Exchange Bank

March 1, 2019

Dear Shareholders:

As we look forward to 2019, we reflect on all that we have accomplished over the last year. It is appropriate that we continue to recognize and acknowledge the journey to recovery after the October 2017 wildfires. Exchange Bank's culture of caring, combined with our strong values and dedication to doing our part for the greater good of the community, was very evident over the past 15 months. The compassion and generous spirit of our employees continues to have a direct and positive impact on our community. We are deeply grateful and proud of the contribution the Bank and our employees have made toward the recovery efforts and we will continue to be there as our community moves forward.

Throughout 2018, we remained focused on executing our strategic plan and are very proud of the financial performance that Exchange Bank delivered for its shareholders. From almost every viewpoint, 2018 was a successful year for our Bank. We continued to execute our goal of creating long-term shareholder value by effectively balancing our reinvestment in the company and our community, while delivering an excellent return on invested capital and assets.

From an operating standpoint, 2018 was a year in which the dedication and hard work of our employees became clearly evident in the outstanding financial results of the Bank. In addition to the extraordinary efforts of our employees and continued support by our valued clients, many variables lined up in a very positive manner for the Bank.

Net income surpassed that of any prior year in our Bank's history. Net income was $38.5 million, an increase of $19.0 million, or 97%, as compared to $19.5 million for 2017. While net income after tax was impacted by the Tax Cuts and Jobs Act of 2017, which became effective in 2018, reducing the federal tax rate to 21% from 35%, the real indicator of the Bank's operations for the year is income before tax. By this measure, the Bank had an extraordinary year. Income before taxes for the year ended December 31, 2018 totaled $53.5 million, compared to $43.6 million a year ago, an increase of 23%. The earnings of the Bank were driven primarily by continued growth in average loans and investments, which were funded by a significant increase in the level of average low cost core deposits outstanding during the year. The growth in loans and investments led to an increase in net interest income of $12.4 million, a 15% increase over 2017.

As a result of the devastating wildfires that impacted our communities late in 2017, the Bank experienced an increase of approximately $300 million in insurance related deposits from our clients who were impacted by the fires. We expected the rebuilding of our community and the customer redeployment of these deposits to happen at a faster pace than what has actually transpired. As a result, these deposits remained with the Bank throughout much of the year and contributed to an increase in average deposits outstanding during 2018 of $345 million. This additional liquidity was generally invested in short to intermediate term investment securities, which generated additional interest income of approximately $5.0 million. It is important to note that we believe that a good portion of these fire insurance related deposits will leave the Bank over the next year as our customers' rebuilding and relocation efforts progress at a more rapid pace.

We are proud of our efforts to support the credit needs of our clients and community during 2018. Average loans outstanding during the year increased by $51 million, or 3.5% over the average balance outstanding at December 31, 2017. The modest growth in net loans outstanding during 2018 understates the Bank’s true commitment to supporting the economic growth of the communities we serve. In fact, the Bank supported our clients with new loan production exceeding $300 million during 2018. This was largely offset by an unusually high volume of prepayments the Bank experienced as clients elected to refinance existing debt with other financial institutions offering aggressive long-term fixed interest rates during a period when the Federal Reserve was increasing interest rates.

As a result of a rising interest rate environment and diligent management of our balance sheet, the Bank was able to reprice loans and investments at a more rapid rate than similar increases on its cost of deposits. The net impact of this positive repricing environment led to an increase in net interest income of approximately $3.9 million during 2018.

The comparisons between net income after tax for the years ending December 31, 2018 and 2017 were strongly influenced by the impact of a change in the tax law enacted during 2017. This new tax law caused a turnaround in income tax expense of approximately $12.9 million. The turnaround in income tax expense came in two forms. First, the Bank benefited from a lower federal income tax rate, which contributed approximately $6.0 million in tax savings in 2018. Second, as a result of the enactment of the new tax law, the Bank reported an additional adjustment to income tax expense of $6.9 million in the fourth quarter of 2017. The increase in income tax expense was the result of a one-time adjustment related to the carrying value of the Bank’s net deferred tax assets due to the reduction in federal income tax rates from 35% to 21%. This unusual adjustment of $6.9 million in income tax expense in 2017 did not exist in 2018.

The Bank’s non-interest income for the year increased from $24.3 million in 2017 to $25.8 million in 2018, an increase of 6%. This increase was centered in our Trust & Investment Management department and SBA lending division. Non-interest income generated by our trust and investment business increased $600,000 and revenues generated from gains on the sale of SBA loans increased $800,000. Also, during the first quarter of 2018, the Bank benefitted from a gain of $3.25 million on the sale of other real estate held for sale. Such a gain is of a nonrecurring nature and will not be repeated in 2019.

During 2018, the Bank successfully executed in a number of areas of our strategic plan, including the strengthening of our management team and continued investment in technology to drive future efficiencies in the Bank. As a result of these initiatives, total operating expenses for the Bank grew by over 6%, increasing from $61.7 million to $65.6 million in 2018. The largest component of this increase resides in salaries and benefits, which increased by

$2.6 million. In addition to adding key senior management roles, we continued to enhance our strength in such areas as risk management and information technology. Additionally, due to the burdens of the high cost of living in Sonoma County, we invested in our employees by providing non-senior management staff with a cost of living salary adjustment.

A key initiative for us during 2018 was to continue growing the Bank's capital. While the Bank continued to reward its shareholders with two increases to the quarterly dividend during the year, as a result of strong earnings growth we were successful in growing our capital from $203.2 million to $231.6 million, an increase of 14%. This allowed the Bank to increase its tangible capital ratio from 8.68% at December 31, 2017 to 9.22% at December 31, 2018.

The Bank's capital ratios exceed all regulatory definitions of "well capitalized." As of December 31, 2018, the Bank reported total risk-based capital of 15.14%. Additionally, the Bank's liquidity position remains strong due to the outstanding quality of our investment securities portfolio and strong overnight cash position. Exchange Bank paid a quarterly cash dividend of $1.00 per share on common stock outstanding to shareholders on December 14, 2018. Total dividends paid to Exchange Bank shareholders during 2018 were $6.60 million and represented an increase of 13.2% above total dividends of $5.83 million paid to shareholders during 2017.

Our loan growth was primarily centered in business and commercial real estate and construction lending. In the commercial real estate portfolio, loan growth was diversified across all property types. While expanding the loan portfolio, we prudently managed interest rate risk with 80% of our loan portfolio repricing or maturing within five years. As interest rates rise, this will position the Bank with improved revenue opportunities.

The Bank's credit quality remains strong with non-accrual loans at .28% of total loans at December 31, 2018. Classified loans to capital declined from 8.4% in 2017 to 4.80% in 2018. Despite continued loan growth, as a result of our strong credit quality metrics, the Bank did not make any provision for loan losses in 2018 and was able to maintain a ratio of loan loss reserves to total loans of 2.63%.

Exchange Bank's Trust & Investment Management department has been a fiduciary of client assets since 1963. We have an experienced team of professionals who work with their clients to help them define and achieve their long-term goals. We also have several credentialed trust and investment professionals who work closely with the top estate planning attorneys in Sonoma County. Whether working with private clients and their families or business clients and their employee benefit trust account (401k plans), our goal is to create a trusted relationship that helps our clients feel confident and secure about meeting their financial goals.

Over the past several years, our Trust & Investment Management department has delivered strong financial performance, growing our client base and expanding our presence in the markets we serve. This department continues to be a consistent revenue and earnings growth contributor to the Bank. The department contributed a record $7.3 million in gross revenue to the Bank for 2018, an increase of $600 thousand, or 9% over the prior year. Total client assets under management in 2018 grew to a record $1.2 billion. Our Trust & Investment Management department is the sixth largest community bank trust department by asset size in the state of California.

The Bank successfully executed its strategic plan of expanding its presence in the Sacramento market with the acquisition of the trust department of First Northern Bank of Dixon. We consolidated the employees and approximately $45 million in trust assets into our existing operations in Roseville, California. We will continue to grow our trust business by expanding our geographic presence into other contiguous markets where we have identified a team of experienced professionals. In early 2019, the Bank executed an agreement to acquire another $85 million in trust assets from a community bank in the South Bay. We believe the expansion of our Trust & Investment Management department will provide value to our shareholders, clients and employees. The progress we have made in 2018 positions the Bank for continued growth and success.

2018 was a tale of two distinct stories in terms of expectations relating to economic growth and market optimism. The year began on a high with the perceived benefit from tax reform and its positive impact on consumers and businesses. In addition to tax cuts, the White House increased federal government spending for both 2018 and 2019. Federal Reserve officials expressed greater confidence that the economy was poised for strong growth and that inflation would rise to their target rate of 2%, resulting in the Fed raising the Fed funds rate four times during 2018. As a result of this robust outlook for economic growth and growing concerns regarding inflationary pressures, treasury yields rose to the highest levels in almost a decade. Ultimately, the unemployment rate closed the year at 3.9%, near the lowest level in the U.S. since 1969. Employers added an average of 220,000 jobs a month, the best growth since 2015, and payrolls have grown for 100 straight months. In short, U.S. economic growth exceeded expectations and the expansion stretched to become the second longest in U.S. history.

The second story of the economy began to emerge in the fourth quarter of 2018, a period when optimism of economic strength faded to concerns of weakness. During this period, the markets abruptly turned their attention to lingering concerns regarding trade tensions, a slowing of the Chinese economy, renewed worries about the direction of Brexit, the potential for tariff wars, the impact of a tightening monetary policy, a higher interest rate environment and an extended partial shutdown of the federal government. Additionally, American manufacturing growth slowed and was followed by other economic signs of weakness, including ebbing consumer confidence as well as weakness in the housing market and vehicle sales.

The U.S. economy is clearly slowing down. The optimism that prevailed a year ago has moderated, and businesses and consumers are being cautious. Although the economy just finished a very good year, the economic outlook is uncertain. This recent and more cautious outlook for both the global and U.S. economic growth has caused a sell-off in stocks in recent months, which had their worst year since 2008. The economy may be at a crossroads with so many outstanding issues—the potential for positive and negative surprises is unusually high. As a result of this growing body of evidence pointing to weaker economic growth, the Fed has recently signaled its intention to take a break from its recent pattern of raising interest rates.

Beyond fiscal and monetary policy, our operations are directly impacted by the regulatory environment in which we operate. We continue to navigate compliance and regulatory changes, operating under a regulatory environment that is expected to be a challenge for the foreseeable future. We believe that any new regulatory requirements must ensure new regulations are appropriate for the size, risk profile and complexity of the financial institution. Many regulations have led directly to an increase in operating expenses in the form of higher personnel and technology costs. Information security expectations, residential mortgage regulations and, in particular, the Bank Secrecy Act/Anti-Money Laundering regulations are the most expensive to implement and continue to be a burden on the banking industry. We also spend a considerable amount of resources to safeguard our customers from fraud, cybersecurity risk and to protect their privacy.

Technology advancements are fast evolving and influencing every aspect of our professional and personal lives, at the same time transforming the retail banking sector. Advances in technology allow faster, more efficient and safer delivery of our products and services, resulting in a more engaging customer experience and the ability to better control costs.

Today, more than ever, we must continue to invest in new technologies. As a company, we are making significant investments in technology, and we have no doubt this will continue to be one of the largest areas of investment for the Bank over the next several years. We continue to increase capital investments in projects that will enhance our customer experience and position the Bank for long-term growth.

In 2019, we will begin to make a significant investment in a new core operating system and our online and mobile banking platform. In order to keep pace with fintech firms who continue to make retail banking inroads, we must update and replace our legacy core operating system, resulting in the enhanced delivery of our products and services while reducing our operating costs.

A new core operating platform will drive the Bank forward in a digital era. The core system project and “best of suite” hosted model will assist the Bank in operating more efficiently, grow more effectively and allow our employees to focus their energies on the strategic business of banking, new product development, digital transformation and seamless delivery of our products and services. Expected to be in place in late 2020, this new system brings real time processing to customer transactions, improved bank efficiencies and the technology needed to accommodate faster processing and provide for growth in the future. This decision was not taken lightly and will require the allocation of extensive financial and human resources. We do not make decisions to drive short-term earnings, but focus on investing for long-term results. The core system decision will be the biggest driver of change in our Bank over the next two years and is the key to improving efficiency not only within our information technology group, but within many lines of business. This decision will be the cornerstone of the Bank’s digital transformation strategy in 2019 and beyond.

We also continue to invest in key technologies at the Bank’s co-location facility to ensure we have sufficient computing capacity and viable operating systems in the event of a regional disaster. Our cybersecurity strategy is focused on protecting the Bank from the ever-growing information security threat landscape. We will continue to work tirelessly to implement the necessary tools to strengthen our security controls and protect our customer relationships. All of these technologies are being implemented to protect, streamline and improve the delivery of critical services to our customers.

Digital technologies are reshaping business models and the competitive landscape, reinventing the customer experience and redefining relationships between banks and their customers. In defining our digital delivery priorities for 2019, the need to meet our customers where they prefer to bank—whether at home or on vacation, with a mobile phone, tablet, or desktop computer—our mobile app and broader digital platform should be our customers' financial home; a one-stop-shop for understanding and managing their finances. We recognize that customer preferences continue to evolve and that we need to continually invest in digital technology to deliver a seamless experience across all of our delivery channels.

We have evaluated the current set of digital services we provide and have established a long-term digital strategy. As a result, we are moving forward in early 2019 with a complete conversion of our internet and mobile banking platform to an innovative and leading provider of consumer, business and voice digital banking. The conversion is targeted to go live in late July 2019. Online and mobile channels such as internet banking, mobile banking and consumer and business online account opening, will be greatly enhanced. Deploying a new online banking platform will be a huge win for our customers, offering numerous features that our current providers cannot offer.

Our products and services are no longer exclusively delivered through our branch network. Today, we have over 34,000 customers who bank online and over 17,000 active mobile banking users, a 12.5% increase above last year, resulting in approximately 37% of our consumer deposit base utilizing mobile banking.

The reality is that mobile delivery channels are a key component of the evolution of the branch that allow customers to truly have an omni-channel experience, conducting their business when and how they choose.

Despite the advancement of technology, the branch still plays an important role in providing one-on-one customer service and meeting the needs of the community. As a community bank, our branches remain an essential, yet evolving, part of our retail strategy. Convenient access to a physical branch continues to rank at or near the top of consumers' and small business owners' priorities when choosing a bank. Although mobile and other self-service channels are available for simple transactions, for more complex financial transactions consumers continue to express a strong preference for the face-to-face interaction afforded by a branch.

The branch of the future will phase out legacy systems and operate in a tablet environment. The traditional teller line will be replaced with bankers who are equipped with touch screen devices, allowing our employees to support a more engaged customer experience. The branch of the future will also incorporate self-service kiosks and interactive teller machines allowing customers to handle their business in the branch at their own convenience. However, our bankers will continue to be available for personal touch services.

