

Edgar Filing: Bank of Marin Bancorp - Form 10-Q

Bank of Marin Bancorp  
Form 10-Q  
August 07, 2017  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

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

For the quarterly period ended June 30, 2017

OR

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

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

Commission File Number 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 Blvd., Suite 100, Novato, CA 94947  
(Address of principal executive office) (Zip Code)

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

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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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Emerging growth company

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

Indicate by check mark if the registrant is a shell company, as defined in Rule 12b-2 of the Exchange Act.

Yes  No

As of July 31, 2017, there were 6,165,751 shares of common stock outstanding.

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## PART I FINANCIAL INFORMATION

## ITEM 1. Financial Statements

BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CONDITION  
at June 30, 2017 and December 31, 2016

| (in thousands, except share data; unaudited)   | June 30,<br>2017 | December 31,<br>2016 |
|--|------------------|----------------------|
| <b>Assets</b>  |                  |                      |
| Cash and due from banks  | \$137,906        | \$48,804             |
| Investment securities  |                  |                      |
| Held-to-maturity, at amortized cost  | 163,018          | 44,438               |
| Available-for-sale, at fair value  | 238,870          | 372,580              |
| Total investment securities  | 401,888          | 417,018              |
| Loans, net of allowance for loan losses of \$15,232 and \$15,442 at June 30, 2017 and December 31, 2016, respectively  | 1,476,253        | 1,471,174            |
| Bank premises and equipment, net   | 8,390            | 8,520                |
| Goodwill   | 6,436            | 6,436                |
| Core deposit intangible  | 2,344            | 2,580                |
| Interest receivable and other assets   | 67,499           | 68,961               |
| Total assets   | \$2,100,716      | \$2,023,493          |
| <b>Liabilities and Stockholders' Equity</b>  |                  |                      |
| <b>Liabilities</b>   |                  |                      |
| <b>Deposits</b>  |                  |                      |
| Non-interest bearing   | \$892,988        | \$817,031            |
| Interest bearing   |                  |                      |
| Transaction accounts   | 87,866           | 100,723              |
| Savings accounts   | 165,596          | 163,516              |
| Money market accounts  | 546,586          | 539,967              |
| Time accounts  | 147,504          | 151,463              |
| Total deposits   | 1,840,540        | 1,772,700            |
| Subordinated debentures  | 5,666            | 5,586                |
| Interest payable and other liabilities   | 13,777           | 14,644               |
| Total liabilities  | 1,859,983        | 1,792,930            |
| <b>Stockholders' Equity</b>  |                  |                      |
| Preferred stock, no par value,<br>Authorized - 5,000,000 shares, none issued   | —                | —                    |
| Common stock, no par value,<br>Authorized - 15,000,000 shares;<br>Issued and outstanding - 6,160,952 and 6,127,314 at<br>June 30, 2017 and December 31, 2016, respectively | 88,949           | 87,392               |
| Retained earnings  | 152,883          | 146,464              |
| Accumulated other comprehensive loss, net  | (1,099)          | (3,293)              |
| Total stockholders' equity   | 240,733          | 230,563              |
| Total liabilities and stockholders' equity   | \$2,100,716      | \$2,023,493          |

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

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BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| (in thousands, except per share amounts; unaudited)              | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2017      | June 30, 2016 | June 30, 2017    | June 30, 2016 |
| Interest income  |                    |               |                  |               |
| Interest and fees on loans                                       | \$16,423           | \$16,097      | \$32,272         | \$33,238      |
| Interest on investment securities                                |                    |               |                  |               |
| Securities of U.S. government agencies                           | 1,534              | 1,191         | 3,052            | 2,543         |
| Obligations of state and political subdivisions                  | 553                | 588           | 1,121            | 1,174         |
| Corporate debt securities and other                              | 36                 | 77            | 73               | 182           |
| Interest on Federal funds sold and short-term investments        | 157                | 40            | 217              | 51            |
| Total interest income  | 18,703             | 17,993        | 36,735           | 37,188        |
| Interest expense   |                    |               |                  |               |
| Interest on interest-bearing transaction accounts                | 21                 | 28            | 50               | 55            |
| Interest on savings accounts                                     | 16                 | 14            | 31               | 28            |
| Interest on money market accounts                                | 114                | 107           | 227              | 218           |
| Interest on time accounts  | 139                | 193           | 285              | 389           |
| Interest on Federal Home Loan Bank ("FHLB") and other borrowings | —                  | 378           | —                | 478           |
| Interest on subordinated debentures                              | 109                | 107           | 217              | 216           |
| Total interest expense   | 399                | 827           | 810              | 1,384         |
| Net interest income  | 18,304             | 17,166        | 35,925           | 35,804        |
| Provision for loan losses  | —                  | —             | —                | —             |
| Net interest income after provision for loan losses              | 18,304             | 17,166        | 35,925           | 35,804        |
| Non-interest income  |                    |               |                  |               |
| Service charges on deposit accounts                              | 447                | 441           | 899              | 897           |
| Wealth Management and Trust Services                             | 504                | 527           | 1,007            | 1,093         |
| Debit card interchange fees                                      | 384                | 381           | 756              | 719           |
| Merchant interchange fees  | 112                | 128           | 208              | 241           |
| Earnings on bank-owned life insurance                            | 210                | 209           | 419              | 410           |
| Dividends on FHLB stock  | 176                | 185           | 408              | 354           |
| Gains on investment securities, net                              | 10                 | 284           | 10               | 394           |
| Other income   | 253                | 266           | 504              | 476           |
| Total non-interest income  | 2,096              | 2,421         | 4,211            | 4,584         |
| Non-interest expense   |                    |               |                  |               |
| Salaries and related benefits                                    | 7,287              | 6,724         | 14,762           | 13,472        |
| Occupancy and equipment  | 1,380              | 1,175         | 2,699            | 2,456         |
| Depreciation and amortization                                    | 463                | 441           | 944              | 894           |
| Federal Deposit Insurance Corporation insurance                  | 162                | 246           | 323              | 507           |
| Data processing  | 963                | 916           | 1,902            | 1,772         |
| Professional services  | 522                | 554           | 1,044            | 1,052         |
| Directors' expense   | 224                | 116           | 382              | 305           |
| Information technology   | 186                | 165           | 384              | 358           |
| (Reversal) provision for losses on off-balance sheet commitments | (208)              | )150          | (43)             | )150          |
| Other expense  | 1,652              | 1,530         | 3,245            | 3,061         |
| Total non-interest expense                                       | 12,631             | 12,017        | 25,642           | 24,027        |
| Income before provision for income taxes                         | 7,769              | 7,570         | 14,494           | 16,361        |
| Provision for income taxes                                       | 2,583              | 2,733         | 4,760            | 5,878         |

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|   |         |         |          |          |
|---|---------|---------|----------|----------|
| Net income  | \$5,186 | \$4,837 | \$9,734  | \$10,483 |
| Net income per common share:  |         |         |          |          |
| Basic   | \$0.85  | \$0.80  | \$1.60   | \$1.73   |
| Diluted   | \$0.84  | \$0.79  | \$1.58   | \$1.72   |
| Weighted average shares:  |         |         |          |          |
| Basic   | 6,110   | 6,078   | 6,101    | 6,063    |
| Diluted   | 6,174   | 6,109   | 6,173    | 6,100    |
| Dividends declared per common share   | \$0.27  | \$0.25  | \$0.54   | \$0.50   |
| Comprehensive income:   |         |         |          |          |
| Net income  | \$5,186 | \$4,837 | \$9,734  | \$10,483 |
| Other comprehensive income  |         |         |          |          |
| Change in net unrealized gain or loss on available-for-sale securities  | 1,961   | 2,119   | 3,635    | 5,042    |
| Amortization of net unrealized loss on available for sale securities transferred to held-to-maturity securities | 124     | —       | 165      | —        |
| Reclassification adjustment for gains on available-for-sale securities included in net income                   | (10)    | (284)   | (10)     | (394)    |
| Net change in unrealized loss on available-for-sale securities, before tax                                      | 2,075   | 1,835   | 3,790    | 4,648    |
| Tax effect  | 892     | 776     | 1,596    | 1,950    |
| Other comprehensive income, net of tax  | 1,183   | 1,059   | 2,194    | 2,698    |
| Comprehensive income  | \$6,369 | \$5,896 | \$11,928 | \$13,181 |

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

BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
for the year ended December 31, 2016 and the six months ended June 30, 2017

| (in thousands, except share data; unaudited)   | Common Stock |          | Retained Earnings | Accumulated                                     | Total      |
|--|--------------|----------|-------------------|---|------------|
|  | Shares       | Amount   |                   | Other Comprehensive Income (Loss), Net of Taxes |            |
| Balance at December 31, 2015   | 6,068,543    | \$84,727 | \$129,553         | \$ 193  | \$214,473  |
| Net income   | —            | —        | 23,134            | —   | 23,134     |
| Other comprehensive loss   | —            | —        | —                 | (3,486)   | (3,486 )   |
| Stock options exercised  | 36,117       | 1,227    | —                 | —   | 1,227      |
| Excess tax benefit - stock-based compensation  | —            | 161      | —                 | —   | 161        |
| Stock issued under employee stock purchase plan  | 621          | 32       | —                 | —   | 32         |
| Restricted stock granted   | 16,910       | —        | —                 | —   | —          |
| Stock-based compensation - stock options   | —            | 347      | —                 | —   | 347        |
| Stock-based compensation - restricted stock  | —            | 638      | —                 | —   | 638        |
| Cash dividends paid on common stock  | —            | —        | (6,223)           | —   | (6,223 )   |
| Stock purchased by directors under director stock plan   | 516          | 26       | —                 | —   | 26         |
| Stock issued in payment of director fees   | 4,607        | 234      | —                 | —   | 234        |
| Balance at December 31, 2016   | 6,127,314    | \$87,392 | \$146,464         | \$ (3,293)                                      | )\$230,563 |
| Net income   | —            | —        | 9,734             | —   | 9,734      |
| Other comprehensive income   | —            | —        | —                 | 2,194   | 2,194      |
| Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings | 5,893        | 28       | —                 | —   | 28         |
| Stock issued under employee stock purchase plan  | 280          | 17       | —                 | —   | 17         |
| Stock issued to employee stock ownership plan  | 11,732       | 698      | —                 | —   | 698        |
| Restricted stock granted   | 14,230       | —        | —                 | —   | —          |
| Stock-based compensation - stock options   | —            | 282      | —                 | —   | 282        |
| Stock-based compensation - restricted stock  | —            | 428      | —                 | —   | 428        |
| Cash dividends paid on common stock  | —            | —        | (3,315)           | —   | (3,315 )   |
| Stock purchased by directors under director stock plan   | 315          | 22       | —                 | —   | 22         |
| Stock issued in payment of director fees   | 1,188        | 82       | —                 | —   | 82         |
| Balance at June 30, 2017   | 6,160,952    | \$88,949 | \$152,883         | \$ (1,099)                                      | )\$240,733 |

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



BANK OF MARIN BANCORP  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
for the six months ended June 30, 2017 and 2016

| (in thousands; unaudited)   | June 30,<br>2017 | June 30,<br>2016 |
|---|------------------|------------------|
| Cash Flows from Operating Activities:   |                  |                  |
| Net income  | \$9,734          | \$10,483         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| (Reversal of) provision for losses on off-balance sheet commitments               | (43              | ) 150            |
| Compensation expense--common stock for director fees                              | 106              | 97               |
| Stock-based compensation expense  | 710              | 478              |
| Amortization of core deposit intangible   | 236              | 267              |
| Amortization of investment security premiums, net of accretion of discounts       | 1,496            | 1,466            |
| Accretion of discount on acquired loans   | (498             | ) (832 )         |
| Accretion of discount on subordinated debentures                                  | 80               | 98               |
| Net amortization of deferred loan origination costs/fees                          | 60               | 43               |
| Write-down of other real estate owned   | —                | 13               |
| Gain on sale of investment securities   | (10              | ) (394 )         |
| Depreciation and amortization   | 944              | 894              |
| Gain on sale of repossessed assets  | (1               | ) —              |
| Earnings on bank-owned life insurance policies                                    | (419             | ) (410 )         |
| Net change in operating assets and liabilities:                                   |                  |                  |
| Deferred rent and other rent-related expenses                                     | 114              | (262 )           |
| Interest receivable and other assets  | 93               | 2,439            |
| Interest payable and other liabilities  | (389             | ) (4,035 )       |
| Total adjustments   | 2,479            | 12               |
| Net cash provided by operating activities   | 12,213           | 10,495           |
| Cash Flows from Investing Activities:   |                  |                  |
| Purchase of held-to-maturity securities   | (4,496           | ) (2,424 )       |
| Purchase of available-for-sale securities   | (9,377           | ) (19,916 )      |
| Proceeds from sale of available-for-sale securities                               | 1,321            | 68,673           |
| Proceeds from paydowns/maturities of held-to-maturity securities                  | 14,601           | 13,243           |
| Proceeds from paydowns/maturities of available-for-sale securities                | 15,385           | 49,576           |
| Loans originated and principal collected, net                                     | (4,563           | ) 4,996          |
| Purchase of bank-owned life insurance policies                                    | —                | (1,864 )         |
| Purchase of premises and equipment  | (814             | ) (239 )         |
| Proceeds from sale of repossessed assets  | 170              | —                |
| Purchase of Federal Home Loan Bank stock  | —                | (1,792 )         |
| Cash paid for low-income housing investment                                       | (628             | ) (225 )         |
| Net cash provided by investing activities   | 11,599           | 110,028          |
| Cash Flows from Financing Activities:   |                  |                  |
| Net increase (decrease) in deposits   | 67,840           | (22,611 )        |
| Proceeds from stock options exercised   | 88               | 1,200            |
| Payment of tax withholdings for stock options exercised                           | (60              | ) —              |
| Proceeds from stock issued under employee and director stock purchase plans       | 737              | 27               |
| Federal Home Loan Bank repayments   | —                | (67,000 )        |
| Cash dividends paid on common stock   | (3,315           | ) (3,044 )       |
| Net cash provided by (used in) financing activities                               | 65,290           | (91,428 )        |
| Net increase in cash and cash equivalents   | 89,102           | 29,095           |

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|  |           |          |
|--|-----------|----------|
| Cash and cash equivalents at beginning of period   | 48,804    | 26,343   |
| Cash and cash equivalents at end of period   | \$137,906 | \$55,438 |
| Supplemental disclosure of cash flow information:  |           |          |
| Cash paid in interest  | \$751     | \$1,336  |
| Cash paid in income taxes  | \$4,620   | \$7,095  |
| Supplemental disclosure of non-cash investing and financing activities:                              |           |          |
| Change in net unrealized gain or loss on available-for-sale securities                               | \$3,635   | \$5,042  |
| Securities transferred from available-for-sale to held-to-maturity                                   | \$128,965 | \$—      |
| Amortization of net unrealized loss on available-for-sale securities transferred to held-to-maturity | \$165     | \$—      |
| Stock issued in payment of director fees   | \$82      | \$137    |

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

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

## Note 1: 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 the holding company and the Bank that are consolidated for financial reporting purposes. The accompanying unaudited consolidated interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations. Although we believe that the disclosures are adequate and the information presented is not misleading, we suggest that these interim financial statements be read in conjunction with the annual financial statements and the notes thereto included in our 2016 Annual Report on Form 10-K. In the opinion of Management, the unaudited consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in stockholders’ equity, and cash flows for the periods presented. All material intercompany transactions have been eliminated. The results of these interim periods may not be indicative of the results for the full year or for any other period.

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 (See Note 6, Borrowings). 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.

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 earnings per share (“EPS”) are calculated by dividing net income by the weighted average number of common shares outstanding during each 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 the quarterly diluted EPS is computed using the average market prices during the three months included in the reporting period under the treasury stock method. 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. 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 not significant for these participating securities.

|  | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2017      | June 30, 2016 | June 30, 2017    | June 30, 2016 |
| (in thousands, except per share data)          |                    |               |                  |               |
| Weighted average basic shares outstanding      | 6,110              | 6,078         | 6,101            | 6,063         |
| Potentially dilutive common shares related to: |                    |               |                  |               |
| Stock options                                  | 52                 | 27            | 57               | 31            |
| Unvested restricted stock awards               | 12                 | 4             | 15               | 6             |
| Weighted average diluted shares outstanding    | 6,174              | 6,109         | 6,173            | 6,100         |
| Net income                                     | \$5,186            | \$4,837       | \$9,734          | \$10,483      |
| Basic EPS                                      | \$0.85             | \$0.80        | \$1.60           | \$1.73        |

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|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Diluted EPS  | \$0.84 | \$0.79 | \$1.58 | \$1.72 |
| Weighted average anti-dilutive shares not included in the calculation of diluted EPS | 33     | 70     | 23     | 60     |

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Note 2: Recently Adopted and Issued Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-05, Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. A contract novation refers to replacing one of the parties to a derivative instrument with a new party. This ASU clarifies that a change in counterparty in a derivative instrument does not, in and of itself, require dedesignation of that hedging relationship and therefore discontinue the application of hedge accounting. We adopted the amendments prospectively effective January 1, 2017, which did not have a material impact on our financial condition or results of operations as there were no changes in counterparties.

In March 2016, the FASB issued ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). This ASU identifies areas for simplification involving several aspects of accounting for share-based payment transactions, including the income tax consequences, classification of awards as equity or liabilities, forfeiture accounting, and classifications on the statement of cash flows. We adopted the requirements of this ASU effective January 1, 2017, which impacted the following areas:

**Forfeiture rates:** We have elected to account for forfeitures as they occur. Previously, we accounted for forfeitures based on an estimate of the number of awards expected to vest. The policy change was applied using a modified retrospective approach and did not have a material effect on our financial condition or results of operations.

