Exchange Bank

February 28, 2020

Dear Shareholders:

On May 1, 2020 we will celebrate our 130th anniversary of service to our community. Exchange Bank opened its doors for business on May 1, 1890. Today, we have over 430 dedicated employees and total assets in excess of $2.6 billion. As we look ahead to 2020 and beyond, we celebrate our legacy, but today we must focus on our future.

We begin this letter with a sense of pride in how our Bank and employees responded in the face of another wildfire that struck our community. After the destructive wildfires of 2017, disaster struck again in 2019 with the Kincade Fire. The community and businesses were further impacted by multiple rolling blackouts following the fire. Once again, we saw the amazing spirit, cooperation, support and kindness of our people and we are grateful for all of the firefighters, first responders and hundreds of volunteers who worked tirelessly to protect our community.

In an effort to support our customers, we waived a variety of service charge fees, extended and deferred payments on customers' loans and provided necessary relief on customers' mortgages. Since 1890, the mission of Exchange Bank has been to support and contribute to our community. We demonstrated our support during this difficult time by donating in excess of $40,000 to several organizations providing much needed services to fire victims.

We continue to operate in a period of dynamic change, with shifting customer expectations, intense competition from other financial institutions, non-bank fintechs and rapidly evolving technology. We are balancing the need to deliver strong financial results with the requirement to make critical investments in our Bank that position us for long-term growth. In 2019, we further positioned the Bank for sustainable growth with major investments to our digital capabilities, technology infrastructure and revenue producing initiatives with our Trust and Investment Management department. While making these important investments, we continued to strengthen the core income of the Bank. Despite the short-term impact of expenses associated with these major investments, we are proud to have delivered another year of strong financial performance across most key metrics.

Exchange Bank reported net income after taxes for the year ending December 31, 2019 of $36.50 million. While net income for 2019 came in slightly lower than the $38.51 million recorded in 2018, when adjusted for elements that were unusual to our normal sources of revenue and expense, the true outstanding results of 2019 as compared to 2018 become evident.

During 2019, we undertook a major Bank-wide initiative of converting our existing online and mobile banking platform to a new state-of-the-art digital platform. As a result of this successful initiative, we recognized operating expenses totaling approximately $1.86 million that were not present during the similar 12-month period in 2018. Additionally, during 2018, we recognized an unusually large gain of $3.25 million on the sale of other real estate owned (OREO) that did not exist in the similar year ending December 31, 2019. Absent this unusual gain of $3.25 million in 2018 and the one-time expense of $1.86 million relating to our digital conversion in 2019 (both adjusted for the impact of taxes), we would have experienced net income of approximately $36.17 million in the year ending December 31, 2018 compared to net income of $37.84 million during the year ending December 31, 2019, an increase of 4.6%.

The following table sets forth a reconciliation of GAAP net income to normalized earnings by removing OREO gains from 2018 and removing unusual operating expenses relating to our digital conversion in 2019, both adjusted for the impact of associated income tax expense.

| (All $ in millions) | **2019** | **2018** |
|---|---|---|
| **Reported Net Income** | $36.50 | $38.51 |
| OREO Gain | | (3.25) |
| Digital Conversion Operating Expenses | 1.86 | |
| Provision for Income Tax | (.52) | .91 |
| **Normalized Net Income After Tax** | $37.84 | $36.17 |

We continue to experience growth in our primary business of meeting the credit needs of our communities. In this regard, we experienced strong growth in net interest income, which increased from $93.3 million in 2018 to $96.9 million in 2019, an increase of 3.84%. Contributing to the positive trend in net interest income was growth in the loan portfolio and the generally rising interest rate environment during much of 2018. As a result of the lagged effect of higher treasury yields during 2018 as well as prudent management of the balance sheet, we were able to increase our net interest margin from 3.73% during the 12 months in 2018 to 3.89% for the similar period ending December 31, 2019. Due to the material decline in interest rates during 2019, we will be challenged to continue to increase our net interest margin into 2020.

The Bank's balance sheet growth during the year was somewhat inhibited as we continued to witness deposit withdrawals from clients who were impacted by the wildfires of 2017. As the rebuild efforts have continued to accelerate, those clients have had the opportunity to utilize cash reserves from their insurance proceeds held at the Bank to rebuild or relocate their primary residence. As a result, we estimate that approximately $150 million of deposits related to insurance proceeds were utilized by clients and exited our Bank during 2019, and we estimate there is another $170 million of insurance related deposits that remain. This runoff of insurance related deposits was largely offset by organic growth in deposits totaling approximately $122 million, resulting in a net decline in total deposits of $25 million, as total deposits declined from $2.380 billion at December 31, 2018 to $2.355 billion at December 31, 2019. The Bank's net growth in deposits will continue to be challenged by deposit runoff utilized to support the rebuild efforts throughout 2020.

When excluding the OREO gain of $3.25 million from non-interest income during the year ending December 31, 2018, non-interest income would have increased from $22.5 million to $24.2 million during 2019. This 7.6% increase in non-interest income year-over-year was primarily driven by an increase of approximately $1.3 million in revenue generated by our trust and investment management business. In addition to organic growth of approximately $500,000 in the Sonoma County market, approximately $800,000 of growth in trust revenue was the result of recent acquisitions of trust business in the Sacramento and South Bay markets.

Operating expenses for the year ending December 31, 2019 increased by $4.7 million or 7.2% over the similar period in 2018 as we continued to invest in technology and personnel necessary to support future growth. We recognized approximately $1.86 million of expenses during 2019 relating to the implementation of a new online and mobile banking platform that are spread between salaries, professional fees and other expenses. Exclusive of these non-recurring expenses, total operating expenses would have increased by $3 million or 4.6%.

We remain committed to meeting the credit needs of our customers and community in a responsible and consistent manner. Mindful that the economy is well into the longest expansion in history, we continue to adhere to our credit underwriting standards.

We are proud of our efforts to support our customers as our loan portfolio expanded in 2019 by $67 million, or 4.42%, to $1.581 billion, versus loans of $1.514 billion at the end of 2018. The increase in the loan portfolio is primarily attributable to growth in commercial real estate and residential mortgage loans. The growth in loans outstanding during 2019 understates our true commitment to supporting the economic growth of the communities we serve. In fact, we supported our clients with new loan production exceeding $400 million during 2019. This was largely offset by an unusually high volume of payoffs within our construction loan portfolio and clients taking advantage of other financial institutions offering aggressive, long-term, fixed interest rate loans.

The Bank's credit quality remains strong, with non-accrual loans at December 31, 2019 of $3.45 million, representing 0.33% of total loans, versus non-accrual loans of $4.31 million, or 0.38% of total loans at December 31, 2018. Despite continued loan growth, as a result of maintaining exceptional credit quality and a net recovery position in our loan charge-offs, we did not make any provision for loan losses in 2019 and were able to maintain a ratio of loan loss reserves to total loans of 2.52%.

Continuing to grow our capital position remained a key initiative in 2019. As a result of strong earnings growth, we continued to reward our shareholders with three increases to the quarterly dividend during the year and were successful in growing our capital from $231.6 million to $270.8 million, an increase of 17%. This allowed the Bank to increase its tangible capital ratio from 9.22% at December 31, 2018 to 10.39% at December 31, 2019.

The Bank's capital ratios exceed all regulatory definitions of "well capitalized". As of December 31, 2019, we reported total risk-based capital of 15.79%. Additionally, our liquidity position remains strong due to the outstanding quality of our investment securities portfolio and strong overnight cash position. For the full year of 2019, Exchange Bank paid common dividends of $4.40 per share compared to $3.85 in 2018. Total dividends paid to our shareholders during 2019 were $7.5 million, an increase of 14% above total dividends of $6.6 million paid in 2018. Those distributions resulted in a dividend payout ratio of nearly 21%.

Our Trust and Investment Management department has been a trusted fiduciary since 1963. This department provides trust and investment services to a wide range of individuals, companies and associations and has grown to oversee more than $1.2 billion in client assets under management. We attribute our growth largely to the individualized approach we take to help clients achieve their long-term financial goals.

Top talent is our single most important asset. We have an experienced team, including 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.