During 2018, we received approval from the City of Sebastopol for the construction of our striking new branch of the future. Construction will begin in 2019 and will be completed by mid-2020. The branch will be designed with a refreshed open layout to provide an improved customer experience to reflect our brand and the spirit of the Sebastopol community. We will offer new ways for our customers to interact with our staff. In partnership with our new core provider, we will attempt to pilot the use of tablets for basic transactions and new account activity and install our first self-service interactive teller machine.

We also completed one of our strategic retail initiatives of delivering a new frontline sales and service platform to our branches. It has significantly improved our new account opening process by capturing the customer's signature electronically and initiating our transition to a paperless branch environment, streamlining processes and reducing expenses. As we move forward with our core conversion, we will continue to improve our branch operating platforms to ensure we deliver the best possible customer experience.

We have good deposit market share in most of our communities, yet we continue to see growth opportunities with existing and new customers. We continually look to refine our product offerings. In 2019, we will introduce a more robust and simplified set of deposit products that will reward our customers' relationship with Exchange Bank.

The quality of the branch experience is driven by the quality of our employees and their personal interaction with customers. Our mission includes investing in our most valuable asset—our employees. Developing our employees remains a key commitment for us and we must continue to focus on investing in the Bank's future leaders. The Bank continues to expand learning and leadership development at all levels and supports our employees by offering financial assistance to further their education. Our commitment to developing our employees to meet the changing banking environment will be key in continuing to differentiate Exchange Bank in the future.

At Exchange Bank, we understand that our success is directly linked to the success of our communities. Giving back to the communities where we live and work is part of our legacy—a cornerstone of Exchange Bank's mission. The passion and leadership of our team members, combined with the Bank's financial resources, make a difference in the communities we serve. We are once again very proud of our employees who contributed thousands of hours and personal resources in support of local charitable and civic organizations. In 2018, we awarded over $700,000 to more than 300 non-profit, charitable and civic organizations to improve the lives of people throughout Sonoma County.

Bank-sponsored fundraisers are a tradition that foster a spirit of giving throughout the Bank. In 2018, our employees personally raised over $100,000 through a variety of fundraising activities. For the past 25 years, the Volunteer Center of Sonoma County has named Exchange Bank the corporate fundraising champion for the Human Race. In 2018, our employees raised over $42,000 for this event.

In recognition of our employees' exceptional work and dedication, we are proud to report that Exchange Bank was recognized as one of Sonoma County's "Best Places to Work" for the thirteenth consecutive year. We have also been recognized as "Best Local Bank," "Best Business and Consumer Bank," and one of Sonoma County's "Healthiest Places to Work." In 2018, we were also a recipient of a "Community Philanthropy Award." The Bank's legacy of financial leadership and community support is grounded in its core values of Commitment, Respect, Integrity and Teamwork.

These awards are a reflection of what we value most—making a difference in the lives of our customers, teammates and community.

We extend our deepest gratitude to our more than 400 employees for their commitment and hard work and all that they accomplished in 2018. We are excited about the opportunities before us to further strengthen and grow the Bank. As we look ahead, we believe the fundamental elements of our core business are solid and we are well positioned for growth in 2019 and beyond. We are confident that we will build on our success while continuing to drive long-term value for you, our shareholders.

We want to thank our Board of Directors, our senior leadership team and all of our employees for the passion and commitment they demonstrate every day. Together, we are building a stronger Exchange Bank for our shareholders, our customers, our employees and our community.

On behalf of our Board of Directors and employees, we sincerely thank you, our shareholders, for your commitment and continued support. We look forward to a successful 2019.

We would like to invite you to our Annual Shareholders' Meeting on Friday, March 22, 2019 at 2:00 p.m. If you are unable to attend, we would request your proxy vote be given to management. In the interim, if you have any specific questions you would like answered, please direct them in writing to:

Marlene Soiland
Corporate Secretary
Exchange Bank
P.O. Box 403
Santa Rosa CA 95402

You may also contact the chairman directly via e-mail at: bill.schrader@exchangebank.com

Sincerely,

William R. Schrader
Chairman of the Board

Gary Hartwick
President and Chief Executive Officer

Exchange Bank

NOTICE OF ANNUAL SHAREHOLDERS MEETING
TO BE HELD MARCH 22, 2019

March 1, 2019

Dear Shareholder:

The annual meeting of the shareholders of Exchange Bank will be held at the Andrew J. Shepard Administrative Services Building, second floor, 444 Aviation Boulevard, Santa Rosa, California on **Friday, March 22, 2019** at **2:00 p.m.** At the meeting, we will review our operating results for 2018 and attend to formal matters as follows:

1. To elect the following ten nominees to serve as directors for the ensuing year:

   - James M. Ryan
   - Marlene K. Soiland
   - Dante B. Benedetti
   - Carlos G. Tamayo
   - Daniel G. Libarle
   - William R. Schrader
   - Richard W. Abbey
   - Bruce E. DeCrona
   - Steven G. Dutton
   - Gary T. Hartwick
   - Deborah A. Meekins

2. To transact such other business as may properly come before the meeting.

Shareholders of record at the close of business on February 22, 2019 are entitled to notice of and to vote at the meeting.

It is important that your shares be represented at the meeting in person or by proxy. The giving of such proxy will not affect your right to revoke such proxy or to vote in person should you later decide to attend the meeting. For this reason, please complete, sign, date and return the proxy card as promptly as possible in the postage prepaid envelope whether or not you plan to attend the meeting in person.

The following information is included in accordance with the Bank's bylaws:

Any common stock shareholder may nominate a person for election to the Board of Directors at any meeting of shareholders called for the election of directors, provided that the nomination is received by the President not less than thirty-five (35) or more than sixty (60) days prior to any such meeting. To be eligible, all nominees submitted by shareholders must satisfy the age and residency requirements in Section 3.2 of the bylaws and include the name and address of the nominee(s) and all other information required by the bylaws.

Section 3.3 of the Bank's bylaws provides: "Nominations, other than those made by the Board of Directors shall be made in writing and shall be delivered or mailed to the President of the Corporation not less than thirty-five (35) days nor more than sixty (60) days prior to any meeting of shareholders called for the election of directors, provided, however, that if less than twenty-one (21) days' notice of the meeting is given to shareholders, such nomination shall be mailed or delivered to the President of the Corporation not later than the close of business on the seventh (7^{th}) day following the day on which the notice of meeting was mailed. Such notification shall contain the following information as to each proposed nominee and as to each person, acting alone or in conjunction with one or more other persons, in making such nomination or in organizing, directing or financing such nomination or solicitation of proxies to vote for the nominee: (a) the name, age, birthdate, residence address and business address of each proposed nominee and each such person and the date as of which such nominee commenced residency at such residence address; (b) the principal occupation or employment, the name, type of business and address of the organization or other entity in which such employment is carried on of each proposed nominee and of each such person; (c) if the proposed nominee is an attorney, a statement as to whether or not either he or she or any firm with whom he or she has a relationship as partner, associate, of counsel, employee, or otherwise, acts as legal counsel for any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation; (d) a statement as to each proposed nominee and a statement as to each such person stating whether the nominee or person concerned has been a participant in any proxy contest within the past ten years, and, if so, the statement shall indicate the principals involved, the subject matter of the contest, the outcome thereof, and the relationship of the nominee or person to the principals; (e) the amount of stock of the Corporation owned beneficially, directly or indirectly, by each proposed nominee or by members of his or her family residing with him or her and the names of the registered owners thereof; (f) the amount of stock of the Corporation owned of record but not beneficially by each proposed nominee or by members of his or her family residing with him or her and by each such person or by members of his or her family residing with him or her and the names of the beneficial owners thereof; (g) if any shares specified in (e) or (f) above were acquired in the last two years, a statement of the dates of acquisition and amounts acquired on each date; (h) a statement showing the extent of any borrowings to purchase shares of the Corporation specified in (e) or (f) above acquired within the preceding two years, and if funds were borrowed otherwise than pursuant to a margin account or bank loan in the regular course of business of a bank, the material provisions of such borrowings and the names of the lenders; (i) the details of any contract, arrangement or understanding relating to the securities of the Corporation, to which each proposed nominee or to which each such person is a party, such as joint venture or option arrangements, puts or calls, guaranties against loss, or guaranties of profit or arrangements as to the division of losses or profits or with respect to the giving or withholding of proxies, and the name or names of the persons with whom such contracts, arrangements or understandings exist; (j) the details of any contract, arrangement, or understanding to which each proposed nominee or to which such person is a party with any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, or with any officer, director, employee, agent, nominee, attorney, or other representative of such covered entity; (k) a description of any arrangement or understanding of each proposed nominee and of each such person with any person regarding future employment or with respect to any future transaction to which the Corporation will or may be a party; (l) a statement as to each proposed nominee and a statement as to each such person as to whether or not the nominee or person concerned will bear any part of the expense incurred in any proxy solicitation, and, if so, the amount thereof; (m) a statement as to each proposed nominee and a statement as to each such person describing any conviction for a felony that occurred during the preceding ten years involving the unlawful possession, conversion or appropriation of money or other property, or the payment of taxes; (n) the total number of shares that will be voted for each proposed nominee; (o) the amount of stock, if any, owned, directly or indirectly, by each proposed nominee or by members of his or her family residing with him or her, in any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation; and (p) the identity of any banking corporation, affiliate or subsidiary thereof, or bank holding company or industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, as to which such nominee or any other such person serves as a director, officer, employee, agent, consultant, advisor, nominee or attorney, together with a description of such relationship."

The Chairman of the Board (or other person presiding at the meeting in accordance with the bylaws) may, in his or her discretion, determine and declare to the meeting that a nomination not made in accordance with Sections 3.2 and 3.3 of the bylaws shall be disregarded.

If you have questions about the operations of the Bank, you may submit them in writing before the meeting. Any questions that cannot be answered within a reasonable time during the meeting will be responded to in a post meeting report mailed by the Corporate Secretary to all shareholders within 30 days of the Annual Meeting.

As required by FDIC regulations, the Bank's annual disclosure statement will be sent to any shareholder upon request. The first copy of the annual disclosure statement will be provided to a shareholder without charge. If you wish a copy of this information, please send a written request to my attention at the address below or you may call (707) 524-3121.

By Order of the Board of Directors,

Marlene Soiland

Marlene K. Soiland
Corporate Secretary

MKS/ks

TRANSACTIONS WITH DIRECTORS AND OFFICERS

The Bank has had and expects in the future to have banking transactions in the ordinary course of its business with some of its Directors and Officers and their associates, including transactions with corporations or partnerships of which such persons are directors, officers, controlling shareholders, or partners on substantially the same terms (including interest rates and collateral) as those prevailing for comparable transactions with others. Management believes that in 2018 such transactions did not involve more than the normal risk of collectability or present other unfavorable features. Loans to Directors and Executive Officers of the Bank are subject to limitations prescribed by the Financial Code of the State of California as well as applicable federal law and regulations.

In addition, these transactions are disclosed as required by law.

EXCHANGE BANK
BOARD OF DIRECTORS

Richard W. Abbey, Esq. | *Abbey, Weitzenberg, Warren & Emery*
Mr. Abbey was appointed to the board in 2010 and serves as chair of the board's Technology Committee. He also serves on the board's Community Reinvestment Act, Governance/Nominating, and Trust Committees. Mr. Abbey received his degree from the University of California, Berkeley and his law degree from the University of California, Los Angeles. He has been a practicing attorney in Sonoma County since 1973 and presently is a member of the firm Abbey, Weitzenberg, Warren and Emery. He served as the outside general counsel for the Exchange Bank from the mid-1980s until his recent retirement from that role. Mr. Abbey's community involvement activities include the Redwood Empire Food Bank, YMCA, Social Advocates for Youth, Sonoma County Bar Association, and Schools Plus Enrichment Foundation.

Dante B. Benedetti | *Chairman Emeritus, Clover Sonoma*
Mr. Benedetti was elected a director in 2002 and named a Doyle trustee in 2008. He is currently chair of the board's Compensation/Management Succession Committee and also serves on the Audit, Community Reinvestment Act, Governance/Nominating, and Trust Committees. He attended Santa Rosa Junior College and Sonoma State University. Mr. Benedetti is the past president and past chairman of Clover Stornetta Farms, Inc. and is chairman emeritus of Clover Sonoma. Active in the community, he is past president of United Way North Bay and a past member of the board at Sonoma County Community Foundation, Hanna Boys Center, California Dairy Institute, Culinary Institute of America, California Independent Grocers Association, and the Sonoma County Probation Department Advisory Board.

Bruce E. DeCrona | *Retired, Banker*
Mr. DeCrona was elected to the board in 2014 and serves as the board's Audit Committee Chair. He also serves on the board's Compensation/Management Succession, Technology, and Trust Committees. Mr. DeCrona retired from Exchange Bank in 2013 after serving nearly 18 years in the roles of chief financial officer and chief operating officer. Before that he worked for 19 years at First Interstate Bank in Nevada and Arizona, prior to the bank's purchase by Wells Fargo Bank. He is a graduate of the University of Nevada as well as the Pacific Coast Banking School. In addition to being a board member for the Luther Burbank Center for the Arts, he is also an active volunteer for several other organizations, including the Council on Aging.

Steven G. Dutton | *President and Co-owner, Dutton Ranch Corp.*
Mr. Dutton was appointed to the board in 2014 and currently serves on the board's Audit, Community Reinvestment Act, Loan, and Trust Committees. He is a fifth generation Sonoma County farmer and lifelong resident of Sebastopol. He is partners with Dan Goldfield in Dutton-Goldfield Winery and is also partners with his brother in Dutton Ranch Corp. and Dutton Bros. Farming. Mr. Dutton is actively involved in the agricultural community, contributing to many local associations and boards. He is past president and current board member of the Sonoma County Farm Bureau and involved in the Russian River Valley Winegrowers Foundation, Sonoma County Farm Trails and is a member of the Santa Rosa Junior College Viticulture Advisory Committee.

Gary T. Hartwick | *President and CEO, Exchange Bank*

Mr. Hartwick was elected to the board in 2014 when he was appointed president and chief executive officer of Exchange Bank. He also serves on the board's Loan, Technology, and Trust Committees. Mr. Hartwick joined Exchange Bank in 2009 and has served as chief credit officer and chief operating officer. He is a graduate of California State University Sacramento and the Pacific Coast Banking School. His community activities include serving as a board member for the Volunteer Center of Sonoma County and the Redwood Empire Food Bank. He is a former Advisory Board member for the Boys & Girls Club of South Sonoma and Marin Counties and a former member of the board at the Luther Burbank Center for the Arts.