**Income taxes:** We have recorded excess tax benefits (deficiencies) 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 (expense) in the consolidated statements of comprehensive income with a corresponding decrease (increase) to current taxes payable. Previous to the adoption of this ASU, excess tax benefits (deficiencies) were recognized as an increase (decrease) to common stock in the consolidated statements of changes in stockholders' equity. In addition, we have reflected excess tax benefits as an operating activity in the consolidated statements of cash flows. Previous to the adoption of this ASU, excess tax benefits were shown as a financing activity. We applied the amendment prospectively and prior period financial statements have not been restated. For the six months ended June 30, 2017, we recognized \$169 thousand in excess tax benefits recorded as a reduction to income tax expense.

**Statutory tax withholding:** Cash paid for tax withholdings when shares are surrendered in a cashless stock option exchange has been classified as a financing activity in the consolidated statements of cash flows. There were no shares surrendered for tax withholdings prior to the adoption of ASU 2016-09.

In March 2017, the FASB issued ASU No. 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium and require the premium to be amortized to the earliest call date. The ASU is effective for annual periods beginning after December 15, 2018, including interim periods within those periods. We early adopted this ASU effective January 1, 2017, which did not have a material impact on our financial condition and results of operations.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU is a converged standard involving FASB and International Financial Reporting Standards that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount and at a time that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Subsequent updates related to Revenue from Contracts with Customers (Topic 606) are as follows:

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August 2015 ASU No. 2015-14 - Deferral of the Effective Date, institutes a one-year deferral of the effective date of this amendment to annual reporting periods beginning after December 15, 2017. Early application is permitted only as of annual periods beginning after December 15, 2016, including interim reporting periods within that reporting period. March 2016 ASU No. 2016-08 - Principal versus Agent Considerations (Reporting Revenue Gross versus Net), clarifies the implementation guidance on principal versus agent considerations and on the use of indicators that assist an entity in determining whether it controls a specified good or service before it is transferred to the customer.

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April 2016 ASU No. 2016-10 - Identifying Performance Obligations and Licensing, provides guidance in determining performance obligations in a contract with a customer and clarifies whether a promise to grant a license provides a right to access or the right to use intellectual property.

May 2016 ASU No. 2016-12 - Narrow Scope Improvements and Practical Expedients, gives further guidance on assessing collectability, presentation of sales taxes, noncash consideration, and completed contracts and contract modifications at transition.

December 2016 ASU No. 2016-20 - Technical Corrections and Improvements to Topic 606, further clarifies specific aspects of previously issued guidance or corrects unintended application of the guidance.

Our revenue is mainly comprised of interest income on financial instruments, which is explicitly excluded from the scope of ASU 2014-09. We have identified applicable sources of non-interest income and are gathering and reviewing related contracts and evaluating their potential impact to our revenue recognition under the new standards. While the recognition of certain components of our non-interest income may be affected by the ASU, we do not expect it to have a material impact on our financial condition and results of operations.

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 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 that is currently required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

Requires public companies to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

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.

Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU may affect our financial statement presentation and related footnotes, but we do not expect it to have a material impact on our financial condition or results of operations.

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. Early application of the amendments is permitted. We intend to adopt this ASU during the first quarter of 2019, as required, and are continuing to evaluate our lease agreements and potential accounting software solutions as they become available. As of June 30, 2017, our undiscounted operating lease obligations that were off-balance sheet totaled \$19.4 million (See Note 8, Commitments

and Contingencies). Upon adoption of this ASU, the present values of leases currently classified as operating leases will be recognized as lease assets and liabilities on our balance sheet. Additional disclosures of key information about our leasing arrangements will also be required. We do not expect that the ASU will have a material impact on our capital ratios or return on average assets when adopted and we are currently evaluating the effect that the ASU will have on other components of our financial condition and results of operations.

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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. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Management refined our allowance for loan loss model in 2016 and enhanced our loan-level data collection and methodology for analyzing credit losses in preparation for the new accounting standards. We will continue our evaluation of the provisions of this ASU and will be monitoring developments, additional guidance and the potential outcome the amendments will have on our financial condition and results of operations upon adoption in the first quarter of 2020.

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. This ASU may affect our presentation of certain cash flows and their categorization as operating, investing or financing activities in the consolidated statements of cash flows, but we do not expect it to have a material impact on our financial condition or results of operations.

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 are effective for annual periods after December 31, 2017, including interim periods within those periods. The amendments will be adopted prospectively. We will consider these amendments in our evaluation of the accounting for any future business acquisitions or asset disposals.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. This amendment simplifies how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test, which would measure a goodwill impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. Instead, an entity will perform only Step 1 of its quantitative goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount, and then recognizing an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The new guidance does not amend the optional qualitative assessment of goodwill impairment, which Bancorp currently uses. The ASU is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. We anticipate that this ASU will simplify our evaluation of the impairment of goodwill and do not expect it to have a material impact on our financial condition and results of operations.

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. Early adoption is permitted, including adoption in an interim period. The amendments should be applied prospectively to an award modified on or after the adoption date. We do not expect this ASU to have a material impact on our financial condition or results of operations.

Note 3: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

We group our assets and liabilities that are measured at fair value in three levels within the fair value hierarchy, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1: Valuations are based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2: Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuations for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3: Valuations are based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Values are determined using pricing models and discounted cash flow models and may include significant Management judgment and estimation.

Transfers between levels of the fair value hierarchy are recognized through our monthly and/or quarterly valuation process in the reporting period during which the event or circumstances that caused the transfer occurred.

The following table summarizes our assets and liabilities that were required to be recorded at fair value on a recurring basis.

| (in thousands)<br>Description of Financial Instruments  | Carrying<br>Value | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
|---|-------------------|--|---|--|
| June 30, 2017   |                   |  |   |  |
| Securities available-for-sale:  |                   |  |   |  |
| Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies | \$ 120,914        | \$   | -\$ 120,343   | \$ 571   |
| Debentures of government sponsored agencies   | 35,378            | —  | 35,378  | —  |
| Privately-issued collateralized mortgage obligations  | 130               | —  | 130   | —  |
| Obligations of state and political subdivisions   | 77,423            | —  | 77,423  | —  |
| Corporate bonds   | 5,025             | —  | 5,025   | —  |
| Derivative financial assets (interest rate contracts)   | 39                | —  | 39  | —  |
| Derivative financial liabilities (interest rate contracts)  | 935               | —  | 935   | —  |
| December 31, 2016   |                   |  |   |  |
| Securities available-for-sale:  |                   |  |   |  |
| Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies | \$ 254,041        | \$   | -\$ 253,434   | \$ 607   |
| Debentures of government sponsored agencies   | 35,403            | —  | 35,403  | —  |
| Privately-issued collateralized mortgage obligations  | 419               | —  | 419   | —  |
| Obligations of state and political subdivisions   | 77,701            | —  | 77,701  | —  |

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|  |       |   |       |   |
|--|-------|---|-------|---|
| Corporate bonds  | 5,016 | — | 5,016 | — |
| Derivative financial assets (interest rate contracts)      | 55    | — | 55    | — |
| Derivative financial liabilities (interest rate contracts) | 933   | — | 933   | — |

Securities available-for-sale are recorded at fair value on a recurring basis. When available, quoted market prices (Level 1) are used to determine the fair value of securities available-for-sale. If quoted market prices are not available, we obtain pricing information from a reputable third-party service provider, who may utilize valuation techniques that use current market-based or independently sourced parameters, such as bid/ask prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, probability of default, loss severity and credit spreads (Level 2). Level 2 securities include obligations of state and political subdivisions, U.S. agencies or government-sponsored

agencies' debt securities, mortgage-backed securities, government agency-issued, privately-issued collateralized mortgage obligations, and corporate bonds. As of June 30, 2017 and December 31, 2016, there were no securities that were considered Level 1 securities. As of June 30, 2017, we had one available-for-sale security that was considered a Level 3 security. The security is a U.S. government agency obligation collateralized by a small number of business equipment loans guaranteed by the Small Business Administration ("SBA") program. The security is not actively traded and is owned only by a few investors. The significant unobservable data that is reflected in the fair value measurement include dealer quotes, projected prepayment speeds/average life and credit information, among other things. The unrealized gain or loss on this SBA-guaranteed security increased by \$1 thousand in the same period recorded as part of other comprehensive income.

Securities held-to-maturity may be written down to fair value (determined using the same techniques discussed above for securities available-for-sale) as a result of other-than-temporary impairment, and we did not record any write-downs during 2017 or 2016.

On a recurring basis, derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs, reflecting market expectations of future interest rates as of the measurement date. Standard valuation techniques are used to calculate the present value of the future expected cash flows assuming an orderly transaction. Valuation adjustments may be made to reflect both our own credit risk and the counterparties' credit risk in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for London Interbank Offered Rate ("LIBOR") and Overnight Index Swap ("OIS") rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR and OIS swap rates, and one-month and three-month LIBOR basis spreads at commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. We project spot rates at reset days specified by each swap contract to determine future cash flows, then discount to present value using either LIBOR or OIS curves depending on whether the swap positions are fully collateralized as of the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, a credit valuation adjustment ("CVA") is applied to reflect the credit risk we pose to counterparties. We have used the spread between the Standard & Poor's BBB rated U.S. Bank Composite rate and LIBOR for the closest maturity term corresponding to the duration of the swaps to derive the CVA. A similar credit risk adjustment, correlated to the credit standing of the counterparty, is made when collateral posted by the counterparty does not fully cover their liability to the Bank. For further discussion on our methodology in valuing our derivative financial instruments, refer to Note 9, Derivative Financial Instruments and Hedging Activities.

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets, such as impaired loans and other real estate owned ("OREO").

The following table presents the carrying value of assets measured at fair value on a non-recurring basis and that were held in the consolidated statements of condition at each respective period end, by level within the fair value hierarchy as of June 30, 2017 and December 31, 2016.

| (in thousands)          | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|-------------------------|----------------|--|---|---|
| June 30, 2017           |                |  |   |   |
| Other real estate owned | 238            | —  | —   | 238                                       |
| December 31, 2016       |                |  |   |   |
|                         | 408            | —  | —   | 408                                       |

Other real estate  
owned

When a loan is identified as impaired, it is reported at the lower of cost or fair value, measured based on the loan's observable market price (Level 1) or the current net realizable value of the underlying collateral securing the loan, if the loan is collateral dependent (Level 3). Net realizable value of the underlying collateral is the fair value of the collateral less estimated selling costs and any prior liens. Appraisals, recent comparable sales, offers and listing prices are factored in when valuing the collateral. We review and verify the qualifications and licenses of the certified general appraisers used for appraising commercial properties or certified residential appraisers for residential properties. Real estate appraisals may utilize a combination of approaches including replacement cost, sales comparison and the income approach. Comparable sales and income data are analyzed by the appraisers and adjusted to reflect differences between them and the subject property such as property characteristics, leasing status and physical condition. When

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appraisals are received, Management reviews the underlying assumptions and methodology utilized, as well as the overall resulting value in conjunction with independent data sources such as recent market data and industry-wide statistics. We generally use a 6% discount for selling costs which is applied to all properties, regardless of size. Appraised values may be adjusted to reflect changes in market conditions that have occurred subsequent to the appraisal date, or for revised estimates regarding the timing or cost of the property sale. These adjustments are based on qualitative judgments made by Management on a case-by-case basis and are generally unobservable valuation inputs as they are specific to the underlying collateral. There have been no significant changes in the valuation techniques during 2017. As of June 30, 2017 and December 31, 2016, there were no collateral-dependent loans whose principal balances had been written down to the values of the underlying collateral.

OREO represents collateral acquired through foreclosure and is initially recorded at fair value as established by a current appraisal, adjusted for disposition costs. Subsequently, OREO is measured at lower of cost or fair value. OREO values are reviewed on an ongoing basis and any subsequent decline in fair value is recorded as a foreclosed asset expense in the current period. The value of OREO is determined based on independent appraisals, similar to the process used for impaired loans, discussed above, and is classified as Level 3. All OREO resulted from an acquisition. There were no changes in the estimated fair values of OREO during the first six months of 2017 or 2016.

#### Disclosures about Fair Value of Financial Instruments

The table below is a summary of fair value estimates for financial instruments as of June 30, 2017 and December 31, 2016, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note). The carrying amounts in the following table are recorded in the consolidated statements of condition under the indicated captions. Further, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements such as bank-owned life insurance policies ("BOLI"). Additionally, we hold shares of FHLB stock and Visa Inc. Class B common stock at cost. These shares are restricted from resale, except among member banks, and their values are discussed in Note 4, Investment Securities.

| (in thousands)                         | June 30, 2017    |            |                      | December 31, 2016 |            |                      |
|--|------------------|------------|----------------------|-------------------|------------|----------------------|
|  | Carrying Amounts | Fair Value | Fair Value Hierarchy | Carrying Amounts  | Fair Value | Fair Value Hierarchy |
| Financial assets                       |                  |            |                      |                   |            |                      |
| Cash and cash equivalents              | \$ 137,906       | \$ 137,906 | Level 1              | \$ 48,804         | \$ 48,804  | Level 1              |
| Investment securities held-to-maturity | 163,018          | 165,028    | Level 2              | 44,438            | 45,097     | Level 2              |
| Loans, net                             | 1,476,253        | 1,454,371  | Level 3              | 1,471,174         | 1,473,360  | Level 3              |
| Interest receivable                    | 6,003            | 6,003      | Level 2              | 6,319             | 6,319      | Level 2              |
| Financial liabilities                  |                  |            |                      |                   |            |                      |
| Deposits                               | 1,840,540        | 1,840,737  | Level 2              | 1,772,700         | 1,773,102  | Level 2              |
| Subordinated debentures                | 5,666            | 5,153      | Level 3              | 5,586             | 5,083      | Level 3              |
| Interest payable                       | 114              | 114        | Level 2              | 134               | 134        | Level 2              |

Following is a description of methods and assumptions used to estimate the fair value of each class of financial instrument not recorded at fair value but required for disclosure purposes:

**Cash and Cash Equivalents** - The carrying amounts of cash and cash equivalents approximate their fair value because of the short-term nature of these instruments.

**Held-to-maturity Securities** - Held-to-maturity securities, which generally consist of obligations of state and political subdivisions and corporate bonds, are recorded at their amortized cost. Their fair value for disclosure purposes is determined using methodologies similar to those described above for available-for-sale securities using Level 2 inputs.

If Level 2 inputs are not available, we may utilize pricing models that incorporate unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities (Level 3). As of June 30, 2017 and December 31, 2016, we did not hold any held-to-maturity securities whose fair value was measured using significant unobservable inputs.

Loans - The fair value of loans with variable interest rates approximates their current carrying value, because their rates are regularly adjusted to current market rates. The fair value of fixed rate loans or variable loans at negotiated interest rate floors or ceilings with remaining maturities in excess of one year is estimated by discounting the future



cash flows using current market rates at which similar loans would be made to borrowers with similar creditworthiness and similar remaining maturities. The allowance for loan losses (“ALLL”) is considered to be a reasonable estimate of the portion of loan discount attributable to credit risks.

Interest Receivable and Payable - The interest receivable and payable balances approximate their fair value due to the short-term nature of their settlement dates.

Deposits - The fair value of deposits without stated maturity, such as transaction accounts, savings accounts and money market accounts, is the amount payable on demand at the reporting date. The fair value of time deposits is estimated by discounting the future cash flows using current rates offered for deposits of similar remaining maturities.

Federal Home Loan Bank Borrowing - The fair value is estimated by discounting the future cash flows using current rates offered by the FHLB for similar credit advances corresponding to the remaining term of our fixed-rate credit advances.

Subordinated Debentures - The fair values of the subordinated debentures are estimated by discounting the future cash flows (interest payment at a rate of three-month LIBOR plus 3.05% and 1.40%) to their present values using current market rates at which similar bonds would be issued with similar credit ratings as ours and similar remaining maturities. Each interest payment is discounted at the spot rate of the corresponding term, determined based on the yields and terms of comparable trust preferred securities, plus a liquidity premium. In July 2010, the Dodd-Frank Act was signed into law and limits the ability of certain bank holding companies to treat trust preferred security debt issuances as Tier 1 capital. This law effectively closed the trust preferred securities markets for new issuances and led to the absence of observable or comparable transactions in the market place. Due to the use of unobservable inputs of trust preferred securities, we consider the fair value to be a Level 3 measurement. See Note 6, Borrowings, for further information.

Commitments - The value of unrecognized financial instruments is estimated based on the fee income associated with the commitments which, in the absence of credit exposure, is considered to approximate their settlement value. The fair value of commitment fees was not material at June 30, 2017 and December 31, 2016, respectively.

