is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. This ASU establishes a five-step model that must be used to recognize revenue that requires the entity to identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the entity satisfies the performance obligation. The ASU does not apply to the majority of our revenue, including revenue associated with financial instruments, such as loans and investment securities, and certain non-interest income, such as earnings on bank owned life insurance, dividends on Federal Home Loan Bank ("FHLB") stock, gains or losses on sales of investment securities, and deposit overdraft charges. The standard allowed the use of either the full retrospective or modified retrospective transition method. We elected to apply the modified retrospective transition method to incomplete contracts as of the initial date of application on January 1, 2018. The adoption of the new standards did not have a material impact on our financial condition or results of operations as revenue recognition under the new standards did not change significantly from our current practice of recognizing the in-scope non-interest income. In addition, we did not retroactively revise prior period amounts or record a cumulative adjustment to retained earnings upon adoption. We considered the nature, amount, timing, and uncertainty of revenue from contracts with customers and determined that significant revenue streams are sufficiently disaggregated in the consolidated statements of comprehensive income.

Descriptions of our significant revenue-generating transactions that are within the scope of the new revenue recognition standards, which are presented in the consolidated statements of comprehensive income as components of non-interest income, are as follows:

- Wealth Management & Trust ("WM&T") fees - WM&T services include, but are not limited to: customized investment advisory and management; administrative services such as bill pay and tax reporting; trust administration, estate settlement, custody and fiduciary services. Performance obligations for investment advisory and management services are generally satisfied over time. Revenue is recognized monthly according to a tiered fee schedule based on the client's month-end market value of assets under our management. WM&T does not earn revenue based on performance or incentives. Costs associated with WM&T revenue-generating activities, such as payments to sub-advisors, are recorded separately as part of professional service expenses when incurred.

- Deposit account service charges - Service charges on deposit accounts consist of monthly maintenance fees, business account analysis fees, business online banking fees, check order charges, and other deposit account-related fees. Performance obligations for monthly maintenance fees and account analysis fees are satisfied, and the related revenue recognized, when we complete our performance obligation each month. Performance obligations related to transaction-based services (such as check orders) are satisfied, and the related revenue recognized, at a point in time

when completed, except for business accounts subject to analysis where the transaction-based fees are part of the monthly account analysis fees.

- Debit card interchange fees - We issue debit cards to our consumer and small business customers that allow them to purchase goods and services from merchants in person, online, or via mobile devices using funds held in their demand deposit accounts held with us. Debit cards issued to our customers are part of global electronic payment networks (such as Visa) who pass a portion of the merchant interchange fees to debit card-issuing member banks like us when our customers make purchases through their networks. Performance

obligations for debit card services are satisfied and revenue is recognized daily as the payment networks process transactions. Because we act in an agent capacity, we determined that network costs previously recorded as a component of non-interest expense should be netted with interchange fees recorded in non-interest income. The amount of the reclassification was immaterial.

Advertising Costs are expensed as incurred. For the years ended December 31, 2018 and 2017, advertising costs totaled $666 thousand and $567 thousand, respectively.

Comprehensive Income includes net income, changes in the unrealized gains or losses on available-for-sale investment securities, and amortization of net unrealized gains or losses on securities transferred from available-for-sale to held-to-maturity, net of related taxes, reported on the consolidated statements of comprehensive income and as components of stockholders' equity.

Fair Value Measurements: We use fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. We base our fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Securities available-for-sale and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record certain assets and liabilities at fair value on a non-recurring basis, such as purchased loans and acquired deposits recorded at acquisition date, certain impaired loans, other real estate owned and securities held-to-maturity that are other-than-temporarily impaired. These non-recurring fair value adjustments typically involve write-downs of individual assets due to application of lower-of-cost or market accounting.

When we develop our fair value measurement process, we maximize the use of observable inputs. Whenever there is no readily available market data, we use our best estimates and assumptions in determining fair value, but these estimates involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded earnings or disclosures could have been materially different from those reflected in these consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this ASU make improvements to accounting standards related to financial instruments, including but not limited to the following:

- Requires equity investments, except for those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.
- Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When impairment exists, an entity is required to measure the investment at fair value.
- Eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value required under current standards for financial instruments measured at amortized cost on the consolidated balance sheet.
- Requires public companies to use the exit price notion when measuring and disclosing the fair value of financial instruments.
- Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.

The ASU required an entity to apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. We adopted the requirements of this ASU effective January 1, 2018, which did not have a material impact on our financial condition and results of operations. Our disclosures of the fair value of our loans held for investment, which are recorded at amortized cost, now incorporate the exit price notion reflecting factors such as a liquidity premium. Additionally, at the date of adoption, FHLB stock and Visa Inc. Class B common stock were carried at cost, as there was no impairment or changes resulting from observable price changes

in orderly transactions for the identical or a similar investment of the same issuer. For further information on our use of fair value measurements and our related valuation methodologies, see Note 9, Fair Value of Assets and Liabilities.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant accounting estimates reflected in the consolidated financial statements include ALLL, other-than-temporary impairment of investment securities, accrued liabilities, accounting for income taxes and fair value measurements (including fair values of acquired assets and assumed liabilities at acquisition dates) as discussed in the Notes herein.

Other Recently Adopted Accounting Standards

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This ASU provides guidance on how to present and classify eight specific cash flow topics in the statement of cash flows. The ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments should be applied using a retrospective transition method to each period presented, if practical. We adopted the requirements of this ASU effective January 1, 2018, which did not have a significant impact on our consolidated statements of cash flows.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This amendment helps organizations address certain stranded income tax effects in accumulated other comprehensive income (AOCI) resulting from the enactment of the Tax Cuts and Jobs Act of 2017. The ASU requires financial statement preparers to disclose a description of the accounting policy for releasing income tax effects from AOCI, whether or not they elect to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act of 2017, and information about the other income tax effects that are reclassified. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The amendments in this ASU should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate tax rate in the Tax Cuts and Jobs Act of 2017 is recognized. We early adopted this ASU in the first quarter of 2018 by reclassifying $638 thousand from AOCI to retained earnings. This amount represents the stranded income tax effects related to the unrealized loss on available-for-sale securities in AOCI on the date of the enactment of the Tax Cuts and Jobs Act of 2017.

Accounting Standards Not Yet Effective

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The amendments in this ASU intend to increase transparency and comparability among organizations by recognizing an asset, which represents the right to use the asset for the lease term, and a lease liability, which is a lessee's obligation to make lease payments measured on a discounted basis. This ASU generally applies to leasing arrangements exceeding a twelve-month term. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective method of adoption. In July 2018, the FASB issued two amendments to ASU 2016-02: ASU No. 2018-10, Codification Improvements to Topic 842, Leases, which provides various corrections and clarifications to ASU 2016-02; and ASU No. 2018-11, Leases (Topic 842): Targeted Improvements, which provides a new optional transition method and provides a lessor with practical expedients for separating lease and non-lease components of a lease. Entities will apply a modified retrospective approach at either the beginning of the earliest period presented or at the beginning of the period of adoption through a cumulative-effect adjustment to retained earnings. We adopted this ASU effective January 1, 2019 as required using the latter approach.