Daniel G. Libarle | *President, Lace House Linen Supply, Inc.*

Mr. Libarle was elected to the Board in 2007 and serves as chair of the board's Governance/Nominating Committee, and Loan Committee. He also serves on the Audit, Community Reinvestment Act, Compensation/Management Succession, and Trust Committees. A graduate of San Jose State University, Mr. Libarle is president of their family-owned business, Lace House Linen Supply, Inc. The Petaluma business has been in operation since 1915. Mr. Libarle has previous banking experience as the founding chairman of the Bank of Petaluma. That bank was bought by Greater Bay Bank and he served on their board until it was bought by Wells Fargo Bank. He has been very active in his community. His involvement includes the Rotary Club, Boys & Girls Club, Chamber of Commerce, United Way, and several trade groups.

Deborah A. Meekins | *Retired, Banker*

Ms. Meekins was appointed to the Board in 2018 and serves as chair of the Board's Community Reinvestment Act Committee. She also serves on the Audit, Technology, and Trust Committees. Before retiring, Ms. Meekins served as the CEO of Sonoma National Bank, executive vice president and retail banking director, chief production officer and California market president of Sterling Savings Bank, and most recently as president and CEO of Poppy Bank. Ms. Meekins is the past chair of the Santa Rosa Chamber of Commerce, United Way, Santa Rosa Memorial Hospital Foundation, and the Rose Parade. She currently serves on the board of Western Bankers Association, Santa Rosa Memorial Hospital Foundation and the Redwood Empire Food Bank.

James M. Ryan | *President, Ryan Mortgage Company*

Mr. Ryan was elected to the board in 1997 and is vice-chairman. In 2007, Mr. Ryan was named a Doyle Trustee. Mr. Ryan serves on the board's Audit, Community Reinvestment Act, Compensation/Management Succession, Governance/Nominating, Loan, and Trust Committees. He is a graduate of California State University Sacramento and is a licensed real estate broker, certified public accountant (inactive) and a licensed general contractor. Mr. Ryan is the owner and president of both Ryan Mortgage Company, Inc. and Ryan Realty, Inc. in Santa Rosa. He has served as a director of the American Red Cross, Sonoma County Chapter, and numerous trade associations.

William R. Schrader | *Chairman of the Board, Exchange Bank*
Mr. Schrader was elected to the board in 2008 when he was appointed president. He joined the Exchange Bank in 1978 and has served as senior loan officer, chief operating officer, and was president and chief executive officer when he retired from the Bank in 2014. Today, he serves as chairman of the board and also serves on the board's Audit, Community Reinvestment Act, Compensation/Management Succession, Governance/Nominating, Loan, Technology, and Trust Committees. Mr. Schrader is a graduate of St. Mary's College and received his master's from Golden Gate University. He is also a graduate of the Pacific Coast School of Banking. His community involvement includes past board chair and director positions for the YMCA, Santa Rosa Diocesan School Board, Hanna Boys Center, NAMI, Santa Rosa Community Health Center, California Bankers Association and past vice-chair for the Committee for the Shelterless (COTS).

Marlene K. Soiland | *President and CEO, Soiland Management Company*
Ms. Soiland was elected to the Board in 1997 and is corporate secretary and chair of the board's Trust Committee. Ms. Soiland also serves on the board's Audit, Community Reinvestment Act, Compensation/Management Succession, Governance/Nominating, Loan, and Technology Committees. After graduation from Cal Poly in San Luis Obispo, she returned to Santa Rosa and her family business. She is currently president and owner of Soiland Management Co., Inc. Ms. Soiland is involved in several community groups such as the Sonoma County Alliance, Sonoma County Innovation Council, Institute for Family Business, and Community Foundation Sonoma County.

Carlos G. Tamayo | *Chairman of the Board, La Tortilla Factory*
Mr. Tamayo was elected a director in 2004 and serves on the board's Audit, Community Reinvestment Act, Compensation/Management Succession, Governance/Nominating, Loan, and Trust Committees. Mr. Tamayo is a graduate of Arizona State University with a master's degree from American Graduate School of International Management. Mr. Tamayo is the chairman of La Tortilla Factory, a family owned business founded in Santa Rosa in 1977. He currently serves on the Church Council at Spring Hills Community Church. His past community activities include the Salvation Army, Hispanic Chamber of Commerce, Lions Club, Sonoma County Community Foundation, and various trade groups.

EXCHANGE BANK AND SUBSIDIARIES
Santa Rosa, California

CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2018 and 2017

EXCHANGE BANK AND SUBSIDIARIES
Santa Rosa, California

FINANCIAL STATEMENTS
December 31, 2018 and 2017

CONTENTS

Crowe

Crowe LLP
Independent Member Crowe Global

INDEPENDENT AUDITOR'S REPORT

To the Stockholders and
Board of Directors
Exchange Bank and Subsidiaries
Santa Rosa, California

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Exchange Bank and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

(Continued)

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Exchange Bank and Subsidiaries as of December 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

We have also audited in accordance with auditing standards generally accepted in the United States of America, Exchange Bank and Subsidiaries' internal control over financial reporting as of December 31, 2018 based on criteria established in the 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and our report dated February 20, 2019 expressed an unqualified opinion.

Crowe LLP

Crowe LLP

Sacramento, California
February 20, 2019

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2018 and 2017
(In thousands, except share and par value amounts)

	2018	2017
ASSETS		
Cash and due from banks	$ 152,890	$ 308,087
Short-term investments	234	230
Total cash and cash equivalents	153,124	308,317
Interest-bearing deposits in other financial institutions	44,000	52,000
Available-for-sale investment securities	844,905	638,912
Loans and leases	1,514,404	1,497,785
Less allowance for loan and lease losses	(39,854)	(40,323)
Net loans and leases	1,474,550	1,457,462
Federal Home Loan Bank stock	11,303	10,015
Bank premises and equipment, net	17,591	18,762
Bank owned life insurance	47,530	45,441
Other real estate owned	1,022	41
Accrued interest receivable and other assets	59,935	53,142
Total assets	$ 2,653,960	$ 2,584,092
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$ 886,864	$ 894,899
Interest bearing	1,492,819	1,448,770
Total deposits	2,379,683	2,343,669
Accrued interest payable and other liabilities	42,705	37,218
Total liabilities	2,422,388	2,380,887
Commitments and contingencies (Note 14)		
Stockholders' equity:		
Preferred stock, 1,000,000 shares authorized:		
None issued or outstanding	-	-
Common stock, $2.50 par value; 3,000,000 shares authorized; 1,714,344 shares issued and outstanding	4,286	4,286
Additional paid-in capital	46,026	46,026
Retained earnings	193,687	161,775
Accumulated other comprehensive loss, net of taxes	(12,427)	(8,882)
Total stockholders' equity	231,572	203,205
Total liabilities and stockholders' equity	$ 2,653,960	$ 2,584,092

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2018 and 2017
(In thousands, except per share amounts)

	2018	2017
Interest income:		
Interest and fees on loans and leases	$ 74,634	$ 70,186
Interest on investment securities:		
Taxable	19,402	10,315
Exempt from Federal income taxes	1,920	1,868
Total interest income	95,956	82,369
Interest expense:		
Interest on deposits	2,627	830
Interest on borrowings	-	587
Total interest expense	2,627	1,417
Net interest income before provision for loan and lease losses	93,329	80,952
Provision for (reversal of) loan and lease losses	-	-
Net interest income after provision for loan and lease losses	93,329	80,952
Non-interest income:		
Service charges and fees	4,845	5,067
Trust income	7,330	6,709
Merchant discount and interchange fees	4,413	4,207
Income from bank owned life insurance	1,639	1,592
Gain on sale of assets	3,251	1,574
Other income	4,293	5,143
Total non-interest income	25,771	24,292
Non-interest expense:		
Salaries and employee benefits	36,086	33,528
Occupancy and equipment	7,663	7,459
Professional fees	7,440	6,268
FDIC assessments	840	745
Other expenses	13,576	13,673
Total non-interest expense	65,605	61,673
Income before provision for income taxes	53,495	43,571
Provision for income taxes	14,984	24,063
Net income	$ 38,511	$ 19,508
Basic and diluted earnings per common share	$ 22.46	$ 11.38

See accompanying notes to consolidated financial statements.

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31, 2018 and 2017
(In thousands)

	2018	2017
Net Income	$ 38,511	$ 19,508
Other comprehensive income:		
Unrealized gains/losses on securities:		
Unrealized holding gains (losses) arising during the period	(2,483)	(1,995)
Tax effect	735	827
Changes in unrealized (loss) gain on available-for-sale investment securities, net of tax	(1,748)	(1,168)
Defined benefit pension plans:		
Net gains (losses) arising during the period	(3,468)	1,952
Tax effect	1,026	(577)
Changes in defined benefit pension plans, net of tax	(2,442)	1,375
Change in deferred compensation trust liabilities	900	209
Tax effect	(255)	(62)
Changes in deferred compensation trust, net of tax	645	147
Other comprehensive (loss) income	(3,545)	354
Total Comprehensive Income	$ 34,966	$ 19,862

See accompanying notes to consolidated financial statements.

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2018 and 2017
(In thousands)

	Common Stock	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income (Net of Taxes)	Total Stockholders' Equity
Balance, January 1, 2017	$ 4,286	$ 46,026	$ 146,284	$ (7,424)	$ 189,172
Net Income	-	-	19,508	-	19,508
Other comprehensive income	-	-	-	354	354
Reclassification associated with the Adoption of ASU 2018-02	-	-	1,812	(1,812)	-
Cash Dividends ($3.40 per share)	-	-	(5,829)	-	(5,829)
Balance, December 31, 2017	$ 4,286	$ 46,026	$ 161,775	$ (8,882)	$ 203,205
Net Income	-	-	38,511	-	38,511
Other comprehensive loss	-	-	-	(3,545)	(3,545)
Cash Dividends, ($3.85 per share)	-	-	(6,599)	-	(6,599)
Balance, December 31, 2018	$ 4,286	$ 46,026	$ 193,687	$ (12,427)	$ 231,572

See accompanying notes to consolidated financial statements.

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2018 and 2017
(In thousands)

	2018	2017
Cash flows from operating activities:		
Net Income	$ 38,511	$ 19,508
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,363	2,212
Provision for (benefit from) deferred income taxes	944	6,047
Gain on sale of assets	(1,856)	(1,029)
Gain on sale of other real estate owned	(3,251)	(1,574)
Loss (gain) on sale/call/OTTI on investments	200	-
Accretion of discounts and amortization of premiums on investment securities	2,482	3,029
Net change in deferred loan origination fees	151	(498)
Net loans sold or (originated) with intent to sell and sold	3,442	(2,188)
Increase in bank owned life insurance, net of expenses	(1,209)	(1,185)
Changes in operating assets and liabilities:		
Accrued interest receivable and other assets	(8,876)	101
Accrued interest payable and other liabilities	5,567	1,914
Net cash provided by operating activities	38,468	26,337
Cash flows from investing activities:		
Decrease in Interest-bearing deposits in other financial institutions	8,000	24,500
Proceeds from sale of other real estate owned	3,252	2,097
Proceeds from maturities of investment securities	166,842	80,291
Purchase of investment securities	(378,001)	(209,981)
Purchase of Federal Home Loan Bank (FHLB) stock	(1,288)	-
Net increase in loans and leases	(19,807)	(65,064)
Purchase of bank premises and equipment	(1,194)	(3,293)
Net cash used in investing activities	(222,196)	(171,450)
Cash flows from financing activities:		
Net increase in demand, interest bearing and savings deposits	44,605	404,774
Net decrease in time deposits	(8,591)	(4,515)
Repayments of long-term FHLB advances	-	(8,000)
Purchase of bank owned life insurance	(880)	(989)
Cash paid for dividends	(6,599)	(5,829)
Net cash provided by financing activities	28,535	385,441
Increase (Decrease) in cash and cash equivalents	(155,193)	240,328
Cash and cash equivalents, beginning of year	308,317	67,989
Cash and cash equivalents, end of year	$ 153,124	$ 308,317
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest expense	$ 2,537	$ 1,324
Income taxes	$ 15,106	$ 16,505
Noncash transfers of loans to OREO	$ 982	$ -

See accompanying notes to consolidated financial statements.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Nature of Operations: Exchange Bank (the "Bank"), a California corporation, and its wholly-owned subsidiaries, A. J. Ventures, Inc., AJV-Alderbrook LLC conduct their business from their headquarters in Santa Rosa, California. The Bank is a full service bank providing a range of commercial and retail banking services to individuals and businesses. The Bank, through its loan portfolio, has geographically concentrated credit risk in Sonoma County. Additionally, the loan portfolio has a concentration in loans secured by real estate.

The accounting and reporting policies of the Bank and its subsidiaries conform with accounting principles generally accepted in the United States of America and prevailing practices within the financial services industry. A summary of the more significant accounting and reporting policies follows:

Principles of Consolidation: The consolidated financial statements include the accounts of the Bank and its wholly-owned subsidiaries, A. J. Ventures, Inc. and AJV-Alderbrook LLC. The subsidiaries are used to hold real estate properties acquired through, or in lieu of, loan foreclosure. All intercompany accounts and transactions have been eliminated upon consolidation.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents: For purposes of the consolidated statement of cash flows, the Bank considers all highly liquid investments with maturities of three months or less at date of acquisition to be cash equivalents. Cash equivalents include cash, due from banks, money market investments and Federal funds sold. Generally, Federal funds are sold for one-day periods. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions, and federal funds purchased and sold.

Investment Securities: The Bank classifies its investment securities as either available-for-sale or held-to-maturity at the time of purchase. Available-for-sale investment securities are measured at fair value with a corresponding recognition of the net unrealized holding gain or loss, net of income taxes, within accumulated other comprehensive income (loss), which is a separate component of stockholders' equity, until realized. Held-to-maturity investment securities are measured at amortized cost, based on the Bank's positive intent and ability to hold such securities to maturity. At December 31, 2018 and 2017, the Bank did not hold any held-to-maturity investment securities.

Premiums and discounts are amortized or accreted over the life of the related investment security as an adjustment to interest income using a method that approximates the interest method. Interest income is recognized when earned. Realized gains and losses on the sale of investment securities are recorded on the trade date and are computed using the specific identification method for determining the cost of investment securities sold.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

Federal Home Loan Bank (FHLB) Stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Loans and Leases: Loans that management has the ability and intent to hold for the foreseeable future or maturity or payoff are reported at the principal amounts outstanding, adjusted for unamortized discounts and premiums and net of deferred loan origination fees and costs, write-downs and the allowance for loan losses. Direct financing leases are carried net of unearned income. Income from leases is recognized by a method that approximates a level yield on the outstanding net investment in the lease.

The Bank may charge fees for originating loans and leases. These origination and commitment fees, net of certain related direct loan and lease origination costs, are deferred. The net deferred fees or costs are recognized as an adjustment of yield over the contractual life of the loan or lease using the interest method. The unamortized balance of deferred fees and costs is reported as a component of net loans and leases.