#### Note 4: 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”) 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”), 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:

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| (in thousands)                                       | June 30, 2017    |                  |                |                | December 31, 2016      |                  |                         |                  |
|--|------------------|------------------|----------------|----------------|------------------------|------------------|-------------------------|------------------|
|  | Amortized Cost   |                  | Fair Value     |                | Gross Unrealized Gains |                  | Gross Unrealized Losses |                  |
|  | Cost             | Value            | Gains          | (Losses)       | Cost                   | Value            | Gains                   | (Losses)         |
| <b>Held-to-maturity:</b>                             |                  |                  |                |                |                        |                  |                         |                  |
| Obligations of state and political subdivisions      | \$24,059         | \$24,729         | \$671          | \$(1)          | \$30,856               | \$31,544         | \$694                   | \$(6)            |
| Corporate bonds                                      | —                | —                | —              | —              | 3,519                  | 3,518            | —                       | (1)              |
| MBS pass-through securities issued by FHLMC and FNMA | 107,526          | 108,360          | 897            | (63)           | 10,063                 | 10,035           | 126                     | (154)            |
| CMOs issued by FHLMC                                 | 31,433           | 31,940           | 507            | —              | —                      | —                | —                       | —                |
| <b>Total held-to-maturity</b>                        | <b>163,018</b>   | <b>165,029</b>   | <b>2,075</b>   | <b>(64)</b>    | <b>44,438</b>          | <b>45,097</b>    | <b>820</b>              | <b>(161)</b>     |
| <b>Available-for-sale:</b>                           |                  |                  |                |                |                        |                  |                         |                  |
| <b>Securities of U.S. government agencies:</b>       |                  |                  |                |                |                        |                  |                         |                  |
| MBS pass-through securities issued by FHLMC and FNMA | 89,422           | 89,836           | 630            | (216)          | 193,998                | 190,566          | 145                     | (3,577)          |
| CMOs issued by FNMA                                  | 12,182           | 12,237           | 80             | (25)           | 13,790                 | 13,772           | 91                      | (109)            |
| CMOs issued by FHLMC                                 | 9,381            | 9,405            | 24             | —              | 43,452                 | 42,758           | 37                      | (731)            |
| CMOs issued by GNMA                                  | 9,361            | 9,436            | 77             | (2)            | 6,844                  | 6,945            | 102                     | (1)              |
| Debentures of government-sponsored agencies          | 35,490           | 35,378           | —              | (112)          | 35,486                 | 35,403           | 7                       | (90)             |
| Privately issued CMOs                                | 129              | 130              | 1              | —              | 419                    | 419              | 1                       | (1)              |
| Obligations of state and political subdivisions      | 76,955           | 77,423           | 772            | (304)          | 79,306                 | 77,701           | 135                     | (1,740)          |
| Corporate bonds                                      | 4,964            | 5,025            | 61             | —              | 4,959                  | 5,016            | 57                      | —                |
| <b>Total available-for-sale</b>                      | <b>237,884</b>   | <b>238,870</b>   | <b>1,645</b>   | <b>(659)</b>   | <b>378,254</b>         | <b>372,580</b>   | <b>575</b>              | <b>(6,249)</b>   |
| <b>Total investment securities</b>                   | <b>\$400,902</b> | <b>\$403,899</b> | <b>\$3,720</b> | <b>\$(723)</b> | <b>\$422,692</b>       | <b>\$417,677</b> | <b>\$1,395</b>          | <b>\$(6,410)</b> |

The amortized cost and fair value of investment debt securities by contractual maturity at June 30, 2017 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.

| (in thousands)                     | June 30, 2017    |                  |                    |                  | December 31, 2016 |                 |                    |                  |
|------------------------------------|------------------|------------------|--------------------|------------------|-------------------|-----------------|--------------------|------------------|
|                                    | Held-to-Maturity |                  | Available-for-Sale |                  | Held-to-Maturity  |                 | Available-for-Sale |                  |
|                                    | Amortized Cost   | Fair Value       | Amortized Cost     | Fair Value       | Amortized Cost    | Fair Value      | Amortized Cost     | Fair Value       |
| Within one year                    | \$4,501          | \$4,524          | \$22,959           | \$22,942         | \$13,473          | \$13,506        | \$20,136           | \$20,109         |
| After one but within five years    | 15,894           | 16,300           | 57,536             | 57,592           | 16,706            | 17,150          | 58,334             | 58,267           |
| After five years through ten years | 43,392           | 44,274           | 79,739             | 80,018           | 3,000             | 3,125           | 113,576            | 110,842          |
| After ten years                    | 99,231           | 99,931           | 77,650             | 78,318           | 11,259            | 11,316          | 186,208            | 183,362          |
| <b>Total</b>                       | <b>\$163,018</b> | <b>\$165,029</b> | <b>\$237,884</b>   | <b>\$238,870</b> | <b>\$44,438</b>   | <b>\$45,097</b> | <b>\$378,254</b>   | <b>\$372,580</b> |

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

| (in thousands)       | Three months ended  |               | Six months ended |               |
|----------------------|---------------------|---------------|------------------|---------------|
|                      | June 30, 2017       | June 30, 2016 | June 30, 2017    | June 30, 2016 |
|                      | Available-for-sale: |               |                  |               |
| Sales proceeds       | \$1,321             | \$13,688      | \$1,321          | \$68,673      |
| Gross realized gains | 13                  | 284           | 13               | 458           |

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Gross realized losses (3 ) — (3 ) (64 )

Investment securities carried at \$119.8 million and \$109.1 million at June 30, 2017 and December 31, 2016, respectively, were pledged with the State of California: \$119.0 million and \$108.3 million to secure public deposits in compliance with the Local Agency Security Program at June 30, 2017 and December 31, 2016, respectively, and \$814 thousand and \$822 thousand to provide collateral for trust deposits at June 30, 2017 and December 31, 2016, respectively. In addition, investment securities carried at \$2.0 million and \$2.1 million were pledged to collateralize a

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Wealth Management and Trust Services (“WMTS”) checking account at June 30, 2017 and December 31, 2016, respectively.

As part of our ongoing review of our investment securities portfolio, we reassessed the classification of certain MBS pass-through and CMOs securities issued by FHLMC and FNMA. Effective February 24, 2017, we transferred \$129 million of these securities, which we intend and have the ability to hold to maturity, from available-for-sale securities to held-to-maturity at fair value. The unrealized pre-tax loss of \$3.0 million at the date of transfer remained in accumulated other comprehensive income and is amortized over the remaining lives of the securities.

#### Other-Than-Temporarily Impaired ("OTTI") Debt Securities

We have evaluated the credit of our investment securities and their issuers and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired as of June 30, 2017. We do not have the intent and it is more likely than not that we will not have to sell the remaining securities temporarily impaired at June 30, 2017 before recovery of the amortized cost basis.

There were 59 and 134 investment securities in unrealized loss positions at June 30, 2017 and December 31, 2016, respectively. Those securities are summarized and classified according to the duration of the loss period in the tables below:

| June 30, 2017<br><br>(in thousands)                  | < 12 continuous<br>months |                    | ≥ 12 continuous<br>months |                    | Total securities<br>in a loss position |                    |
|--|---------------------------|--------------------|---------------------------|--------------------|--|--------------------|
|  | Fair<br>value             | Unrealized<br>loss | Fair<br>value             | Unrealized<br>loss | Fair<br>value                          | Unrealized<br>loss |
| Held-to-maturity:                                    |                           |                    |                           |                    |  |                    |
| Obligations of state and political subdivisions      | \$ 132                    | \$ (1 )            | \$ 545                    | \$ —               | \$ 677                                 | \$ (1 )            |
| MBS pass-through securities issued by FHLMC and FNMA | 2,321                     | (63 )              | —                         | —                  | 2,321                                  | (63 )              |
| Total held-to-maturity                               | 2,453                     | (64 )              | 545                       | —                  | 2,998                                  | (64 )              |
| Available-for-sale:                                  |                           |                    |                           |                    |  |                    |
| MBS pass-through securities issued by FHLMC and FNMA | 25,380                    | (201 )             | 9,117                     | (15 )              | 34,497                                 | (216 )             |
| CMOs issued by FNMA                                  | 8,452                     | (25 )              | —                         | —                  | 8,452                                  | (25 )              |
| CMOs issued by GNMA                                  | 1,278                     | (2 )               | —                         | —                  | 1,278                                  | (2 )               |
| Debentures of government- sponsored agencies         | 24,926                    | (66 )              | 9,953                     | (46 )              | 34,879                                 | (112 )             |
| Obligations of state add political subdivisions      | 21,434                    | (290 )             | 1,391                     | (14 )              | 22,825                                 | (304 )             |
| Total available-for-sale                             | 81,470                    | (584 )             | 20,461                    | (75 )              | 101,931                                | (659 )             |
| Total temporarily impaired securities                | \$ 83,923                 | \$ (648 )          | \$ 21,006                 | \$ (75 )           | \$ 104,929                             | \$ (723 )          |

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| December 31, 2016<br>(in thousands)                  | < 12 continuous<br>months |                    | ≥ 12 continuous<br>months |                    | Total securities<br>in a loss position |                    |
|--|---------------------------|--------------------|---------------------------|--------------------|--|--------------------|
|  | Fair<br>value             | Unrealized<br>loss | Fair<br>value             | Unrealized<br>loss | Fair<br>value                          | Unrealized<br>loss |
| <b>Held-to-maturity:</b>                             |                           |                    |                           |                    |  |                    |
| Obligations of state and political subdivisions      | \$2,250                   | \$(154)            | \$—                       | \$—                | \$2,250                                | \$(154)            |
| Corporate bonds                                      | 3,362                     | (6)                | —                         | —                  | 3,362                                  | (6)                |
| MBS pass-through securities issued by FHLMC and FNMA | 3,518                     | (1)                | —                         | —                  | 3,518                                  | (1)                |
| <b>Total held-to-maturity</b>                        | <b>9,130</b>              | <b>(161)</b>       | <b>—</b>                  | <b>—</b>           | <b>9,130</b>                           | <b>(161)</b>       |
| <b>Available-for-sale:</b>                           |                           |                    |                           |                    |  |                    |
| MBS pass-through securities issued by FHLMC and FNMA | 162,016                   | (3,577)            | —                         | —                  | 162,016                                | (3,577)            |
| CMOs issued by FNMA                                  | 9,498                     | (109)              | —                         | —                  | 9,498                                  | (109)              |
| CMOs issued by FHLMC                                 | 31,545                    | (731)              | —                         | —                  | 31,545                                 | (731)              |
| CMOs issued by GNMA                                  | 1,583                     | (1)                | —                         | —                  | 1,583                                  | (1)                |
| Debentures of government- sponsored agencies         | 19,951                    | (38)               | 9,946                     | (52)               | 29,897                                 | (90)               |
| Obligations of state and political subdivisions      | 59,567                    | (1,740)            | —                         | —                  | 59,567                                 | (1,740)            |
| Corporate bonds                                      | 154                       | (1)                | —                         | —                  | 154                                    | (1)                |
| <b>Total available-for-sale</b>                      | <b>284,314</b>            | <b>(6,197)</b>     | <b>9,946</b>              | <b>(52)</b>        | <b>294,260</b>                         | <b>(6,249)</b>     |
| <b>Total temporarily impaired securities</b>         | <b>\$293,444</b>          | <b>\$(6,358)</b>   | <b>\$9,946</b>            | <b>\$(52)</b>      | <b>\$303,390</b>                       | <b>\$(6,410)</b>   |

As of June 30, 2017, there was one debenture of government-sponsored agency security, one MBS pass-through security issued by FNMA and two obligations of U.S. state and political subdivisions security that have been in a continuous loss position for twelve months or more. We have evaluated the securities and believe that the decline in fair value is primarily driven by factors other than credit. It is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists on these securities. The debenture of government-sponsored agency security is supported by the U.S. Federal Government, which protects us from credit losses. Based upon our assessment of the credit fundamentals, we concluded that these securities were not other-than-temporarily impaired at June 30, 2017.

There were 55 investment securities in our portfolio that had been in temporary loss positions for less than twelve months as of June 30, 2017, and their temporary loss positions mainly arose from changes in interest rates since purchase. They consisted of two debentures of U.S. government-sponsored agencies, 36 obligations of U.S. state and political subdivisions, twelve MBS and five CMOs issued by government-sponsored agencies. Securities of government-sponsored agencies are supported by the U.S. Federal Government, which protects us from credit losses. Other temporarily impaired securities are deemed creditworthy after internal analysis of the issuers' latest financial information and credit enhancement. Additionally, all are rated as investment grade by at least one major rating agency. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at June 30, 2017.

#### 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 \$10.2 million of FHLB stock recorded at cost in other assets on the consolidated statements of condition at both June 30, 2017 and December 31, 2016. 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. Management does not believe that the FHLB stock is other-than-temporarily-impaired, due to FHLB's current financial condition. On July 27, 2017, FHLB announced a cash dividend for the second quarter of 2017 at an annualized dividend rate of 7.00% to be distributed in mid-August 2017. Cash dividends paid on FHLB capital stock are recorded as non-interest income.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock with a carrying value of zero, which is equal to our cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s Covered Litigation escrow account. As a result of the restriction, these shares are not considered available-for-sale and are not carried at fair value. When converting this Class B common stock to Class A common stock based on the conversion rate of 1.6483 and the closing stock price of Class A shares, the value of our shares of Class B common stock would have been \$2.6 million and \$2.2 million at June 30, 2017 and December 31, 2016, respectively. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. For further information, see Note 8, Commitments and Contingencies.

We invest in low-income housing tax credit funds as a limited partner, which totaled \$2.3 million and \$2.5 million recorded in other assets as of June 30, 2017 and December 31, 2016, respectively. In the first six months of 2017, we recognized \$175 thousand of low-income housing tax credits and other tax benefits, net of \$139 thousand of amortization expense of low-income housing tax credit investment, as a component of income tax expense. As of June 30, 2017, our unfunded commitments for these low-income housing tax credit funds totaled \$820 thousand. We did not recognize any impairment losses on these low-income housing tax credit investments during the first six months of 2017 or 2016.

#### Note 5: Loans and Allowance for Loan Losses

##### Credit Quality of Loans

The following table shows outstanding loans by class and payment aging as of June 30, 2017 and December 31, 2016.

##### Loan Aging Analysis by Loan Class

| (in thousands)                 | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential <sup>1</sup> | Installment and other consumer | Total        |
|--------------------------------|---------------------------|--|----------------------------------|--------------|-------------|--------------------------------|--------------------------------|--------------|
| June 30, 2017                  |                           |  |                                  |              |             |                                |                                |              |
| 30-59 days past due            | \$ —                      | \$ —                                   | \$ —                             | \$ —         | \$ 244      | \$ —                           | \$ 150                         | \$ 394       |
| 60-89 days past due            | —                         | —                                      | —                                | —            | —           | —                              | —                              | —            |
| 90 days or more past due       | —                         | —                                      | —                                | —            | —           | —                              | —                              | —            |
| Total past due                 | —                         | —                                      | —                                | —            | 244         | —                              | 150                            | 394          |
| Current                        | 217,417                   | 265,249                                | 717,197                          | 54,990       | 119,256     | 92,421                         | 24,561                         | 1,491,091    |
| Total loans <sup>3</sup>       | \$ 217,417                | \$ 265,249                             | \$ 717,197                       | \$ 54,990    | \$ 119,500  | \$ 92,421                      | \$ 24,711                      | \$ 1,491,485 |
| Non-accrual loans <sup>2</sup> | \$ —                      | \$ —                                   | \$ 1,041                         | \$ —         | \$ 87       | \$ —                           | \$ 51                          | \$ 1,179     |
| December 31, 2016              |                           |  |                                  |              |             |                                |                                |              |
| 30-59 days past due            | \$ 283                    | \$ —                                   | \$ —                             | \$ —         | \$ 77       | \$ —                           | \$ 2                           | \$ 362       |
| 60-89 days past due            | —                         | —                                      | —                                | —            | —           | —                              | 49                             | 49           |
| 90 days or more past due       | —                         | —                                      | —                                | —            | 91          | —                              | —                              | 91           |
| Total past due                 | 283                       | —                                      | —                                | —            | 168         | —                              | 51                             | 502          |
| Current                        | 218,332                   | 247,713                                | 724,228                          | 74,809       | 117,039     | 78,549                         | 25,444                         | 1,486,114    |
| Total loans <sup>3</sup>       | \$ 218,615                | \$ 247,713                             | \$ 724,228                       | \$ 74,809    | \$ 117,207  | \$ 78,549                      | \$ 25,495                      | \$ 1,486,616 |
| Non-accrual loans <sup>2</sup> | \$ —                      | \$ —                                   | \$ —                             | \$ —         | \$ 91       | \$ —                           | \$ 54                          | \$ 145       |

<sup>1</sup> Our residential loan portfolio does not include sub-prime loans, nor is it our practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or higher loan-to-value ratios.

<sup>2</sup> There were no purchased credit impaired ("PCI") loans that had stopped accruing interest at June 30, 2017 and December 31, 2016. Amounts exclude accruing PCI loans of \$2.3 million and \$2.9 million at June 30, 2017 and December 31, 2016, respectively, 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 June 30, 2017 or December 31, 2016.

<sup>3</sup> Amounts include net deferred loan origination costs of \$823 thousand and \$883 thousand at June 30, 2017 and December 31, 2016, respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of \$1.4 million and \$1.8 million at June 30, 2017 and December 31, 2016, respectively.

Our commercial loans are generally made 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 a personal guarantee. We target stable businesses



with guarantors that have proven to be resilient in periods of economic stress. Typically, the guarantors provide an additional source of repayment for most of our credit extensions.

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. Commercial real estate loans may be adversely affected by conditions in the real estate markets or in the general economy. In the event of a vacancy, guarantors are expected to carry the loans until a replacement tenant can be found. 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. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record, and independent appraisals. The construction industry can be affected by significant events, 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 and other residential tenancy-in-common fractional interest loans ("TIC"), floating homes and mobile homes along with a small number of installment loans. 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. Our other residential loans include TIC units located almost entirely in San Francisco County.

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. Definitions of loans that are risk graded "Special Mention" 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 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 new information is received. Borrowers are required to submit financial information at regular intervals. Generally, 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. Investor commercial real estate borrowers are generally required to submit rent rolls or property income statements annually. Construction loans are monitored monthly, and reviewed on an ongoing basis. Home equity and other consumer loans are reviewed based on delinquency. Loans graded “Watch” or worse, regardless of loan type, are reviewed 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 June 30, 2017 and December 31, 2016.