Upon adoption, we did not record a cumulative effect to retained earnings. We recorded a right-of-use asset of approximately $13.4 million and a lease liability of approximately $15.4 million. The difference between the asset and liability was attributed to the reclassification of deferred rent and unaccreted lease incentives, which were netted with the right-of-use asset at the adoption date. The right-of-use asset did not materially impact our financial condition as it would have represented only 0.5% of our consolidated assets and reduced our total risk-based capital ratio by only 10 basis points as of December 31, 2018.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The standard will replace today's "incurred loss" model with a "current expected credit loss" ("CECL") model. The CECL model will apply to estimated credit losses on loans receivable, held-to-maturity debt securities, unfunded loan commitments, and certain other financial assets measured at amortized cost. The CECL model is based on lifetime expected losses, rather than incurred losses, and requires the recognition of credit loss expense in the consolidated statement of income and a related allowance for credit losses on the consolidated statement of condition at the time of origination or purchase of a loan receivable or held-to-maturity debt security. Likewise, subsequent changes in this estimate are recorded through credit loss expense and related allowance. The CECL model requires the use of not only relevant historical experience and current conditions, but reasonable and supportable forecasts of future events and circumstances, incorporating a broad range of information in developing credit loss estimates, which could result in significant changes to both the timing and amount of credit loss expense and allowance. Under ASU 2016-13, available-for-sale debt securities are evaluated for impairment if fair value is less than amortized cost. Estimated credit losses are recorded through a credit loss expense and an allowance, rather than a write-down of the investment. Changes in fair value that are not credit-related will continue to be recorded in other comprehensive income. The ASU also expands the disclosure requirements regarding assumptions, models, and methods for estimating the allowance for loan losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Entities will apply a modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. While we believe the change from an incurred loss model to a CECL model has the potential to increase the allowance for loan losses at the adoption date, we cannot reasonably quantify the impact of the adoption of the amendments to our financial condition or results of operations at this time due to the complexity and extensive changes from these amendments. We have formed an internal CECL committee and are working with our third-party vendor to identify data gaps and determine the appropriate methodologies and resources to utilize in preparation for transition to the new accounting standards, including but not limited to the use of certain tools to forecast future economic conditions that affect the cash flows of our loans over their lifetime.

In June 2018, the FASB issued ASU No. 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. This update simplifies the accounting for share-based payment transactions for acquiring goods and services from nonemployees, applying some of the same requirements as employee share-based payment transactions. The ASU will not affect the accounting for share-based payment awards to nonemployee directors, which will continue to be treated as employee share-based transactions under the current standards. ASU 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The requirements of the ASU will be adopted through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption. We adopted the requirements of this ASU effective January 1, 2019, which did not have a material impact on our financial condition or results of operations, as it is not our practice to issue stock-based awards to pay for goods and services from nonemployees, other than nonemployee directors.

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement. The amendments in this ASU remove, modify, and add disclosure requirements for the fair value reporting of assets and liabilities. The modifications and additions relate to Level 3 fair value measurements at the end of the reporting period. ASU 2018-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Entities should disclose and describe the range and weighted-average of significant observable inputs used to develop Level 3 fair value measurements prospectively. Early adoption is permitted. Entities making this election are permitted to early adopt the eliminated or modified disclosure requirements and delay the adoption of all the new disclosure requirements until the

ASU's effective date. As the ASU’s requirements only relate to disclosures, the amendments will not impact our financial condition or results of operations.

In August 2018, the FASB issued ASU No. 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. This standard aligns the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software, regardless of whether they convey a license to the hosted software. The accounting for the service element of a hosting arrangement that is a service contract is not affected by this ASU. The amendments

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are effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. An entity has the option to apply amendments in the ASU either retrospectively or prospectively to all implementation costs incurred after the date of adoption. Early adoption is permitted, including adoption in an interim period. We do not expect that the ASU will have a material impact on our financial condition or results of operations.

In October 2018, the FASB issued ASU No. 2018-16, Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes. This update adds an alternative fifth permissible U.S. benchmark rate to be used for hedge accounting purposes. As we have already adopted the amendments in ASU 2017-12, which changed both the designation and measurement guidance for qualifying hedging relationships, the amendments in ASU 2018-16 are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The amendments should be adopted on a prospective basis for qualifying new or re-designated hedging relationships entered into on or after the date of adoption. Early adoption is permitted in any interim period upon issuance of this ASU if an entity already has adopted ASU 2017-12. We adopted this ASU effective January 1, 2019, and expect the amendment to affect the measurement of our hedging activities, but we do not expect it to have a material impact on our financial condition or results of operations.

Note 2: Investment Securities

Our investment securities portfolio consists of obligations of state and political subdivisions, corporate bonds, U.S. government agency securities, including residential and commercial mortgage-backed securities (“MBS”\"CMBS") and collateralized mortgage obligations (“CMOs”) issued or guaranteed by Federal National Mortgage Association ("FNMA"), Federal Home Loan Mortgage Corporation ("FHLMC"), or Government National Mortgage Association ("GNMA"), Small Business Administration ("SBA") backed securities, debentures issued by government-sponsored agencies such as FNMA, Federal Farm Credit Bureau, FHLB and FHLMC, as well as privately issued CMOs, as reflected in the table below:

	December 31, 2018				December 31, 2017			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
(in thousands)	Cost	Value	Gains	(Losses)	Cost	Value	Gains	(Losses)
Held-to-maturity:								
Securities of U.S. government agencies:								
MBS pass-through securities issued by FHLMC and FNMA	$88,606	$85,804	$7	$(2,809)	$100,376	$100,096	$234	$(514)
SBA-backed securities	8,720	8,757	37	—	—	—	—	—
CMOs issued by FNMA	11,447	11,327	—	(120)	—	—	—	—
CMOs issued by FHLMC	33,583	33,021	8	(570)	31,010	30,938	2	(74)
CMOs issued by GNMA	3,739	3,769	30	—	—	—	—	—
Obligations of state and political subdivisions	11,111	11,216	128	(23)	19,646	19,998	383	(31)
Total held-to-maturity	157,206	153,894	210	(3,522)	151,032	151,032	619	(619)
Available-for-sale:								
Securities of U.S. government agencies:								
MBS pass-through securities issued by FHLMC and FNMA	95,339	94,467	358	(1,230)	65,559	65,262	126	(423)
SBA-backed securities	50,722	50,781	465	(406)	25,979	25,982	58	(55)
CMOs issued by FNMA	28,275	28,079	134	(330)	35,340	35,125	33	(248)

CMOs issued by FHLMC	145,979	144,836	454	(1,597)	70,514	69,889	3	(628)
CMOs issued by GNMA	11,294	11,021	1	(274)	17,953	17,785	26	(194)
Debentures of government- sponsored agencies	52,956	53,018	185	(123)	12,940	12,938	3	(5)
Privately issued CMOs	295	297	2	—	1,432	1,431	1	(2)
Obligations of state and political subdivisions	79,046	77,960	134	(1,220)	98,027	97,491	298	(834)
Corporate bonds	2,004	2,005	15	(14)	6,541	6,564	26	(3)
Total available-for-sale	465,910	462,464	1,748	(5,194)	334,285	332,467	574	(2,392)
Total investment securities	$623,116	$616,358	$1,958	$(8,716)	$485,317	$483,499	$1,193	$(3,011)

The amortized cost and fair value of investment debt securities by contractual maturity at December 31, 2018 are shown below. Expected maturities may differ from contractual maturities if the issuers of the securities have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2018				December 31, 2017			
	Held-to-Maturity		Available-for-Sale		Held-to-Maturity		Available-for-Sale	
(in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$6,194	$6,182	$9,863	$9,795	$2,151	$2,172	$10,268	$10,272
After one but within five years	5,481	5,492	84,871	84,435	15,577	15,791	71,576	71,237
After five years through ten years	59,231	58,120	252,274	250,055	54,641	54,554	129,723	128,954
After ten years	86,300	84,100	118,902	118,179	78,663	78,515	122,718	122,004
Total	$157,206	$153,894	$465,910	$462,464	$151,032	$151,032	$334,285	$332,467

Sales of investment securities and gross gains and losses are shown in the following table.