2019 marked another year of impressive financial performance, growing our client base and expanding our presence in the markets we serve and in new geographic areas. The department generated a record $8.6 million in gross revenue to the Bank for 2019, an increase of $1.3 million, or 18% over the prior year. Our Trust and Investment Management department is the fifth largest community bank trust department by asset size in the state of California.

In late 2018, we successfully executed our strategic plan by expanding our presence in the Sacramento market with the acquisition of the trust department of First Northern Bank of Dixon. In April 2019, we again executed our growth strategy with the successful acquisition of the California trust assets of American Trust and Savings Bank. We consolidated the employees and approximately $72 million in trust assets into a new trust office in Los Altos, California. This acquisition was designed for Exchange Bank to establish a foothold in the South Bay that would lead with our Trust and Investment Management department and grow into a team that would acquire a broad range of clients. This concept has already proven to be a success as we have added two significant relationships resulting in two commercial real estate loans totaling $30 million.

We have a proud legacy of serving our clients and we believe the continued expansion of our Trust and Investment Management team will provide value to our shareholders, clients and employees. The progress we have made over the last two years positions our Bank for continued growth and success.

The economy continues to thrive with the longest U.S. economic expansion ever recorded. Unemployment running at 3.5% is at a 50-year low and we continue to witness strength in new job creation. For all of last year, employers added 2.11 million jobs. The positive U.S. economic performance is truly remarkable given the global economy's anemic rate of growth. We can thank the American consumer who continues to spend as wages and incomes continue to rise in a range of 3%. From a year earlier, consumer spending increased 2.5% in the third quarter, roughly consistent with the pace over the past year. The housing sector was a tailwind for growth as residential investment rose at a 5.1% annual pace. Consumers are the lifeblood of the U.S. economy as their spending accounts for nearly 70% of economic output. Still, business spending declined during 2019. Nonresidential fixed investment, which reflects business spending on software, research and development, equipment and facilities, fell. The weak number suggests that factors including political uncertainty and the outlook for trade tariffs are weighing on business decisions to spend on new equipment and facilities.

After raising the Fed Funds rate four times during 2018, the Fed abruptly shifted course during 2019. Persistent concerns of economic weakness driven primarily by a period of intense and escalating trade tension between China and the U.S. caused the Fed to lower the Fed Funds rate on three occasions during 2019. With a slightly weaker outlook for GDP growth and inflation, the Fed is now projected to be on hold at this lower rate for an extended period of time.

Within the U.S., the outlook remains favorable on many fronts. The rate cuts in 2019 should reinvigorate investment in 2020. Additionally, the outlook is enhanced by recent compromise in America's nearly two-year trade war with China. Consumer spending is expected to remain strong in 2020 as job security, rising incomes and a growing economy are expected to have a positive impact in household attitudes, all resulting in moderately faster GDP growth by mid-year.

Because of the rapid pace of change, it is vitally important that we make appropriate investments in our Bank to meet customer demands and stay competitive.

We are focused on the future, modernizing our operations and investing in new capabilities. In 2019, we made substantial progress in areas of strategic importance. We devoted significant investments to our delivery channel strategy, including improvements to our digital capabilities and facilitating seamless customer experiences across the Bank.

We live in a fast-paced and ever-changing world and helping our customers access their Bank is an absolute necessity. As the digital transformation accelerates, we must accelerate our efforts to deliver a customer experience that is not only high-tech, but high-touch as well. Therefore, in 2019 we embarked on a strategic initiative to adopt a new suite of online and mobile banking technologies to improve our customer experience in our digital delivery channel.

Our new online banking platform serves consumer and business with online banking, mobile banking and online account opening. The new online banking platform will serve as one of two cornerstones of our digital strategy over the next several years. The cash management capabilities that the new platform offers will allow us to actively promote those services and attract commercial customers with complex needs. Our new consumer online banking product is equally robust and the mobile capabilities are excellent across the entire platform.

In March 2019, a contract was finalized for the conversion to a new core banking platform that will drive the Bank forward in a digital era. This conversion is the second cornerstone of our digital transformation. Our new core banking platform, expected to be in place in late 2020, will provide the Bank a suite of products in a hosted environment–a paradigm shift as we have historically run our applications in-house. We are investing in this new core operating platform to enhance our capabilities, operate more efficiently, grow more effectively and simplify our operations so we can provide a customer experience that is faster, safer and easier for our customers. This conversion will require the allocation of substantial financial and human resources. The core operating system decision will be the biggest driver of change in our Bank over the next couple of years and is the key to improving efficiency within our company.

With the growth of digital banking, there is an increasing awareness of the potential threat of cybercrime. We leverage technology as a defense against cybersecurity risks to ensure a continual focus to protect our customers' information, at all times, and we take that responsibility very seriously. Our cybersecurity strategy is focused on protecting the Bank from malicious cybersecurity threats. We will continue to work tirelessly to implement the necessary tools to strengthen our security controls and protect our customer relationships. New technologies have been installed to facilitate greater protection of confidential information and our cybersecurity program was strengthened in light of the ever-increasing security risk.

We will continue to invest in technologies that improve performance, reliability and safety for our customers. Going forward, our strategic focus on technology will help us meet customer expectations, future challenges in the ever-changing banking environment and capitalize on new opportunities.

Today, our products and services are no longer exclusively delivered through our branch network. Customer expectations are evolving rapidly and we must ensure our customers can bank through multiple channels whenever and wherever they choose. As digital technology transforms the banking industry, we see technology as a way to enhance (not replace) the personal and trusted relationship between our employees and customers.

It is becoming more apparent that an increasing number of consumers are interacting with our Bank through their mobile devices. Indeed, 65% of our online banking customers are now accessing their accounts through a mobile device. Approximately 47% of our consumer deposit base are utilizing mobile banking, a 27% increase over last year. At year-end we had 38,757 customers who bank online and an average of 24,755 active users per month. In addition, we have 13,454 registered mobile deposit users, an increase of 15.3% over the prior year.

Looking ahead in 2020, we will continue to leverage our digital channels strategy to transform the customer experience, enhance our products and use online marketing to help grow our business. We will be launching an innovative online and mobile account opening solution to provide a quick, intuitive process for customers to open new deposit accounts.

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.

We offer a complete suite of retail banking products and services. Following a review of our consumer checking account products, it was recognized that if we are to attract new customers to our Bank and retain the deposit balances that have grown over the past several years, we needed to refresh our product line-up. As a result, in 2019 we introduced a simplified product strategy to improve customer retention and new customer acquisition. The new consumer checking line-up is designed to encourage utilization and reward customers based on the depth of their relationship. To encourage a younger demographic, we will leverage our digital channels strategy by providing enhanced online new account opening and real-time online and mobile banking enrollment.

We continue to invest in our branch network by remodeling and rebranding branches to create a better customer experience. During 2019, we began construction of our striking new Sebastopol branch, with estimated completion by mid-2020. The branch was designed with a refreshed, open layout to provide an improved customer experience reflecting our brand and the spirit of the Sebastopol community. The design has been described as a nod to Sebastopol's agricultural past, with influences from the surrounding wine and apple industries.

At Exchange Bank, our employees are our most valuable asset and are the driving force behind our success. Developing our employees remains a key commitment for us and we must continue to focus on investing in our future leaders. We are committed to leadership development at all levels and support our employees by offering financial assistance to further their education and achieve their professional goals.

Our success is dependent on the interactions our employees have with our customers every day. We would not be able to accomplish our objectives without the effort and dedication of our employees who fully embrace a customer-centric service model and our commitment to improving the lives of people in our community.

Throughout the nearly 130 years since our founding, we have been committed to serving the communities in which we operate. 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–it's our mission and a cornerstone of our culture. We are once again very proud of our employees' commitment to the community, as demonstrated by over 4,000 volunteer hours they give each year in support of local charitable and civic organizations. Additionally, in 2019 our employees personally raised over $100,000 through a variety of fundraising activities for programs that make a difference in our communities. In 2019, we increased our philanthropic giving and awarded over $900,000 to more than 300 non-profit, charitable and civic organizations throughout Sonoma County to support fire relief efforts, charitable initiatives and local events.