For all classes of loans, interest is accrued daily based upon outstanding loan and lease balances. However, when, in the opinion of management, loans or leases become 90 days past due, unless the loan is well-secured and in process of collection, or are considered impaired and the future collectability of interest and principal is in serious doubt, a loan or lease is placed on nonaccrual status and the accrual of interest income is suspended. Any interest accrued but unpaid is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans or leases, or payments received on nonaccrual loans or leases for which the ultimate collectability of principal is not in doubt, are applied first to earned but unpaid interest and then to principal. Generally, loans and leases are restored to accrual status when the obligation is brought current and has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loan Sales and Servicing: Included in the portfolio are loans guaranteed by the Small Business Administration (SBA) that may be sold in the secondary market. Loans held for sale are carried at the lower of cost or market value. Fair value is determined by the specific identification method as of the balance sheet date or the date that the purchasers have committed to purchase the loans. At the time the loan is sold, the related right to service the loan is recorded at fair value with the Bank earning future servicing income. Gains and losses are recognized based on the difference between the selling price and the fair value of servicing assets or liabilities and the allocated carrying value of the loans sold. At December 31, 2018 and 2017 the balance of loans originated and unsold under the SBA program totaled $9,045 and $13,296, respectively. Management has determined that the unsold loans originated through the SBA program were not material for disclosure as held for sale at December 31, 2018 and 2017.

Loans held for sale subsequently transferred to the loan portfolio are transferred at the lower of cost or fair value at the date of transfer. Any difference between the carrying amount of the loan and its outstanding principal balance is recognized as an adjustment to yield by the interest method.

Servicing rights acquired through 1) a purchase or 2) the origination of loans which are sold or securitized with servicing rights retained are recognized as separate assets or liabilities. Servicing assets or liabilities are recorded at fair value, and are subsequently amortized into non-interest income in proportion to and over the period of the related net servicing income or expense. SBA loans with unpaid balances of approximately $68,129 and $59,786 were being serviced for others at December 31, 2018 and 2017, respectively. Servicing assets at December 31, 2018 and 2017 and servicing fee income net of servicing rights amortization during the years ended December 31, 2018 and 2017 were not material for disclosure.

Allowance for Loan and Lease Losses: The allowance for loan and lease losses is a valuation allowance for probable incurred credit losses in the Bank's loan portfolio as of the balance-sheet date. For all loan classes the allowance is established through a provision for loan and lease losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves related to loans that are not impaired.

For all classes of the portfolio, a loan or lease is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Loans and leases determined to be impaired are individually evaluated for impairment. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. When a loan or lease is impaired, the Bank measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Bank for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The determination of the general reserve for loans and leases that are not impaired is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment over the prior five years, internal asset classifications, and qualitative factors to include economic trends in the Bank's service areas, industry experience and trends, concentrations, estimated collateral values, the Bank's underwriting policies, the character of the loan portfolio, and probable losses in the portfolio taken as a whole.

The Bank maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include real estate – commercial, real estate – construction, commercial, lease financing and consumer loans. The allowance for loan and lease losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Bank's overall allowance, which is included on the consolidated balance sheet.

The Bank assigns a risk rating to all loans except pools of homogeneous loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Bank and the Bank's regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into five major categories, defined as follows:

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

Special Mention – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Substandard – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

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

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

The general reserve component of the allowance for loan and lease losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Real Estate–Commercial – This segment is comprised of loans used to finance the acquisition of commercial real property. These loans are secured by first liens against the underlying real property. The inherent risk is driven by the borrower's capacity to service the debt combined with the value of the property collateral relative to the loan balance. Economic trends including consumer spending, consumer confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Real Estate–Construction – This segment is comprised of loans used to acquire, develop, and/or construct residential housing or commercial property types, including office, industrial and retail. Inherent risk is high as this segment evidences construction risk and absorption risk. Economic trends including consumer spending, consumer confidence, business confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair absorption and compromise the borrower's capacity to service the underlying debt.

Commercial – These loans are primarily for business purposes and are typically secured by personal property and in some cases by junior liens against real property. Credit risk is mitigated by financial covenants and financial reporting requirements. Economic trends including consumer spending, consumer confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Lease Financing – This segment is primarily comprised of smaller business purpose commitments used to finance an array of business equipment. Leases are amortized over a specific period of time. Economic trends including consumer spending, consumer confidence, market interest rates, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Loans and receivables in homogeneous loan portfolio segments are not evaluated for specific impairment. Rather, the sole component of the allowance for these loan types is determined by collectively measuring impairment reserve factors based on management's assessment of the following for each homogeneous loan portfolio segment: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are described in further detail below for each homogeneous loan portfolio segment.

Consumer – This segment is comprised of single family 1-4 residential mortgages, installment and home equity loans and lines used to finance direct consumer purchases and/or establish lines of credit for consumer purposes. Economic trends including consumer spending, consumer confidence, market interest rates, trends in housing values, and general economic growth are closely correlated to the credit quality of these loans. A sustained decline in the economy can impair a borrower's capacity to service the underlying debt.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators, the FDIC and the California Department of Business Oversight, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Off-Balance-Sheet Commitments: The Bank also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical loss data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued interest payable and other liabilities on the consolidated balance sheet and is not significant.

Other Real Estate Owned: Real estate properties acquired through, or in lieu of, loan foreclosure are expected to be sold and are initially recorded at the fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for loan and lease losses. Subsequent declines in the fair value of real estate owned, along with related expenses from operations, are charged to noninterest expense as incurred.

Bank Premises and Equipment: Bank premises and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed on the straight-line basis over the lesser of the life of the lease or the estimated useful lives of the assets, ranging from 3 to 10 years for furniture and equipment, 5 to 10 years for leasehold improvements and 10 to 40 years for premises. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred. The Bank evaluates premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

Bank Owned Life Insurance: The Bank has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Retirement Plan and Postretirement Healthcare Plan: The Bank has a defined benefit pension plan covering all qualified personnel employed for the minimum required term of one year. Benefits are based on years of service and compensation projected to the separation date. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. It is the Bank's policy to contribute annually an amount at least equal to the minimum required by law. During 2007, the Plan was amended to freeze future benefit accruals for participants who have less than 15 years of service and age plus years of service less than 60. The plan was also amended to limit cost-of-living adjustments for continuing active participants. The amendments are expected to significantly reduce Plan liability and future net period pension costs.

In order to comply with ERISA requirements when the number of Plan participants fell below 50, effective December 31, 2016, the Plan was further amended to complete the freeze of future benefit accruals for all remaining Grandfathered Plan Participants (those plan participants that met the rule of eligibility during 2007 and continued to accrue plan benefits). Effective December 31, 2016, (the “Grandfathered Freeze Date”), Service, Credited Service, Average Compensation and Covered Compensation was frozen for the remaining Grandfathered Plan Participants. The changes described in the plan freeze above, only affect future benefits that have not yet accrued. They will not affect any benefits that both active and retired employees have already accrued and earned. The Bank will not be terminating the plan at this time. The Plan will continue to operate as an ERISA qualified defined benefit plan, with the Bank maintaining a fiduciary obligation to manage the assets and provide future benefits to all active and retired plan participants and their beneficiaries under existing terms. The amendments as described above are expected to significantly reduce Plan liability and future net periodic pension costs.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In addition, the Bank sponsors a defined benefit postretirement healthcare plan that covers both salaried and non-salaried employees. The Plan provides medical benefits through health maintenance organizations. The Plan is funded by a voluntary employee beneficiary association (VEBA) trust maintained by the Bank. The contribution level for a retiree is based on a percentage of premium that varies according to the retiree's years of service with the Bank. The Bank's contribution for dependents is 50% of the Bank's share of the retiree's annual premium. The portion paid by the Bank is limited to 200% of the 1991 premium. Future cost-sharing plans are not expected to change from the current stated policy in the written plan. In addition, for the group of retirees that retired prior to January 1, 1991, the retiree medical benefit will be paid fully by the Bank for the life of the retiree and dependent. For employees retiring prior to January 1, 1992, or active employees with more than 25 years of service as of December 31, 1991, the 200% limit on lifetime benefits will not apply and the Bank will pay 100% of the retiree's premium and 50% of the dependent's premium. Effective December 31, 2007, the Plan was amended to cover only active employees who have at least 15 years of service and age plus years of service more than 60. The Plan was also amended to limit the maximum reimbursement amount to grandfathered retirees. The amendments are expected to significantly reduce Plan liability and future net period pension costs.

Other Postretirement Benefits: The Bank has established deferred compensation and salary continuation agreements providing nonqualified defined benefit retirement income for certain executive officers of the Bank. In connection with establishing these agreements, the Bank purchased single premium life insurance policies on each participant. The salary continuation agreements are accounted for by accruing a liability based upon the present value of each individual's benefit at retirement age and recognizing the related cost of these benefits over the term of employment. The single payment premium for the life insurance policies is recorded based on the cash surrender values of the policies adjusted for income earned on the investment and expense related to mortality costs.

The Bank also has endorsement split-dollar life insurance agreements with certain employees whereby the Bank has effectively agreed to maintain a life insurance policy during the employees' postretirement period. The Bank is accruing, over the employees' service period, a liability for the actuarial present value of future costs to maintain life insurance during the employees' postretirement period.

Income Taxes: Income tax expense is the total of current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates which are expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. On the consolidated balance sheet, net deferred tax assets are included in accrued interest receivable and other assets.

As a result of tax law “H.R.1” commonly known as the “Tax Cuts and Jobs Act (Tax Act)” as signed into law on December 22, 2017, the Bank reported an additional adjustment to income tax expense in the fourth quarter of 2017. The increase in income tax expense was the result of re-measuring the Bank’s net deferred tax assets due to the reduction in federal income tax rates from 35% to 21%.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Based upon their analysis of available evidence, management determined that it is "more likely than not" that all of the deferred income tax assets as of December 31, 2018 and 2017 will be fully realized and therefore no valuation allowance was recorded.

The Bank uses a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Bank recognizes interest and/or penalties related to income tax matters in income tax expense.

Earnings Per Common Share: Earnings per common share is computed by dividing net income by the weighted average number of shares outstanding during the year, which was 1,714,344 for 2018 and 2017, respectively. There were no dilutive shares or share equivalents.

Comprehensive Income: Comprehensive income includes net income and other comprehensive income. Other comprehensive income for the Bank includes unrealized gains and losses on investment securities classified as available-for-sale, and changes in the funded status of defined benefit pension plans and the deferred compensation trust.

Advertising: Advertising costs are charged to expense in the period incurred and totaled $1,216 and $1,071 for the years ended December 31, 2018 and 2017, respectively.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

In October 2017, much of the North Bay region of Northern California was struck by widespread and destructive wildfires. Fortunately, there was no damage to bank facilities and no significant impairment to services. Management has assessed the impact of the fires on our loan and investment portfolios; including mapping client addresses and locations of municipal bond issuers to areas affected by the fires and evaluating any known damage to collateral and businesses. Based on our assessment, the loss to properties and businesses located in the affected areas that are pledged as collateral to our loans or bonds is minimal and are therefore, not expected to have a significant impact on the Bank. Management will continue to update and refine our estimates of the wildfires' impact on our business and result of operations as they become probable and estimable. However, at this time, the long-term impact to the Napa and Sonoma regional economies is uncertain.

Subsequent Events: The Bank reviewed all events occurring from December 31, 2018 through February 20, 2019, the date the financial statements were available to be issued. There were no subsequent events that were considered necessary for disclosure and there were no subsequent events requiring accrual.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impact of New Accounting Standards:

ASU 2014-09, Revenue from Contracts with Customers: In May 2014, FASB amended existing guidance related to revenue form contracts with customers. This amendment supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this amendment specifies the accounting for some costs to obtain or fulfill a contract with a customer. These amendments are effective for public business entities (PBE) for annual reporting periods beginning after December 15, 2017. The Bank adopted ASU 2014-09 on January 1, 2018 utilizing the modified retrospective approach. Since the guidance does not apply to revenue associated with financial instruments such as loans and investments, which are accounted for under other provisions of GAAP, it had no impact on the Bank's interest income, our largest component of income. There was no impact to other revenue streams including, trust income, certain deposit related fees and interchange fees.

In January 2016, the FASB issued Accounting Standards Update 2016-01, Financial Instruments – Overall (Subtopic 825-10) which, among other things, (i) requires equity investments, excluding those accounted for under the equity method or that result in consolidation, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) 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 became effective for Exchange Bank in the first quarter of 2018 and continues to have no material impact on its consolidated financial statements. See Note 2 – Fair Value Measurements for disclosure of the fair value of financial instruments based on an exit price notion as required by ASU 2016-01.

ASU 2016-02, Leases In February 2016, the FASB amended existing guidance that requires lessees recognize the following for all leases (with the exception of short-term leases) at the commencement date (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. These amendments are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (i.e. January 1, 2019, for a calendar year entity). Nonpublic business entities should apply the amendments for fiscal years beginning after December 15, 2019 (i.e. January 1, 2020, for a calendar year entity), and interim periods within fiscal years beginning after December 15, 2020. Early application is permitted for all public business entities and all nonpublic business entities upon issuance.

(Continued)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Lessees (for capital and operating leases) and lessors (for sales-type, direct financing and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The adoption of this standard is not expected to have a material effect on the Bank's operating results. However, management has determined that the provisions of this ASU will result in an increase in assets to recognize the present value of the leased assets with a corresponding increase in liabilities for the lease obligations.

ASU 2016-13, Financial Instruments – Credit Losses. In June 2016, FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor.

Transition:

For debt securities with other-than temporary impairment, the guidance will be applied prospectively

- Existing purchased credit impaired (PCI) assets will be grandfathered and classified as purchased credit deteriorated (PCD) asserts at the date of adoption. The asset will be grossed up for the Allowance for expected credit losses for all PCD assets at the date of adoption and will continue to recognize the noncredit discount in interest income based on the yield of such assets as of the adoption date. Subsequent changes in expected credit losses will be recorded through the allowance.
- For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective.

These amendments are effective as follows:

- For PBEs that meet the definition of an SEC filer, the standard will be effective for fiscal years beginning after Dec. 15, 2019, including interim periods in those fiscal years. For calendar year-end SEC filers, it is effective for March 31, 2020 Interim Financial Statements.
  For PBEs that do not meet the definition of an SEC filer, the standard will be effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For calendar year-end PBEs that are not SEC filers, it is effective for March 31, 2021 Interim Financial Statements.
- For all other entities, the standard will be effective for fiscal years beginning after December 15, 2020, and interim periods within the fiscal years beginning after Dec.15, 2021. For calendar year-end entities that are not PBEs, it is effective for Dec. 31, 2021 Annual Financial Statements. All entities may early adopt for fiscal years beginning after Dec. 15, 2018, including interim periods in those fiscal years, which means that calendar year-end entities may adopt as early as the March 31, 2019, interim financial statements.