(in thousands)	2018	2017
Available-for-sale:		
Sales proceeds	$16,972	$55,408
Gross realized gains	$27	$46
Gross realized losses	$(106)	$(231)

Pledged investment securities are shown in the following table:

(in thousands)	December 31, 2018	December 31, 2017
Pledged to the State of California:		
Secure public deposits in compliance with the Local Agency Security Program	$ 125,696	$ 107,829
Collateral for trust deposits	734	761
Total investment securities pledged to the State of California	$ 126,430	$ 108,590
Collateral for Wealth Management and Trust Services ("WMTS') checking account	$ 2,000	$ 2,026

As part of our ongoing review of our investment securities portfolio, we reassessed the classification of certain securities issued by government sponsored agencies. During 2018 and 2017, we transferred $27.4 million and $129 million, respectively, from available-for-sale to held-to-maturity at fair value. We intend and have the ability to hold these securities to maturity. The net unrealized pre-tax loss of $278 thousand and $3.0 million, at the respective transfer dates, remained in accumulated other comprehensive income and are amortized over the remaining lives of the securities. Amortization of the net unrealized pre-tax losses totaled $516 thousand in 2018 and $426 thousand in 2017.

There were 229 and 198 securities in unrealized loss positions at December 31, 2018 and 2017, respectively. Those securities are summarized and classified according to the duration of the loss period in the tables below:

December 31, 2018	< 12 continuous months		≥ 12 continuous months		Total securities in a loss position	
(in thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity:						
MBS pass-through securities issued by FHLMC and FNMA	$198	$ (9)	$83,990	$ (2,800)	$84,188	$ (2,809)
CMOs issued by FNMA	—	—	11,327	(120)	11,327	(120)
CMOs issued by FHLMC	2,880	(3)	28,171	(567)	31,051	(570)
Obligations of state and political subdivisions	—	—	3,565	(23)	3,565	(23)
Total held-to-maturity	3,078	(12)	127,053	(3,510)	130,131	(3,522)
Available-for-sale:						
MBS pass-through securities issued by FHLMC and FNMA	19,971	(128)	50,077	(1,102)	70,048	(1,230)
SBA-backed securities	13,175	(122)	20,123	(284)	33,298	(406)
CMOs issued by FNMA	2,345	(8)	16,138	(322)	18,483	(330)
CMOs issued by FHLMC	24,094	(330)	74,243	(1,267)	98,337	(1,597)
CMOs issued by GNMA	1,666	(7)	9,112	(267)	10,778	(274)
Debentures of government-sponsored agencies	4,992	(8)	11,349	(115)	16,341	(123)
Obligations of state and political subdivisions	15,290	(54)	52,804	(1,166)	68,094	(1,220)
Corporate bonds	—	—	1,004	(14)	1,004	(14)
Privately issued CMO's					—	—
Total available-for-sale	81,533	(657)	234,850	(4,537)	316,383	(5,194)
Total temporarily impaired securities	$84,611	$ (669)	$361,903	$ (8,047)	$446,514	$ (8,716)

December 31, 2017	< 12 continuous months		> 12 continuous months		Total securities in a loss position	
(in thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity:						
MBS pass-through securities issued by FHLMC and FNMA	$16,337	$ (143)	$46,845	$ (371)	$63,182	$ (514)
CMOs issued by FHLMC	11,066	(31)	13,824	(43)	24,890	(74)
Obligations of state and political subdivisions	3,648	(31)	—	—	3,648	(31)
Total held-to-maturity	31,051	(205)	60,669	(414)	91,720	(619)
Available-for-sale:						
MBS pass-through securities issued by FHLMC and FNMA	32,189	(121)	15,325	(302)	47,514	(423)
SBA-backed securities	11,028	(53)	165	(2)	11,193	(55)
CMOs issued by FNMA	26,401	(171)	5,440	(77)	31,841	(248)
CMOs issued by FHLMC	69,276	(628)	—	—	69,276	(628)
CMOs issued by GNMA	14,230	(194)	—	—	14,230	(194)
Debentures of government- sponsored agencies	2,984	(5)	—	—	2,984	(5)
Obligations of state and political subdivisions	52,197	(288)	19,548	(546)	71,745	(834)
Corporate bonds	3,060	(3)			3,060	(3)
Privately issued CMO's	1,310	(2)	—	—	1,310	(2)
Total available-for-sale	212,675	(1,465)	40,478	(927)	253,153	(2,392)

Total temporarily impaired securities	$243,726	$(1,670)	$101,147	$(1,341)	$344,873	$(3,011)

As of December 31, 2018, 188 investment securities in our portfolio had been in a continuous loss position for twelve months or more and 41 investment securities had been in a loss position for less than twelve months.

Securities issued by government-sponsored agencies, such as FNMA and FHLMC, usually have implicit credit support by the U.S. federal government. However, since 2008, FNMA and FHLMC have been under government

conservatorship and, therefore, contractual cash flows for these investments carry explicit guarantees by the U.S. federal government. Securities issued by the SBA and GNMA have explicit credit guarantees by the U.S. federal government, which protects us from credit losses on the contractual cash flows of the securities.

Other temporarily impaired securities, including obligations of state and political subdivisions and corporate bonds, were deemed credit worthy after our internal analysis of the issuers' latest financial information, credit ratings by major credit agencies, and/or credit enhancements. Based on our comprehensive analyses, we determined that the decline in the fair values of these securities was primarily driven by factors other than credit, such as changes in market interest rates and liquidity spreads subsequent to purchase. At December 31, 2018, Management determined that it did not intend to sell investment securities with unrealized losses, and it is more than likely than not that we will not have to sell any of the securities with unrealized losses before recovery of their amortized cost. Therefore, we do not consider these investment securities to be other-than-temporarily impaired at December 31, 2018.

Non-Marketable Securities

As a member of the FHLB, we are required to maintain a minimum investment in FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can increase in the event we increase our total asset size or borrowings with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at the $100 per share par value. We held $11.1 million of FHLB stock included in other assets on the consolidated statements of condition at both December 31, 2018 and 2017. The carrying amounts of these investments are reasonable estimates of fair value because the securities are restricted to member banks and they do not have a readily determinable market value. Based on our analysis of FHLB’s financial condition and certain qualitative factors, we determined that the FHLB stock was not impaired at December 31, 2018 and 2017. On February 21, 2019, FHLB announced a cash dividend for the fourth quarter of 2018 at an annualized dividend rate of 7.00% to be distributed in mid-March 2019. Cash dividends paid on FHLB capital stock are recorded as non-interest income.