Our customer focus and commitment to our community resulted in many accolades during 2019. We are proud to report that Exchange Bank was recognized as one of Sonoma County's "Best Places to Work" for the fourteenth consecutive year. We were also recognized as "Best Local Bank", "Best Business and Consumer Bank" and one of Sonoma County's "Healthiest Places to Work". In 2019 we were also a recipient of a "Community Philanthropy Award". These honors are a reflection of the company values that have been instilled in our Bank by our original founders in 1890.

As we look ahead, we believe the fundamental elements of our core business are solid and we are well positioned for growth in 2020 and beyond. We are confident that we will continue to develop our strategy of building the business for the long-term. We are excited by the challenges and opportunities before us and are confident in our ability to meet them.

We would like to thank our leadership team and all of our 430 employees for their continued hard work and commitment to providing excellent service to our customers every day while continuing to drive long-term value for you, our shareholders.

We would especially like to thank Dante (Dan) Benedetti and Carlos Tamayo for their years of dedicated and valued service to Exchange Bank, as they retired from our board at year-end. Dante (Dan) Benedetti, past president and chairman of the board of Clover Stornetta Farms and current chairman emeritus of Clover Sonoma, served for 18 years as a board member–11 of which he also served as a trustee of the Frank P. Doyle Trust. Carlos Tamayo, chairman of the board of La Tortilla Factory, served as a board member for 15 years. The leadership and service of these men had a lasting and positive impact on our Bank. We are grateful for the many years they invested in Exchange Bank.

We are grateful to you, our shareholders, as well as our valued customers and our devoted employees for the continued support over the past year. We would also like to thank our Board of Directors for their ongoing service and valued counsel.

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 2020.

We would like to invite you to our Annual Shareholders' Meeting on Friday, March 20, 2020 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

# NOTICE OF ANNUAL SHAREHOLDERS MEETING
# TO BE HELD MARCH 20, 2020

February 28, 2020

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 20, 2020** at **2:00 p.m.** At the meeting, we will review our operating results for 2019 and attend to formal matters as follows:

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

    - James M. Ryan
    - Marlene K. Soiland
    - 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 21, 2020 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 2019 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.

**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 Community Reinvestment Act, 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 and Compensation Committees. 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 and Santa Rosa Memorial Hospital.

**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.

# EXCHANGE BANK AND SUBSIDIARIES
Santa Rosa, California

# CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2019 and 2018

EXCHANGE BANK AND SUBSIDIARIES
Santa Rosa, California

FINANCIAL STATEMENTS
December 31, 2019 and 2018

CONTENTS

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, 2019 and 2018, 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, 2019 and 2018, 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, 2019 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 19, 2020 expressed an unmodified opinion.

Crowe LLP

Crowe LLP

Sacramento, California
February 19, 2020

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2019 and 2018
(In thousands, except share and par value amounts)

| | 2019 | 2018 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $ 204,716 | $ 152,890 |
| Short-term investments | 239 | 234 |
| Total cash and cash equivalents | 204,955 | 153,124 |
| Interest-bearing deposits in other financial institutions | 60,000 | 44,000 |
| Available-for-sale investment securities | 718,055 | 844,905 |
| Loans and leases | 1,581,269 | 1,514,404 |
| Less allowance for loan and lease losses | (39,907) | (39,854) |
| Net loans and leases | 1,541,362 | 1,474,550 |
| Federal Home Loan Bank stock | 13,483 | 11,303 |
| Bank premises and equipment, net | 18,335 | 17,591 |
| Bank owned life insurance | 51,666 | 47,530 |
| Other real estate owned | 40 | 1,022 |
| Accrued interest receivable and other assets | 65,222 | 59,935 |
| Total assets | $ 2,673,118 | $ 2,653,960 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Deposits: | | |
| Non-interest bearing | $ 867,878 | $ 886,864 |
| Interest bearing | 1,487,126 | 1,492,819 |
| Total deposits | 2,355,004 | 2,379,683 |
| Accrued interest payable and other liabilities | 47,299 | 42,705 |
| Total liabilities | 2,402,303 | 2,422,388 |
| 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 | 222,645 | 193,687 |
| Accumulated other comprehensive loss, net of taxes | (2,142) | (12,427) |
| Total stockholders' equity | 270,815 | 231,572 |
| Total liabilities and stockholders' equity | $ 2,673,118 | $ 2,653,960 |

See accompanying notes to consolidated financial statements

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2019 and 2018
(In thousands, except per share amounts)

| | 2019 | 2018 |
|---|---|---|
| Interest income: | | |
| Interest and fees on loans and leases | $ 78,845 | $ 74,634 |
| Interest on investment securities: | | |
| Taxable | 21,015 | 19,402 |
| Exempt from Federal income taxes | 1,729 | 1,920 |
| Total interest income | 101,589 | 95,956 |
| Interest expense: | | |
| Interest on deposits | 4,679 | 2,627 |
| Total interest expense | 4,679 | 2,627 |
| Net interest income before provision for loan and lease losses | 96,910 | 93,329 |
| Provision for loan and lease losses | - | - |
| Net interest income after provision for loan and lease losses | 96,910 | 93,329 |
| Non-interest income: | | |
| Service charges and fees | 5,076 | 4,845 |
| Trust income | 8,633 | 7,330 |
| Merchant discount and interchange fees | 4,642 | 4,413 |
| Income from bank owned life insurance | 1,740 | 1,639 |
| (Loss) gain on sale of assets | (86) | 3,251 |
| Other income | 4,226 | 4,293 |
| Total non-interest income | 24,231 | 25,771 |
| Non-interest expense: | | |
| Salaries and employee benefits | 39,061 | 36,086 |
| Occupancy and equipment | 7,664 | 7,663 |
| Professional fees | 8,177 | 7,440 |
| FDIC assessments | 450 | 840 |
| Other expenses | 14,986 | 13,576 |
| Total non-interest expense | 70,338 | 65,605 |
| Income before provision for income taxes | 50,803 | 53,495 |
| Provision for income taxes | 14,302 | 14,984 |
| Net income | $ 36,501 | $ 38,511 |
| Basic and diluted earnings per common share | $ 21.29 | $ 22.46 |

See accompanying notes to consolidated financial statements.

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31, 2019 and 2018
(In thousands)

| | 2019 | 2018 |
|---|---|---|
| Net Income | $ 36,501 | $ 38,511 |
| Other comprehensive income: | | |
| Unrealized gains/losses on securities: | | |
| Unrealized holding gains (losses) arising during the period | 12,708 | (2,483) |
| Tax effect | (3,757) | 735 |
| Changes in unrealized (loss) gain on available-for-sale investment securities, net of tax | 8,951 | (1,748) |
| Defined benefit pension plans: | | |
| Net gains (losses) arising during the period | 2,997 | (3,468) |
| Tax effect | (886) | 1,026 |
| Changes in defined benefit pension plans, net of tax | 2,111 | (2,442) |
| Change in deferred compensation trust liabilities | (1,102) | 900 |
| Tax effect | 325 | (255) |
| Changes in deferred compensation trust, net of tax | (777) | 645 |
| Other comprehensive (loss) income | 10,285 | (3,545) |
| Total Comprehensive Income | $ 46,786 | $ 34,966 |

See accompanying notes to consolidated financial statements.

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2019 and 2018
(In thousands)

| | Common Stock | Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) Income (Net of Taxes) | Total Stockholders' Equity |
|---|---|---|---|---|---|
| Balance, January 1, 2018 | $ 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 |
| Net Income | - | - | 36,501 | - | 36,501 |
| Other comprehensive income | - | - | - | 10,285 | 10,285 |
| Cash Dividends ($4.40 per share) | - | - | (7,545) | - | (7,545) |
| Balance, December 31, 2019 | $ 4,286 | $ 46,026 | $ 222,645 | $ (2,142) | $270,815 |

See accompanying notes to consolidated financial statements.