While management is currently evaluating the provisions of ASU No. 2016-13 to determine the potential impact the new standard will have on the Bank's Financial Statements, The Bank has taken steps to prepare for the implementation when it becomes effective, such as forming an internal task force, gathering pertinent data, consulting with outside professionals, and evaluating current IT systems. Management expects to recognize a one-time cumulative effect adjustment to the allowance for credit losses as of the first reporting period in which the new standard is effective, but cannot yet estimate the magnitude of the one-time

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

adjustment or the overall impact of the new guidance on the Bank's regulatory capital, financial position, results of operations or cash flows.

ASU 2017-08 In March 2017, the FASB issued Accounting Standards Update No. 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The amendment in this ASU shortens the amortization period for certain callable debt securities held at a premium to the earliest call date. The amendment does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendment is effective for fiscal years beginning after December 15, 2018, including interim periods within those periods. The Bank does not expect any material impact from adoption of ASU 2017-08 relating to premium amortization of callable securities in future periods.

ASU 2018-02, Income Statement – Reporting Comprehensive Income: Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income: In February 2018, the FASB issued guidance that allows, but does not require, entities to reclassify certain income tax effects in accumulated other comprehensive income (AOCI) to retained earnings that resulted from the Tax Act. The amendments are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted for public business entities for which financial statements have not yet been issued. The Bank has elected to adopt the provisions of ASU 2018-02 during 2017 and has recorded a reclassification entry of $1,812, which reduced AOCI and increased retained earnings. The adoption of this reclassification adjustment did not have an impact on total stockholders' equity or net income.

(Continued)

(In thousands, except per share amounts)

NOTE 2 – FAIR VALUE MEASUREMENTS

Fair Value Measurements

Fair Value Hierarchy - The Bank groups its assets and liabilities measured at fair value within three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Valuations within these levels are based upon:

Level 1 – Quoted market prices for identical instruments traded in active exchange markets.

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

Level 3 – Model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Bank's estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Assets Recorded at Fair Value - The following tables present information about the Bank's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2018 and 2017:

Recurring Basis

	2018			
Description	Fair Value	Level 1	Level 2	Level 3
Debt securities:				
U.S. Government agencies	$ 318,965	$ -	$ 318,965	$ -
Obligations of states and political subdivisions	152,391	-	152,391	-
Government sponsored entities residential mortgage-backed securities	194,468	-	194,468	-
U.S. Treasuries	171,616	-	171,616	-
Other securities	7,465	-	7,465	-
Total assets measured at fair value	$ 844,905	$ -	$ 844,905	$ -

(Continued)

(In thousands, except per share amounts)

NOTE 2 – FAIR VALUE MEASUREMENTS (Continued)

	2017			
Description	Fair Value	Level 1	Level 2	Level 3
Debt securities:				
U.S. Government agencies	$ 271,574	$ -	$ 271,574	$ -
Obligations of states and political subdivisions	176,092	-	176,092	-
Government sponsored entities residential mortgage-backed securities	121,570	-	121,570	-
U.S. Treasuries	61,718	-	61,718	-
Other securities	7,958	-	7,958	-
Total assets measured at fair value	$ 638,912	$ -	$ 638,912	$ -

Fair values for available-for-sale investment securities are based on quoted market prices for similar securities.

Non-recurring Basis

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value which was below cost at the reporting date.

	2018			
	Fair Value	Level 1	Level 2	Level 3
Impaired loans:				
Real estate – commercial	$ 3,455	$ -	$ -	$ 3,455
Real estate – construction	1,065	-	-	1,065
Commercial	8,505	-	-	8,505
Lease financing	172	-	-	172
Consumer	3,378	-	-	3,378
Total assets measured at fair value on a non-recurring basis	$ 16,575	$ -	$ -	$ 16,575

	2017			
	Fair Value	Level 1	Level 2	Level 3
Impaired loans:				
Real estate – commercial	$ 10,684	$ -	$ -	$ 10,684
Real estate – construction	1,040	-	-	1,040
Commercial	5,001	-	-	5,001
Lease financing	230	-	-	230
Consumer	3,515	-	-	3,515
Total assets measured at fair value on a non-recurring basis	$ 20,470	$ -	$ -	$ 20,470

NOTE 2 – FAIR VALUE MEASUREMENTS (Continued)

Impaired loans are collateral dependent and have been adjusted to fair value based on the estimated fair value of the underlying collateral, less estimated selling costs. If the Bank determines that the value of an impaired loan is less than the recorded investment in the loan, the carrying value is adjusted through a charge-off recorded through the allowance for loan and lease losses. Total losses of $402 and $175 represent impairment charges recognized during the years ended December 31, 2018 and 2017, respectively related to the above impaired loans.

The following methods were used to estimate the fair value of each class of assets above:

Impaired Loans – The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for collateral-dependent impaired loans are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Bank. Once received, a member of the credit administration department reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On a quarterly basis, the Bank compares the actual selling price of collateral that has been sold to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value.

(Continued)

(In thousands, except per share amounts)

NOTE 2 – FAIR VALUE MEASUREMENTS (Continued)

The following table presents quantitative information about Level 3 fair value measurements for impaired financial instruments measured at fair value on a non-recurring basis at December 31, 2018:

Description	Fair Value	Valuation Technique	Significant Unobservable Input	Range (Weighted Average)
Real Estate Commercial	$ 3,455	Sales Comparison	a. Appraiser adjustments on sales comparable data can range 5% to 10%	0.5% to 0.75% 0.07%
		Management estimates	b. Management adjustments for depreciation in values depending on property types	
Real Estate Construction	$ 1,065	Income Approach	a. Appraisers required to apply a discounted cash flow approach as sales data is limited	1% to 4% 2.9%
		Management estimates	b. Management adjustments for depreciation in values depending on property types	
Commercial	$ 8,505	Sales Comparison	a. Appraiser adjustments on sales comparable data can range up to 20%	0.5% to 20% 1.7%
		Management estimates	b. Management adjustments for depreciation in values depending on property types	
			c. Selling and holding cost	
			d. Personal property collateral or unsecured loans are discounted based on management's estimate of loss given default	
Leasing	$ 172	Management estimate	a. Personal property collateral is discounted based on management's assessment of probability of default	15.0% to 50% 37.6%
Consumer	$ 3,378	Sales Comparison	a. Appraiser adjustments on sales comparable data can range up to 35%	0.75% to 35% 4.8%
		Management estimates	b. Personal property collateral is discounted based on management's assessment of probability of default	

(Continued)

(In thousands, except per share amounts)

NOTE 2 – FAIR VALUE MEASUREMENTS (Continued)

The following table presents quantitative information about Level 3 fair value measurements for impaired financial instruments measured at fair value on a non-recurring basis at December 31, 2017:

Description	Fair Value	Valuation Technique	Significant Unobservable Input	Range (Weighted Average)
Real Estate Commercial	$ 10,684	Sales Comparison	a. Appraiser adjustments on sales comparable data can range up to 50%	0.43% to 2% 1.5%
		Management estimates	b. Management adjustments for depreciation in values depending on property types	
Real Estate Construction	$ 1,040	Income Approach	a. Appraisers required to apply a discounted cash flow approach as sales data is limited	0% to 14% 14%
		Management estimates	b. Management adjustments for depreciation in values depending on property types	
Commercial	$ 5,001	Sales Comparison	a. Appraiser adjustments on sales comparable data can range up to 10%	.3% to 10% 4.8%
		Management estimates	b. Management adjustments for depreciation in values depending on property types	
			c. Personal property collateral or unsecured loans are discounted based on management’s estimate of loss given default	
Leasing	$ 230	Management estimate	a. Personal property collateral is discounted based on management’s assessment of probability of default	1.5% to 100% 25.5%
Consumer	$ 3,515	Sales Comparison	a. Appraiser adjustments on sales comparable data can range up to 75%	0.8% to 25% 2.1%
		Management estimates	b. Personal property collateral is discounted based on management’s assessment of probability of default	

(Continued)

(In thousands, except per share amounts)

NOTE 2 – FAIR VALUE MEASUREMENTS (Continued)

Fair Value of Financial Instruments: The estimated carrying amounts and fair values of the Bank's financial instruments are as follows:

December 31, 2018	Carrying Amount	Fair Value Measurements at Using: Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and cash equivalents	$ 153,124	$ 153,124	$ -	$ -	$ 153,124
Interest-bearing deposits In banks	44,000	44,000	-	-	44,000
Available-for-sale securities	844,905	-	844,905	-	844,905
FHLB stock	11,303	N/A	N/A	N/A	N/A
Loans and leases, net	1,474,550	-		1,460,682	1,460,682
Accrued interest receivable	11,488	5,299	199	5,990	11,488
Financial liabilities:					
Deposits	$ 2,379,683	$ 2,200,619	$ 176,868	$ -	$ 2,377,487
Accrued interest payable	1,302	1,201	101	-	1,302

December 31, 2017	Carrying Amount	Fair Value Measurements at Using: Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and cash equivalents	$ 308,317	$ 308,317	$ -	$ -	$ 308,317
Interest-bearing deposits In banks	52,000	52,000	-	-	52,000
Available-for-sale securities	638,912	-	638,912	-	638,912
FHLB stock	10,015	N/A	N/A	N/A	N/A
Loans and leases, net	1,457,462	-	-	1,456,931	1,456,931
Accrued interest receivable	10,545	4,474	152	5,919	10,545
Financial liabilities:					
Deposits	$ 2,343,669	$ 2,156,029	$ 185,460	$ -	$ 2,341,489
Accrued interest payable	1,212	1,172	40	-	1,212

Because no market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented.

(Continued)

(In thousands, except per share amounts)

NOTE 3 – AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2018 and 2017 consisted of the following:

	2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government agencies	$ 322,209	$ 277	$ (3,521)	$ 318,965
Obligations of states and political subdivisions	153,434	146	(1,189)	152,391
Government sponsored entities residential mortgage-backed securities	196,051	694	(2,277)	194,468
U.S. Treasuries	172,135	136	(655)	171,616
Other securities	7,800	6	(341)	7,465
	$ 851,629	$ 1,259	$ (7,983)	$ 844,905

	2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Government agencies	$ 274,726	$ 22	$ (3,174)	$ 271,574
Obligations of states and political subdivisions	176,646	434	(988)	176,092
Government sponsored entities residential mortgage-backed securities	121,747	377	(554)	121,570
U.S. Treasuries	62,033	1	(316)	61,718
Other securities	8,001	52	(95)	7,958
	$ 643,153	$ 886	$ (5,127)	$ 638,912

Net unrealized (losses) on available-for-sale investment securities totaling $(6,724) and $(4,241) were recorded, net of $1,988 and $1,253 in deferred tax assets, as accumulated other comprehensive income within stockholders' equity at December 31, 2018 and 2017, respectively. There were no sales of available-for-sale investments during the years ended December 31, 2018 and 2017. There were no transfers of available-for-sale investment securities for the years ended December 31, 2018 and 2017.

(Continued)

(In thousands, except per share amounts)

NOTE 3 – AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

Available-for-sale investment securities with unrealized losses at December 31, 2018 and 2017 are summarized and classified according to the duration of the loss period as follows:

	2018		2017	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Less than twelve months:				
U.S. Government agencies	$ 37,278	$ (205)	$ 111,775	$ (722)
Obligations of states and political subdivisions	11,360	(121)	105,662	(682)
Government guaranteed mortgage backed securities	64,350	(755)	74,076	(434)
U.S. Treasury	88,554	(98)	53,726	(270)
Other securities	3,601	(199)	-	-
Greater than twelve months:				
U.S. Government agencies	$ 213,111	$ (3,316)	$ 141,908	$ (2,452)
Obligations of states and political subdivisions	93,137	(1,068)	18,240	(305)
Government guaranteed mortgage backed securities	64,638	(1,522)	6,636	(120)
U.S. Treasury	45,449	(557)	3,995	(47)
Other securities	1,858	(142)	1,905	(95)
	$ 623,336	$ (7,983)	$ 517,923	$ (5,127)

U.S. Treasury and U.S. Government Agencies: The Bank holds 268 securities issued by U.S. Treasury and U.S Government Agencies, of which 48 have been in a continuous loss position for less than 12 months and 159 have been in a continuous loss position for 12 months or longer. Management believes that the unrealized losses on the Bank's investment in U.S. Treasuries and Government agencies are caused by the fluctuation in interest rates and are not attributable to changes in credit quality. Management intends to hold these investments until at least a recovery of fair value or until maturity. Because the Bank does not have the intent to sell these securities and it is likely that it will not be required to sell these securities before their anticipated recovery, the Bank does not consider these investments to be other-than-temporarily impaired at December 31, 2018.

Obligations of States and Political Subdivisions: The Bank holds 349 securities issued by state and political subdivisions, of which 75 have been in a continuous loss position for less than 12 months and 229 have been in a continuous loss position for 12 months or longer. Management believes that the unrealized losses on the Bank's investment in obligations of states and political subdivisions are a result of the fluctuation in interest rates. The contractual cash flows of these investments are considered a general obligation of, or supported by specific revenues of, a state or local municipality and the Bank intends to hold these investments until at least a recovery of fair value or until maturity. Therefore, the Bank expects to collect all amounts due, and because the Bank does not have the intent to sell these securities and it is likely that it will not be required to sell these securities before their anticipated recovery it does not consider these securities to be other-than-temporarily impaired at December 31, 2018.

(Continued)

(In thousands, except per share amounts)

NOTE 3 – AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

Government Guaranteed Mortgage Backed Securities: The Bank holds 83 Government Guaranteed Mortgage Backed Securities, of which 24 have been in a continuous loss position for less than 12 months and 33 have been in a continuous loss position for 12 months or longer. Management believes that the unrealized losses on the Bank's investment in government guaranteed mortgage backed securities is caused by the fluctuation in interest rates and is not attributable to changes in credit quality. Management intends to hold these investments until at least a recovery of fair value or until maturity. Because the Bank does not have the intent to sell these securities and it is likely that it will not be required to sell these securities before their anticipated recovery, the Bank does not consider these investments to be other-than-temporarily impaired at December 31, 2018.

Other Securities: Management continually evaluates the portfolio for credit issues that it believes may have an impact on the ability to fully recover the amortized cost basis of the bond and would therefore be considered a permanent impairment. The Bank has recorded $200 of such impairment in the current year, which is reflected in the reduced amortized cost in the table below. The Bank believes that the remaining unrealized losses on the Bank’s investment in other securities are caused by the fluctuation in interest rates and are not attributable to changes in credit quality. Management intends to hold these investments until at least a recovery of fair value or until maturity. The Bank does not have the intent to sell these securities and it is likely that it will not be required to see the securities before their anticipated recovery, the Bank does not consider the remaining investments to be other-than-temporarily impaired at December 31, 2018.