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        |
|-------------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|---------------------------|--------------|
| June 30, 2017     |                           |  |                                  |              |             |                   |                                |                           |              |
| Pass              | \$ 201,289                | \$ 250,534                             | \$ 713,341                       | \$ 51,752    | \$ 118,191  | \$ 92,421         | \$ 24,372                      | \$ 2,255                  | \$ 1,454,155 |
| Special Mention   | 3,535                     | 4,533                                  | —                                | —            | —           | —                 | —                              | —                         | 8,068        |
| Substandard       | 12,555                    | 9,066                                  | 2,855                            | 3,238        | 1,209       | —                 | 339                            | —                         | 29,262       |
| Total loans       | \$ 217,379                | \$ 264,133                             | \$ 716,196                       | \$ 54,990    | \$ 119,400  | \$ 92,421         | \$ 24,711                      | \$ 2,255                  | \$ 1,491,485 |
| December 31, 2016 |                           |  |                                  |              |             |                   |                                |                           |              |
| Pass              | \$ 201,987                | \$ 234,849                             | \$ 720,417                       | \$ 71,564    | \$ 115,680  | \$ 78,549         | \$ 25,083                      | \$ 2,920                  | \$ 1,451,049 |
| Special Mention   | 9,197                     | 4,799                                  | 607                              | —            | 1,334       | —                 | —                              | —                         | 15,937       |
| Substandard       | 7,391                     | 6,993                                  | 1,498                            | 3,245        | 91          | —                 | 412                            | —                         | 19,630       |
| Total loans       | \$ 218,575                | \$ 246,641                             | \$ 722,522                       | \$ 74,809    | \$ 117,105  | \$ 78,549         | \$ 25,495                      | \$ 2,920                  | \$ 1,486,616 |

Troubled Debt Restructuring

Our loan portfolio includes certain loans that have been modified in a troubled debt restructuring (“TDR”), where economic concessions have been granted 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.

A loan may no longer be reported as a TDR if all of the following conditions are met:

- 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 removal of TDR status must be approved by the same Management level that approved the upgrading of the loan classification. There were no loans removed from TDR designation during 2017 and 2016.

The following table summarizes the carrying amount of TDR loans by loan class as of June 30, 2017 and December 31, 2016.

(in thousands)

| Recorded investment in Troubled Debt Restructurings <sup>1</sup> | June 30, December |          |
|--|-------------------|----------|
|  | 2017              | 31, 2016 |
| Commercial and industrial  | \$2,075           | \$ 2,207 |

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|  |          |          |
|--|----------|----------|
| Commercial real estate, owner-occupied | 7,000    | 6,993    |
| Commercial real estate, investor       | 2,214    | 2,256    |
| Construction                           | 3,238    | 3,245    |
| Home equity                            | 487      | 625      |
| Other residential                      | 1,170    | 1,965    |
| Installment and other consumer         | 888      | 877      |
| Total                                  | \$17,072 | \$18,168 |

<sup>1</sup> There were no TDR loans on non-accrual status at June 30, 2017 and December 31, 2016.

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The following table presents information for loans modified in a TDR during the presented periods, including the number of contracts modified, the recorded investment in the loans prior to modification, and the recorded investment in the loans 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 |
|---|------------------------------|--|---|---|
| Troubled Debt Restructurings during the three months ended June 30, 2017: |                              |  |   |   |
| None  | —                            | \$ —   | \$ —  | \$ —  |
| Troubled Debt Restructurings during the three months ended June 30, 2016: |                              |  |   |   |
| Commercial real estate, investor  | 1                            | \$ 281   | \$ 281  | \$ 281  |
| Home equity <sup>1</sup>  | 1                            | 87   | 222   | 222   |
| Total   | 2                            | \$ 368   | \$ 503  | \$ 503  |
| Troubled Debt Restructurings during the six months ended June 30, 2017:   |                              |  |   |   |
| Installment and consumer  | 1                            | \$50   | \$50  | \$49  |
| Troubled Debt Restructurings during the six months ended June 30, 2016:   |                              |  |   |   |
| Commercial real estate, investor  | 2                            | \$1,830  | \$1,826   | \$1,808   |
| Home equity <sup>1</sup>  | 1                            | 187  | 222   | 222   |
| Total   | 3                            | \$1,917  | \$2,048   | \$2,030   |

<sup>1</sup> The home equity TDR modification during the second quarter of 2016 included debt consolidation, which increased the post-modification balance.

The modifications during the six months ended June 30, 2017 and 2016 primarily involved interest rate concessions, renewals, and other changes to loan terms. During the first six months of 2017 and 2016, 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     |
|---|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-----------|
| June 30, 2017   |                           |  |                                  |              |             |                   |                                |           |
| Recorded investment in impaired loans:  |                           |  |                                  |              |             |                   |                                |           |
| With no specific allowance recorded   | \$ 345                    | \$ —                                   | \$ 1,041                         | \$ 2,688     | \$ 87       | \$ 1,003          | \$ 98                          | \$ 5,262  |
| With a specific allowance recorded  | 1,730                     | 7,000                                  | 2,214                            | 550          | 487         | 167               | 841                            | 12,989    |
| Total recorded investment in impaired loans   | \$ 2,075                  | \$ 7,000                               | \$ 3,255                         | \$ 3,238     | \$ 574      | \$ 1,170          | \$ 939                         | \$ 18,251 |
| Unpaid principal balance of impaired loans  | \$ 2,053                  | \$ 6,993                               | \$ 3,268                         | \$ 3,238     | \$ 572      | \$ 1,168          | \$ 939                         | \$ 18,231 |
| Specific allowance  | 31                        | 121                                    | 374                              | 5            | 7           | 2                 | 97                             | 637       |
| Average recorded investment in impaired loans during the quarter ended June 30, 2017                | 2,072                     | 7,000                                  | 3,283                            | 3,240        | 642         | 1,173             | 943                            | 18,353    |
| Interest income recognized on impaired loans during the quarter ended June 30, 2017 <sup>1</sup>    |                           |  |                                  |              |             |                   |                                |           |
| Average recorded investment in impaired loans during the six months ended June 30, 2017             | 2,117                     | 6,998                                  | 2,941                            | 3,241        | 667         | 1,437             | 939                            | 18,340    |
| Interest income recognized on impaired loans during the six months ended June 30, 2017 <sup>1</sup> |                           |  |                                  |              |             |                   |                                |           |
| Average recorded investment in impaired loans during the quarter ended June 30, 2016                | 3,771                     | 7,081                                  | 3,917                            | 3,238        | 1,286       | 1,993             | 1,184                          | 22,470    |
| Interest income recognized on impaired loans during the quarter ended June 30, 2016 <sup>1</sup>    |                           |  |                                  |              |             |                   |                                |           |
| Average recorded investment in impaired loans during the six months ended June 30, 2016             | 4,027                     | 7,037                                  | 3,523                            | 3,238        | 1,077       | 1,998             | 1,211                          | 22,111    |
| Interest income recognized on impaired loans during the six months ended June 30, 2016 <sup>1</sup> |                           |  |                                  |              |             |                   |                                |           |

<sup>1</sup> No interest income on impaired loans was recognized on a cash basis during the three and six months ended June 30, 2017 and 2016.

| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Total |
|----------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------|
|----------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------|

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December 31, 2016

Recorded investment in impaired loans:

|   |          |          |          |          |        |          |        |          |
|---|----------|----------|----------|----------|--------|----------|--------|----------|
| With no specific allowance recorded         | \$ 315   | \$ —     | \$ —     | \$ 2,692 | \$ 91  | \$ 1,008 | \$ 103 | \$4,209  |
| With a specific allowance recorded          | 1,892    | 6,993    | 2,256    | 553      | 624    | 957      | 829    | 14,104   |
| Total recorded investment in impaired loans | \$ 2,207 | \$ 6,993 | \$ 2,256 | \$ 3,245 | \$ 715 | \$ 1,965 | \$ 932 | \$18,313 |
| Unpaid principal balance of impaired loans  | \$ 2,177 | \$ 6,993 | \$ 2,252 | \$ 3,238 | \$ 713 | \$ 1,965 | \$ 932 | \$18,270 |
| Specific allowance                          | \$ 285   | \$ 163   | \$ 375   | \$ 8     | \$ 7   | \$ 55    | \$ 98  | \$991    |

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 portions of impaired loans outstanding at June 30, 2017 and December 31, 2016. In addition, the recorded investment in impaired loans is net of purchase discounts or premiums on acquired loans and deferred fees and costs. At June 30, 2017 and December 31, 2016, respectively, unused commitments to extend credit on impaired loans, including performing loans to borrowers whose terms have been modified in TDRs, totaled \$963 thousand and \$1.6 million.

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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 Period

| (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     |
|----------------------------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-----------|
| Three months ended June 30, 2017 |                           |  |                                  |              |             |                   |                                |             |           |
| Beginning balance                | \$ 4,413                  | \$ 1,992                               | \$ 6,133                         | \$ 546       | \$ 990      | \$ 444            | \$ 359                         | \$ 342      | \$ 15,219 |
| Provision (reversal)             | (490)                     | 90                                     | (68)                             | (135)        | (9)         | 65                | (23)                           | 570         | —         |
| Charge-offs                      | —                         | —                                      | —                                | —            | —           | —                 | —                              | —           | —         |
| Recoveries                       | 9                         | —                                      | —                                | —            | —           | —                 | 4                              | —           | 13        |
| Ending balance                   | \$ 3,932                  | \$ 2,082                               | \$ 6,065                         | \$ 411       | \$ 981      | \$ 509            | \$ 340                         | \$ 912      | \$ 15,232 |
| Three months ended June 30, 2016 |                           |  |                                  |              |             |                   |                                |             |           |
| Beginning balance                | \$ 2,799                  | \$ 1,619                               | \$ 6,571                         | \$ 822       | \$ 1,044    | \$ 430            | \$ 434                         | \$ 1,309    | \$ 15,028 |
| Provision (reversal)             | (192)                     | 12                                     | 19                               | 9            | 31          | (4)               | (20)                           | 145         | —         |
| Charge-offs                      | —                         | —                                      | —                                | —            | —           | —                 | (4)                            | —           | (4)       |
| Recoveries                       | 30                        | —                                      | 5                                | —            | 1           | —                 | 27                             | —           | 63        |
| Ending balance                   | \$ 2,637                  | \$ 1,631                               | \$ 6,595                         | \$ 831       | \$ 1,076    | \$ 426            | \$ 437                         | \$ 1,454    | \$ 15,087 |

Allowance for Loan Losses Rollforward for the Period

| (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     |
|--------------------------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-----------|
| Six months ended June 30, 2017 |                           |  |                                  |              |             |                   |                                |             |           |
| Allowance for loan losses:     |                           |  |                                  |              |             |                   |                                |             |           |
| Beginning balance              | \$ 3,248                  | \$ 1,753                               | \$ 6,320                         | \$ 781       | \$ 973      | \$ 454            | \$ 372                         | \$ 1,541    | \$ 15,442 |
| Provision (reversal)           | 896                       | 329                                    | (255)                            | (370)        | 8           | 55                | (34)                           | (629)       | —         |
| Charge-offs                    | (284)                     | —                                      | —                                | —            | —           | —                 | (3)                            | —           | (287)     |
| Recoveries                     | 72                        | —                                      | —                                | —            | —           | —                 | 5                              | —           | 77        |
| Ending balance                 | \$ 3,932                  | \$ 2,082                               | \$ 6,065                         | \$ 411       | \$ 981      | \$ 509            | \$ 340                         | \$ 912      | \$ 15,232 |
| Six months ended June 30, 2016 |                           |  |                                  |              |             |                   |                                |             |           |
| Allowance for loan losses:     |                           |  |                                  |              |             |                   |                                |             |           |
| Beginning balance              | \$ 3,023                  | \$ 2,249                               | \$ 6,178                         | \$ 724       | \$ 910      | \$ 394            | \$ 425                         | \$ 1,096    | \$ 14,999 |
| Provision (reversal)           | (440)                     | (618)                                  | 407                              | 107          | 165         | 32                | (11)                           | 358         | —         |
| Charge-offs                    | (9)                       | —                                      | —                                | —            | —           | —                 | (4)                            | —           | (13)      |
| Recoveries                     | 63                        | —                                      | 10                               | —            | 1           | —                 | 27                             | —           | 101       |
| Ending balance                 | \$ 2,637                  | \$ 1,631                               | \$ 6,595                         | \$ 831       | \$ 1,076    | \$ 426            | \$ 437                         | \$ 1,454    | \$ 15,087 |



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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       |
|--|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-------------|
| June 30, 2017  |                           |  |                                  |              |             |                   |                                |             |             |
| Ending ALLL related to loans collectively evaluated for impairment | \$3,901                   | \$1,961                                | \$5,691                          | \$406        | \$974       | \$507             | \$243                          | \$912       | \$14,595    |
| Ending ALLL related to loans individually evaluated for impairment | 31                        | 121                                    | 374                              | 5            | 7           | 2                 | 97                             | —           | 637         |
| Ending ALLL related to purchased credit-impaired loans             | —                         | —                                      | —                                | —            | —           | —                 | —                              | —           | —           |
| Ending balance   | \$3,932                   | \$2,082                                | \$6,065                          | \$411        | \$981       | \$509             | \$340                          | \$912       | \$15,232    |
| Recorded Investment:   |                           |  |                                  |              |             |                   |                                |             |             |
| Collectively evaluated for impairment                              | \$215,304                 | \$257,133                              | \$712,941                        | \$51,752     | \$118,826   | \$91,251          | \$23,772                       | \$—         | \$1,470,979 |
| Individually evaluated for impairment                              | 2,075                     | 7,000                                  | 3,255                            | 3,238        | 574         | 1,170             | 939                            | —           | 18,251      |
| Purchased credit-impaired  | 38                        | 1,116                                  | 1,001                            | —            | 100         | —                 | —                              | —           | 2,255       |
| Total  | \$217,417                 | \$265,249                              | \$717,197                        | \$54,990     | \$119,500   | \$92,421          | \$24,711                       | \$—         | \$1,491,485 |
| Ratio of allowance for loan losses to total loans                  | 1.81                      | %0.78                                  | %0.85                            | %0.75        | %0.82       | %0.55             | %1.38                          | %NM         | 1.02        |
| Allowance for loan losses to non-accrual loans                     | NM                        | NM                                     | 583                              | %NM          | 1,128       | %NM               | 667                            | %NM         | 1,292       |
| 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, 2016  |                           |  |                                  |              |             |                   |                                |             |             |
| Ending ALLL related to loans collectively evaluated for impairment | \$2,963                   | \$1,590                                | \$5,945                          | \$773        | \$966       | \$399             | \$274                          | \$1,541     | \$14,451    |
| Ending ALLL related to loans individually evaluated for impairment | 285                       | 163                                    | 375                              | 8            | 7           | 55                | 98                             | —           | 991         |
| Ending ALLL related to purchased credit-impaired loans             | —                         | —                                      | —                                | —            | —           | —                 | —                              | —           | —           |
| Ending balance   | \$3,248                   | \$1,753                                | \$6,320                          | \$781        | \$973       | \$454             | \$372                          | \$1,541     | \$15,442    |
| Recorded Investment:   |                           |  |                                  |              |             |                   |                                |             |             |
| Collectively evaluated for impairment                              | \$216,368                 | \$239,648                              | \$720,266                        | \$71,564     | \$116,390   | \$76,584          | \$24,563                       | \$—         | \$1,465,383 |
| Individually evaluated for impairment                              | 2,207                     | 6,993                                  | 2,256                            | 3,245        | 715         | 1,965             | 932                            | —           | 18,313      |

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|   |           |           |           |          |           |          |          |     |             |
|---|-----------|-----------|-----------|----------|-----------|----------|----------|-----|-------------|
| Purchased credit-impaired                         | 40        | 1,072     | 1,706     | —        | 102       | —        | —        | —   | 2,920       |
| Total   | \$218,615 | \$247,713 | \$724,228 | \$74,809 | \$117,207 | \$78,549 | \$25,495 | \$— | \$1,486,616 |
| Ratio of allowance for loan losses to total loans | 1.49      | %0.71     | %0.87     | %1.04    | %0.83     | %0.58    | %1.46    | %NM | 1.04        |
| Allowance for loan losses to non-accrual loans    | NM        | NM        | NM        | NM       | 1,071     | %NM      | 683      | %NM | 10,650      |

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 two bank acquisitions to be PCI loans based on credit indicators such as nonaccrual 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<br><br>(in thousands)        | June 30, 2017                  |                   | December 31, 2016              |                   |
|--|--------------------------------|-------------------|--------------------------------|-------------------|
|  | Unpaid<br>Principal<br>Balance | Carrying<br>Value | Unpaid<br>Principal<br>Balance | Carrying<br>Value |
| Commercial and industrial              | \$38                           | \$ 38             | \$45                           | \$ 40             |
| Commercial real estate, owner occupied | 1,320                          | 1,116             | 1,344                          | 1,072             |
| Commercial real estate, investor       | 1,001                          | 1,001             | 1,713                          | 1,706             |
| Home equity                            | 242                            | 100               | 248                            | 102               |
| Total purchased credit-impaired loans  | \$2,601                        | \$ 2,255          | \$3,350                        | \$ 2,920          |

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<br><br>(in thousands)                       | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2017      | June 30, 2016 | June 30, 2017    | June 30, 2016 |
| Balance at beginning of period                               | \$1,386            | \$1,742       | \$1,476          | \$2,618       |
| Removals <sup>1</sup>  | —                  | —             | —                | (778 )        |
| Accretion  | (80 )              | (87 )         | (170 )           | (185 )        |
| Reclassifications from nonaccretable difference <sup>2</sup> | —                  | —             | —                | —             |
| Balance at end of period                                     | \$1,306            | \$1,655       | \$1,306          | \$1,655       |

<sup>1</sup> Represents the accretable difference that is relieved when a loan exits the PCI population due to pay-off, full charge-off, or transfer to repossessed assets, etc.

<sup>2</sup> Primarily relates to changes in expected credit performance and changes in expected timing of cash flows.

#### Pledged Loans

Our FHLB line of credit is secured under terms of a blanket collateral agreement by a pledge of certain qualifying loans with an unpaid principal balance of \$877.3 million and \$869.2 million at June 30, 2017 and December 31, 2016, respectively. In addition, we pledge a certain residential loan portfolio, which totaled \$64.3 million and \$54.6 million at June 30, 2017 and December 31, 2016, respectively, to secure our borrowing capacity with the Federal Reserve Bank ("FRB"). Also see Note 6, 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. During the first quarter of 2017, a new director joined our Board of Directors resulting in the reclassification of existing loans to the director's business to related party status. Related party loans totaled \$9.1 million at June 30, 2017 compared to \$2.0 million at December 31, 2016. In addition, undisbursed commitments to related parties totaled \$9.2 million and \$1.1 million at June 30, 2017 and December 31, 2016, respectively.