As a member bank of Visa U.S.A., we held 10,439 and 16,939 shares of Visa Inc. Class B common stock at December 31, 2018 and 2017, respectively. These shares have a carrying value of zero and are restricted from resale to non-member banks of Visa U.S.A. until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s Covered Litigation escrow account. Because of the restriction and the uncertainty on the conversion rate to Class A shares, these shares lack a readily determinable fair value. When converting this Class B common stock to Class A common stock based on the conversion rate of 1.6298, as of December 31, 2018 and 1.6483 as of December 31, 2017, and the closing stock price of Class A shares at those respective dates, the converted value of our shares of Class B common stock would have been $2.2 million and $3.2 million at December 31, 2018 and 2017, respectively. The conversion rate is subject to further adjustment upon the final settlement of the covered litigation against Visa Inc. and its member banks. As such, the fair value of these Class B shares can differ significantly from their converted values. For further information, refer to Note 12, Commitments and Contingencies.

In October 2018, we sold 6,500 shares of our holdings of Visa Inc. Class B common stock to a member bank of Visa U.S.A. The pre-tax gain from the sale, net of sales commission, was $956 thousand.

We invest in low income housing tax credit funds as a limited partner, which totaled $4.6 million and $2.1 million recorded in other assets as of December 31, 2018 and 2017, respectively. In 2018, we recognized $597 thousand of low income housing tax credits and other tax benefits, net of $507 thousand of amortization expense of low income housing tax credit investment, as a component of income tax expense. As of December 31, 2018, our unfunded commitments for these low income housing tax credit funds totaled $3.1 million. We did not recognize any impairment losses on these low income housing tax credit investments during 2018 or 2017, as the value of the future tax benefits exceeds the carrying value of the investments.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 was signed into law, which reduced the federal corporate income tax rate from 35% to 21% for tax years beginning 2018. Due to the tax rate change, we revised the amortization schedule according to the proportional amortization method for the tax deduction benefits on these low income housing tax credit investments starting in 2018 using the 21% federal tax rate and recorded a catch-up amortization expense of $67 thousand in 2017 as a component of income tax expense.

Note 3: Loans and Allowance for Loan Losses

Credit Quality of Loans

Virtually all of our loans are from customers located in California, primarily in Marin, Alameda, Sonoma, San Francisco, Napa, and Contra Costa counties. Approximately 88% and 87% of total loans were secured by real estate at December 31, 2018 and 2017, respectively. At December 31, 2018 and 2017, 67% of our loans were for commercial real estate, 85% of which were secured by real estate located in Marin, Sonoma, Alameda, San Francisco and Napa counties (California).

The following table shows outstanding loans by class and payment aging as of December 31, 2018 and 2017.

Loan Aging Analysis by Class

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2018								
30-59 days past due	$ 5	$ —	$ 1,004	$ —	$—		$ 112	$1,121
60-89 days past due	—	—	—	—	—	—	—	—
90 days or more past due	—	—	—	—	—	—	—	—
Total past due	5	—	1,004	—	—	—	112	1,121
Current	230,734	313,277	872,406	76,423	124,696	117,847	27,360	1,762,743
Total loans [2]	$ 230,739	$ 313,277	$ 873,410	$ 76,423	$124,696	$117,847	$ 27,472	$1,763,864
Non-accrual loans [1]	$ 319	$ —	$ —	$ —	$313	$—	$ 65	$697
December 31, 2017								
30-59 days past due	$ —	$ —	$ —	$ —	$99	$255	$ 330	$684
60-89 days past due	1,340	—	—	—	—	—	—	1,340
90 days or more past due	—	—	—	—	307	—	—	307
Total past due	1,340	—	—	—	406	255	330	2,331
Current	234,495	300,963	822,984	63,828	132,061	95,271	27,080	1,676,682
Total loans [2]	$ 235,835	$ 300,963	$ 822,984	$ 63,828	$132,467	$95,526	$ 27,410	$1,679,013
Non-accrual loans [1]	$ —	$ —	$ —	$ —	$406	$—	$ —	$406

[1] Includes no purchased credit impaired ("PCI") loans at December 31, 2018. Three purchased credit impaired loans with unpaid balances totaling $131 thousand and no carrying values were not accreting interest at December 31, 2017. Amounts exclude accreting PCI loans of $2.1 million and December 31, 2018 and 2017, as we have a reasonable expectation about future cash flows to be collected and we continue to recognize accretable yield on these loans in interest income. There were no accruing loans past due more than ninety days at December 31, 2018 or 2017.
[2] Amounts include net deferred loan origination costs of $635 thousand and $818 thousand at December 31, 2018 and 2017, respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of $708 thousand and $1.2 million at December 31, 2018 and 2017, respectively.

We generally make commercial loans to established small and mid-sized businesses to provide financing for their growth and working capital needs, equipment purchases and acquisitions. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay obligations as agreed. Commercial loans are made based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral and guarantor support. The cash flows of borrowers, however, may not occur as expected, and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed, such as

accounts receivable and inventory, and typically include personal guarantees. We target stable businesses with guarantors who provide additional sources of repayment and have proven to be resilient in periods of economic stress.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans discussed above. We underwrite these loans to be repaid from cash flow and to be supported by real property collateral. Underwriting standards for commercial real estate loans include, but are not limited to, debt coverage and loan-to-value ratios. Furthermore, substantially all of our loans are guaranteed by the owners of the properties. Conditions in the real estate markets or in the general economy may adversely affect our commercial real estate loans. In the event of a vacancy, we expect guarantors to carry the loans until they find a replacement tenant. The owner's substantial equity investment provides a strong economic incentive to continue to support the commercial real estate projects. As such, we have generally experienced a relatively low level of loss and delinquencies in this portfolio.

Construction loans are generally made to developers and builders to finance construction, renovation and occasionally land acquisitions in anticipation of near-term development. Construction loans are structured with interest reserves that are used for the payment of interest during the development and marketing periods and capitalized as part of the

loan balance. If we determine that a construction loan is impaired before the depletion of the interest reserve, then we apply the interest funded by the interest reserve against the loan's principal balance. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record, and independent appraisals. We monitor all construction projects to determine whether they are on schedule, completed as planned and in accordance with the approved construction budgets. Significant events can affect the construction industry, including: the inherent volatility of real estate markets and vulnerability to delays due to weather, change orders, inability to obtain construction permits, labor or material shortages, and price changes. Estimates of construction costs and value associated with the completed project may be inaccurate. Repayment of construction loans is largely dependent on the ultimate success of the project.

Consumer loans primarily consist of home equity lines of credit, other residential loans, and floating homes along with a small number of installment loans. Our other residential loans include tenancy-in-common fractional interest loans ("TIC") located almost entirely in San Francisco County. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. Diversification among consumer loan types, coupled with relatively small loan amounts that are spread across many individual borrowers, mitigates risk. We do not originate sub-prime residential mortgage loans, nor is it our practice to underwrite loans commonly referred to as "Alt-A mortgages," the characteristics of which are reduced documentation, borrowers with low FICO scores or collateral with high loan-to-value ratios.