Contractual Maturities: The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because the issuers of securities may have the right to call or prepay obligations with or without prepayment penalties.

	Amortized Cost	Estimated Fair Value
Within one year	$ 209,855	$ 209,228
After one year through five years	309,116	305,681
After five years through ten years	126,300	125,264
After ten years	10,307	10,264
	655,578	650,437
Investment securities not due at a single maturity date:		
Government sponsored entities mortgage-backed securities	196,051	194,468
	$ 851,629	$ 844,905

The only significant concentration of investment securities (greater than 10% of stockholders' equity) in any individual security issuer at December 31, 2018 is certain U.S. Government sponsored entities mortgage-backed securities such as Federal National Mortgage Association and Federal Home Loan Mortgage Corporation and certain U.S. Government agencies such as Federal Home Loan Bank.

Investment securities with amortized costs of $20,339 and $157,561 and fair values of $20,058 and $157,241 as of December 31, 2018 and 2017, respectively, were pledged to secure public and trust deposits, FHLB borrowing arrangements (see Note 8) and for other purposes required or permitted by law.

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES

Loans and leases are reported net of deferred loan origination fees and costs of $1,368 in 2018 and $1,519 in 2017 and consist of the following at December 31:

	2018	2017
Real estate – commercial	$ 743,777	$ 732,120
Real estate – construction	57,800	83,569
Commercial	289,629	282,960
Lease financing	50,843	42,918
Consumer	372,355	356,218
Total	1,514,404	1,497,785
Less: Allowance for loan and lease losses	(39,854)	(40,323)
	$ 1,474,550	$ 1,457,462

The components of the Bank's leases receivable at December 31 are as follows:

	2018	2017
Future lease payments receivable	$ 55,483	$ 46,298
Residual interests	117	122
Deferred broker costs	1,146	1,042
Unearned income	(5,903)	(4,544)
Net lease financing receivable	$ 50,843	$ 42,918

Future lease payments receivable are as follows:

Year Ending December 31,	
2019	$ 1,247
2020	5,846
2021	11,356
2022	16,398
2023	17,158
Thereafter	3,478
	$ 55,483

Certain loans have been pledged to secure borrowing arrangements (see Note 8).

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

Activity in the allowance for loan and lease losses for the years ended December 31, 2018 and 2017 was as follows:

	2018	2017
Balance, beginning of year	$ 40,323	$ 38,009
Provision for (reversal of) loan and lease losses	-	-
Loans charged-off	(1,691)	(414)
Recoveries	1,222	2,728
Balance, end of year	$ 39,854	$ 40,323

The following tables show the activity of the allowance for loan and lease losses for the year ended December 31, 2018 and 2017 by portfolio segment, and the allocation of the allowance for loan and lease losses at December 31, 2018 and 2017 by portfolio segment and by impairment methodology:

	December 31, 2018					
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Consumer	Total
Allowance for Credit Losses						
Beginning balance	$ 16,301	$ 8,569	$ 12,236	$ 461	$ 2,756	$ 40,323
Provision for loan and lease losses	-	-	-	-	-	-
Loans charged-off	-	-	(437)	(586)	(668)	(1,691)
Recoveries	7	450	94	326	345	1,222
Ending balance allocated to portfolio segments	$ 16,308	$ 9,019	$ 11,893	$ 201	$ 2,433	$ 39,854
Ending balance: individually evaluated for impairment	$ 25	$ 50	$ 291	$ 104	$ 250	$ 720
Ending balance: collectively evaluated for impairment	$ 16,283	$ 8,969	$ 11,602	$ 97	$ 2,183	$ 39,134
Loans						
Ending balance	$ 743,777	$ 57,800	$ 289,629	$ 50,843	$ 372,355	$1,514,404
Ending balance: individually evaluated for impairment	$ 3,480	$ 1,713	$ 8,796	$ 276	$ 3,628	$ 17,893
Ending balance: collectively evaluated for impairment	$ 740,297	$ 56,087	$ 280,833	$ 50,567	$ 368,727	$1,496,511

(Continued)

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

	December 31, 2017					
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Consumer	Total
Allowance for Credit Losses						
Beginning balance	$ 16,294	$ 7,724	$ 10,714	$ 637	$ 2,640	$ 38,009
Provision for loan and lease losses	-	-	-	-	-	-
Loans charged-off	-	-	(75)	(217)	(122)	(414)
Recoveries	7	845	1,597	41	238	2,728
Ending balance allocated to portfolio segments	$ 16,301	$ 8,569	$ 12,236	$ 461	$ 2,756	$ 40,323
Ending balance: individually evaluated for impairment	$ 170	$ 169	$ 243	$ 79	$ 171	$ 832
Ending balance: collectively evaluated for impairment	$ 16,131	$ 8,400	$ 11,993	$ 382	$ 2,585	$ 39,491
Loans						
Ending balance	$ 732,120	$ 83,569	$ 282,960	$ 42,918	$ 356,218	$1,497,785
Ending balance: individually evaluated for impairment	$ 10,846	$ 1,210	$ 5,253	$ 297	$ 3,686	$ 21,292
Ending balance: collectively evaluated for impairment	$ 721,274	$ 82,359	$ 277,707	$ 42,621	$ 352,532	$1,476,493

The following tables show the loan portfolio allocated by management's internal risk ratings at December 31, 2018 and 2017:

	December 31, 2018 Commercial Credit Exposure Credit Risk Profile by Internally Assigned Grade				
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Total
Grade:					
Pass	$ 736,986	$ 56,087	$ 272,934	$ 50,394	$ 1,116,401
Special Mention	3,598	-	11,344	4	14,946
Substandard	3,193	1,713	5,351	445	10,702
Total	$ 743,777	$ 57,800	$ 289,629	$ 50,843	$ 1,142,049

(Continued)

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

	December 31, 2018 Consumer Credit Exposure Credit Risk Profile Based on Payment Activity	
	Consumer	Total
Grade:		
Performing	$ 369,470	$ 369,470
Non-performing	2,885	2,885
Total	$ 372,355	$ 372,355

	December 31, 2017 Commercial Credit Exposure Credit Risk Profile by Internally Assigned Grade				
	Real Estate – Commercial	Real Estate – Construction	Commercial	Lease Financing	Total
Grade:					
Pass	$ 724,732	$ 82,359	$ 264,318	$ 41,970	$ 1,113,379
Special Mention	2,586	-	6578	294	9,458
Substandard	4,802	1,210	12,064	654	18,730
Total	$ 732,120	$ 83,569	$ 282,960	$ 42,918	$ 1,141,567

	December 31, 2017 Consumer Credit Exposure Credit Risk Profile Based on Payment Activity	
	Consumer	Total
Grade:		
Performing	$ 355,282	$ 355,282
Non-performing	936	936
Total	$ 356,218	$ 356,218

The following tables show an aging analysis of the loan portfolio by the time past due at December 31, 2018 and 2017:

	December 31, 2018					
	30-89 Days Past Due	Greater Than 90 Days	Nonaccrual	Total Past Due	Current	Total Loans
Real estate – commercial	$ 52	$ -	$ -	$ 52	$ 743,725	$ 743,777
Real estate – construction	-	-	604	604	57,196	57,800
Commercial	543	-	599	1,142	288,487	289,629
Lease financing	249	-	234	483	50,360	50,843
Consumer	613	17	2,868	3,498	368,857	372,355
Total	$ 1,457	$ 17	$ 4,305	$ 5,779	$ 1,508,625	$ 1,514,404

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

	December 31, 2017					
	30-89 Days Past Due	Greater Than 90 Days	Nonaccrual	Total Past Due	Current	Total Loans
Real estate – commercial	$ -	$ -	$ -	$ -	$ 732,120	$ 732,120
Real estate – construction	-	-	-	-	83,569	83,569
Commercial	169	-	1,577	1,746	281,214	282,960
Lease financing	129	14	217	360	342,558	42,918
Consumer	587	-	936	1,523	354,695	356,218
Total	$ 885	$ 14	$ 2,730	$ 3,629	$ 1,494,156	$ 1,497,785

The following tables show information related to impaired loans at and for the years ended December 31, 2018 and 2017:

	December 31, 2018				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:	$ -	$ -	$ -	$ -	$ -
With an allowance recorded:					
Real estate – commercial	$ 3,480	$ 3,480	$ 25	$ 7,165	$ 174
Real estate – construction	$ 1,713	$ 1,713	$ 50	$ 1,464	$ 93
Commercial	$ 8,796	$ 9,373	$ 291	$ 7,013	$ 442
Lease financing	$ 276	$ 276	$ 104	$ 294	$ 7
Consumer	$ 3,628	$ 4,055	$ 250	$ 3,674	$ 169
Total:					
Real estate – commercial	$ 3,480	$ 3,480	$ 25	$ 7,165	$ 174
Real estate – construction	$ 1,713	$ 1,713	$ 50	$ 1,464	$ 93
Commercial	$ 8,796	$ 9,373	$ 291	$ 7,013	$ 442
Lease financing	$ 276	$ 276	$ 104	$ 294	$ 7
Consumer	$ 3,628	$ 4,055	$ 250	$ 3,674	$ 169

(Continued)

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

	December 31, 2017				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:	$ -	$ -	$ -	$ -	$ -
With an allowance recorded:					
Real estate – commercial	$ 10,850	$ 10,846	$ 170	$ 13,068	$ 494
Real estate – construction	$ 1,215	$ 1,210	$ 169	$ 1,345	$ 67
Commercial	$ 5,229	$ 7,439	$ 243	$ 7,829	$ 380
Lease financing	$ 312	$ 297	$ 79	$ 249	$ -
Consumer	$ 3,720	$ 4,091	$ 171	$ 3,759	$ 189
Total:					
Real estate – commercial	$ 10,850	$ 10,846	$ 170	$ 13,068	$ 494
Real estate – construction	$ 1,215	$ 1,210	$ 169	$ 1,345	$ 67
Commercial	$ 5,229	$ 7,439	$ 243	$ 7,829	$ 380
Lease financing	$ 312	$ 297	$ 79	$ 249	$ -
Consumer	$ 3,720	$ 4.091	$ 171	$ 3,759	$ 189

Non-accrual loans totaled $4,305 and $2,730 at December 31, 2018 and 2017, respectively. Accruing loans that were past due 90 days or more totaled $17 at December 31, 2018, as compared to $14 at December 31, 2017

Included in the impaired loans above are 36 loans in the amount of $15,213 and 42 loans in the amount of $19,325 that were considered to be troubled debt restructurings at December 31, 2018 and December 31, 2017, respectively.

For the years ended December 31, 2018 and 2017, the average recorded investment in impaired loans was $19,610 and $26,250, respectively. The Bank had $720 of specific allowance for loan and lease losses on impaired loans with a recorded investment of $17,893 at December 31, 2018 as compared to $832 of specific allowance for loan and lease losses on impaired loans with a recorded investment of $21,326 at December 31, 2017. Interest income on a cash basis was not significant. The impact of interest on non-accrual loans reflects a net loss of $397 for the year ended December 31, 2018, compared with the net recovery of $1,355 for the year ended December 31, 2017.

Salaries and employee benefits totaling $2,878 and $3,146 have been deferred as loan and lease origination costs for the years ended December 31, 2018 and 2017, respectively.

The Bank has allocated $720 and $801 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2018 and 2017. The Bank has commitments to lend $0 in additional amounts to customers with outstanding loans classified as troubled debt restructurings, as of December 31, 2018.

During the periods ending December 31, 2018 and 2017, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 12 months to 5 years. Modifications involving an extension of the maturity date were for periods ranging from 6 months to 24 months.

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ended December 31, 2018:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Real estate – commercial	-	$ -	$ -
Real estate – construction	-	-	-
Commercial	4	663	663
Lease financing	-	-	-
Consumer	3	21	21
Total	7	$ 684	$ 684

The troubled debt restructurings described above increased the allowance for loan losses by $57 and resulted in $0 in charge offs during the period ended December 31, 2018.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the period ended December 31, 2018:

	Number of Loans	Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Lease financing	-	$ -

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

(In thousands, except per share amounts)

NOTE 4 – LOANS AND LEASES (Continued)

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ended December 31, 2017:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings:			
Real estate – commercial	1	$ 809	$ 809
Real estate – construction	-	-	-
Commercial	-	-	-
Lease financing	-	-	-
Consumer	2	127	127
Total	3	$ 936	$ 936

The troubled debt restructurings described above increased the allowance for loan losses by $18 and resulted in $212 in charge offs during the period ended December 31, 2017.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the period ended December 31, 2017:

	Number of Loans	Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Lease financing	-	$ -

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

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

NOTE 5 – FEDERAL HOME LOAN BANK STOCK

As a member of the Federal Home Loan Bank of San Francisco (FHLB), the Bank is required to own capital stock in an amount specified by regulation. At December 31, 2018 and 2017, the Bank owned 113,030 and 100,153 shares of $100 par value FHLB stock respectively. The stock is carried at cost and is redeemable at par with certain restrictions. The amount of stock required to be held is adjusted periodically based on a determination made by the FHLB.

(In thousands, except per share amounts)

NOTE 6 – BANK PREMISES AND EQUIPMENT

Bank premises and equipment at December 31 consist of the following:

	2018	2017
Land	$ 3,462	$ 3,462
Buildings	26,248	25,721
Leasehold improvements	7,064	7,464
Equipment	17,975	18,368
Construction in progress	445	1,183
	55,194	56,198
Less: accumulated depreciation and amortization	(37,603)	(37,436)
	$ 17,591	$ 18,762

Depreciation and amortization expense were $2,363 and $2,212 for the years ended December 31, 2018 and 2017, respectively.

NOTE 7 – INTEREST-BEARING DEPOSITS

Interest-bearing deposits at December 31 consisted of the following:

	2018	2017
Savings	$ 518,948	$ 474,789
Money market	288,881	319,105
NOW accounts	508,122	469,416
Time, $250,000 or more	54,918	46,506
Other time	121,950	138,954
	$ 1,492,819	$ 1,448,770

The Bank's other time deposits included brokered deposits which totaled $1,463 or 0.1% and $2,404 or 0.1% of total deposits, respectively, for the years ended December 31, 2018 and 2017. Brokered deposits were entirely under the Certificate of Deposit Account Registry Service (CDARS) program, which allows the Bank's deposit customers to have the entire balance of their certificate of deposit account insured by the FDIC. There were no wholesale brokered certificates of deposit at December 31, 2018 and 2017.

(Continued)

(In thousands, except per share amounts)

NOTE 7 – INTEREST-BEARING DEPOSITS (Continued)

Aggregate annual maturities of time deposits at December 31, 2018 are as follows:

Year Ending December 31,	
2019	$ 143,278
2020	22,365
2021	6,691
2022	3,371
2023	1,163
	$ 176,868

NOTE 8 – FEDERAL HOME LOAN BANK ADVANCES AND OTHER LONG-TERM DEBT

Federal Home Loan Bank Advances: The Bank may borrow from the Federal Home Loan Bank, on either a short-term or long-term basis, up to 30% of its assets provided that adequate collateral has been pledged. As of December 31, 2018, the Bank has pledged investment securities with a carrying value of $33,798 and loans with a carrying value of $898,844 to secure this borrowing arrangement. There were no outstanding advances from the Federal Home Loan Bank of San Francisco at December 31, 2018 and 2017.