#### Note 6: Borrowings

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Federal Funds Purchased – The Bank had unsecured lines of credit totaling \$92.0 million with correspondent banks for overnight borrowings at both June 30, 2017 and December 31, 2016. In general, interest rates on these lines approximate the federal funds target rate. We had no overnight borrowings under these credit facilities at June 30, 2017 or December 31, 2016.

Federal Home Loan Bank Borrowings – As of June 30, 2017 and December 31, 2016, the Bank had lines of credit with the FHLB totaling \$508.4 million and \$513.7 million, respectively, based on eligible collateral of certain loans. We had no FHLB overnight borrowings at June 30, 2017 or December 31, 2016.

Federal Reserve Line of Credit – The Bank has a line of credit with the Federal Reserve Bank of San Francisco ("FRBSF") secured by certain residential loans. At June 30, 2017 and December 31, 2016, the Bank had borrowing

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capacity under this line totaling \$50.1 million and \$43.1 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 (the "Trusts"), established for the sole purpose of issuing trust preferred securities on September 22, 2003 and December 29, 2005, respectively. 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 \$8.0 million issued by the Trusts which have identical maturity, repricing and payment terms as the subordinated debentures. 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. Accretion on the subordinated debentures totaled \$80 thousand and \$98 thousand in the first six months of 2017 and 2016, respectively. Bancorp has the option to defer payment of the interest on the subordinated debentures 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 following is a summary of the contractual terms of the subordinated debentures due to the Trusts as of June 30, 2017:

(in thousands)

Subordinated debentures due to NorCal Community Bancorp Trust I on October 7, 2033 with interest payable quarterly, based on 3-month LIBOR plus 3.05%, repricing quarterly (4.21% as of June 30, 2017), redeemable, \$4,124 in whole or in part, on any interest payment date

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 (2.65% as of June 30, 2017), redeemable, 4,124 in whole or in part, on any interest payment date

|       |         |
|-------|---------|
| Total | \$8,248 |
|-------|---------|

#### Note 7: Stockholders' Equity

##### Dividends

Presented below is a summary of cash dividends paid to common shareholders, recorded as a reduction of retained earnings.

| (in thousands, except per share data) | Three months ended |               | Six months ended |               |
|---------------------------------------|--------------------|---------------|------------------|---------------|
|                                       | June 30, 2017      | June 30, 2016 | June 30, 2017    | June 30, 2016 |
| Cash dividends to common stockholders | \$1,660            | \$1,526       | \$3,315          | \$3,044       |
| Cash dividends per common share       | \$0.27             | \$0.25        | \$0.54           | \$0.50        |

The Board of Directors declared a cash dividend of \$0.29 per share on July 21, 2017 payable on August 11, 2017 to shareholders of record at the close of business on August 4, 2017.

Pursuant to a Rights Agreement filed with the SEC on July, 7, 2017, the Board of Directors declared a dividend of one preferred share purchase right for each outstanding share of common stock, no par value, of Bancorp. The dividend will be paid July 23, 2017 to shareholders of record on that date. Each right entitles the registered holder to purchase from Bancorp one one-hundredth of a share of Series A Junior Participating Preferred Stock, no par value, of Bancorp at a price of \$90 per one one-hundredth of a preferred share, subject to adjustment. The description and terms of the rights are set forth in the Rights Agreement. The Rights Agreement is designed to discourage takeovers that involve

abusive tactics or do not provide fair value to shareholders. The Rights Agreement replaces similar Rights Agreements dated June 14, 2007 and June 17, 2016 (Amendment No.1), which expire on July 23, 2017. The new Rights Agreement expires on July 23, 2022.

#### Share-Based Payments

The fair value of stock options as of the grant date is recorded as stock-based compensation expense in the consolidated statements of comprehensive income over the requisite service period with a corresponding increase in common stock.

Stock-based compensation also includes compensation expense related to the issuance of unvested restricted stock awards and performance-based stock awards pursuant to the 2007 Equity Plan. The grant-date fair value of the restricted stock awards and performance-based stock awards, which is equal to the intrinsic value on that date, is being recorded as compensation expense over the requisite service period with a corresponding increase in common stock as the shares vest.

Performance-based stock awards 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.

We adopted ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting effective January 1, 2017 as discussed in Note 2, which requires us to record excess tax benefits (deficiencies) resulting from the exercise of non-qualified stock options, the disqualifying disposition of incentive stock options and vesting of restricted stock awards as income tax benefits (expense) in the consolidated statements of comprehensive income with a corresponding decrease (increase) to current taxes payable. Previous to the adoption of this ASU, excess tax benefits (deficiencies) were recognized as an increase to common stock in the consolidated statements of changes in stockholders' equity.

The holders of unvested restricted stock awards and performance-based stock awards are entitled to dividends on the same per-share ratio as holders of common stock. Upon the adoption of the above ASU, tax benefits on dividends paid on unvested restricted stock awards are recorded as tax benefits in the consolidated statements of comprehensive income with a corresponding decrease to current taxes payable. Dividends on forfeited awards are included in stock-based compensation expense. Previous to the adoption of the ASU, tax benefits on dividends were recognized as an increase to common stock in the consolidated statements of changes in stockholders' equity.

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. As of the 2017 Equity Plan's effective date, there were 118,668 shares available for future grants, which represented the remaining shares available under the 2007 Equity Plan. There were no material differences in the design, terms or conditions of the 2017 and 2007 Equity Plans.

Under the 2017 Equity Plan, stock options may be net settled by a reduction in the number of shares otherwise deliverable upon exercise in satisfaction of the exercise payment and applicable tax withholding requirements. During the first six months of 2017, we withheld 5,651 shares totaling \$385 thousand at a weighted-average price of \$68.04 for cashless stock option exercises. There were no stock options exercised under net settlement arrangements in 2016. Shares withheld under net settlement arrangements are available for future grants under the 2017 Equity Plan.

#### Note 8: Commitments and Contingencies

##### Financial Instruments with Off-Balance Sheet Risk

We make commitments to extend credit in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination

clauses and may require payment of a fee. Because various commitments will expire without being fully drawn upon, the total commitment amount does not necessarily represent future cash requirements.

We are exposed to credit loss equal to the contractual amount of the commitment in the event of nonperformance by the borrower. We use the same credit underwriting criteria for all credit exposure. The amount of collateral obtained, if deemed necessary by us, is based on Management's credit evaluation of the borrower. Collateral types pledged may include accounts receivable, inventory, other personal property and real property.

The contractual amount of undrawn loan commitments and standby letters of credit not reflected on the consolidated statements of condition are as follows:

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| (in thousands)                                  | June 30, December 31, |            |
|---|-----------------------|------------|
|   | 2017                  | 2016       |
| Commercial lines of credit                      | \$205,471             | \$ 216,774 |
| Revolving home equity lines                     | 156,168               | 148,143    |
| Undisbursed construction loans                  | 26,711                | 44,798     |
| Personal and other lines of credit              | 10,377                | 10,635     |
| Standby letters of credit                       | 1,829                 | 1,939      |
| Total commitments and standby letters of credit | \$400,556             | \$ 422,289 |

We record an allowance for losses on these off-balance sheet commitments based on an estimate of probabilities of these commitments being drawn upon according to our historical utilization experience on different types of commitments and expected loss. We set aside an allowance for losses on off-balance sheet commitments in the amount of \$856 thousand and \$899 thousand as of June 30, 2017 and December 31, 2016, respectively, which is recorded in interest payable and other liabilities on the consolidated statements of condition.

### Operating Leases

We rent certain premises under long-term, non-cancelable operating leases expiring at various dates through the year 2032. Most of the leases contain certain renewal options and escalation clauses. At June 30, 2017, the approximate minimum future commitments payable under non-cancelable contracts for leased premises are as follows:

| (in thousands)                | 2017    | 2018    | 2019    | 2020    | 2021    | Thereafter | Total    |
|-------------------------------|---------|---------|---------|---------|---------|------------|----------|
| Operating leases <sup>1</sup> | \$1,964 | \$3,932 | \$3,739 | \$3,420 | \$2,138 | \$ 4,234   | \$19,427 |

<sup>1</sup> Minimum payments have not been reduced by minimum sublease rentals of \$101 thousand due in the future under non-cancelable subleases.

Rent expense included in occupancy expense totaled \$2.0 million and \$1.9 million for the six months ended June 30, 2017 and 2016, respectively.

### Litigation Matters

We may be party to legal actions which arise from time to time during the normal course of business. We believe, after consultation with legal counsel, that litigation contingent liability, if any, would not have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. ("Visa") by its member banks in connection with lawsuits related to anti-trust charges and interchange fees ("Covered Litigation"). Visa maintains an escrow account from which settlements of, or judgments in, the Covered Litigation are paid. While the accrual related to the Covered Litigation could be higher or lower than the litigation escrow account balance, Visa did not record an additional accrual for the Covered Litigation during 2017. At June 30, 2017, according to the latest SEC Form 10-Q filed by Visa, Inc. on July 20, 2017, the balance of the escrow account was \$978.0 million. In 2012, Visa reached a \$4.0 billion interchange multidistrict litigation class settlement agreement. However, in February 2017, a number of class plaintiffs sought to either file an amended complaint for damages or file a new class complaint against Visa claiming for putative injunction relief. Visa has reached settlement agreements with individual merchants representing 34% of the sales volume of merchants who opted out of the 2012 Settlement Agreement. Litigation is ongoing and until the appeal process is complete, Visa is uncertain whether it will resolve the claims as contemplated by the settlement agreement and additional lawsuits may arise. The conversion rate of Visa Class B common stock held by us to Class A common stock (as discussed in Note 4 above) may decrease if Visa makes more Covered Litigation settlement payments in the future, and the full effect on member banks is still uncertain. However, we are not aware of significant future cash settlement payments required by us on the Covered

Litigation.

Note 9: Derivative Financial Instruments and Hedging Activities

We have entered into interest rate swap agreements, primarily as an asset/liability management strategy, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans (or 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. Converting our fixed-rate interest payments

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to floating-rate interest payments, generally benchmarked to the one-month U.S. dollar LIBOR index, protects us against changes in the fair value of our loans associated with fluctuating interest rates.

Our credit exposure, if any, on interest rate swap asset positions is limited to the fair value (net of any collateral pledged to us) and interest payments of all swaps by each counterparty. Conversely, when an interest rate swap is in a liability position exceeding a certain threshold, we may be required to post collateral to the counterparty in an amount determined by the agreements. Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap values.

As of June 30, 2017, we had five interest rate swap agreements, which are scheduled to mature in June 2031, October 2031, July 2032, August 2037 and October 2037. All of our derivatives are accounted for as fair value hedges. The notional amounts of the interest rate contracts are equal to the notional amounts of the hedged loans. Our interest rate swap payments are settled monthly with counterparties. Accrued interest on the swaps totaled \$10 thousand and \$13 thousand as of June 30, 2017 and December 31, 2016, respectively.

Information on our derivatives follows:

| (in thousands)                                  | Asset derivatives |                   | Liability derivatives |                   |
|---|-------------------|-------------------|-----------------------|-------------------|
|   | June 30, 2017     | December 31, 2016 | June 30, 2017         | December 31, 2016 |
| Fair value hedges:                              |                   |                   |                       |                   |
| Interest rate contracts notional amount         | \$4,119           | \$ 4,217          | \$15,155              | \$ 15,495         |
| Interest rate contracts fair value <sup>1</sup> | \$39              | \$ 55             | \$935                 | \$ 933            |

| (in thousands)  | Three months ended |               |   |
|---|--------------------|---------------|---|
|   | June 30, 2017      | June 30, 2016 |   |
| Increase (decrease) in value of designated interest rate swaps due to LIBOR interest rate movements recognized in interest income | \$(129)            | \$(190)       | ) |
| Payment on interest rate swaps recorded in interest income  | \$(87)             | \$(138)       | ) |
| (Decrease) increase in value of hedged loans recognized in interest income  | \$191              | \$ 240        |   |
| Decrease in value of yield maintenance agreement recognized against interest income   | \$(4)              | \$(11)        | ) |
| Net loss on derivatives recognized against interest income <sup>2</sup>   | \$(29)             | \$(99)        | ) |

| (in thousands)   | Six months ended |               |   |
|--|------------------|---------------|---|
|  | June 30, 2017    | June 30, 2016 |   |
| Decrease in value of designated interest rate swaps due to LIBOR interest rate movements recognized in interest income | \$(18)           | \$(1,066)     | ) |
| Payment on interest rate swaps recorded in interest income   | \$(185)          | \$(313)       | ) |
| Increase in value of hedged loans recognized in interest income  | \$78             | \$ 1,290      |   |
| Decrease in value of yield maintenance agreement recognized against interest income                                    | \$(7)            | \$(23)        | ) |
| Net loss on derivatives recognized against interest income <sup>2</sup>  | \$(132)          | \$(112)       | ) |

<sup>1</sup> See Note 3, Fair Value of Assets and Liabilities, for valuation methodology.

<sup>2</sup> Includes hedge ineffectiveness gain of \$58 thousand and gain of \$39 thousand for the quarters ended June 30, 2017 and June 30, 2016, respectively. Ineffectiveness gain of \$53 thousand and gain of \$201 thousand was recorded in interest income during the six months ended June 30, 2017 and June 30, 2016, respectively. Changes in value of swaps were included in the assessment of hedge effectiveness. Hedge ineffectiveness is the measure of the extent to which the change in the fair value of the hedging instruments does not exactly offset the change in the fair value of the hedged items from period to period.

Our derivative transactions with counterparties are under International Swaps and Derivative Association (“ISDA”) master agreements that include “right of set-off” provisions. “Right of set-off” provisions are legally enforceable rights to offset recognized amounts and there may be an intention to settle such amounts on a net basis. We do not offset such financial instruments for financial reporting purposes.

Information on financial instruments that are eligible for offset in the consolidated statements of condition follows:

Offsetting of Financial Assets and Derivative Assets

| (in thousands)               | Gross Amounts of Recognized Assets <sup>1</sup> | Gross Amounts Offset in the Statements of Condition | Net Amounts Presented in the Statements of Condition <sup>1</sup> | Gross Amounts of Not Offset in the Statements of Condition | Cash Collateral Received | Net Amount |
|------------------------------|---|---|---|--|--------------------------|------------|
| June 30, 2017                |   |   |   |  |                          |            |
| Derivatives by Counterparty: |   |   |   |  |                          |            |
| Counterparty A               | \$ 39   | \$  | -\$ 39  | \$ (39 )   | \$                       | -\$ —      |
| December 31, 2016            |   |   |   |  |                          |            |
| Derivatives by Counterparty: |   |   |   |  |                          |            |
| Counterparty A               | \$ 55   | \$  | -\$ 55  | \$ (55 )   | \$                       | -\$ —      |

<sup>1</sup> Amounts exclude accrued interest totaling \$1 thousand at both June 30, 2017 and December 31, 2016, respectively.

Offsetting of Financial Liabilities and Derivative Liabilities

| (in thousands)               | Gross Amounts of Recognized Liabilities <sup>2</sup> | Gross Amounts Offset in the Statements of Condition | Net Amounts Presented in the Statements of Condition <sup>2</sup> | Gross Amounts of Not Offset in the Statements of Condition | Cash Collateral Pledged | Net Amount |
|------------------------------|--|---|---|--|-------------------------|------------|
| June 30, 2017                |  |   |   |  |                         |            |
| Derivatives by Counterparty: |  |   |   |  |                         |            |
| Counterparty A               | \$ 935   | \$  | -\$ 935   | \$(39)\$ (896 )  | \$                      | —          |
| December 31, 2016            |  |   |   |  |                         |            |
| Derivatives by Counterparty: |  |   |   |  |                         |            |
| Counterparty A               | \$ 933   | \$  | -\$ 933   | \$(55)\$ (878 )  | \$                      | —          |

<sup>2</sup> Amounts exclude accrued interest totaling \$9 thousand and \$12 thousand at June 30, 2017 and December 31, 2016, respectively.

For more information on how we account for our interest rate swaps, refer to Note 1 to the Consolidated Financial Statements included in our 2016 Form 10-K filed with the SEC on March 14, 2017.

Note 10: Subsequent Event

On July 31, 2017, Bancorp entered into a definitive agreement to acquire Bank of Napa, N.A. ("Napa"). Napa has two branch offices serving Napa County, and had assets of \$246.1 million, total deposits of \$217.7 million, and total loans of \$139.3 million as of June 30, 2017. The transaction is expected to close in the fourth quarter of 2017 and is subject to a number of conditions, including approvals of the regulatory agencies and Napa's shareholders. For more information concerning the transaction, please see the 8-K Reports filed by Bancorp with the Securities and Exchange Commission on July 31 and August 1, 2017, respectively. For other important factors regarding the Napa acquisition, please see the Forward-Looking Statements and Risk Factors sections of this Form 10-Q.

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

Management's discussion of the financial condition and results of operations, which is unaudited, should be read in conjunction with the related consolidated financial statements in this Form 10-Q and with the audited consolidated financial statements and accompanying notes included in our 2016 Annual Report on Form 10-K. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

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; integration of acquisitions; competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; natural disasters; adverse weather conditions; and other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services.

The events or factors that could cause results or performance to materially differ from those expressed in the forward-looking statements concerning the Napa acquisition include, but are not limited to:

- the businesses of Bancorp and Napa may not be integrated successfully or such integration may be more difficult, time-consuming or costly than expected;
- expected cost savings from the acquisition may not be fully realized or realized within the expected time frame;
- revenues following the merger may be lower than expected;
- customer and employee relationships and business operations may be disrupted by the acquisition;
- the ability to obtain required regulatory and shareholder approvals, and the ability to complete the acquisition on the expected timeframe may be more difficult, time-consuming or costly than expected;
- changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Board of Governors of the Federal Reserve; the quality and composition of the loan and securities portfolios; demand for loan products; deposit flows; competition; demand for financial services in the companies' respective market areas; their implementation of new technologies; their ability to develop and maintain secure and reliable electronic systems; and accounting principles, policies, and guidelines, and
- other risk factors detailed from time to time in filings made by Bancorp with the SEC.