We use a risk rating system to evaluate asset quality, and to identify and monitor credit risk in individual loans, and in the loan portfolio. Our definitions of “Special Mention” risk graded loans, or worse, are consistent with those used by the Federal Deposit Insurance Corporation ("FDIC"). Our internally assigned grades are as follows:

Pass and Watch: Loans to borrowers of acceptable or better credit quality. Borrowers in this category demonstrate fundamentally sound financial positions, repayment capacity, credit history and management expertise. Loans in this category must have an identifiable and stable source of repayment and meet the Bank’s policy regarding debt service coverage ratios. These borrowers are capable of sustaining normal economic, market or operational setbacks without significant financial consequences. Negative external industry factors are generally not present. The loan may be secured, unsecured or supported by non-real estate collateral for which the value is more difficult to determine and/or marketability is more uncertain. This category also includes “Watch” loans, where the primary source of repayment has been delayed. “Watch” is intended to be a transitional grade, with either an upgrade or downgrade within a reasonable period.

Special Mention: Potential weaknesses that deserve close attention. If left uncorrected, those potential weaknesses may result in deterioration of the payment prospects for the asset. Special Mention assets do not present sufficient risk to warrant adverse classification.

Substandard: Inadequately protected by either the current sound worth and paying capacity of the obligor or the collateral pledged, if any. A Substandard asset has a well-defined weakness or weaknesses that jeopardize(s) the liquidation of the debt. Substandard assets are characterized by the distinct possibility that we will sustain some loss if such weaknesses or deficiencies are not corrected. Well-defined weaknesses include adverse trends or developments of the borrower’s financial condition, managerial weaknesses and/or significant collateral deficiencies.

Doubtful: Critical weaknesses that make collection or liquidation in full improbable. There may be specific pending events that work to strengthen the asset; however, the amount or timing of the loss may not be determinable. Pending events generally occur within one year of the asset being classified as Doubtful. Examples include: merger, acquisition, or liquidation; capital injection; guarantee; perfecting liens on additional collateral; and refinancing. Such loans are placed on non-accrual status and usually are collateral-dependent.

We regularly review our credits for accuracy of risk grades whenever we receive new information. Borrowers are generally required to submit financial information at regular intervals. Typically, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity. In addition, investor commercial real estate borrowers are usually required to submit rent rolls or property income statements annually. We monitor construction loans monthly. We review home equity and other consumer loans based on delinquency. We also review loans graded "Watch" or worse, regardless of loan type, no less than quarterly.

The following table represents an analysis of the carrying amount in loans, net of deferred fees and costs and purchase premiums or discounts, by internally assigned risk grades, including PCI loans, at December 31, 2018 and 2017.

Credit Risk Profile by Internally Assigned Risk Grade

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
December 31, 2018									
Pass	$ 219,625	$ 299,998	$ 870,443	$ 73,735	$ 122,844	$ 117,847	$ 27,312	$ 2,112	$ 1,733,916
Special Mention	9,957	4,106	2,156	—	1,121	—	—	—	17,340
Substandard	1,126	7,986	—	2,688	648	—	160	—	12,608
Total loans	$ 230,708	$ 312,090	$ 872,599	$ 76,423	$ 124,613	$ 117,847	$ 27,472	$ 2,112	$ 1,763,864
December 31, 2017									
Pass	$ 214,636	$ 281,104	$ 818,570	$ 60,859	$ 130,558	$ 95,526	$ 27,287	$ 1,325	$ 1,629,865
Special Mention	9,318	9,284	1,850	—	—	—	—	790	21,242
Substandard	11,816	9,409	1,774	2,969	1,815	—	123	—	27,906
Total loans	$ 235,770	$ 299,797	$ 822,194	$ 63,828	$ 132,373	$ 95,526	$ 27,410	$ 2,115	$ 1,679,013

Troubled Debt Restructuring

Our loan portfolio includes certain loans modified in a troubled debt restructuring (“TDR”), where we have granted economic concessions to borrowers experiencing financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs on non-accrual status at the time of restructure may be returned to accruing status after Management considers the borrower’s sustained repayment performance for a reasonable period, generally six months, and obtains reasonable assurance of repayment and performance.

We may remove a loan from TDR designation if it meets all of the following conditions:

- The loan is subsequently refinanced or restructured at current market interest rates and the new terms are consistent with the treatment of creditworthy borrowers under regular underwriting standards;
- The borrower is no longer considered to be in financial difficulty;
- Performance on the loan is reasonably assured; and
- Existing loan did not have any forgiveness of principal or interest.

The same Management level that approved the loan classification upgrade must approve the removal of TDR status. During 2018, one TIC loan and one home equity loan with recorded investments totaling $247 thousand were removed from TDR designation after meeting all of the conditions above. There were no loans removed from TDR designation during 2017.

The following table summarizes the carrying amount of TDR loans by loan class as of December 31, 2018 and December 31, 2017.

(in thousands)	As of	
Recorded investment in Troubled Debt Restructurings[1]	December 31, 2018	December 31, 2017
Commercial and industrial	$ 1,506	$ 2,165
Commercial real estate, owner-occupied	6,993	6,999
Commercial real estate, investor	1,821	2,171
Construction	2,688	2,969

Home equity	251	347
Other residential	462	1,148
Installment and other consumer[2]	685	721
Total	$14,406	$ 16,520

[1]Includes no acquired TDR loans as of December 31, 2018 or December 31, 2017.

[2] There were two TDR loans on non-accrual status with recorded investments totaling $65 thousand at December 31, 2018 and no TDR loans on non-accrual status at December 31, 2017.

The following table presents information for loans modified in a TDR during the presented periods, including the number of modified contracts, the recorded investment in the loans prior to modification, and the recorded investment in the loans at period end after being restructured. The table excludes fully charged-off TDR loans and loans modified in a TDR and subsequently paid-off during the years presented.

(dollars in thousands)	Number of Contracts Modified	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment at Period End
TDRs modified during 2018:				
Commercial and industrial	2	$ 254	$ 245	$ 172
TDRs modified during 2017:				
Installment and other consumer	1	$ 50	$ 50	$ 47

The modifications during 2018 and 2017 primarily involved maturity or payment extensions, interest rate concessions, renewals, and other changes to loan terms. During 2018 and 2017, there were no defaults on loans that had been modified in a TDR within the prior twelve-month period. We report defaulted TDRs based on a payment default definition of more than ninety days past due.

Impaired Loans

The following tables summarize information by class on impaired loans and their related allowances. Total impaired loans include non-accrual loans, accruing TDR loans and accreting PCI loans that have experienced post-acquisition declines in cash flows expected to be collected.