EXCHANGE BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2019 and 2018
(In thousands)

| | 2019 | 2018 |
|---|---|---|
| **Cash flows from operating activities**: | | |
| Net Income | $ 36,501 | $ 38,511 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,340 | 2,363 |
| Provision for (benefit from) deferred income taxes | (449) | 944 |
| Gain on sale of guaranteed portion of SBA loans | (1,550) | (1,856) |
| Loss (gain) on sale of other real estate owned | 86 | (3,251) |
| Loss on sale/call/OTTI on investments | - | 200 |
| Accretion of discounts and amortization of premiums on investment securities | 907 | 2,482 |
| Net change in deferred loan origination fees | (149) | 151 |
| Net loans sold or (originated) with intent to sell and sold | 5,790 | 3,442 |
| Increase in bank owned life insurance, net of expenses | (1,480) | (1,209) |
| Changes in operating assets and liabilities: | | |
| Accrued interest receivable and other assets | (673) | (8,876) |
| Accrued interest payable and other liabilities | (1,932) | 5,567 |
| Net cash provided by operating activities | 39,391 | 38,468 |
| **Cash flows from investing activities**: | | |
| (Increase) decrease in Interest-bearing deposits in other financial institutions | (16,000) | 8,000 |
| Proceeds from sale of other real estate owned | 1,665 | 3,252 |
| Proceeds from maturities of investment securities | 494,411 | 166,842 |
| Purchase of investment securities | (355,759) | (378,001) |
| Purchase of Federal Home Loan Bank (FHLB) stock | (2,180) | (1,288) |
| Net increase in loans and leases | (71,734) | (19,807) |
| Purchase of bank premises and equipment | (3,084) | (1,194) |
| Net cash provided by (used in) investing activities | 47,319 | (222,196) |
| **Cash flows from financing activities**: | | |
| Net increase in demand, interest bearing and savings deposits | (33,991) | 44,605 |
| Net decrease in time deposits | 9,312 | (8,591) |
| Purchase and redemption of bank owned life insurance | (2,655) | (880) |
| Cash paid for dividends | (7,545) | (6,599) |
| Net cash provided by (used in) financing activities | (34,879) | 28,535 |
| Increase (decrease) in cash and cash equivalents | 51,831 | (155,193) |
| Cash and cash equivalents, beginning of year | 153,124 | 308,317 |
| **Cash and cash equivalents, end of year** | $ 204,955 | $ 153,124 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest expense | $ 4,481 | $ 2,537 |
| Income taxes | $ 14,398 | $ 15,106 |
| Noncash transfers of loans to OREO | $ - | $ 982 |
| Lease liabilities arising from obtaining right of use assets | $ 5,608 | $ - |

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, 2019 and 2018, the Bank did not hold any held-to-maturity investment securities.

Premiums and discounts are amortized or accreted to the call date 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.

**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, 2019 and 2018 the balance of loans originated and unsold under the SBA program totaled $8,652 and $9,045, 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, 2019 and 2018.

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 $77,679 and $68,129 were being serviced for others at December 31, 2019 and 2018, respectively. Servicing assets at December 31, 2019 and 2018 and servicing fee income net of servicing rights amortization during the years ended December 31, 2019 and 2018 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.

**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, 2019 and 2018 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 2019 and 2018, 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 $1,094 and $1,216 for the years ended December 31, 2019 and 2018, 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.

In October of 2019 Sonoma County was impacted by the Kinkade fires which burned a substantial amount of acres and caused widespread evacuations throughout Sonoma County. 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, and evaluated any known damage to collateral and businesses. Based on our assessment, the loss to properties and business located in the affected areas that are pledged as collateral to our loans or bonds is minimal and therefore, not expected to have significant impact on the Bank.

(Continued)

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Subsequent Events: The Bank reviewed all events occurring from December 31, 2019 through February 19, 2020, 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.

Impact of New Accounting Standards:

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). The Bank adopted ASU 2016-02 effective January 1, 2019. See Note 17.

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.

The standard will be effective for fiscal years beginning after December 15, 2022, and including interim periods within those fiscal years.

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) assets 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, net of taxes, as of the beginning of the first reporting period in which the guidance is effective.

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

(Continued)

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities. In March 2017, the FASB issued Accounting Standards Update No. 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20). 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 adopted ASU-2017-08 on January 1, 2019 and the impact was not material.

(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, 2019 and 2018:

Recurring Basis

| | 2019 | | | |
|---|---|---|---|---|
| Description | Fair Value | Level 1 | Level 2 | Level 3 |
| Debt securities: | | | | |
| U.S. Government agencies | $ 267,566 | $ - | $ 267,566 | $ - |
| Obligations of states and political subdivisions | 137,959 | - | 137,959 | - |
| Government sponsored entities residential mortgage-backed securities | 242,159 | - | 242,159 | - |
| U.S. Treasuries | 64,359 | - | 64,359 | - |
| Other securities | 6,012 | - | 6,012 | - |
| Total assets measured at fair value | $ 718,055 | $ - | $ 718,055 | $ - |

(Continued)

(In thousands, except per share amounts)

**NOTE 2 – FAIR VALUE MEASUREMENTS** (Continued)

| | 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 | $ | - |

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.

| | 2019 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Fair Value | | Level 1 | | Level 2 | | Level 3 | |
| Impaired loans: | | | | | | | | |
| Real estate – commercial | $ | 2,769 | $ | - | $ | - | $ | 2,769 |
| Real estate – construction | | 1,000 | | - | | - | | 1,000 |
| Commercial | | 2,745 | | - | | - | | 2,745 |
| Lease financing | | 35 | | - | | - | | 35 |
| Consumer | | 2,014 | | - | | - | | 2,014 |
| Total assets measured at fair value on a non-recurring basis | $ | 8,563 | $ | - | $ | - | $ | 8,563 |

| | 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 |

(Continued)

**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 $ and $402 represent impairment charges recognized during the years ended December 31, 2019 and 2018, 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, 2019:

| Description | Fair Value | Valuation Technique | Significant Unobservable Input | Range (Weighted Average) |
|---|---|---|---|---|
| Real Estate Commercial | $ 2,769 | Income Approach | a. Appraiser adjustments on sales comparable data can range 5% to 10% | 0.5% to 0.75% 0.75% |
| | | Management estimates | b. Management adjustments for depreciation in values depending on property types | |
| Real Estate Construction | $ 1,000 | Discounted Cash Flow | a. Appraisers required to apply a discounted cash flow approach as sales data is limited | 1% 1% |
| | | Management estimates | b. Management adjustments for depreciation in values depending on property types | |
| Commercial | $ 2,745 | Sales Comparison | a. Appraiser adjustments on sales comparable data can range up to 18% | 0.93% to 18% 6.08% |
| | | 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 | $ 35 | Management estimate | a. Personal property collateral is discounted based on management's assessment of probability of default | 15.0% to 50% 48% |
| Consumer | $ 2,014 | Sales Comparison | a. Appraiser adjustments on sales comparable data can range up to 10% | 2.9% to 19.7% 4.28% |
| | | 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, 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%<br>0.7% |
| | | 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%<br>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%<br>1.7% |
| | | 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 | $ 172 | Management estimate | a. Personal property collateral is discounted based on management's assessment of probability of default | 15.0% to 50%<br>37.6% |
| Consumer | $ 3,378 | Sales Comparison | a. Appraiser adjustments on sales comparable data can range up to 35% | 0.75% to 35%<br>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)

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

| December 31, 2019 | Carrying Amount | Fair Value Measurements at Using: Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|---|
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 204,955 | $ 204,955 | $ - | $ - | $ 204,955 |
| Interest-bearing deposits In banks | 60,000 | 60,000 | - | - | 60,000 |
| Available-for-sale securities | 718,055 | - | 718,055 | - | 718,055 |
| FHLB stock | 13,483 | N/A | N/A | N/A | N/A |
| Loans and leases, net | 1,541,362 | - | - | 1,569,436 | 1,569,436 |
| Accrued interest receivable | 11,606 | 5,244 | 238 | 6,124 | 11,606 |
| Financial liabilities: | | | | | |
| Deposits | $ 2,355,004 | $ 2,168,114 | $ 186,180 | $ - | $ 2,354,294 |
| Accrued interest payable | 1,500 | 1,350 | 150 | - | 1,500 |

| 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 |

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.