Important factors that could cause results or performance to materially differ from those expressed in our prior forward-looking statements are detailed in the Risk Factors section of this Form 10-Q and in Item 1A. Risk Factors section of our 2016 Form 10-K as filed with the SEC, copies of which are available from us at no charge.

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.

#### 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 as a result of the need to make estimates about the effect of matters that are inherently uncertain and imprecise. There have been no material changes to our critical accounting policies, which include: Allowance for Loan Losses, Other-than-temporary Impairment of Investment Securities, Accounting for Income Taxes, and Fair Value Measurements. For a detailed discussion, refer to Note 1 to the Consolidated Financial Statements included in our 2016 Form 10-K filed with the SEC on March 14, 2017.





## Executive Summary

On July 31, 2017, Bancorp entered into a definitive agreement to acquire Bank of Napa, N.A. ("Napa"). Pursuant to the definitive agreement, Napa will be merged with and into our subsidiary, Bank of Marin, and we will issue shares of our common stock to the shareholders of Napa. Napa has two branch offices serving Napa County, and had assets of \$246.1 million, total deposits of \$217.7 million, and total loans of \$139.3 million as of June 30, 2017. We expect the acquisition to be immediately accretive to our earnings and to increase our presence in Napa County. Upon closing of the transaction, our assets will increase to approximately \$2.4 billion. The transaction is expected to close in the fourth quarter of 2017 and is subject to a number of conditions, including receipt of regulatory approvals and approval of Napa's shareholders. For other important factors regarding the Napa acquisition, please see the Forward-Looking Statements and Risk Factors sections of this Form 10-Q.

Earnings in the second quarter of 2017 totaled \$5.2 million, compared to \$4.8 million in the second quarter of 2016. Diluted earnings per share were \$0.84 in the second quarter of 2017, compared to \$0.79 in the same quarter a year ago. Earnings for the first six months of 2017 totaled \$9.7 million compared to \$10.5 million in the same period last year. Diluted earnings per share were \$1.58 and \$1.72 in the first six months of 2017 and 2016, respectively.

The following are highlights of our operating and financial performance for the periods presented:

The Board of Directors declared a cash dividend of \$0.29 per share on July 21, 2017, an increase of \$0.02 per share and the 49th consecutive dividend paid by the Bank.

Return on assets was 1.01% for the quarter and 0.96% for the six months ended June 30, 2017, compared to 0.99% for the quarter and 1.07% for the six months ended June 30, 2016. Return on equity was 8.74% for the quarter and 8.34% for the six months ended June 30, 2017, compared to 8.68% for the quarter and 9.52% for the six months ended June 30, 2016.

The tax-equivalent net interest margin was 3.85% in the second quarter of 2017, compared to 3.77% in the same quarter a year ago. Net interest income totaled \$18.3 million in the second quarter of 2017, compared to \$17.2 million in the same quarter last year.

Loans increased by \$4.9 million and totaled \$1,491.5 million at June 30, 2017, compared to \$1,486.6 million at December 31, 2016. New loan originations in the first six months of 2017 of \$79.4 million were primarily in commercial real estate, including both owner-occupied and investor-owned, spread throughout our markets, and tenancy-in-common fractional interest loans. Loan originations combined with changes in the utilization of loan commitments, pay-offs of \$80.8 million, and scheduled payments, produced the net increase from December 31, 2016. Our current pipeline approximates last year at this time, and should translate into loan growth throughout the year.

Excellent credit quality remains the hallmark of our culture. Non-accrual loans totaled \$1.2 million, or 0.08% of loans at June 30, 2017, compared to \$145.0 thousand, or 0.01% of loans at December 31, 2016. A well secured \$1.0 million commercial real estate loan was placed on non-accrual status during the first quarter of 2017. Classified loans totaled \$29.3 million at June 30, 2017, up from \$19.6 million at December 31, 2016. One relationship of \$8.4 million and the non-accrual loan of \$1.0 million previously mentioned were downgraded to substandard in the first quarter of 2017. Accruing loans past due 30 to 89 days totaled \$393 thousand at June 30, 2017, compared to \$410 thousand at December 31, 2016.

Deposits totaled \$1,840.5 million at June 30, 2017, compared to \$1,772.7 million at December 31, 2016, a \$67.8 million increase. We continue to see fluctuations from large deposit clients' seasonal cash flows and the placement by existing clients of funds from asset sales that will be distributed to the beneficiaries of trusts or transitioned into real estate or other investments. Non-interest bearing deposits represented 48.5% of total deposits, and the cost of total deposits dropped two basis points to 0.06%, from the first six months of 2016.

All capital ratios are above regulatory requirements for a well-capitalized institution. The total risk-based capital ratio for Bancorp was 15.0% at June 30, 2017 compared to 14.3% at December 31, 2016.



Looking forward into 2017, we believe we are well-positioned for future growth with strong capital and liquidity, potential net interest margin expansion and a low cost deposit base. With a robust loan pipeline, and credit quality that remains at the top of our peer group, we are looking forward to continued success.

We have ample liquidity and capital to support both organic growth and potential acquisitions, such as the Napa transaction described above.

Acquisitions continue to remain a component of our strategic plan.

While we are investing in a number of strategic initiatives that aim at our long-term profitability, our short-term non-interest expenses are likely to increase, primarily due to acquisition-related expenses and facility expansions. In addition to the announced acquisition, we have signed a lease for our new branch in Healdsburg, California, which is scheduled to open on August 7, 2017. We are also expanding our geographic reach by adding a commercial banking office in the East Bay by the end of the year, which continues to be one of the strongest growth markets in the Bay Area region.

Our disciplined credit culture and relationship banking are keys to our success.

## RESULTS OF OPERATIONS

Highlights of the financial results are presented in the following tables:

| (dollars in thousands)                                 | June 30, 2017 | December 31, 2016 |   |
|--|---------------|-------------------|---|
| Selected financial condition data:                     |               |                   |   |
| Total assets   | \$2,100,716   | \$2,023,493       |   |
| Loans, net   | 1,476,253     | 1,471,174         |   |
| Deposits   | 1,840,540     | 1,772,700         |   |
| Borrowings   | 5,666         | 5,586             |   |
| Stockholders' equity                                   | 240,733       | 230,563           |   |
| Asset quality ratios:                                  |               |                   |   |
| Allowance for loan losses to total loans               | 1.02%         | 1.04              | % |
| Allowance for loan losses to non-accrual loans         | 12.92         | x 106.50          | x |
| Non-accrual loans to total loans                       | 0.08%         | 0.01              | % |
| Capital ratios:  |               |                   |   |
| Equity to total assets ratio                           | 11.46         | % 11.39           | % |
| Total capital (to risk-weighted assets)                | 15.01         | % 14.32           | % |
| Tier 1 capital (to risk-weighted assets)               | 14.06         | % 13.37           | % |
| Tier 1 capital (to average assets)                     | 11.61         | % 11.39           | % |
| Common equity Tier 1 capital (to risk weighted assets) | 13.74         | % 13.07           | % |

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| (dollars in thousands, except per share data) | Three months<br>ended |          | Six months<br>ended |          |
|---|-----------------------|----------|---------------------|----------|
|   | June 30, June 30,     |          | June 30, June 30,   |          |
|   | 2017                  | 2016     | 2017                | 2016     |
| Selected operating data:                      |                       |          |                     |          |
| Net interest income                           | \$18,304              | \$17,166 | \$35,925            | \$35,804 |
| Non-interest income                           | 2,096                 | 2,421    | 4,211               | 4,584    |
| Non-interest expense                          | 12,631                | 12,017   | 25,642              | 24,027   |
| Net income                                    | 5,186                 | 4,837    | 9,734               | 10,483   |
| Net income per common share:                  |                       |          |                     |          |
| Basic   | \$0.85                | \$0.80   | \$1.60              | \$1.73   |
| Diluted                                       | \$0.84                | \$0.79   | \$1.58              | \$1.72   |
| Performance and other financial ratios:       |                       |          |                     |          |
| Return on average assets                      | 1.01%                 | 0.99%    | 0.96%               | 1.07%    |
| Return on average equity                      | 8.74%                 | 8.68%    | 8.34%               | 9.52%    |
| Tax-equivalent net interest margin            | 3.85%                 | 3.77%    | 3.82%               | 3.90%    |
| Efficiency ratio                              | 61.92%                | 61.35%   | 63.89%              | 59.49%   |
| Dividend payout ratio on common stock         | 31.76%                | 31.25%   | 33.75%              | 28.90%   |

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 impacted 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 the net interest income and/or margin due to an imbalance in the timing of repricing and maturity of assets and liabilities. We manage interest rate risk exposure with the goal of minimizing the impact 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.

Average Statements of Condition and Analysis of Net Interest Income

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 each period reported.

|  | Three months ended<br>June 30, 2017 |                             |                | Three months ended<br>June 30, 2016 |                             |                |
|--|-------------------------------------|-----------------------------|----------------|-------------------------------------|-----------------------------|----------------|
|  | Average<br>Balance                  | Interest<br>Income/ Expense | Yield/<br>Rate | Average<br>Balance                  | Interest<br>Income/ Expense | Yield/<br>Rate |
| (dollars in thousands)                                 |                                     |                             |                |                                     |                             |                |
| <b>Assets</b>  |                                     |                             |                |                                     |                             |                |
| Interest-bearing due from banks <sup>1</sup>           | \$56,597                            | \$ 157                      | 1.10 %         | \$28,766                            | \$40                        | 0.54 %         |
| Investment securities <sup>2, 3</sup>                  | 408,335                             | 2,355                       | 2.31 %         | 389,023                             | 2,080                       | 2.14 %         |
| Loans <sup>1, 3, 4</sup>                               | 1,487,419                           | 16,868                      | 4.49 %         | 1,440,847                           | 16,416                      | 4.51 %         |
| Total interest-earning assets <sup>1</sup>             | 1,952,351                           | 19,380                      | 3.93 %         | 1,858,636                           | 18,536                      | 3.95 %         |
| Cash and non-interest-bearing due from banks           | 46,204                              |                             |                | 40,540                              |                             |                |
| Bank premises and equipment, net                       | 8,390                               |                             |                | 8,827                               |                             |                |
| Interest receivable and other assets, net              | 60,115                              |                             |                | 60,205                              |                             |                |
| Total assets   | \$2,067,060                         |                             |                | \$1,968,208                         |                             |                |
| <b>Liabilities and Stockholders' Equity</b>            |                                     |                             |                |                                     |                             |                |
| Interest-bearing transaction accounts                  | \$94,799                            | \$21                        | 0.09 %         | \$93,355                            | \$28                        | 0.12 %         |
| Savings accounts                                       | 163,424                             | 16                          | 0.04 %         | 149,234                             | 14                          | 0.04 %         |
| Money market accounts                                  | 539,192                             | 114                         | 0.08 %         | 510,727                             | 107                         | 0.08 %         |
| Time accounts including CDARS                          | 146,042                             | 139                         | 0.38 %         | 160,031                             | 193                         | 0.48 %         |
| Overnight borrowings <sup>1</sup>                      | —                                   | —                           | — %            | 1,082                               | 1                           | 0.40 %         |
| FHLB fixed-rate advances <sup>1</sup>                  | —                                   | —                           | — %            | 12,363                              | 377                         | 12.07 %        |
| Subordinated debentures <sup>1</sup>                   | 5,646                               | 109                         | 7.59 %         | 5,471                               | 107                         | 7.78 %         |
| Total interest-bearing liabilities                     | 949,103                             | 399                         | 0.17 %         | 932,263                             | 827                         | 0.36 %         |
| Demand accounts  | 868,070                             |                             |                | 797,935                             |                             |                |
| Interest payable and other liabilities                 | 11,771                              |                             |                | 13,853                              |                             |                |
| Stockholders' equity                                   | 238,116                             |                             |                | 224,157                             |                             |                |
| Total liabilities & stockholders' equity               | \$2,067,060                         |                             |                | \$1,968,208                         |                             |                |
| Tax-equivalent net interest income/margin <sup>1</sup> |                                     | \$ 18,981                   | 3.85 %         |                                     | \$ 17,709                   | 3.77 %         |
| Reported net interest income/margin <sup>1</sup>       |                                     | \$ 18,304                   | 3.71 %         |                                     | \$ 17,166                   | 3.65 %         |

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|   |       |        |
|---|-------|--------|
| Tax-equivalent net interest rate spread | 3.76% | 3.59 % |
|---|-------|--------|

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| (dollars in thousands)                                 | Six months ended<br>June 30, 2017 |                             |                | Six months ended<br>June 30, 2016 |                             |                |
|--|-----------------------------------|-----------------------------|----------------|-----------------------------------|-----------------------------|----------------|
|  | Average<br>Balance                | Interest<br>Income/ Expense | Yield/<br>Rate | Average<br>Balance                | Interest<br>Income/ Expense | Yield/<br>Rate |
| <b>Assets</b>  |                                   |                             |                |                                   |                             |                |
| Interest-bearing due from banks <sup>1</sup>           | \$43,043                          | \$217                       | 1.00 %         | \$18,881                          | \$51                        | 0.53 %         |
| Investment securities <sup>2, 3</sup>                  | 411,427                           | 4,716                       | 2.29 %         | 408,539                           | 4,344                       | 2.13 %         |
| Loans <sup>1, 3, 4</sup>                               | 1,482,977                         | 33,090                      | 4.44 %         | 1,441,724                         | 33,872                      | 4.65 %         |
| Total interest-earning assets <sup>1</sup>             | 1,937,447                         | 38,023                      | 3.90 %         | 1,869,144                         | 38,267                      | 4.05 %         |
| Cash and non-interest-bearing due from banks           | 42,189                            |                             |                | 35,182                            |                             |                |
| Bank premises and equipment, net                       | 8,415                             |                             |                | 8,985                             |                             |                |
| Interest receivable and other assets, net              | 59,071                            |                             |                | 59,200                            |                             |                |
| Total assets   | \$2,047,122                       |                             |                | \$1,972,511                       |                             |                |
| <b>Liabilities and Stockholders' Equity</b>            |                                   |                             |                |                                   |                             |                |
| Interest-bearing transaction accounts                  | \$97,943                          | \$50                        | 0.10 %         | \$97,173                          | \$55                        | 0.11 %         |
| Savings accounts                                       | 162,175                           | 31                          | 0.04 %         | 145,866                           | 28                          | 0.04 %         |
| Money market accounts                                  | 528,923                           | 227                         | 0.09 %         | 519,856                           | 218                         | 0.08 %         |
| Time accounts including CDARS                          | 146,501                           | 285                         | 0.39 %         | 160,486                           | 389                         | 0.49 %         |
| Overnight borrowings <sup>1</sup>                      | —                                 | —                           | — %            | 10,825                            | 23                          | 0.42 %         |
| FHLB fixed-rate advances <sup>1</sup>                  | —                                 | —                           | — %            | 13,681                            | 455                         | 6.59 %         |
| Subordinated debentures <sup>1</sup>                   | 5,627                             | 217                         | 7.67 %         | 5,445                             | 216                         | 7.86 %         |
| Total interest-bearing liabilities                     | 941,169                           | 810                         | 0.17 %         | 953,332                           | 1,384                       | 0.29 %         |
| Demand accounts  | 857,253                           |                             |                | 782,757                           |                             |                |
| Interest payable and other liabilities                 | 13,200                            |                             |                | 14,917                            |                             |                |
| Stockholders' equity                                   | 235,500                           |                             |                | 221,505                           |                             |                |
| Total liabilities & stockholders' equity               | \$2,047,122                       |                             |                | \$1,972,511                       |                             |                |
| Tax-equivalent net interest income/margin <sup>1</sup> |                                   | \$37,213                    | 3.82 %         |                                   | \$36,883                    | 3.90 %         |
| Reported net interest income/margin <sup>1</sup>       |                                   | \$35,925                    | 3.69 %         |                                   | \$35,804                    | 3.79 %         |
| Tax-equivalent net interest rate spread                |                                   |                             | 3.73 %         |                                   |                             | 3.76 %         |

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the Federal statutory rate of 35 percent.

<sup>4</sup> 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.

## 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.

| (in thousands)                           | Three Months Ended June 30,<br>2017 Compared to Three Months<br>Ended<br>June 30, 2016 |            |      |         | Six Months Ended June 30,<br>2017 Compared to Six Months<br>Ended<br>June 30, 2016 |            |      |         |
|--|--|------------|------|---------|--|------------|------|---------|
|  | Volume   | Yield/Rate | Mix  | Total   | Volume   | Yield/Rate | Mix  | Total   |
| Interest-bearing due from banks          | \$38   | \$ 41      | \$38 | \$117   | \$65   | \$ 44      | \$57 | \$166   |
| Investment securities <sup>1</sup>       | 103  | 164        | 8    | 275     | 31   | 339        | 2    | 372     |
| Loans <sup>1</sup>                       | 531  | (76)       | )(3  | )452    | 969  | (1,702     | )(49 | )(782 ) |
| Total interest-earning assets            | 672  | 129        | 43   | 844     | 1,065  | (1,319     | )10  | (244 )  |
| Interest-bearing transaction accounts    | —  | (7         | )—   | (7      | )—   | (6         | )1   | (5 )    |
| Savings accounts                         | 1  | 1          | —    | 2       | 3  | —          | —    | 3       |
| Money market accounts                    | 6  | 1          | —    | 7       | 4  | 5          | —    | 9       |
| Time accounts, including CDARS           | (17  | )(40       | )3   | (54     | )(34   | )(77       | )7   | (104 )  |
| FHLB borrowings and overnight borrowings | (378   | )—         | —    | (378    | )(478  | )—         | —    | (478 )  |
| Subordinated debentures                  | 3  | (1         | )—   | 2       | 7  | (6         | )—   | 1       |
| Total interest-bearing liabilities       | (385   | )(46       | )3   | (428    | )(498  | )(84       | )8   | (574 )  |
|  | \$1,057  | \$ 175     | \$40 | \$1,272 | \$1,563  | \$ (1,235  | )\$2 | \$330   |

<sup>1</sup> Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the federal statutory rate of 35%.