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2018								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 303	$ —	$ —	$ 2,688	$ 313	$ 462	$ 111	$ 3,877
With a specific allowance recorded	1,522	6,993	1,821	—	251	—	574	11,161
Total recorded investment in impaired loans	$ 1,825	$ 6,993	$ 1,821	$ 2,688	$ 564	$ 462	$ 685	$ 15,038
Unpaid principal balance of impaired loans	$ 1,813	$ 6,993	$ 1,812	$ 2,688	$ 562	$ 461	$ 684	$ 15,013
Specific allowance	$ 466	$ 189	$ 45	$ —	$ 5	$ —	$ 73	$ 778
Average recorded investment in impaired loans during 2018	$ 1,980	$ 7,000	$ 1,904	$ 2,803	$ 671	$ 915	$ 704	$ 15,977
Interest income recognized on impaired loans during 2018 [1]	$ 239	$ 266	$ 83	$ 156	$ 19	$ 45	$ 29	$ 837
December 31, 2017								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 309	$ —	$ —	$ 2,689	$ 406	$ 995	$ 46	$ 4,445
With a specific allowance recorded	1,856	6,999	2,171	280	347	153	675	12,481
Total recorded investment in impaired loans	$ 2,165	$ 6,999	$ 2,171	$ 2,969	$ 753	$ 1,148	$ 721	$ 16,926
Unpaid principal balance of impaired loans	$ 2,278	$ 6,993	$ 2,168	$ 2,963	$ 750	$ 1,147	$ 720	$ 17,019

Specific allowance	$ 50	$ 188	$ 159	$ 7	$ 6	$ 1	$ 102	$ 513
Average recorded investment in impaired loans during 2017	$ 2,113	$ 6,998	$ 2,842	$ 3,132	$ 679	$ 1,324	$ 841	$ 17,929
Interest income recognized on impaired loans during 2017 [1]	$ 202	$ 266	$ 87	$ 147	$ 24	$ 62	$ 37	$ 825

[1] Interest income recognized on a cash basis totaled $135 thousand and $100 thousand in 2018 and 2017, respectively, and was primarily related to the payoff of non-accrual commercial PCI loans.

Management monitors delinquent loans continuously and identifies problem loans, generally loans graded Substandard or worse, loans on non-accrual status and loans modified in a TDR, to be evaluated individually for impairment testing. Generally, the recorded investment in impaired loans is net of any charge-offs from estimated losses related to specifically-identified impaired loans when they are deemed uncollectible. There were no charged-off amounts on impaired loans at December 31, 2018 or 2017. In addition, the recorded investment in impaired loans is net of purchase discounts or premiums on acquired loans and deferred fees and costs. At December 31, 2018 and 2017, unused

commitments to extend credit on impaired loans, including performing loans to borrowers whose terms have been modified in TDRs, totaled $1.1 million and $935 thousand, respectively.

The following tables disclose activity in the allowance for loan losses ("ALLL") and the recorded investment in loans by class, as well as the related ALLL disaggregated by impairment evaluation method.

Allowance for Loan Losses Rollforward for the Year Ended

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
Year ended December 31, 2018									
Beginning balance	$ 3,654	$ 2,294	$ 6,475	$ 681	$1,031	$ 536	$ 378	$ 718	$15,767
Provision (reversal)	(1,232)	113	1,228	75	(116)	264	(108)	(224)	—
Charge-offs	(3)	—	—	—	—	—	(2)	—	(5)
Recoveries	17	—	—	—	—	—	42	—	59
Ending balance	$ 2,436	$ 2,407	$ 7,703	$ 756	$915	$ 800	$ 310	$ 494	$15,821
Year ended December 31, 2017									
Beginning balance	$ 3,248	$ 1,753	$ 6,320	$ 781	$973	$ 454	$ 372	$ 1,541	$15,442
Provision (reversal)	584	541	155	(100)	58	82	3	(823)	500
Charge-offs	(289)	—	—	—	—	—	(4)	—	(293)
Recoveries	111	—	—	—	—	—	7	—	118
Ending balance	$ 3,654	$ 2,294	$ 6,475	$ 681	$1,031	$ 536	$ 378	$ 718	$15,767

Allowance for Loan Losses and Recorded Investment In Loans

(dollars in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
December 31, 2018									
Ending ALLL related to loans collectively evaluated for impairment	$1,970	$2,218	$7,658	$756	$910	$800	$237	$494	$15,043
Ending ALLL related to loans individually evaluated for impairment	466	189	45	—	5	—	73	—	778
Ending ALLL related to purchased credit-impaired loans	—	—	—	—	—	—	—	—	—
Ending balance	$2,436	$2,407	$7,703	$756	$915	$800	$310	$494	$15,821
Recorded Investment:									
Collectively evaluated for impairment	$228,883	$305,097	$870,778	$73,735	$124,049	$117,385	$26,787	$—	$1,746,714
Individually evaluated for impairment	1,825	6,993	1,821	2,688	564	462	685	—	15,038
Purchased credit-impaired	31	1,187	811	—	83	—	—	—	2,112
Total	$230,739	$313,277	$873,410	$76,423	$124,696	$117,847	$27,472	$—	$1,763,864
Ratio of allowance for loan losses to total loans	1.06 %	0.77 %	0.88 %	0.99 %	0.73 %	0.68 %	1.13 %	NM	0.90
	764 %	NM	NM	NM	292 %	NM	477 %	NM	2,270

Allowance for loan losses
to non-accrual loans
NM - Not Meaningful

Allowance for Loan Losses and Recorded Investment In Loans

(dollars in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
December 31, 2017									
Ending ALLL related to loans collectively evaluated for impairment	$3,604	$2,106	$6,316	$674	$1,025	$535	$276	$718	$15,254
Ending ALLL related to loans individually evaluated for impairment	50	188	159	7	6	1	102	—	513
Ending ALLL related to purchased credit-impaired loans	—	—	—	—	—	—	—	—	—
Ending balance	$3,654	$2,294	$6,475	$681	$1,031	$536	$378	$718	$15,767
Loans outstanding:									
Collectively evaluated for impairment	$233,605	$292,798	$820,023	$60,859	$131,620	$94,378	$26,689	$—	$1,659,972
Individually evaluated for impairment	2,165	6,999	2,171	2,969	753	1,148	721	—	16,926
Purchased credit-impaired	65	1,166	790	—	94	—	—	—	2,115
Total	$235,835	$300,963	$822,984	$63,828	$132,467	$95,526	$27,410	$—	$1,679,013
Ratio of allowance for loan losses to total loans	1.55 %	0.76 %	0.79 %	1.07 %	0.78 %	0.56 %	1.38 %	NM	0.94 %
Allowance for loan losses to non-accrual loans	NM	NM	NM	NM	254 %	NM	NM	NM	3,883 %

NM - Not Meaningful

Purchased Credit-Impaired Loans

Acquired loans are considered credit-impaired if there is evidence of significant deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased in our three bank acquisitions to be PCI loans based on credit indicators such as non-accrual status, past due status, loan risk grade, loan-to-value ratio, etc. Revolving credit agreements (e.g., home equity lines of credit and revolving commercial loans) are not considered PCI loans as cash flows cannot be reasonably estimated.

The following table reflects the unpaid principal balance and related carrying value of PCI loans:

PCI Loans	December 31, 2018		December 31, 2017	
(in thousands)	Unpaid Principal Balance	Carrying Value	Unpaid Principal Balance	Carrying Value
Commercial and industrial	$89	$ 31	$276	$ 65
Commercial real estate, owner occupied	1,247	1,187	1,297	1,166
Commercial real estate, investor	1,033	811	1,064	790
Home equity	210	83	231	94
Total purchased credit-impaired loans	$2,579	$ 2,112	$2,868	$ 2,115

The activities in the accretable yield, or income expected to be earned over the remaining lives of the PCI loans were as follows:

Accretable Yield	Years ended	
(in thousands)	December 31, 2018	December 31, 2017
Balance at beginning of period	$1,254	$ 1,476
Additions	—	109
Accretion	(320)	(331)
Balance at end of period	$934	$ 1,254

Pledged Loans

Our FHLB line of credit is secured under terms of a blanket collateral agreement by a pledge of certain qualifying loans with unpaid principal balances of $1,027.4 million and $887.9 million at December 31, 2018 and 2017, respectively. In addition, we pledge eligible TIC loans, which totaled $94.5 million and $67.6 million at December 31, 2018 and 2017, respectively, to secure our borrowing capacity with the Federal Reserve Bank ("FRB"). Also, see Note 7, Borrowings.