(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, 2019 and 2018 consisted of the following:

| | 2019 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Debt securities: | | | | |
| U.S. Government agencies | $ 267,169 | $ 839 | $ (442) | $ 267,566 |
| Obligations of states and political subdivisions | 136,740 | 1,390 | (171) | 137,959 |
| Government sponsored entities residential mortgage-backed securities | 238,516 | 3,665 | (22) | 242,159 |
| U.S. Treasuries | 63,645 | 718 | (4) | 64,359 |
| Other securities | 6,000 | 23 | (11) | 6,012 |
| | $ 712,070 | $ 6,635 | $ (650) | $ 718,055 |

| | 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 |

Net unrealized gains (losses) on available-for-sale investment securities totaling $5,985 and $(6,724) were recorded, net of $(1,769) and $1,988 in deferred tax assets (liabilities), as accumulated other comprehensive income within stockholders' equity at December 31, 2019 and 2018, respectively. There were no sales of available-for-sale investments during the years ended December 31, 2019 and 2018. There were no transfers of available-for-sale investment securities for the years ended December 31, 2019 and 2018.

(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, 2019 and 2018 are summarized and classified according to the duration of the loss period as follows:

| | 2019 | | 2018 | |
|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Less than twelve months: | | | | |
| U.S. Government agencies | $ 70,393 | $ (335) | $ 37,278 | $ (205) |
| Obligations of states and political subdivisions | 25,653 | (163) | 11,360 | (121) |
| Government guaranteed mortgage backed securities | 8,380 | (9) | 64,350 | (755) |
| U.S. Treasury | 1,006 | - | 88,554 | (98) |
| Other securities | - | - | 3,601 | (199) |
| Greater than twelve months: | | | | |
| U.S. Government agencies | $ 64,962 | $ (107) | $ 213,111 | $ (3,316) |
| Obligations of states and political subdivisions | 1,814 | (8) | 93,137 | (1,068) |
| Government guaranteed mortgage backed securities | 2,941 | (13) | 64,638 | (1,522) |
| U.S. Treasury | 5,003 | (4) | 45,449 | (557) |
| Other securities | 1,989 | (11) | 1,858 | (142) |
| | $ 182,141 | $ (650) | $ 623,336 | $ (7,983) |

U.S. Treasury and U.S. Government Agencies: The Bank holds 170 securities issued by U.S. Treasury and U.S Government Agencies, of which 34 have been in a continuous loss position for less than 12 months and 32 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, 2019.

Obligations of States and Political Subdivisions: The Bank holds 296 securities issued by state and political subdivisions, of which 41 have been in a continuous loss position for less than 12 months and 10 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, 2019.

(Continued)

(In thousands, except per share amounts)

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

Government Guaranteed Mortgage Backed Securities: The Bank holds 149 Government Guaranteed Mortgage Backed Securities, of which 7 have been in a continuous loss position for less than 12 months and 5 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, 2019.

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 holds 3 corporate bonds, of which 1 has been in a continuous loss for greater that 12 months or longer. Management believes the unrealized losses on the Bank's investment in corporate bonds is caused by the fluctuation in interest rates and is not attributable to changes in credit quality. The Bank does not have the intent to sell these securities and it is likely it will not be required to sell the securities before their anticipated recovery, the Bank does not consider the remaining investments to be other-than-temporarily impaired at December 31, 2019.

Contractual Maturities: The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2019, 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 | $ 120,530 | $ 120,615 |
| After one year through five years | 197,170 | 198,859 |
| After five years through ten years | 143,465 | 143,834 |
| After ten years | 12,389 | 12,588 |
| | 473,554 | 475,896 |
| Investment securities not due at a single maturity date: | | |
| Government sponsored entities mortgage-backed securities | 238,516 | 242,159 |
| | $ 712,070 | $ 718,055 |

The only significant concentration of investment securities (greater than 10% of stockholders' equity) in any individual security issuer at December 31, 2019 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 $23,166 and $20,339 and fair values of $23,382 and $20,058 as of December 31, 2019 and 2018, 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 $1,517 in 2019 and $1,368 in 2018 and consist of the following at December 31:

| | 2019 | 2018 |
|---|---|---|
| Real estate – commercial | $ 736,224 | $ 743,777 |
| Real estate – construction | 98,118 | 57,800 |
| Commercial | 285,604 | 289,629 |
| Lease financing | 49,807 | 50,843 |
| Consumer | 411,516 | 372,355 |
| Total | 1,581,269 | 1,514,404 |
| Less: Allowance for loan and lease losses | (39,907) | (39,854) |
| | $ 1,541,362 | $ 1,474,550 |

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

| | 2019 | 2018 |
|---|---|---|
| Future lease payments receivable | $ 54,332 | $ 55,483 |
| Residual interests | 96 | 117 |
| Deferred broker costs | 1,088 | 1,146 |
| Unearned income | (5,709) | (5,903) |
| Net lease financing receivable | $ 49,807 | $ 50,843 |

Future lease payments receivable are as follows:

| Year Ending December 31, | |
|---|---|
| 2020 | $ 1,984 |
| 2021 | 6,814 |
| 2022 | 12,403 |
| 2023 | 16,704 |
| 2024 | 13,760 |
| Thereafter | 2,667 |
| | $ 54,332 |

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, 2019 and 2018 was as follows:

| | 2019 | 2018 |
|---|---|---|
| Balance, beginning of year | $ 39,854 | $ 40,323 |
| Provision for (reversal of) loan and lease losses | - | - |
| Loans charged-off | (1,946) | (1,691) |
| Recoveries | 1,999 | 1,222 |
| Balance, end of year | $ 39,907 | $ 39,854 |

The following tables show the activity of the allowance for loan and lease losses for the year ended December 31, 2019 and 2018 by portfolio segment, and the allocation of the allowance for loan and lease losses at December 31, 2019 and 2018 by portfolio segment and by impairment methodology:

| | December 31, 2019 | | | | | |
|---|---|---|---|---|---|---|
| | Real Estate – Commercial | Real Estate – Construction | Commercial | Lease Financing | Consumer | Total |
| Allowance for Credit Losses | | | | | | |
| Beginning balance | $ 16,308 | $ 9,019 | $ 11,893 | $ 201 | $ 2,433 | $ 39,854 |
| Provision for loan and lease losses | (533) | (67) | (222) | 1,111 | (289) | - |
| Loans charged-off | (104) | - | (199) | (1,117) | (526) | (1,946) |
| Recoveries | 135 | 1,393 | 259 | 96 | 116 | 1,999 |
| Ending balance allocated to portfolio segments | $ 15,806 | $ 10,345 | $ 11,731 | $ 291 | $ 1,734 | $ 39,907 |
| Ending balance: individually evaluated for impairment | $ 21 | $ 10 | $ 382 | $ 33 | $ 188 | $ 634 |
| Ending balance: collectively evaluated for impairment | $ 15,785 | $ 10,335 | $ 11,349 | $ 258 | $ 1,546 | $ 39,273 |
| Loans | | | | | | |
| Ending balance | $ 736,224 | $ 98,118 | $ 285,604 | $ 49,807 | $ 411,516 | $1,581,269 |
| Ending balance: individually evaluated for impairment | $ 2,790 | $ 1,010 | $ 3,127 | $ 68 | $ 2,202 | $ 9,197 |
| Ending balance: collectively evaluated for impairment | $ 733,434 | $ 97,108 | $ 282,477 | $ 49,739 | $ 409,314 | $1,572,072 |

(Continued)

(In thousands, except per share amounts)

**NOTE 4 – LOANS AND LEASES** (Continued)

| | 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 | $ 431 | $ 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 |

The following tables show the loan portfolio allocated by management's internal risk ratings at December 31, 2019 and 2018:

| | December 31, 2019<br>Commercial Credit Exposure<br>Credit Risk Profile by Internally Assigned Grade | | | | |
|---|---|---|---|---|---|
| | Real Estate – Commercial | Real Estate – Construction | Commercial | Lease Financing | Total |
| Grade: | | | | | |
| Pass | $ 732,302 | $ 89,627 | $ 273,447 | $ 49,576 | $ 1,144,952 |
| Special Mention | 403 | 7,481 | 3,178 | 17 | 11,079 |
| Substandard | 3,519 | 1,010 | 8,979 | 214 | 13,722 |
| Total | $ 736,224 | $ 98,118 | $ 285,604 | $ 49,807 | $ 1,169,753 |