## Second Quarter of 2017 Compared to Second Quarter of 2016

Net interest income totaled \$18.3 million in the second quarter of 2017, compared to \$17.2 million in the same quarter a year ago. The tax-equivalent net interest margin was 3.85% in the second quarter of 2017, compared to 3.77% in the same quarter of the previous year. The \$1.1 million increase was primarily driven by a \$93.7 million increase in interest earning assets. In addition, the second quarter of 2016 included a \$312 thousand prepayment fee on the retirement of a FHLB fixed advance. Higher yields on investment securities and interest-bearing cash, and upward repricing of variable rate loans also positively impacted interest income.

## First Six Months of 2017 Compared to First Six Months of 2016

Net interest income totaled \$35.9 million in the first six months of 2017, compared to \$35.8 million in the same period of 2016. The tax-equivalent net interest margin was 3.82% and 3.90% in the first six months of 2017 and 2016, respectively. The \$121 thousand increase in net interest income primarily relates to a \$68.3 million increase in average earning assets compared to June 30, 2016, a decrease in interest expense resulting from a prepayment fee and interest associated with the retirement of a FHLB fixed advance in June 2016 and a decline in the average rate on deposits. Additionally, the higher yield on investment securities and interest-bearing cash, and the upward repricing of variable rate loans positively impacted interest income, partially offset by a decrease of \$990 thousand in acquired loan income and a decline in the yield on fixed rate loans when compared to June 30, 2016.

## 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 and June 2017, have positively impacted yields on our rate sensitive interest-earning assets. The increase in June 2017, to the current target range for the federal funds rate of 1.00% to 1.25%, was the fourth rate hike since 2008. If interest rates continue to rise, we anticipate that our net interest income will increase. While short-term interest

rates have risen and improved the Bank's yields on prime-rate adjustable assets, there has been little movement in longer-term rates that influence competitive pricing for fixed-rate lending activities.

#### Impact of Acquired Loans on Net Interest Margin

Early pay-offs or prepayments of acquired loans with significant unamortized purchase discount/premium have resulted in net interest margin volatility and cannot be predicted. As our acquired loans continue to pay off, we expect the accretion on acquired loans to continue to decline. Accretion and gains on pay-offs of purchased loans recorded to interest income were as follows:

|                                | Three months ended                        |   | Six months ended                          |   |
|--------------------------------|---|---|---|---|
|                                | June 30, 2017                             | June 30, 2016                             | June 30, 2017                             | June 30, 2016                             |
| (dollars in thousands)         | Dollar Amount                             | Dollar Amount                             | Dollar Amount                             | Dollar Amount                             |
|                                | Basis point impact to net interest margin | Basis point impact to net interest margin | Basis point impact to net interest margin | Basis point impact to net interest margin |
| Accretion on PCI loans         | \$80 2 bps                                | \$87 2 bps                                | \$1702 bps                                | \$1852 bps                                |
| Accretion on non-PCI loans     | \$1783 bps                                | \$3177 bps                                | \$3283 bps                                | \$6477 bps                                |
| Gains on pay-offs of PCI loans | \$84 2 bps                                | \$— 0 bps                                 | \$84 1 bps                                | \$7408 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.

There was no provision for loan losses recorded in the second quarter of 2017, consistent with the same quarter a year ago, as the level of reserves was deemed appropriate for the loan portfolio. Net recoveries in the second quarter of 2017 totaled \$13 thousand compared to net recoveries of \$59 thousand in the same quarter a year ago.

The ratio of loan loss reserves to total loans was 1.02% at June 30, 2017, compared to 1.04% at December 31, 2016. At June 30, 2017, total loan loss reserve to loans excluding acquired loans was 1.07%. Non-accrual loans totaled \$1.2 million, or 0.08% of total loans, at June 30, 2017, compared to \$145 thousand, or 0.01%, at December 31, 2016. A well secured \$1.0 million commercial real estate loan was placed on non-accrual status during the first quarter of 2017.

No provision for loan losses was recorded in the first half of 2017 or 2016. Net charge-offs were \$210 thousand in the first half of 2017, compared to net recoveries of \$89 thousand in the first half of 2016.

Impaired loan balances totaled \$18.3 million at both June 30, 2017 and December 31, 2016, with specific valuation allowances of \$637 thousand and \$991 thousand for the same respective dates. Classified assets (loans with substandard or doubtful risk grades) increased to \$29.3 million at June 30, 2017, from \$19.6 million at December 31, 2016. The increase was primarily related to one relationship of \$8.4 million and the non-accrual loan of \$1.0 million mentioned above that were downgraded to substandard in the first quarter of 2017. There were no loans with doubtful risk grades at June 30, 2017 or December 31, 2016.

For more information, refer to Note 5 to the Consolidated Financial Statements in this Form 10-Q.



Non-interest Income

The tables below detail the components of non-interest income.

| (dollars in thousands)                | Three months ended |               | Amount<br>Increase<br>(Decrease) | Percent<br>Increase<br>(Decrease) |   |
|---------------------------------------|--------------------|---------------|----------------------------------|-----------------------------------|---|
|                                       | June 30, 2017      | June 30, 2016 |                                  |                                   |   |
| Service charges on deposit accounts   | \$447              | \$441         | \$ 6                             | 1.4                               | % |
| Wealth Management and Trust Services  | 504                | 527           | (23 )                            | (4.4 )                            | % |
| Debit card interchange fees           | 384                | 381           | 3                                | 0.8                               | % |
| Merchant interchange fees             | 112                | 128           | (16 )                            | (12.5 )                           | % |
| Earnings on bank-owned life insurance | 210                | 209           | 1                                | 0.5                               | % |
| Dividends on FHLB stock               | 176                | 185           | (9 )                             | (4.9 )                            | % |
| Gains on investment securities, net   | 10                 | 284           | (274 )                           | (96.5 )                           | % |
| Other income                          | 253                | 266           | (13 )                            | (4.9 )                            | % |
| Total non-interest income             | \$2,096            | \$2,421       | \$ (325 )                        | (13.4 )                           | % |

| (dollars in thousands)                | Six months ended |               | Amount<br>Increase<br>(Decrease) | Percent<br>Increase<br>(Decrease) |   |
|---------------------------------------|------------------|---------------|----------------------------------|-----------------------------------|---|
|                                       | June 30, 2017    | June 30, 2016 |                                  |                                   |   |
| Service charges on deposit accounts   | \$899            | \$897         | \$ 2                             | 0.2                               | % |
| Wealth Management and Trust Services  | 1,007            | 1,093         | (86 )                            | (7.9 )                            | % |
| Debit card interchange fees           | 756              | 719           | 37                               | 5.1                               | % |
| Merchant interchange fees             | 208              | 241           | (33 )                            | (13.7 )                           | % |
| Earnings on bank-owned life insurance | 419              | 410           | 9                                | 2.2                               | % |
| Dividends on FHLB stock               | 408              | 354           | 54                               | 15.3                              | % |
| Gains on investment securities, net   | 10               | 394           | (384 )                           | (97.5 )                           | % |
| Other income                          | 504              | 476           | 28                               | 5.9                               | % |
| Total non-interest income             | \$4,211          | \$4,584       | \$ (373 )                        | (8.1 )                            | % |

Second Quarter of 2017 Compared to Second Quarter of 2016

Non-interest income decreased by \$325 thousand in the second quarter of 2017 to \$2.1 million, compared to \$2.4 million in the same quarter a year ago. The decrease was primarily due to a \$274 thousand decrease in gains from the sale of investment securities.

First Six Months of 2017 Compared to First Six Months of 2016

Non-interest income decreased by \$373 thousand to \$4.2 million in the first six months of 2017, compared to \$4.6 million for the first six months of 2016. The decrease was primarily due to a \$384 thousand decrease in gains from the sale of investment securities.

## Non-interest Expense

The tables below detail the components of non-interest expense.

| (dollars in thousands)   | Three months ended |               | Amount Increase (Decrease) | Percent Increase (Decrease) |   |
|--|--------------------|---------------|----------------------------|-----------------------------|---|
|  | June 30, 2017      | June 30, 2016 |                            |                             |   |
|  |                    |               |                            |                             |   |
| Salaries and related benefits                                    | \$7,287            | \$6,724       | \$ 563                     | 8.4                         | % |
| Occupancy and equipment  | 1,380              | 1,175         | 205                        | 17.4                        | % |
| Depreciation and amortization                                    | 463                | 441           | 22                         | 5.0                         | % |
| Federal Deposit Insurance Corporation insurance                  | 162                | 246           | (84 )                      | (34.1 )                     | % |
| Data processing  | 963                | 916           | 47                         | 5.1                         | % |
| Professional services  | 522                | 554           | (32 )                      | (5.8 )                      | % |
| Directors' expense   | 224                | 116           | 108                        | 93.1                        | % |
| Information technology   | 186                | 165           | 21                         | 12.7                        | % |
| (Reversal) provision for losses on off-balance sheet commitments | (208 )             | 150           | (358 )                     | (238.7 )                    | % |
| Other non-interest expense                                       |                    |               |                            |                             |   |
| Advertising  | 131                | 98            | 33                         | 33.7                        | % |
| Other expense  | 1,521              | 1,432         | 89                         | 6.2                         | % |
| Total other non-interest expense                                 | 1,652              | 1,530         | 122                        | 8.0                         | % |
| Total non-interest expense                                       | \$12,631           | \$12,017      | \$ 614                     | 5.1                         | % |

| (dollars in thousands)   | Six months ended |               | Amount Increase (Decrease) | Percent Increase (Decrease) |   |
|--|------------------|---------------|----------------------------|-----------------------------|---|
|  | June 30, 2017    | June 30, 2016 |                            |                             |   |
|  |                  |               |                            |                             |   |
| Salaries and related benefits                                    | \$14,762         | \$13,472      | \$ 1,290                   | 9.6                         | % |
| Occupancy and equipment  | 2,699            | 2,456         | 243                        | 9.9                         | % |
| Depreciation and amortization                                    | 944              | 894           | 50                         | 5.6                         | % |
| Federal Deposit Insurance Corporation insurance                  | 323              | 507           | (184 )                     | (36.3 )                     | % |
| Data processing  | 1,902            | 1,772         | 130                        | 7.3                         | % |
| Professional services  | 1,044            | 1,052         | (8 )                       | (0.8 )                      | % |
| Directors' expense   | 382              | 305           | 77                         | 25.2                        | % |
| Information technology   | 384              | 358           | 26                         | 7.3                         | % |
| (Reversal) provision for losses on off-balance sheet commitments | (43 )            | 150           | (193 )                     | (128.7 )                    | % |
| Other non-interest expense                                       |                  |               |                            |                             |   |
| Advertising  | 204              | 201           | 3                          | 1.5                         | % |
| Other expense  | 3,041            | 2,860         | 181                        | 6.3                         | % |
| Total other non-interest expense                                 | 3,245            | 3,061         | 184                        | 6.0                         | % |
| Total non-interest expense                                       | \$25,642         | \$24,027      | \$ 1,615                   | 6.7                         | % |

## Second Quarter of 2017 Compared to Second Quarter of 2016

Non-interest expense increased by \$614 thousand to \$12.6 million in the second quarter of 2017, compared to \$12.0 million in the same quarter a year ago. The increase was primarily due to higher salaries and benefits related to filling open positions, merit increases and incentive bonuses, as well as higher occupancy expense from increased rent and maintenance costs, and higher recruiting fees. Directors' expense increased primarily due to a reclassification of director-related stock option compensation that was previously included in salaries and related benefits, and higher compensation. These increases were partially offset by a \$208 thousand reversal of the provision for losses on off-balance sheet commitments in the second quarter of 2017, compared to a \$150 thousand provision in the second

quarter of 2016, and lower FDIC assessment expense due to decreased assessment rates. The reversal of the provision for losses on off-balance sheet commitments in the second quarter of 2017 resulted from a decrease in total

commitments during the quarter primarily driven by the completion and pay-off of a construction project, and a reduction of estimated loss factors.

#### First Six Months of 2017 Compared to First Six Months of 2016

Non-interest expense totaled \$25.6 million in the first half of 2017, compared to \$24.0 million in the first half of 2016. The increase was primarily due to merit increases, and added salaries and benefits related to filling open positions that resulted in higher incentive bonus, stock-based compensation and 401(k) employer match. Occupancy and equipment expense increased primarily due to higher rent and maintenance costs. Data processing increased primarily due to more customer transaction volume and the addition of new products and services. The increase in other expense is primarily due to recruiting fees. These increases were partially offset by a \$43 thousand reversal of the provision for losses on off-balance sheet commitments recorded in the first half of 2017, compared to a \$150 thousand provision in the first half of 2016, and lower FDIC assessment expense due to decreased assessment rates.

#### Provision for Income Taxes

The provision for income taxes for the second quarter of 2017 totaled \$2.6 million at an effective tax rate of 33.2%, compared to \$2.7 million at an effective tax rate of 36.1% in the same quarter last year. The provision for income taxes for the first half of 2017 totaled \$4.8 million at an effective tax rate of 32.8%, compared to \$5.9 million at an effective tax rate of 35.9% for the first half of 2016. The decrease in the year-to-date effective tax rate is primarily due to higher tax-exempt interest on municipal securities and loans and lower pre-tax income. Additionally, discrete tax benefits from the exercise of stock options and vesting of restricted stock increased in 2017 as a result of the adoption of ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, as discussed in Note 2 to the Consolidated Financial Statements in Item 1 of this report. 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). There may be fluctuations in the effective rate from period to period based on the relationship of net permanent differences to income before tax.

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 June 30, 2017, neither the Bank nor Bancorp had accruals for interest nor penalties related to unrecognized tax benefits.

#### FINANCIAL CONDITION SUMMARY

##### Investment Securities

The investment securities portfolio totaled \$401.9 million at June 30, 2017, a \$15.1 million decrease from December 31, 2016. Year-to-date investment security purchases totaling \$13.9 million partially offset the paydowns and maturities totaling \$30.0 million. Effective February 24, 2017, \$129 million in mortgage-backed securities were transferred from available-for-sale securities to held-to-maturity at fair value to reduce balance sheet volatility, which was made possible by our strong liquidity position.

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The table below summarizes our investment in obligations of state and political subdivisions at June 30, 2017 and December 31, 2016.

| (dollars in thousands)                                | June 30, 2017  |            |   | December 31, 2016 |            |   |
|---|----------------|------------|---|-------------------|------------|---|
|   | Amortized Cost | Fair Value | % of Total State and Political Subdivisions | Amortized Cost    | Fair Value | % of Total State and Political Subdivisions |
| <b>Within California:</b>                             |                |            |   |                   |            |   |
| General obligation bonds                              | \$ 15,620      | \$ 15,779  | 15.5 %                                      | \$ 15,777         | \$ 15,660  | 14.3 %                                      |
| Revenue bonds   | 8,193          | 8,424      | 8.1   | 10,895            | 11,127     | 9.9   |
| Tax allocation bonds                                  | 4,000          | 4,158      | 4.0   | 4,043             | 4,178      | 3.7   |
| Total within California                               | 27,813         | 28,361     | 27.6  | 30,715            | 30,965     | 27.9  |
| <b>Outside California:</b>                            |                |            |   |                   |            |   |
| General obligation bonds                              | 65,399         | 65,926     | 64.7  | 71,534            | 70,376     | 64.9  |
| Revenue bonds   | 7,802          | 7,865      | 7.7   | 7,913             | 7,904      | 7.2   |
| Total outside California                              | 73,201         | 73,791     | 72.4  | 79,447            | 78,280     | 72.1  |
| Total obligations of state and political subdivisions | \$ 101,014     | \$ 102,152 | 100.0 %                                     | \$ 110,162        | \$ 109,245 | 100.0 %                                     |

The portion of the portfolio outside the state of California is distributed among twenty states. The largest concentrations outside California are in Washington (12.9%), Minnesota (12.1%), and Texas (11.8%). Revenue bonds, both within and outside California, primarily consist of bonds relating to essential services (such as public improvements and utilities) and school district bonds.

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 taxpayers and local employers, income indices and home values
- For revenue bonds, the source and strength of revenue for municipal authorities including the obligor's 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

Loans totaled \$1,491.5 million at June 30, 2017, an increase of \$4.9 million from \$1,486.6 million at December 31, 2016. New loan originations in the first six months of 2017 of \$79.4 million were primarily in commercial real estate, including both owner-occupied and investor-owned, spread throughout our markets, and Loans increased by \$4.9 million and totaled \$1,491.5 million at June 30, 2017, compared to \$1,486.6 million at December 31, 2016. New loan originations in the first six months of 2017 of \$79.4 million were primarily in commercial real estate, including both owner-occupied and investor-owned, spread throughout our markets, and tenancy-in-common fractional interest loans. Loan originations combined with changes in the utilization of loan commitments, pay-offs of \$80.8 million, and scheduled payments, produced the net increase from December 31, 2016. Our current pipeline approximates last year at this time, and should translate into loan growth throughout the year.

#### Liabilities



During the first six months of 2017, total liabilities increased by \$67.1 million to \$1,860.0 million. Deposits increased \$67.8 million in the first half of 2017, primarily due to fluctuations from large deposit clients' seasonal cash flows and the placement by existing clients of funds from their asset sales that will be distributed to the beneficiaries of trusts or transitioned into real estate or other investments. Non-interest bearing deposits totaled \$893.0 million, or 48.5% of total deposits at June 30, 2017, compared to 46.1% at December 31, 2016.

### Capital Adequacy

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements as set forth in the tables below can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on our consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and the Bank's prompt corrective action classification are also subject to qualitative judgments by the regulators about components of capital, risk weightings and other factors.