Related Party Loans

The Bank has, and expects to have in the future, banking transactions in the ordinary course of its business with directors, officers, principal shareholders and their businesses or associates. These transactions, including loans, are granted on substantially the same terms, including interest rates and collateral on loans, as those prevailing at the same time for comparable transactions with persons not related to us. Likewise, these transactions do not involve more than the normal risk of collectability or present other unfavorable features.

The following table shows changes in net loans to related parties for each of the two years ended December 31, 2018 and 2017:

(in thousands)	2018	2017
Balance at beginning of year	$11,852	$1,988
Additions	863	3,186
Advances	—	74
Repayments	(2,080)	(128)
Reclassified due to a change in borrower status[1]	—	6,732
Balance at end of year	$10,635	$11,852

[1]During 2017, two new directors joined our Board of Directors resulting in the reclassification of existing loans to those directors and their businesses to related party status.

Undisbursed commitments to related parties totaled $9.1 million as of both December 31, 2018 and 2017.

Note 4: Bank Premises and Equipment

A summary of Bank premises and equipment at December 31 follows:

(in thousands)	2018	2017
Leasehold improvements	$15,024	$14,937
Furniture and equipment	10,839	11,113
Subtotal	25,863	26,050
Accumulated depreciation and amortization	(18,487)	(17,438)
Bank premises and equipment, net	$7,376	$8,612

The amount of depreciation and amortization totaled $2.1 million and $1.9 million for the years ended December 31, 2018 and 2017, respectively.

Note 5: Bank Owned Life Insurance

We own life insurance policies on the lives of certain current and former officers designated by the Board of Directors to fund our employee benefit programs. Death benefits provided under the specific terms of these insurance policies are estimated to be $82.2 million at December 31, 2018. The benefits to employees' beneficiaries are limited to each employee's active service period. The investment in bank owned life insurance policies are reported in interest

receivable and other assets at their cash surrender value of $39.0 million and $38.1 million at December 31, 2018 and 2017, respectively. The cash surrender value includes both the original premiums paid for the life insurance policies and the accumulated accretion of policy income since inception of the policies. Income of $913 thousand and $845 thousand was recognized on the life insurance policies in 2018 and 2017, respectively. We regularly monitor the credit ratings of our insurance carriers to ensure that they comply with our policy.

Note 6: Deposits

A stratification of time deposits at December 31, 2018 and 2017 is presented in the following table:

(in thousands)	December 31, 2018	December 31, 2017
Time deposits of less than $100 thousand	$ 34,638	$ 39,361
Time deposits of $100 thousand to $250 thousand	51,690	68,391
Time deposits of more than $250 thousand	30,854	52,364
Total time deposits	$ 117,182	$ 160,116

Interest on time deposits was $542 thousand and $576 thousand in 2018 and 2017, respectively.

Scheduled maturities of time deposits at December 31, 2018 are presented as follows:

(in thousands)	2019	2020	2021	2022	2023	Thereafter	Total
Scheduled maturities of time deposits	$76,880	$13,711	$14,366	$8,138	$4,064	$ 23	$117,182

As of December 31, 2018, $125.7 million in securities were pledged as collateral for our local agency deposits.

Our deposit portfolio includes deposits offered through the Promontory Interfinancial Network that are comprised of Certificate of Deposit Account Registry Service® ("CDARS") balances included in time deposits and Insured Cash Sweep® ("ICS") balances included in money market deposits. In addition, we offer deposits through Reich & Tang Deposit Networks, LLC, comprised of Demand Deposit Marketplace℠ ("DDM") balances. Through these two networks we are able to offer our customers access to FDIC-insured deposit products in aggregate amounts exceeding current insurance limits. When we place funds through CDARS, ICS and DDM, on behalf of a customer, we have the option of receiving matching deposits through the network's reciprocal deposit program. We consider the reciprocal deposits to be in-market deposits as distinguished from traditional out-of-market brokered deposits. We had $7.7 million and $13.5 million in CDARS and $44.1 million and $41.0 million in ICS balances in the reciprocal deposit program at December 31, 2018 and 2017, respectively. In addition, we had $22.7 million and $29.2 million in DDM balances in the reciprocal deposit program at December 31, 2018 and 2017, respectively. We also have the ability to place deposits through the networks for which we receive no matching deposits ("one-way" deposits). One-way CDARS and ICS deposits totaled $15.2 million and $4.2 million at December 31, 2018 and 2017, respectively.

The aggregate amount of deposit overdrafts that have been reclassified as loan balances was $131 thousand and $224 thousand at December 31, 2018 and 2017, respectively. Collectability of these overdrafts is subject to the same credit review process as other loans.

The Bank accepts deposits from shareholders, directors and employees in the normal course of business, and the terms are comparable to those with non-affiliated parties. The total deposits from directors and their businesses, and executive officers were $33.3 million and $29.9 million at December 31, 2018 and 2017, respectively.

Note 7: Borrowings

Federal Funds Purchased – The Bank had unsecured lines of credit with correspondent banks for overnight borrowings totaling $92.0 million at December 31, 2018 and $100.4 million at December 31, 2017. In general, interest rates on these lines approximate the federal funds target rate. We had no overnight borrowings under these credit facilities at December 31, 2018 and December 31, 2017.

Federal Home Loan Bank Borrowings – As of December 31, 2018 and 2017, the Bank had lines of credit with the FHLB totaling $629.4 million and $538.9 million, respectively, based on eligible collateral of certain loans. FHLB

overnight borrowings were $7.0 million at a rate of 2.56% on December 31, 2018. There were no borrowings at December 31, 2017.

Federal Reserve Line of Credit – The Bank has a line of credit with the FRBSF secured by certain residential loans. At December 31, 2018 and 2017, the Bank had borrowing capacity under this line totaling $69.7 million and $52.1 million, respectively, and had no outstanding borrowings with the FRBSF.

As part of an acquisition, Bancorp assumed two subordinated debentures due to NorCal Community Bancorp Trusts I and II, established for the sole purpose of issuing trust preferred securities on September 22, 2003 and December 29, 2005, respectively. The subordinated debentures were recorded at fair values totaling $4.95 million at acquisition date with contractual values totaling $8.2 million. The difference between the contractual balance and the fair value at acquisition date is accreted into interest expense over the lives of the debentures.

On October 7, 2018, Bancorp redeemed in full the subordinated debentures due to NorCal Community Bancorp Trust I, resulting in $916 thousand accelerated accretion. Accretion on the subordinated debentures totaled $1,025 thousand and $153 thousand in 2018 and 2017, respectively.