(Continued)

(In thousands, except per share amounts)

**NOTE 4 – LOANS AND LEASES** (Continued)

| | December 31, 2019 Consumer Credit Exposure Credit Risk Profile Based on Payment Activity | |
|---|---|---|
| | Consumer | Total |
| Grade: | | |
| Performing | $ 409,571 | $ 409,571 |
| Non-performing | 1,945 | 1,945 |
| Total | $ 411,516 | $ 411,516 |

| | 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 |

| | 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 |

The following tables show an aging analysis of the loan portfolio by the time past due at December 31, 2019 and 2018:

| | December 31, 2019 | | | | | |
|---|---|---|---|---|---|---|
| | 30-89 Days Past Due | Greater Than 90 Days | Nonaccrual | Total Past Due | Current | Total Loans |
| Real estate – commercial | $ 987 | $ - | $ 188 | $ 1,175 | $ 735,049 | $ 736,224 |
| Real estate – construction | - | - | - | - | 98,118 | 98,118 |
| Commercial | 256 | - | 1,248 | 1,504 | 284,100 | 285,604 |
| Lease financing | - | - | 70 | 70 | 49,737 | 49,807 |
| Consumer | 553 | - | 1,945 | 2,498 | 409,018 | 411,516 |
| Total | $ 1,796 | $ - | $ 3,451 | $ 5,247 | $ 1,576,022 | $ 1,581,269 |

(Continued)

(In thousands, except per share amounts)

**NOTE 4 – LOANS AND LEASES** (Continued)

| | 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 |

The following tables show information related to impaired loans at and for the years ended December 31, 2019 and 2018:

| | December 31, 2019 | | | | |
|---|---|---|---|---|---|
| | 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 | $ 2,790 | $ 2,790 | $ 21 | $ 3,135 | $ 17 |
| Real estate – construction | $ 1,010 | $ 1,010 | $ 10 | $ 1,362 | $ 93 |
| Commercial | $ 3,127 | $ 3,562 | $ 382 | $ 5,962 | $ 442 |
| Lease financing | $ 68 | $ 69 | $ 33 | $ 172 | $ 7 |
| Consumer | $ 2,202 | $ 2,549 | $ 188 | $ 2,915 | $ 169 |
| Total: | | | | | |
| Real estate – commercial | $ 2,790 | $ 2,790 | $ 21 | $ 3,135 | $ 17 |
| Real estate – construction | $ 1,010 | $ 1,010 | $ 10 | $ 1,362 | $ 93 |
| Commercial | $ 3,127 | $ 3,562 | $ 382 | $ 5,962 | $ 442 |
| Lease financing | $ 68 | $ 69 | $ 33 | $ 172 | $ 7 |
| Consumer | $ 2,202 | $ 2,549 | $ 188 | $ 2,915 | $ 169 |

(Continued)

(In thousands, except per share amounts)

**NOTE 4 – LOANS AND LEASES** (Continued)

| | 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 |

Non-accrual loans totaled $3,451 and $4,305 at December 31, 2019 and 2018, respectively. Accruing loans that were past due 90 days or more totaled $0 at December 31, 2019, as compared to $17 at December 31, 2018.

Included in the impaired loans above are 30 loans in the amount of $7,472 and 36 loans in the amount of $15,213 that were considered to be troubled debt restructurings at December 31, 2019 and December 31, 2018, respectively.

For the years ended December 31, 2019 and 2018, the average recorded investment in impaired loans was $13,546 and $19,610, respectively. The Bank had $634 of specific allowance for loan and lease losses on impaired loans with a recorded investment of $9,197 at December 31, 2019 as compared to $720 of specific allowance for loan and lease losses on impaired loans with a recorded investment of $17,893 at December 31, 2018. Interest income on a cash basis was not significant. The impact of interest on non-accrual loans reflects a net loss of $330 for the year ended December 31, 2019, compared with the net recovery of $397 for the year ended December 31, 2018.

Salaries and employee benefits totaling $3,064 and $2,878 have been deferred as loan and lease origination costs for the years ended December 31, 2019 and 2018, respectively.

The Bank prospectively applied FASB ASC Topic 842 in the first quarter of 2019. The Bank originates direct financing leases, and manages and reviews lease residuals in accordance with its credit policies. Direct financing leases are generally three to five years in length and may be extended at maturity, however, early cancellation may result in a fee to the borrower. The net unearned income is deferred and amortized over the life of the lease. Income recognized for the period ending December 31, 2019 related to the implementation of FASB ASC Topic 842 was immaterial.

The Bank has allocated $634 and $720 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2019 and 2018. The Bank has commitments to lend $0 in additional amounts to customers with outstanding loans classified as troubled debt restructurings, as of December 31, 2019.

(Continued)

(In thousands, except per share amounts)

**NOTE 4 – LOANS AND LEASES** (Continued)

During the periods ending December 31, 2019 and 2018, 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.

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, 2019:

| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Troubled debt restructurings: | | | |
| Real estate – commercial | - | $ - | $ - |
| Real estate – construction | - | - | - |
| Commercial | 4 | 20 | 20 |
| Lease financing | - | - | - |
| Consumer | 3 | 20 | 16 |
| Total | 7 | $ 40 | $ 36 |

The troubled debt restructurings described above increased the allowance for loan losses by $26 and resulted in $5 in charge offs during the period ended December 31, 2019.

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, 2019:

| | Number of Loans | Recorded Investment |
|---|---|---|
| Troubled debt restructurings that subsequently defaulted: | | |
| Commercial | 1 | $ 68 |
| Consumer | 2 | 11 |
| Total | 3 | $ 79 |

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, 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 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, 2019 and 2018, the Bank owned 134,830 and 113,030 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:

| | 2019 | 2018 |
|---|---|---|
| Land | $ 3,462 | $ 3,462 |
| Buildings | 26,559 | 26,248 |
| Leasehold improvements | 6,561 | 7,064 |
| Equipment | 19,730 | 17,975 |
| Construction in progress | 1,367 | 445 |
| | 57,679 | 55,194 |
| Less: accumulated depreciation and amortization | (39,344) | (37,603) |
| | $ 18,335 | $ 17,591 |

Depreciation and amortization expense were $2,340 and $2,363 for the years ended December 31, 2019 and 2018, respectively.

**NOTE 7 – INTEREST-BEARING DEPOSITS**

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

| | 2019 | 2018 |
|---|---|---|
| Savings | $ 514,756 | $ 518,948 |
| Money market | 294,818 | 288,881 |
| NOW accounts | 491,372 | 508,122 |
| Time, $250,000 or more | 65,749 | 54,918 |
| Other time | 120,431 | 121,950 |
| | $ 1,487,126 | $ 1,492,819 |

The Bank's other time deposits included brokered deposits which totaled $1,476 or 0.1% and $1,463 or 0.1% of total deposits, respectively, at December 31, 2019 and 2018. 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, 2019 and 2018.

(In thousands, except per share amounts)

**NOTE 7 – INTEREST-BEARING DEPOSITS** (Continued)

Aggregate annual maturities of time deposits at December 31, 2019 are as follows:

| Year Ending December 31, | |
|---|---|
| 2020 | $ 146,385 |
| 2021 | 30,198 |
| 2022 | 6,145 |
| 2023 | 2,362 |
| 2024 | 1,090 |
| | $ 186,180 |

**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, 2019, the Bank has pledged investment securities with a carrying value of $41,969 and loans with a carrying value of $936,213 to secure this borrowing arrangement. There were no outstanding advances from the Federal Home Loan Bank of San Francisco at December 31, 2019 and 2018.

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, 2019 and 2018 and a $10,000 unsecured line of credit with its correspondent bank, Wells Fargo as of December 31, 2019.