Management reviews capital ratios on a regular basis to ensure that capital exceeds the prescribed regulatory minimums and is adequate to meet our anticipated future needs. For all periods presented, the Bank's ratios exceed the regulatory definition of "well capitalized" under the regulatory framework for prompt corrective action and Bancorp's ratios exceed the required minimum ratios to be considered a well-capitalized bank holding company. The most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action as of March 31, 2017. There are no conditions or events since that notification that Management believes have changed the Bank's categories and we expect the Bank to remain well capitalized for prompt corrective action purposes.

In July 2013, the Federal Reserve Board of Governors, the FDIC and the Office of the Comptroller of the Currency finalized regulatory capital rules known as "Basel III". The rules became effective beginning January 2015, and will be phased-in by January 2019. The guidelines, among other things, changed the minimum capital requirements of banks and bank holding companies by increasing the Tier 1 capital to risk-weighted assets ratio to 6%, and introduced a new requirement to maintain a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%. By 2019, when fully phased in, the rules will require further increases to certain minimum capital requirements and a capital conservation buffer of an additional 2.5% of risk-weighted assets. Basel III permits certain banks such as us to exclude accumulated other comprehensive income or loss from regulatory capital through a one-time election in the first quarter of 2015. As it was consistent with our existing treatment, there were no changes to our capital ratios as a result of making this election. The Basel III changes that affected us most significantly include:

- shifting off-balance sheet items with an original maturity of one year or less from 0% to 20% risk weight,
- moving past due loan balances from 100% to 150% risk weight,
- deducting deferred tax assets associated with NOLs and tax credits from common equity Tier 1 capital, and
- subjecting deferred tax assets related to temporary timing differences that exceed certain thresholds to 250% risk-weighting, beginning in 2018.

We have modeled our ratios under the fully phased-in Basel III rules, and based on present facts, we do not expect that we will be required to raise additional capital as a result of the fully phased-in rules.

The Bancorp's and Bank's capital adequacy ratios as of June 30, 2017 and December 31, 2016 are presented in the following tables. Bancorp's Tier 1 capital includes the subordinated debentures, which are not included at the Bank level. We continued to build capital in 2017 through the accumulation of net income.

| Capital Ratios for Bancorp<br>(dollars in thousands) | Actual Ratio | Adequately<br>Capitalized | Ratio to be a Well<br>Capitalized Bank |
|--|--------------|---------------------------|--|
|--|--------------|---------------------------|--|

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|  | Threshold <sup>1</sup> |         | Holding Company |         |
|--|------------------------|---------|-----------------|---------|
|  | Amount                 | Ratio   | Amount          | Ratio   |
| June 30, 2017                                  |                        |         |                 |         |
| Total Capital (to risk-weighted assets)        | \$255,140              | 15.01 % | ≥ \$57,238      | ≥ 9.25% |
| Tier 1 Capital (to risk-weighted assets)       | \$239,051              | 14.06 % | ≥ \$23,241      | ≥ 7.25% |
| Tier 1 Capital (to average assets)             | \$239,051              | 11.61 % | ≥ \$2,339       | ≥ 4.00% |
| Common Equity Tier 1 (to risk-weighted assets) | \$233,570              | 13.74 % | ≥ \$7,743       | ≥ 5.75% |
| December 31, 2016                              |                        |         |                 |         |
| Total Capital (to risk-weighted assets)        | \$247,453              | 14.32 % | ≥ \$49,039      | ≥ 8.62% |
| Tier 1 Capital (to risk-weighted assets)       | \$231,111              | 13.37 % | ≥ \$14,479      | ≥ 6.62% |
| Tier 1 Capital (to average assets)             | \$231,111              | 11.39 % | ≥ \$1,189       | ≥ 4.00% |
| Common Equity Tier 1 (to risk-weighted assets) | \$225,925              | 13.07 % | ≥ \$8,559       | ≥ 5.12% |

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<sup>1</sup> The adequately capitalized threshold includes the capital conservation buffer that was effective January 1, 2016. These ratios are not reflected on a fully phased-in basis, which will occur in January 2019.

| Capital Ratios for the Bank<br>(dollars in thousands) | Actual Ratio |        | Adequately Capitalized Threshold <sup>1</sup> |       | Ratio to be Well Capitalized under Prompt Corrective Action Provisions |        |
|---|--------------|--------|---|-------|--|--------|
|   | Amount       | Ratio  | Amount  | Ratio | Amount   | Ratio  |
| June 30, 2017   |              |        |   |       |  |        |
| Total Capital (to risk-weighted assets)               | \$250,894    | 14.76% | \$57,193                                      | 9.25% | \$69,938   | 10.00% |
| Tier 1 Capital (to risk-weighted assets)              | \$234,805    | 13.82% | \$23,205                                      | 7.25% | \$35,951   | 8.00%  |
| Tier 1 Capital (to average assets)                    | \$234,805    | 11.41% | \$2,326                                       | 4.00% | \$02,908   | 5.00%  |
| Common Equity Tier 1 (to risk-weighted assets)        | \$234,805    | 13.82% | \$7,715                                       | 5.75% | \$10,460   | 6.50%  |
| December 31, 2016                                     |              |        |   |       |  |        |
| Total Capital (to risk-weighted assets)               | \$243,468    | 14.09% | \$49,016                                      | 8.62% | \$72,772   | 10.00% |
| Tier 1 Capital (to risk-weighted assets)              | \$227,127    | 13.15% | \$14,462                                      | 6.62% | \$38,218   | 8.00%  |
| Tier 1 Capital (to average assets)                    | \$227,127    | 11.19% | \$1,176                                       | 4.00% | \$01,469   | 5.00%  |
| Common Equity Tier 1 (to risk-weighted assets)        | \$227,127    | 13.15% | \$8,546                                       | 5.12% | \$12,302   | 6.50%  |

<sup>1</sup> The adequately capitalized threshold includes the capital conservation buffer that was effective January 1, 2016. These ratios are not reflected on a fully phased-in basis, which will occur in January 2019.

## 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 6 to the consolidated financial statements. Our Asset Liability Management Committee ("ALCO"), which is comprised of certain Bank directors, 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 June 30, 2017 our liquid assets, which included unencumbered available-for-sale securities and cash, totaled \$323.8 million, an increase of \$9.0 million from December 31, 2016. Our cash and cash equivalents increased \$89.1 million from December 31, 2016. The primary sources of funds during the first six months of 2017 included \$31.3 million in pay-downs and maturities of investment securities, \$12.2 million net cash provided by operating activities and an increase in net deposits of \$67.8 million. The primary uses of liquidity during the first six months of 2017 was \$13.9 million in investment securities purchased, \$4.6 million in loans originated (net of loan principal collected) and \$3.3 million in cash dividends paid on common stock to our shareholders. 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 8 to the consolidated financial statements, totaled \$400.6 million at June 30, 2017. These commitments, to the extent used, are expected to be funded primarily through the repayment of existing loans, deposit growth and liquid assets. Over the next twelve months, \$97.6 million of time deposits will mature. We expect these funds to be replaced with new deposits. Our emphasis on local deposits combined with our well capitalized equity position, 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 \$3.9 million of cash at June 30, 2017, which is deemed sufficient to cover Bancorp's operational needs and cash dividends to shareholders through the end of 2017. 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 3. 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.

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 9 to the Consolidated Financial Statements in this Form 10-Q.

Exposure to interest rate risk is reviewed at least quarterly by ALCO and the Board of Directors. Simulation models are used 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.

The following table estimates the effect of interest rate changes in all points of the yield curve as measured against a flat rate scenario. The Bank currently has low interest rate risk and, in general, is slightly asset sensitive (net interest margin is expected to increase if rates go up due to our adjustable rate loans and our significant non-interest bearing deposit base). Our net interest income is most vulnerable to a falling interest rate environment. Interest rate risk is within policy guidelines established by ALCO and the Board of Directors.

| Immediate Changes in Interest Rates<br>(in basis points) | Estimated Change in NII in Year 1<br>(as percent of NII) | Estimated Change in NII in Year 2<br>(as percent of NII) |    |
|--|--|--|----|
| up 200   | 0.8  | % 6.6  | %  |
| down 100   | (6.6   | )%(11.8  | )% |

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. 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. 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 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Bank of Marin Bancorp and its subsidiary (the "Company") conducted an evaluation under the supervision and with the participation of our Management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act of 1934 (the "Act")) as of the end of the period covered by this report. The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Act is accumulated and communicated to our Management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Controls over Financial Reporting

During the last fiscal quarter there were no significant changes that materially affected, or are reasonably likely to affect, our internal control over financial reporting. The term internal control over financial reporting, as defined by Rule 15d-15(f) of the Act, is a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, 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.

PART II OTHER INFORMATION

ITEM 1 Legal Proceedings

Refer to Note 12 to the Consolidated Financial Statements in Item 8 of our 2016 Form 10-K and Note 8 to the Consolidated Financial Statements in this Form 10-Q.

ITEM 1A Risk Factors

In addition to other information contained in this report, including matters under the section "Forward-Looking Statements," and risks previously disclosed in section Item 1A, "Risk Factors" of our 2016 Form 10-K, you should carefully consider the following risk factors in connection with the proposed acquisition of the Bank of Napa, N.A. ("Napa").

The Market Price of Our Common Stock after the Merger may be Affected by Factors Different from those Affecting Our Shares Currently

The results of operations of the combined company and the market price of our common stock after the completion of the merger may be affected by factors different from those currently affecting our independent results of operations prior to the merger.

Regulatory Approvals May Not Be Received, May Take Longer Than Expected or May Impose Conditions That Are Not Presently Anticipated

Before the merger may be completed, Bancorp and Napa must satisfy a number of conditions. These conditions include obtaining various regulatory approvals or consents, including the Federal Deposit Insurance Corporation and the State of California. In deciding whether to grant these approvals, the relevant governmental authorities will make a determination of whether, among other things, the merger is in the public interest. These regulatory entities may impose conditions on the completion of the merger or require changes to the terms of the merger. Although we do not currently expect that any material conditions or changes would be imposed, there can be no assurance that they will not be. Such conditions or changes could have the effect of delaying completion of the merger or imposing additional



costs on or limiting the revenues of the combined company following the merger, any of which might have a material adverse effect on us following the merger. In addition, we or Napa may elect not to consummate the merger if:

(A) any required regulatory approval has been denied by the relevant regulatory authority and such denial has become final and nonappealable,

(B) any such approval includes any condition, restriction or requirement that would:

(i) have a material adverse effect on Napa's business or,

(ii) would restrict our business after the closing of the merger such that it would have a material adverse effect on us, or

(iii) require the sale by us or Napa of any material portion of assets, or

(C) if a regulatory authority has issued a final, nonappealable injunction permanently enjoining or otherwise prohibiting the completion of the merger.

#### We May Be Unable to Integrate Operations Successfully or to Achieve Expected Cost Savings

Our earnings, financial condition and prospects after the merger will depend in part on our ability to integrate the operations and management of Napa and to continue to implement our own business plan. There is no assurance that we will be able to do so. The issues that we could face include, but are not limited to:

- unexpected problems with operations, personnel, technology or credit;
- loss of customers and employees of Napa;
- difficulty in working with Napa's employees and customers;
- the assimilation of Napa's operations, sites and personnel; and
- instituting and maintaining uniform standards, controls, procedures and policies.

Further, although the boards of directors of both parties anticipate cost savings as a result of the merger, we may not be fully able to realize those savings. Any cost savings that are realized may be offset by losses in revenues or other charges to earnings.

#### We Expect to Incur Significant Costs Associated with the Merger

We estimate that we have incurred or will incur significant transaction costs associated with the merger, a portion of which will be incurred whether or not the merger closes. We believe the combined company may incur charges to operations, which are not currently reasonably estimable, in the quarter in which the merger is completed or subsequent quarters, to reflect costs associated with integrating the two banks. There is no assurance that the combined company will not incur additional material charges in subsequent quarters to reflect additional costs associated with the merger, including charges associated with the impairment of any goodwill booked in connection with the merger.

#### The Failure of the Loan Portfolios to Perform as Expected May Unfavorably Impact Us

Our performance and prospects after the merger will be dependent to a significant extent on the performance of the combined loan portfolios of Bank of Marin and Bank of Napa, and ultimately on the financial condition of their respective borrowers and other customers. The existing loan portfolios of the two banks differ to some extent in the types of borrowers, industries and credits represented. In addition, there are differences in the documentation, classifications, credit ratings and management of the portfolios. As a result, our overall loan portfolio after the merger may have a different risk profile than the loan portfolio of either Bank of Marin or Napa before the merger. The performance of the two loan portfolios will be adversely affected if any of such factors is worse than currently anticipated. In addition, to the extent that present customers are not retained by us, or additional expenses are incurred in retaining them, there could be adverse effects on our future consolidated results of operations following the merger. Realization of improvement in profitability is dependent, in part, on the extent to which the revenues of Napa are

maintained and enhanced.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds

We did not have any unregistered sales or repurchases of our equity securities during the six months ended June 30, 2017.

ITEM 3 Defaults upon Senior Securities

None.

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ITEM 4 Mine Safety Disclosures

Not applicable.

ITEM 5 Other Information

None.

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ITEM 6 Exhibits

The following exhibits are filed as part of this report or hereby incorporated by references to filings previously made with the SEC.

| Exhibit Number | Exhibit Description   | Incorporated by Reference |               |         |                  |       |
|----------------|---|---------------------------|---------------|---------|------------------|-------|
|                |   | Form                      | File No.      | Exhibit | Filing Date      |       |
| 2.01           | <u>Agreement to Merger and Plan of Reorganization with Bank of Napa, dated July 31, 2017</u>  | 8-K                       | 001-33572     | 2.1     | August 1, 2017   |       |
| 3.01           | <u>Articles of Incorporation, as amended</u>  | 10-Q                      | 001-33572     | 3.01    | November 7, 2007 |       |
| 3.02           | <u>Bylaws</u>   | 10-Q                      | 001-33572     | 3.02    | May 9, 2011      |       |
| 3.02a          | <u>Bylaw Amendment</u>  | 8-K                       | 001-33572     | 3.03    | July 6, 2015     |       |
| 4.01           | <u>Rights Agreement, dated July 6, 2017</u>   | 8-A12B                    | 001-33572     | 4.1     | July 7, 2017     |       |
| 10.01          | <u>Employee Stock Ownership Plan</u>  | S-8                       | 333-1448104.1 |         | May 26, 2017     |       |
| 10.02          | <u>2007 Employee Stock Purchase Plan</u>  | S-8                       | 333-1448104.1 |         | July 24, 2007    |       |
| 10.03          | <u>2017 Equity Plan</u>   | S-8                       | 333-1448094.1 |         | June 30, 2017    |       |
| 10.04          | <u>2010 Director Stock Plan</u>   | S-8                       | 333-1676394.1 |         | June 21, 2010    |       |
| 10.05          | <u>Form of Indemnification Agreement for Directors and Executive Officers, dated August 9, 2007</u>   | 10-Q                      | 001-33572     | 10.06   | November 7, 2007 |       |
| 10.06          | <u>Form of Employment Agreement, dated January 23, 2009</u>   | 8-K                       | 001-33572     | 10.1    | January 26, 2009 |       |
| 10.07          | <u>2010 Annual Individual Incentive Compensation Plan</u>   | 8-K                       | 001-33572     | 99.1    | October 21, 2010 |       |
| 10.08          | <u>Salary Continuation Agreement for executive officer Russell Colombo, Chief Executive Officer, dated January 1, 2011</u>                            | 8-K                       | 001-33572     | 10.1    | January 6, 2011  |       |
| 10.09          | <u>Salary Continuation Agreement for executive officer Peter Pelham, Director of Retail Banking, dated January 1, 2011</u>                            | 8-K                       | 001-33572     | 10.4    | January 6, 2011  |       |
| 10.10          | <u>Salary Continuation Agreements for executive officer Tani Girton, Chief Financial Officer, dated October 18, 2013</u>                              | 8-K                       | 001-33572     | 10.2    | November 4, 2014 |       |
| 10.11          | <u>Salary Continuation Agreements for executive officer Elizabeth Reizman, Chief Credit Officer, dated July 20, 2014</u>                              | 8-K                       | 001-33572     | 10.3    | November 4, 2014 |       |
| 10.12          | <u>Salary Continuation Agreement for executive officer Timothy Myers, Executive Vice President and Commercial Banking Manager, dated May 28, 2015</u> | 8-K                       | 001-33572     | 10.4    | June 2, 2015     |       |
| 10.13          | <u>2007 Form of Change in Control Agreement</u>   | 8-K                       | 001-33572     | 10.1    | October 31, 2007 |       |
| 10.14          | <u>Information Technology Services Agreement with Fidelity Information Services, LLC, dated July 11, 2012</u>   | 8-K                       | 001-33572     | 10.1    | July 17, 2012    |       |
| 11.01          | <u>Earnings Per Share Computation - included in Note 1 to the Consolidated Financial Statements</u>   |                           |               |         |                  | Filed |
| 31.01          |   |                           |               |         |                  | Filed |

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|         |   |           |
|---------|---|-----------|
|         | <u>Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |           |
| 31.02   | <u>Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> | Filed     |
| 32.01   | <u>Certification pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002</u>  | Filed     |
| 101.01* | XBRL Interactive Data File  | Furnished |

\* As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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SIGNATURES

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

Bank of Marin Bancorp  
(registrant)

August 7, 2017 /s/ Russell A. Colombo  
Date Russell A. Colombo  
President &  
Chief Executive Officer  
(Principal Executive Officer)

August 7, 2017 /s/ Tani Girton  
Date Tani Girton  
Executive Vice President &  
Chief Financial Officer  
(Principal Financial Officer)

August 7, 2017 /s/ Cecilia Situ  
Date Cecilia Situ  
First Vice President &  
Manager of Finance & Treasury  
(Principal Accounting Officer)