Lines of Credit: The Bank has an unsecured line of credit of $5,000 with its correspondent bank, Pacific Coast Bankers Bank as of December 31, 2018 and 2017.

NOTE 9 – INCOME TAXES

The expense (benefit) from income taxes for the years ended December 31, 2018 and 2017 consisted of the following:

	Federal	State	Total
2018			
Current	$ 8,592	$ 5,448	$ 14,040
Deferred	743	201	944
Provision for income taxes	$ 9,335	$ 5,649	$ 14,984
2017			
Current	$ 13,275	$ 4,741	$ 18,016
Deferred	(699)	(161)	(860)
DTA re-measurement as a result of change in future federal income tax rate	6,907	-	6,907
Provision for income taxes	$ 19,483	$ 4,580	$ 24,063

(Continued)

(In thousands, except per share amounts)

NOTE 9 – INCOME TAXES (Continued)

Deferred tax assets (liabilities) are comprised of the following at December 31, 2018 and 2017:

	2018	2017
Deferred tax assets:		
Allowance for loan losses	$ 11,659	$ 11,781
Deferred compensation	4,080	4,771
Postretirement benefits	1,279	1,267
Restructuring reserve	68	56
Nonaccrual interest	308	270
Bank premises and equipment	223	416
State taxes	1,114	967
SBA Deferred Gain	324	288
Unrealized loss on available-for-sale Investment securities	1,988	1,253
Other	109	95
Total deferred tax assets	21,152	21,164
Deferred tax liabilities:		
Deferred loan costs	(877)	(920)
Unrealized gains on available-for-sale investment securities	-	-
Prepaid expenses	(205)	(282)
Pension expenses	(2,915)	(3,254)
FHLB stock dividends	(272)	(272)
Other	(414)	(530)
Total deferred tax liabilities	(4,683)	(5,258)
Net deferred tax assets	$ 16,469	$ 15,906

The effective tax rate, as a percentage of income before income taxes, differs from the statutory Federal income tax rate as follows:

	Year Ended December 31,	
	2018	2017
Federal income tax expense, at statutory rate	21.0%	35.0%
State franchise tax, net of Federal tax effect	8.3	6.8
DTA re-measurement as a result of change in future federal income tax rate	-	15.8
Tax-exempt interest on obligations of states and political subdivisions	(.8)	(1.5)
Cash surrender value of life insurance	(.6)	(1.3)
Tax credits	(.2)	(.4)
Other	.3	.8
Effective tax rate	28.0%	55.2%

(Continued)

(In thousands, except per share amounts)

NOTE 9 – INCOME TAXES (Continued)

The Bank files income tax returns in the United States jurisdiction and the State of California jurisdiction. The Bank is no longer subject to Federal income tax examinations by tax authorities for years before 2015. The Bank is no longer subject to California income tax examinations by tax authorities for years before 2014.

The Bank recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2018 and 2017, the Bank recognized no interest or penalties.

As a result of tax law “H.R.1” commonly known as the “Tax Cuts and Jobs Act (Tax Act) as signed into law on December 22, 2017, the Bank reported an additional adjustment to income tax expense totaling $6,907 in the fourth quarter of 2017. The increase in income tax expense was the result of re-measuring the Bank’s net deferred tax assets due to the reduction in federal income tax rates from 35% to 21%.

NOTE 10 – RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank enters into transactions with related parties, including Directors and executive officers. The following is a summary of the aggregate activity involving related party borrowers during 2018:

Balance, January 1, 2018	$ 15,264
Disbursements	9,955
Amounts repaid	(7,079)
Balance, December 31, 2018	$ 18,140
Undisbursed commitments to related parties, December 31, 2018	$ 4,140

(Continued)

(In thousands, except per share amounts)

NOTE 11 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The following is changes in accumulated other comprehensive income (loss) by component, net of tax, for the years ending December 31, 2018 and 2017:

	Unrealized Gains and Losses on Available-for-Sale Securities	Post Retirement Benefit Items	Deferred Compensation	Total
December 31, 2018				
Beginning Balance	$ (2,988)	$ (6,323)	$ 429	$ (8,882)
Amounts reclassified from accumulated other comprehensive income	141	51	-	192
Net current period other comprehensive income	(1,889)	(2,493)	645	(3,737)
Ending balance	$ (4,736)	$ (8,765)	$ 1,074	$ (12,427)

	Unrealized Gains and Losses on Available-for-Sale Securities	Post Retirement Benefit Items	Deferred Compensation	Total
December 31, 2017				
Beginning Balance	$ (1,314)	$ (6,333)	$ 223	$ (7,424)
Amounts reclassified from accumulated other comprehensive income	-	(958)	-	(958)
DTA re-measurement as a result of change in future federal income tax rate	(506)	(1,365)	59	(1,812)
Net current period other comprehensive income	(1,168)	2,333	147	1,312
Ending balance	$ (2,988)	$ (6,323)	$ 429	$ (8,882)

(Continued)

(In thousands, except per share amounts)

NOTE 11 – ACCUMULATED OTHER COMPREHENSIVE INCOME (Continued)

The following is significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the year ending December 31, 2018:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
OTTI	$ 200	Other expense
Amortization of defined benefit pension items including prior service costs and actuarial gains (losses)	73	Other expense
	(81)	Provision for income
	$ 192	Net of tax

The following is significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the year ending December 31, 2017:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Amortization of defined benefit pension items including prior service costs and actuarial gains (losses)	$ (1,624)	Other expense
	666	Provision for income taxes
	$ (958)	Net of tax

(Continued)

(In thousands, except per share amounts)

NOTE 12 – RETIREMENT PLAN

The following presents the reconciliations of plan benefit obligations and plan assets from beginning of year to end of year. The Bank uses a December 31 measurement date for the Plan.

	2018	2017
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 50,202	$ 48,135
Service cost	86	134
Interest cost	1,845	1,975
Benefits paid	(2,368)	(2,201)
Actuarial (gain) loss	(3,602)	2,159
Benefit obligation at end of year	$ 46,163	$ 50,202
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 61,209	$ 55,539
Employer contribution	50	-
Benefits and expenses paid	(2,410)	(2,283)
Actual return on plan assets	(2,773)	7,953
Fair value of plan assets at end of year	$ 56,076	$ 61,209
Funded status at end of year	$ 9,913	$ 11,007

Amounts recognized in accumulated other comprehensive income at December 31 consist of:

	2018	2017
Net actuarial loss	$ 11,443	$ 8,258
Prior service cost (credit)	-	-
	$ 11,443	$ 8,258

The accumulated benefit obligation was $46,163 and $50,202 at December 31, 2018 and 2017. The Bank does not expect to contribute to the Plan in 2019.

(Continued)

(In thousands, except per share amounts)

NOTE 12 – RETIREMENT PLAN (Continued)

The following presents the Plan investments, including their fair value and method of fair value determination, as of December 31, 2018 and 2017.

2018	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and equivalents	$ 638	$ 638	$ -	$ -
Equity securities:				
U.S. large-cap (a)	25,862	25,862	-	-
U.S. small-cap (b)	3,047	3,047	-	-
International large-cap (c)	6,035	6,035	-	-
Fixed income securities:				
U.S. Government agencies (d)	50	-	50	-
U.S. corporate bond funds (e)	5,332	5,332	-	-
U.S. Total Bond Market fund (f)	15,112	15,112	-	-
Total	$ 56,076	$ 56,026	$ 50	$ -

2017	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and equivalents	$ 659	$ 659	$ -	$ -
Equity securities:				
U.S. large-cap (a)	29,657	29,657	-	-
U.S. small-cap (b)	3,874	3,874	-	-
International large-cap (c)	7,416	7,416	-	-
Fixed income securities:				
U.S. Government agencies (d)	249	-	249	-
U.S. corporate bond funds (e)	5,319	5,319	-	-
U.S. Total Bond Market fund (f)	14,035	14,035	-	-
Total	$ 61,209	$ 60,960	$ 249	$ -

(Continued)

(In thousands, except per share amounts)

NOTE 12 – RETIREMENT PLAN (Continued)

(a) This category comprises low-cost equity index funds not actively managed that track the S&P 500, as well as actively managed funds that track the Russell 100 value index.
(b) This category represents low-cost actively managed and broadly diversified U.S. small cap equity funds.
(c) This category represents low cost index enhanced and broadly diversified Non U.S. large cap international funds.
(d) This category represents individual government agency fixed income debentures of a short to intermediate term to maturity.
(e) This category represents low-cost actively managed U.S. investment grade bond funds.
(f) This category represents a low-cost bond index fund passively managed to track the broad U.S. fixed income markets.

The fair values for equity securities and mutual funds are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). Certain debt securities are valued at the closing price reported in the active market in which the bond is traded (Level 1 inputs). Other debt securities are valued based upon recent bid prices or the average of recent bid and asked prices when available (Level 2 inputs) and, if not available, they are valued through matrix pricing models developed by sources considered by management to be reliable. Matrix pricing, which is a mathematical technique commonly used to price debt securities that are not actively traded, values debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

In accordance with the "Prudent Expert" rule, the Plan attempts to achieve a balance of risk and reward that will provide the Plan with the greatest risk-adjusted return on assets. The maximization of risk-adjusted return is accomplished by broadly diversifying assets within the major financial asset classes and by maintaining a discipline to the target asset allocation of the Plan. The Plan is managed through a relatively passive approach to asset allocation. The Investment Manager maintains the policy asset allocation listed below except for those unusual and well documented market related events that may dictate otherwise. Stated below is the policy asset allocation at market values of Plan assets. This is the long term asset allocation desired by the Board, which should approximate the actual average asset allocation over a three to five year period. In practice asset allocation is monitored on a monthly basis and at such time as any of the minimum or maximum target asset allocations are pierced, a rebalancing transaction is required to bring all asset allocations back to policy target ranges.

Also stated are the maximum and minimum asset allocation levels at market for each asset category as well as the weighted average expected return for each asset class.

	Minimum	Policy	Maximum	Weighted Average Expected Return
Equity	50%	65%	80%	5.50%
Fixed income	25%	35%	45%	1.25%
Cash and equivalents	0%	0%	5%	0%

(Continued)

(In thousands, except per share amounts)

NOTE 12 – RETIREMENT PLAN (Continued)

The allocation by asset category of the pension plan assets at December 31 is as follows:

	2018	2017
Asset category:		
Equity	62%	67%
Fixed income	37%	32%
Other	1%	1%
Total	100%	100%

The primary investment objective for the Plan assets is to achieve maximum rates of return commensurate with safety of principal, given the asset mix, credit quality and diversification guidelines and restrictions approved by the retirement committee. The asset allocation is reviewed quarterly to determine whether the portfolio mix is within an acceptable range of target allocation. Target asset allocations are based on asset and liability studies with the goal to enhance the expected return of the retirement portfolio while maintaining acceptable levels of risk.

The components of 2018 and 2017 net periodic benefit cost are as follows:

	2018	2017
Service cost	$ 86	$ 134
Interest cost	1,845	1,975
Expected return on plan assets	(4,051)	(3,939)
Amortization of unrecognized prior service cost	-	-
Recognized prior service cost due to curtailment	-	-
Amortization of unrecognized actuarial loss	79	156
Total net periodic cost	$ (2,041)	$ (1,674)
Net (gain) loss, include curtailment	$ 3,264	$ (1,772)
Prior service cost	-	-
Amortization of prior service cost	-	-
Amortization of net gain (loss)	(79)	(156)
Total recognized in other comprehensive income	3,185	(1,928)
Total recognized in net periodic benefit cost and other comprehensive income	$ 1,144	$ (3,602)

The estimated net actuarial loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is $79 as of December 31, 2018.

(Continued)

(In thousands, except per share amounts)

NOTE 12 – RETIREMENT PLAN (Continued)

The weighted average assumptions used to determine benefit obligations at December 31:

	2018	2017
Discount rate	4.35%	3.75%
Rate of compensation increase	N/A	N/A

The weighted average assumptions used to determine net periodic benefit cost at December 31:

	2018	2017
Discount rate	3.75%	4.20%
Rate of compensation increase	N/A	N/A
Expected return of plan assets	6.75%	7.25%

The expected return on retirement plan assets is developed using inflation expectations and risk factors to arrive at a long-term nominal expected return for each asset class. The nominal expected return for each asset class is then weighted based on the target asset allocation to develop the expected long-term rate of return on plan assets.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

Year Ending December 31,	Pension Benefits
2019	$ 2,407
2020	$ 2,528
2021	$ 2,627
2022	$ 2,710
2023	$ 2,768
2024 through 2028	$ 14,568

(Continued)

(In thousands, except per share amounts)

NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN

The following presents the postretirement healthcare plan's combined funded status:

	2018	2017
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 5,314	$ 5,256
Service cost	11	14
Interest cost	192	213
Benefits paid	(492)	(484)
Plan participant contribution	127	125
Actuarial gain	(241)	190
Benefit obligation at end of year	$ 4,911	$ 5,314
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 3,653	$ 3,644
Other payments	(78)	(83)
Plan participant contribution	127	125
Benefits paid	(492)	(484)
Employer contribution	-	-
Actual return on plan assets	(283)	451
Fair value of plan assets at end of year	$ 2,927	$ 3,653
Plan assets less benefit obligation at end of year	$ 1,984	$ (1,661)

Amounts recognized in accumulated other comprehensive income at December 31 consist of:

	2018	2017
Net actuarial loss	$ 1,000	$ 784
Prior service cost	-	(65)
	$ 1,000	$ 719

The accumulated benefit obligation was $4,911 and $5,314 at December 31, 2018 and 2017. The Bank does not expect to contribute to the Plan in 2019.

	2018	2017
Components of net periodic benefit cost:		
Service cost	$ 88	$ 97
Interest cost	192	213
Expected return on plan assets	(233)	(250)
Loss (gain)	59	83
Amortization of unrecognized prior service cost	(65)	(70)
Total net periodic benefit cost	$ 41	$ 73

(Continued)

(In thousands, except per share amounts)

NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN (Continued)

	2018	2017
Net loss (gain)	$ 275	$ (10)
Amortization of net (gain) loss	(59)	(83)
Amortization of prior service cost	65	70
Total recognized in other comprehensive income	281	(23)
Total recognized in net periodic benefit cost and other comprehensive income	$ 322	$ 50

The estimated net actuarial loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is $129 as of December 31, 2018.