**NOTE 9 – INCOME TAXES**

The expense (benefit) from income taxes for the years ended December 31, 2019 and 2018 consisted of the following:

| | Federal | State | Total |
|---|---|---|---|
| 2019 | | | |
| Current | $ 9,195 | $ 5,556 | $ 14,751 |
| Deferred | (265) | (184) | (449) |
| Provision for income taxes | $ 8,930 | $ 5,372 | $ 14,302 |
| 2018 | | | |
| Current | $ 8,592 | $ 5,448 | $ 14,040 |
| Deferred | 743 | 201 | 944 |
| Provision for income taxes | $ 9,335 | $ 5,649 | $ 14,984 |

(Continued)

(In thousands, except per share amounts)

**NOTE 9 – INCOME TAXES** (Continued)

Deferred tax assets (liabilities) are comprised of the following at December 31, 2019 and 2018:

| | 2019 | 2018 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ 11,739 | $ 11,659 |
| Deferred compensation | 5,097 | 4,080 |
| Postretirement benefits | 1,265 | 1,279 |
| Restructuring reserve | 90 | 68 |
| Nonaccrual interest | 232 | 308 |
| Bank premises and equipment | - | 223 |
| State taxes | 1,137 | 1,114 |
| SBA Deferred Gain | 402 | 324 |
| Unrealized loss on available-for-sale Investment securities | - | 1,988 |
| Amortization of trust assets | 61 | - |
| Lease liability | 2,158 | - |
| Other | 150 | 109 |
| Total deferred tax assets | 22,331 | 21,152 |
| Deferred tax liabilities: | | |
| Deferred loan costs | (888) | (877) |
| Unrealized gains on available-for-sale investment securities | (1,769) | - |
| Prepaid expenses | (141) | (205) |
| Pension expenses | (4,274) | (2,915) |
| FHLB stock dividends | (272) | (272) |
| Right of Use asset | (2,158) | - |
| Other | (391) | (414) |
| Total deferred tax liabilities | (9,893) | (4,683) |
| Net deferred tax assets | $ 12,438 | $ 16,469 |

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, | |
|---|---|---|
| | 2019 | 2018 |
| Federal income tax expense, at statutory rate | 21.0% | 21.0% |
| State franchise tax, net of Federal tax effect | 8.4 | 8.3 |
| Tax-exempt interest on obligations of states and political subdivisions | (.7) | (.8) |
| Cash surrender value of life insurance | (.7) | (.6) |
| Tax credits | (.2) | (.2) |
| Other | .4 | .3 |
| Effective tax rate | 28.2% | 28.0% |

(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 2016. The Bank is no longer subject to California income tax examinations by tax authorities for years before 2015.

The Bank recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2019 and 2018, the Bank recognized no interest or penalties.

**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 2019:

| | |
|---|---|
| Balance, January 1, 2018 | $ 18,140 |
| Disbursements | 8,511 |
| Amounts repaid | (6,243) |
| Balance, December 31, 2019 | $ 20,408 |
| Undisbursed commitments to related parties, December 31, 2019 | $ 3,579 |

(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, 2019 and 2018:

| | Unrealized Gains and Losses on Available-for-Sale Securities | Post Retirement Benefit Items | Deferred Compensation | Total |
|---|---|---|---|---|
| December 31, 2019 | | | | |
| Beginning Balance | $ (4,736) | $ (8,765) | $ 1,074 | $ (12,427) |
| Amounts reclassified from accumulated other comprehensive income | - | 251 | - | 251 |
| Net current period other comprehensive income (loss) | 8,951 | 1,860 | (777) | 10,034 |
| Ending balance | $ 4,215 | $ (6,654) | $ 297 | $ (2,142) |

| | 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 (loss) | (1,889) | (2,493) | 645 | (3,737) |
| Ending balance | $ (4,736) | $ (8,765) | $ 1,074 | $ (12,427) |

(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, 2019:

| 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 | $ - | Other expense |
| Amortization of defined benefit pension items including prior service costs and actuarial gains (losses) | 358 | Other expense |
| | (107) | Provision for income taxes |
| | $ 251 | 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, 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 taxes |
| | $ 192 | Net of tax |

(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.

| | 2019 | 2018 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $ 46,163 | $ 50,202 |
| Service cost | - | 86 |
| Interest cost | 1,978 | 1,845 |
| Benefits paid | (2,384) | (2,368) |
| Actuarial (gain) loss | 5,093 | (3,602) |
| Benefit obligation at end of year | $ 50,850 | $ 46,163 |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | $ 56,076 | $ 61,209 |
| Employer contribution | - | 50 |
| Benefits and expenses paid | (2,384) | (2,410) |
| Actual return on plan assets | 11,617 | 2,773 |
| Fair value of plan assets at end of year | $ 65,309 | $ 56,076 |
| Funded status at end of year | $ 14,459 | $ 9,913 |

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

| | 2019 | 2018 |
|---|---|---|
| Net actuarial loss | $ 8,395 | $ 11,443 |
| Prior service cost (credit) | - | - |
| | $ 8,395 | $ 11,443 |

The accumulated benefit obligation was $50,850 and $46,163 at December 31, 2019 and 2018. The Bank does not expect to contribute to the Plan in 2020.

(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, 2019 and 2018.

| 2019 | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Cash and equivalents | $ 827 | $ 827 | $ - | $ - |
| Equity securities: | | | | |
| U.S. large-cap (a) | 31,035 | 31,035 | - | - |
| U.S. small-cap (b) | 3,930 | 3,930 | - | - |
| International large-cap (c) | 7,790 | 7,790 | - | - |
| Fixed income securities: | | | | |
| U.S. Government agencies (d) | 50 | - | 50 | - |
| U.S. corporate bond funds (e) | 5,731 | 5,731 | - | - |
| U.S. Total Bond Market fund (f) | 15,946 | 15,946 | - | - |
| Total | $ 65,309 | $ 65,259 | $ 50 | $ - |

| 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 | $ - |

(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:

| | 2019 | 2018 |
|---|---|---|
| Asset category: | | |
| Equity | 66% | 62% |
| Fixed income | 33% | 37% |
| 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 2019 and 2018 net periodic benefit cost are as follows:

| | 2019 | 2018 |
|---|---|---|
| Service cost | $ - | $ 86 |
| Interest cost | 1,978 | 1,845 |
| Expected return on plan assets | (3,705) | (4,051) |
| Amortization of unrecognized prior service cost | - | - |
| Recognized prior service cost due to curtailment | - | - |
| Amortization of unrecognized actuarial loss | 229 | 79 |
| Total net periodic cost | $ (1,498) | $ (2,041) |
| | | |
| Net (gain) loss, include curtailment | $ (2,819) | $ 3,264 |
| Prior service cost | - | - |
| Amortization of prior service cost | - | - |
| Amortization of net gain (loss) | (229) | (79) |
| Total recognized in other comprehensive income | (3,048) | 3,185 |
| Total recognized in net periodic benefit cost and other comprehensive income | $ (4,546) | $ 1,144 |

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 $229 as of December 31, 2019.