Bancorp has the option to defer payment of the interest on the subordinated debentures in Trust II for a period of up to five years, as long as there is no default on the subordinated debentures. In the event of interest deferral, dividends to Bancorp common stockholders are prohibited. The trust preferred securities were sold and issued in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. Bancorp has guaranteed, on a subordinated basis, distributions and other payments due on trust preferred securities totaling $4.0 million issued by Trust II, which have identical maturity, repricing and payment terms as the subordinated debentures.

The following table summarizes the contractual terms of the subordinated debentures due to Trust II as of December 31, 2018:

(in thousands)	
Subordinated debentures due to NorCal Community Bancorp Trust II on March 15, 2036 with interest payable quarterly, based on 3-month LIBOR plus 1.40%, repricing quarterly (4.19% as of December 31, 2018), redeemable, in whole or in part, on any interest payment date	$4,124

Borrowings at December 31, 2018 and 2017 are summarized as follows:

	2018				2017			
(dollars in thousands)	Carrying Value	Average Balance	Average Rate		Carrying Value	Average Balance	Average Rate	
FHLB overnight borrowings	$7,000	$ 105	2.03	%	$—	$ 1	1.75	%
FHLB fixed-rate advances	$—	$ —	—	%	$—	$ —	—	%
Subordinated debentures	$2,640	$ 5,025	26.29	%[1]	$5,739	$ 5,664	7.65	%

[1] Subordinated debentures average rate includes the impact of the $916 thousand accelerated accretion due to early redemption of subordinated debentures due to NorCal Community Bancorp Trust I.

Note 8: Stockholders' Equity and Stock Plans

Stock Split

On October 22, 2018, Bancorp announced a two-for-one stock split, which occurred on November 27, 2018. All share and per share data have been adjusted to reflect the stock split effective November 27, 2018.

Share-Based Awards

On May 11, 2010, our shareholders approved the 2010 Director Stock Plan to pay director fees in shares of Bancorp common stock up to 300,000 shares. In addition to cash compensation, we issued 5,470 and 5,756 shares of common stock under the 2010 Director Stock Plan to directors in 2018 and 2017, respectively. As of December 31, 2018, 214,398 shares were available for future grants under this plan.

On September 27, 2017, the Board of Directors adopted the 2017 Employee Stock Purchase Plan, effective July 1, 2017. Under the plan, our employees may purchase up to 400,000 of Bancorp's common shares through payroll deductions of between one percent and fifteen percent of pay in each pay period. Shares are purchased quarterly at a five percent discount from the closing market price on the last day of the quarter. As of December 31, 2018, 383,870 shares were available for future purchases under the plan.

On March 17, 2017, the Board of Directors approved the 2017 Equity Plan, which was affirmed by Bancorp's shareholders on May 16, 2017 and replaced the 2007 Equity Plan. The Compensation Committee of the Board of Directors has the discretion to determine which employees, advisors and non-employee directors will receive an award, the timing of awards, the vesting schedule for each award, the type of award to be granted, the number of shares of Bancorp stock to be subject to each option and restricted stock award, and any other terms and conditions. As of December 31, 2018, there were 1,047,784 shares available for future grants to employees, advisors and non-employee directors.

Options are issued at an exercise price equal to the fair value of the stock at the date of grant. Options and restricted stock awarded to officers and employees during 2007 through 2014 vest 20% on each anniversary of the grant date for five years and expire ten years from the grant date. In general, option awards granted after 2014 for employees generally vest by one-third on each anniversary of the grant for three years and expire ten years from the grant date. Options granted to non-employee directors prior to 2016 vest 20% immediately and 20% on each anniversary of the grant date for four years and expire seven years from the grant date. Options granted to non-employee directors in 2016 vest by one-third on each anniversary of the grant for three years and expire ten years from the grant date. Options granted to non-employee directors after 2016 vest immediately and expire ten years from the grant date. Options issued as replacement awards in connection with the Bank of Napa acquisition were for existing stock option agreements that became fully vested due to change in control provisions as part of the merger agreement.

Stock options and restricted stock may be net settled in a cashless exercise by a reduction in the number of shares otherwise deliverable upon exercise or vesting in satisfaction of the exercise payment and/or applicable tax withholding requirements. During 2018, we withheld 46,794 shares totaling $1.7 million at a weighted-average price of $36.28 for cashless exercises. During 2017, we withheld 24,416 shares totaling $801 thousand at a weighted-average price of $32.82 for cashless exercises. Shares withheld under net settlement arrangements are available for future grants.

Performance-based stock awards (restricted stock) are issued to a selected group of employees. Stock award vesting is contingent upon the achievement of pre-established long-term performance goals set by the Compensation Committee of the Board of Directors. Performance is measured over a three-year period and cliff vested. These performance-based stock awards were granted at a maximum opportunity level, and based on the achievement of the pre-established goals, the actual payouts can range from 0% to 200% of the target award. For performance-based stock awards, an estimate is made of the number of shares expected to vest based on the probability that the performance criteria will be achieved to determine the amount of compensation expense to be recognized. The estimate is re-evaluated quarterly and total compensation expense is adjusted for any change in the current period.

A summary of stock option activity for the years ended December 31, 2018 and 2017 is presented in the following table. The intrinsic value of options outstanding and exercisable is calculated as the number of in-the-money options times the difference between the market price of our stock as of each year-end period presented and the exercise prices of the in-the-money options.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Weighted Average Grant-Date Fair Value	Weighted Average Remaining Contractual Term (in years)
Options outstanding at December 31, 2016	363,578	$ 20.60	$ 5,190		5.77
Granted [1]	201,328	19.89		$ 16.31	
Cancelled, expired or forfeited	(4,022)	21.99			
Exercised	(42,948)	19.31	585		

Options outstanding at December 31, 2017	517,936	20.42	7,075		5.34
Exercisable (vested) at December 31, 2017	384,344	17.85	6,212		4.42
Options outstanding at December 31, 2017	517,936	20.42	7,075		5.34
Granted	74,096	33.97		7.17	
Cancelled, expired or forfeited	(9,140)	28.25			
Exercised	(157,192)	13.93	3,462		
Options outstanding at December 31, 2018	425,700	25.01	6,910		5.85
Exercisable (vested) at December 31, 2018	311,050	22.57	5,809		4.94

[1] Includes 140,290 replacement stock option awards issued in the Acquisition with a $13.60 weighted average exercise price and a $20.36 weighted average grant-date fair value. See Note 18, Acquisition.

The following table summarizes non-vested restricted stock awards and changes during the years ended December 31, 2018 and 2017.

	Number of Shares	Weighted Average Grant-Date Fair Value
Non-vested awards at December 31, 2016	79,398	$ 24.08
Granted	32,460	34.80
Vested	(20,642)	22.89
Non-vested awards at December 31, 2017	91,216	28.16
Granted	37,040	33.58
Vested	(28,812)	26.06
Cancelled or forfeited	(12,056)	27.32
Non-vested awards at December 31, 2018	87,388	31.26

A summary of the options outstanding and exercisable by price range as of December 31, 2018 is presented in the following table:

	Stock Options Outstanding as of December 31, 2018			Stock Options Exercisable as of December 31, 2018	
Range of Exercise Prices	Stock Options Outstanding	Remaining Contractual Life (in years)	Weighted Average Exercise Price	Stock Options Exercisable	Weighted Average Exercise Price
$0.00 - $10.00	4,604				