The following table represents the assumed health care trend rates at December 31:

	2018	2017
Health care trend rate assumed for next year	5.50%	5.50%
Rate to which the cost trend rate is assumed to decline	5.50%	5.50%
Year that the rate reaches the ultimate trend rate	2010	2010

The following presents the Plan investments, including their fair value and method of fair value determination, as of December 31, 2018 and 2017.

2018	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash	$ 162	$ 162	$ -	$ -
Equity securities:				
U.S. large-cap (a)	1,693	1,693	-	-
U.S. small-cap (b)	191	191	-	-
International large-cap (c)	440	440	-	-
Fixed income securities:				
Obligations of states and political subdivisions (d)	441	-	441	-
Total	$ 2,927	$ 2,486	$ 441	$ -

(Continued)

(In thousands, except per share amounts)

NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN (Continued)

2017	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash	$ 23	$ 23	$ -	$ -
Equity securities:				
U.S. large-cap (a)	2,209	2,209	-	-
U.S. small-cap (b)	288	288	-	-
International large-cap (c)	566	566	-	-
Fixed income securities:				
Obligations of states and political subdivisions (d)	567	-	567	-
Total	$ 3,653	$ 3,086	$ 567	$ -

(a) This category comprises low-cost equity index funds not actively managed that track the S&P 500.
(b) This category represents low-cost actively managed and broadly diversified U.S. small cap equity funds.
(c) This category represents low cost index enhanced and broadly diversified Non U.S. large cap international funds.
(d) This category represents individual tax exempt state, municipalities and local government agency fixed income debentures of a short to intermediate term to maturity.

The fair values for equity securities and mutual funds are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). Certain debt securities are valued at the closing price reported in the active market in which the bond is traded (Level 1 inputs). Other debt securities are valued based upon recent bid prices or the average of recent bid and asked prices when available (Level 2 inputs) and, if not available, they are valued through matrix pricing models developed by sources considered by management to be reliable. Matrix pricing, which is a mathematical technique commonly used to price debt securities that are not actively traded, values debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities" relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Discounted cash flows are calculated using spread to swap and LIBOR curves that are updated to incorporate loss severities, volatility, credit spread and optionality. During times when trading is more liquid, broker quotes are used (if available) to validate the model. Rating agency and industry research reports as well as defaults and deferrals on individual securities are reviewed and incorporated into the calculations.

In accordance with the "Prudent Expert" rule, the Plan attempts to achieve a balance of risk and reward that will provide the Plan with the greatest risk-adjusted return on assets. The maximization of risk-adjusted return is accomplished by broadly diversifying assets within the major financial asset classes and by maintaining a discipline to the target asset allocation of the Plan. The Plan is managed through a relatively passive approach to asset allocation. The Investment Manager maintains the policy asset allocation listed

(In thousands, except per share amounts)

NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN (Continued)

below except for those unusual and well documented market related events that may dictate otherwise. Stated below is the policy asset allocation at market values of plan assets. This is the long term asset allocation desired by the Board, which should approximate the actual average asset allocation over a three to five year period. In practice, asset allocation is monitored on a monthly basis and at such time as any of the minimum or maximum target asset allocations are pierced, a rebalancing transaction is required to bring all asset allocations back to policy target ranges.

Also stated are the maximum and minimum asset allocation levels at market for each asset category as well as the weighted average expected return for each asset class.

	Minimum	Policy	Maximum	Weighted Average Expected Return
Equity	70%	80%	90%	5.75%
Fixed income	10%	20%	30%	1.00%
Cash and equivalents	0%	0%	20%	0%

The allocation by asset category of the postretirement healthcare plan assets at December 31 is as follows:

	2018	2017
Asset category:		
Equity	79%	84%
Fixed income	15%	15%
Other	6%	1%
Total	100%	100%

The primary investment objective for the Plan's assets is to achieve maximum rates of return commensurate with safety of principal, given the asset mix, credit quality and diversification guidelines and restrictions approved by the retirement committee. The asset allocation is reviewed quarterly to determine whether the portfolio mix is within an acceptable range of target allocation. Target asset allocations are based on asset and liability studies with the goal to enhance the expected return of the retirement portfolio while maintaining acceptable levels of risk. The target asset allocation for the portfolio is 80% equity and 20% fixed income.

The Bank uses a December 31 measurement date for the Plan. For measurement purposes, the healthcare trend rate of 5.5% was used in 2018 and 2017. They will remain at that level thereafter except where the Bank's contribution limit applies. The healthcare cost trend rate assumptions have a significant effect on the amounts reported, but their impact is lessened because the Bank limits its annual increase at twice the 1991 average premium rate. To illustrate, increasing the assumed healthcare cost trend rates by 1.0% in each year would not change the accumulated postretirement benefit obligation as of December 31, 2018 or December 31, 2017. In addition, the aggregate of the service and interest components of net periodic postretirement benefit cost would not change as of December 31, 2018 or December 31, 2017.

Further, decreasing the assumed healthcare cost trend rates by 1.0% in each year would not change the accumulated postretirement benefit obligation as of December 31, 2018 or 2017. In addition, the aggregate service and interest components of net periodic postretirement benefit cost for the year would not change as of December 31, 2018 or 2017.

(Continued)

(In thousands, except per share amounts)

NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN (Continued)

The weighted average assumptions used to determine benefit obligations at December 31 are as follows:

	2018	2017
Discount rate	4.35%	3.75%
Rate of compensation increase	N/A	N/A

The weighted average assumptions used to determine net periodic benefit cost at December 31 are as follows:

	2018	2017
Discount rate	3.75%	4.20%
Expected return of plan assets	6.75%	7.25%
Rate of compensation increase	N/A	N/A

The expected return on retirement plan assets is developed using inflation expectations and risk factors to arrive at a long-term nominal expected return for each asset class. The nominal expected return for each asset class is then weighted based on the target asset allocation to develop the expected long-term rate of return on plan assets.

The plan assets are invested in a 501(c)(9) Voluntary Employees' Beneficiary Association trust which is subject to unrelated business income tax. The plan assets were funded by the Bank initially on December 31, 1991 and periodic contributions have been made since then. As of December 31, 2018, these investments included liquid investments, fixed income debt securities and equity securities.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 was signed into law on December 8, 2003. The Plan was designed to provide only for healthcare premiums and, consequently, the measures of the postretirement benefit obligations and net periodic postretirement benefit cost do not reflect effects of the Act.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Year Ending December 31,	Pension Benefits
2019	$ 405,687
2020	$ 398,629
2021	$ 393,939
2022	$ 383,628
2023	$ 375,001
2024 through 2028	$ 1,719,680

(In thousands, except per share amounts)

NOTE 14 – COMMITMENTS AND CONTINGENCIES

Financial Instruments With Off-Balance-Sheet Risk: The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments represent commitments to originate fixed and variable rate loans and lines of credit and involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the Bank's consolidated balance sheet. The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments to originate loans and lines of credit as it does for on-balance sheet instruments.

The following financial instruments represent off-balance-sheet credit risk at December 31:

	2018	2017
Commitments to extend credit	$ 429,868	$ 370,485
Standby letters of credit	3,805	42,258
Total loan commitments	$ 433,673	$ 412,743

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

Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to customers. The fair value of the liability related to commitments to extend credit and standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2018 and 2017. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

Leases: The Bank leases certain branch premises under operating lease agreements. The leases expire on various dates through 2028 and have renewal options for up to five years. At December 31, 2018, minimum commitments under these non-cancellable leases with initial or remaining terms of one year or more are as follows:

Year Ending December 31,	
2019	$ 1,409
2020	1,038
2021	765
2022	675
2023	686
Thereafter	2,072
	$ 6,645

(Continued)

NOTE 14 – COMMITMENTS AND CONTINGENCIES (Continued)

Rent expense under operating leases was $1,737 and $1,736 for the years ended December 31, 2018 and 2017, respectively.

Federal Reserve Requirement: Federal Reserve Board regulations require the Bank to maintain reserve balances on deposit with the Federal Reserve Bank. The average amount of reserves required at the Federal Reserve Bank for the years ended December 31, 2018 and 2017 were $1,847 and $1,556, respectively.

Contingencies: The Bank is involved in legal proceedings arising in the normal course of business. In the opinion of management, the outcomes of such proceedings will not have a material adverse effect on the Bank's financial position or results of operations.

Uninsured Deposits: The Bank maintains funds on deposit with the Federal Home Loan Bank (FHLB) and other federally insured financial institutions under correspondent banking agreements. Uninsured deposits with the FHLB and correspondent banks totaled $3,380 and $8,862 at December 31, 2018 and 2017, respectively.

Postretirement Benefits: The Bank has salary continuation agreements in place to provide nonqualified defined benefit retirement income for certain executive officers of the Bank. In connection with establishing these agreements, the Bank purchased split-dollar single premium life insurance policies on each participant. The agreements provide that each executive will receive annual benefits over their lifetime commencing with the month following their normal retirement date.

The Bank accrues for these future benefits from the effective date of the agreements until the executives' expected final payment dates in a systematic and rational manner. As of December 31, 2018 and 2017, the Bank had accrued $13,553 and $13,769, respectively, for potential benefits payable. This payable approximates the then present value of the benefits expected to be provided at retirement. The expense recognized under these agreements totaled $865 and $1,109 for the years ended December 31, 2018 and 2017, respectively.

The Bank has also established a deferred compensation plan for certain members of management for the purpose of providing the opportunity to defer compensation. At December 31, 2018 and 2017, the liability for accrued deferred compensation, including interest earned, totaled $1,720 and $2,744, respectively.

The Bank has also executed split-dollar life insurance agreements with certain employees in connection with the salary continuation agreements and deferred compensation plan whereby the Bank has effectively agreed to maintain a life insurance policy during the employees' postretirement period. The Bank had accrued a liability at December 31, 2018 and 2017 in the amount of $2,634 and $2,558, respectively, representing the actuarial present value of the costs to maintain life insurance during the employees' postretirement period.

The cash surrender value of life insurance purchased in connection with these agreements totaled $47,530 and $45,441 as of December 31, 2018 and 2017, respectively.

(Continued)

(In thousands, except per share amounts)

NOTE 15 – REGULATORY MATTERS

Dividend Restrictions: The California Financial Code restricts the total dividend payment of any state banking association in any calendar year to the lesser of (1) the bank's retained earnings or (2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period. In addition, subject to prior regulatory approval, any state banking association may request an exception to this restriction.

Regulatory Capital: Banks and holding companies are subject to regulatory capital requirements administered by federal and state banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2018 and 2017 is 1.875% and 1.25%, respectively. The net unrealized gain or loss on available for sale securities and defined benefit plans are not included in computing regulatory capital. Management believes as of December 31, 2018, the Bank met all capital adequacy requirements to which they were subject.

Prompt corrective action regulations provide five classifications; well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year-end 2018 and 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt correction action. There are no conditions or events since that notification that management believes have changed the Bank's category.

The following table represents the Bank's regulatory capital position as of year-end 2018 and 2017 in relationship to the regulatory requirements to meet the definitions of adequately capitalized and well capitalized. There is an additional element of capital required referred to as the capital contribution buffer that is not included in this table. The capital contribution buffer adds another level of capital of 1.875% over the adequately capitalized ratios and is required to eliminate any regulatory restrictions from the Banks ability to issued dividends, complete stock buybacks or pay management discretionary bonuses.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Minimum Amount	Minimum Ratio	Minimum Amount	Minimum Ratio
December 31, 2018						
Total capital (to risk-weighted assets)	$ 266,196	15.14%	$ 140,658	8.0%	$ 175,823	10.0%
Tier 1 capital (to risk-weighted assets)	$ 243,997	13.88%	$ 105,494	6.0%	$ 140,658	8.0%
Common Tier 1 (CET I)	$ 243,997	13.88%	$ 79,120	4.5%	$ 114,285	6.5%
Tier 1 capital (to average assets)	$ 243,997	9.23%	$ 105,731	4.0%	$ 87,911	5.0%
December 31, 2017						
Total capital (to risk-weighted assets)	$ 235,049	12.92%	$ 145,572	8.0%	$ 181,966	10.0%
Tier 1 capital (to risk-weighted assets)	$ 212,086	11.66%	$ 109,179	6.0%	$ 145,572	8.0%
Common Tier 1 (CET I)	$ 212,086	11.66%	$ 81,885	4.5%	$ 118,278	6.5%
Tier 1 capital (to average assets)	$ 212,086	8.68%	$ 97,775	4.0%	$ 90,983	5.0%

(Continued)

(In thousands, except per share amounts)

NOTE 16 – REVENUE FROM CONTRACTS WITH CUSTOMERS

A subset of our noninterest income relates to certain fee-based revenue within the scope of ASC Topic 606 – *Revenue from Contracts with Customers* (Topic 606). The objective of the standard is to clarify the principles for recognizing revenue from contracts with customers across all industries and to develop a common revenue standard under GAAP. All of the Bank's revenue from contracts with customers in the scope of ASC 606 is recognized within Non-Interest Income. The following table presents the Banks sources of Non-Interest Income for the twelve months ended December 31, 2018 and 2017, respectfully. Items outside the scope of ASC 606 are noted as such.

	2018	2017
Non-interest Income		
Service charges and fees	$ 4,845	$ 5,067
Trust income	7,330	6,709
Merchant discount and interchange fees	4,413	4,207
Income from bank owned life insurance[(a)]	1,639	1,592
Gain on sale of OREO	3,251	1,574
Other income[(a)]	4,293	5,143
Total non-interest income	$ 25,771	$ 24,292

[(a)]Not within the scope of ASC 606.

A description of the Bank's revenue streams accounted for under ASC 606 follows.
Service charges and fees: Retail Banking provides demand deposit, money market and savings account products for consumer and small business customers. Services include online and branch banking, overdraft, ATM use fees, wire transfer services, imaging services and cash alternative services such as cashier's checks. We recognize fee income at the time these services are performed for the customer.

Trust Services: Services provided to Trust customers are a series of distinct services that have the same pattern of transfer each month. Fees for trust accounts are billed and drafted from trust accounts on a predominately monthly basis. The Bank records these fees on the income statement on a monthly basis. Fees are assessed based on the total investable assets of the customer's trust account. As signed contract between the Bank and the customer is maintained for all customer trust accounts with payment terms identified. It is probable that the fees will be collectible as funds being managed are accessible by the asset manager. Past history of trust fee income recorded by the Bank indicates it is highly unlikely that a significant reversal could occur.

Merchant Discount and Interchange Fee: Retail Banking earns fee revenue for debit and credit card processing services. We provide these services to merchant businesses including point-of-sale payment acceptance capabilities and customized payment processing built around the merchant's specific requirements. We earn fee revenue as the merchant's customers make purchases.

Gains/Losses on Sales of OREO: The Bank records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. Upon the transfer of control of the property to the buyer, the OREO asset is derecognized and the gain or loss on sale is recorded.