(Continued)

(In thousands, except per share amounts)

**NOTE 12 – RETIREMENT PLAN** (Continued)

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

| | 2019 | 2018 |
|---|---|---|
| Discount rate | 3.40% | 4.35% |
| Rate of compensation increase | N/A | N/A |

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

| | 2019 | 2018 |
|---|---|---|
| Discount rate | 4.35% | 3.75% |
| Rate of compensation increase | N/A | N/A |
| Expected return of plan assets | 6.75% | 6.75% |

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 |
|---|---|
| 2020 | $ 2,502 |
| 2021 | $ 2,605 |
| 2022 | $ 2,696 |
| 2023 | $ 2,759 |
| 2024 | $ 2,811 |
| 2025 through 2029 | $ 14,706 |

(Continued)

(In thousands, except per share amounts)

## NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN

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

| | 2019 | 2018 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $ 4,911 | $ 5,314 |
| Service cost | (138) | 11 |
| Interest cost | 205 | 192 |
| Benefits paid | (404) | (492) |
| Plan participant contribution | 117 | 127 |
| Actuarial (gain) loss | 554 | (241) |
| Benefit obligation at end of year | $ 5,245 | $ 4,911 |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | $ 2,927 | $ 3,653 |
| Other payments | (223) | (78) |
| Plan participant contribution | 117 | 127 |
| Benefits paid | (404) | (492) |
| Employer contribution | 699 | - |
| Actual return on plan assets | 558 | (283) |
| Fair value of plan assets at end of year | $ 3,674 | $ 2,927 |
| Plan assets less benefit obligation at end of year | $ 1,571 | $ 1,984 |

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

| | 2019 | 2018 |
|---|---|---|
| Net actuarial loss | $ 1,051 | $ 1,000 |
| Prior service cost | - | - |
| | $ 1,051 | $ 1,000 |

The accumulated benefit obligation was $5,245 and $4,911 at December 31, 2019 and 2018. The Bank expects to contribute to the Plan in 2020.

| | 2019 | 2018 |
|---|---|---|
| Components of net periodic benefit cost: | | |
| Service cost | $ 85 | $ 88 |
| Interest cost | 205 | 192 |
| Expected return on plan assets | (184) | (233) |
| Loss (gain) | 129 | 59 |
| Amortization of unrecognized prior service cost | - | (65) |
| Total net periodic benefit cost | $ 235 | $ 41 |

(Continued)

(In thousands, except per share amounts)

**NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN** (Continued)

| | 2019 | 2018 |
|---|---|---|
| Net loss (gain) | $ 180 | $ 275 |
| Amortization of net (gain) loss | (129) | (59) |
| Amortization of prior service cost | - | 65 |
| Total recognized in other comprehensive income | 51 | 281 |
| Total recognized in net periodic benefit cost and other comprehensive income | $ 286 | $ 322 |

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 $29 as of December 31, 2019.

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

| | 2019 | 2018 |
|---|---|---|
| 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, 2019 and 2018.

| 2019 | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Cash | $ 111 | $ 111 | $ - | $ - |
| Equity securities: | | | | |
| U.S. large-cap (a) | 2,123 | 2,123 | - | - |
| U.S. small-cap (b) | 283 | 283 | - | - |
| International large-cap (c) | 551 | 551 | - | - |
| Fixed income securities: | | | | |
| Obligations of states and political subdivisions (d) | 606 | - | 606 | - |
| Total | $ 3,674 | $ 3,068 | $ 606 | $ - |

(Continued)

(In thousands, except per share amounts)

**NOTE 13 – POSTRETIREMENT HEALTHCARE PLAN** (Continued)

| 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 | $ - |

(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:

| | 2019 | 2018 |
|---|---|---|
| Asset category: | | |
| Equity | 81% | 79% |
| Fixed income | 16% | 15% |
| Other | 3% | 6% |
| 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 2019 and 2018. 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. Increasing or decreasing the assumed healthcare cost trend rates by 1.0% in each year would not change the accumulated postretirement benefit obligation nor would the aggregate of the service and interest components of net periodic postretirement benefit cost change.

(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:

| | 2019 | 2018 |
|---|---|---|
| Discount rate | 3.40% | 4.35% |
| 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:

| | 2019 | 2018 |
|---|---|---|
| Discount rate | 4.35% | 3.75% |
| Expected return of plan assets | 6.75% | 6.75% |
| 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, 2019, 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 |
|---|---|
| 2020 | $ 404 |
| 2021 | $ 400 |
| 2022 | $ 390 |
| 2023 | $ 382 |
| 2024 | $ 371 |
| 2025 through 2029 | $ 1,697 |

(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:

| | 2019 | 2018 |
|---|---|---|
| Commitments to extend credit | $ 421,868 | $ 429,868 |
| Standby letters of credit | 5,046 | 3,805 |
| Total loan commitments | $ 426,914 | $ 433,673 |

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, 2019 and 2018. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

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, 2019 and 2018 were $1,990 and $1,847, 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 $3,386 and $3,380 at December 31, 2019 and 2018, respectively.

(Continued)

**NOTE 14 – COMMITMENTS AND CONTINGENCIES** (Continued)

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, 2019 and 2018, the Bank had accrued $13,557 and $13,553, 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 $1,110 and $865 for the years ended December 31, 2019 and 2018, respectively. Amounts recognized in accumulated other comprehensive income as of December 31, 2019 and 2018, were not considered material.

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, 2019 and 2018, the liability for accrued deferred compensation, including interest earned, totaled $3,835 and $1,720, 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, 2019 and 2018 in the amount of $2,708 and $2,634, 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 $51,666 and $47,530 as of December 31, 2019 and 2018, 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 are subject to regulatory capital requirements administered by federal and state banking agencies. Capital adequacy guidelines and prompt corrective action regulation 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 2019 and 2018 is 2.50% and 1.875%, 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, 2019, the Bank met all capital adequacy requirements to which it was 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. As of December 31, 2019 and 2018, 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 December 31, 2019 and 2018 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 conservation buffer that is not included in this table. The capital conservation buffer adds another level of capital of 2.50% over the adequately capitalized ratios and is required to eliminate any regulatory restrictions from the Bank’s 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, 2019 | | | | | | |
| Total capital (to risk-weighted assets) | $ 296,645 | 15.79% | $ 150,324 | 8.0% | $ 187,905 | 10.0% |
| Tier 1 capital (to risk-weighted assets) | $ 272,954 | 14.53% | $ 112,743 | 6.0% | $ 150,324 | 8.0% |
| Common Tier 1 (CET I) | $ 272,954 | 14.53% | $ 84,557 | 4.5% | $ 122,138 | 6.5% |
| Tier 1 capital (to average assets) | $ 272,954 | 10.39% | $ 105,121 | 4.0% | $ 131,401 | 5.0% |
| 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% | $ 132,164 | 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 606 – *Revenue from Contracts with Customers*. 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 Bank's sources of Non-Interest Income for the twelve months ended December 31, 2019 and 2018, respectfully. Items outside the scope of ASC 606 are noted as such.

| | 2019 | 2018 |
|---|---|---|
| Non-interest Income | | |
| Service charges and fees | $ 5,076 | $ 4,845 |
| Trust income | 8,633 | 7,330 |
| Merchant discount and interchange fees | 4,642 | 4,413 |
| Income from bank owned life insurance[a] | 1,740 | 1,639 |
| (Loss) gain on sale of OREO | (86) | 3,251 |
| Other income[a] | 4,226 | 4,293 |
| Total non-interest income | $ 24,229 | $ 25,771 |

[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. A 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.

(Continued)

(In thousands, except per share amounts)

**NOTE 17 – 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. The Bank includes lease extension options in the lease term if, after considering relevant economic factors, it is reasonably certain the Bank will exercise the option. The Bank has also elected not to recognize leases with original lease terms of 12 months or less (short-term leases) on the Bank's balance sheet. At December 31, 2019, minimum commitments under these non-cancellable leases with initial or remaining terms of one year or more are as follows:

| Year Ending December 31, | |
|---|---|
| 2020 | $ 1,638 |
| 2021 | 1,267 |
| 2022 | 1,126 |
| 2023 | 1,149 |
| 2024 | 894 |
| Thereafter | 1,563 |
| Total undiscounted lease payments | 7,637 |
| Less: imputed interest | 336 |
| Net lease liabilities | $ 7,301 |

Leases are classified as operating at the lease commencement date. Lease expenses for operating leases is recognized on a straight-line basis over the lease term. Right-of-use assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term.

Rent expense under operating leases was $1,754 and $1,737 for the years ended December 31, 2019 and 2018, respectively.

As the Bank carries no debt and has not participated in the secondary markets to raise new debt, the Bank has elected to use US Treasury yields as a proxy for the incremental implicit rate of its' leases. The Bank believes that US Treasury yields are not materially different from its ability to access the market through a fully secured borrowing rate.

Right-of-use assets and lease liabilities by lease type and the associated balance sheet classifications, are as follows:

| | Balance Sheet Classification | December 31, 2019 |
|---|---|---|
| Right-of-use assets: | | |
| Operating lease | Accrued interest receivable and other assets | $ 7,301 |
| Lease liabilities: | | |
| Operating lease | Accrued interest payable and other liabilities | $ 7,301 |