Bank of Marin Bancorp
Form 10-Q
May 08, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended March 31, 2018

OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No o

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

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

Emerging growth company o

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

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

As of April 30, 2018, there were 6,983,918 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

(in thousands, except share data; unaudited)	March 31, 2018	December 31, 2017
Assets		
Cash and due from banks	$159,347	$203,545
Investment securities		
Held-to-maturity, at amortized cost	149,013	151,032
Available-for-sale, at fair value	423,882	332,467
Total investment securities	572,895	483,499
Loans, net of allowance for loan losses of $15,771 and $15,767 at March 31, 2018 and December 31, 2017, respectively	1,655,969	1,663,246
Bank premises and equipment, net	8,297	8,612
Goodwill	30,140	30,140
Core deposit intangible	6,262	6,492
Interest receivable and other assets	77,133	72,620
Total assets	$2,510,043	$2,468,154
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest bearing	$1,065,470	$1,014,103
Interest bearing		
Transaction accounts	166,117	169,195
Savings accounts	180,730	178,473
Money market accounts	628,335	626,783
Time accounts	145,942	160,116
Total deposits	2,186,594	2,148,670
Subordinated debentures	5,772	5,739
Interest payable and other liabilities	19,213	16,720
Total liabilities	2,211,579	2,171,129
Stockholders' Equity		
Preferred stock, no par value, Authorized - 5,000,000 shares, none issued	—	—
Common stock, no par value, Authorized - 15,000,000 shares; Issued and outstanding - 6,989,126 and 6,921,542 at March 31, 2018 and December 31, 2017, respectively	145,282	143,967
Retained earnings	160,556	155,544
Accumulated other comprehensive loss, net of taxes	(7,374)	(2,486)
Total stockholders' equity	298,464	297,025
Total liabilities and stockholders' equity	$2,510,043	$2,468,154

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, except per share amounts; unaudited)	Three months ended March 31, 2018	March 31, 2017
Interest income		
Interest and fees on loans	$18,887	$15,849
Interest on investment securities		
Securities of U.S. government agencies	2,475	1,518
Obligations of state and political subdivisions	638	568
Corporate debt securities and other	44	37
Interest on Federal funds sold and due from banks	403	60
Total interest income	22,447	18,032
Interest expense		
Interest on interest-bearing transaction accounts	52	29
Interest on savings accounts	18	15
Interest on money market accounts	216	113
Interest on time accounts	156	146
Interest on subordinated debentures	114	108
Total interest expense	556	411
Net interest income	21,891	17,621
Provision for loan losses	—	—
Net interest income after provision for loan losses	21,891	17,621
Non-interest income		
Service charges on deposit accounts	477	452
Wealth Management and Trust Services	515	503
Debit card interchange fees	396	372
Merchant interchange fees	80	96
Earnings on bank-owned life insurance	228	209
Dividends on FHLB stock	196	232
Other income	350	251
Total non-interest income	2,242	2,115
Non-interest expense		
Salaries and related benefits	9,017	7,475
Occupancy and equipment	1,507	1,319
Depreciation and amortization	547	481
Federal Deposit Insurance Corporation insurance	191	161
Data processing	1,381	939
Professional services	1,299	522
Directors' expense	174	158
Information technology	269	198
Provision for losses on off-balance sheet commitments	—	165
Other expense	1,696	1,593
Total non-interest expense	16,081	13,011
Income before provision for income taxes	8,052	6,725
Provision for income taxes	1,663	2,177
Net income	$6,389	$4,548
Net income per common share:		

Basic	$0.92	$0.75
Diluted	$0.91	$0.74
Weighted average shares:		
Basic	6,914	6,092
Diluted	7,006	6,172
Dividends declared per common share	$0.29	$0.27
Comprehensive income:		
Net income	$6,389	$4,548
Other comprehensive (loss) income		
Change in net unrealized gain or loss on available-for-sale securities	(6,170)	4,710
Net unrealized loss on securities transferred from available-for-sale to held-to-maturity	—	(3,036)
Amortization of net unrealized losses on securities transferred from available-for-sale to held-to-maturity	136	41
Subtotal	(6,034)	1,715
Deferred tax (benefit) expense	(1,784)	704
Other comprehensive (loss) income, net of tax	(4,250)	1,011
Comprehensive income	$2,139	$5,559

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
for the year ended December 31, 2017 and the three months ended March 31, 2018

(in thousands, except share data; unaudited)	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Loss ("AOCI"), Net of Taxes	Total
Balance at December 31, 2016	6,127,314	$87,392	$146,464	$ (3,293)	$230,563
Net income	—	—	15,976	—	15,976
Other comprehensive income	—	—	—	807	807
Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings	9,266	28	—	—	28
Stock issued under employee stock purchase plan	512	32	—	—	32
Stock issued under employee stock ownership plan ("ESOP")	29,547	1,850	—	—	1,850
Restricted stock granted	16,230	—	—	—	—
Restricted stock forfeited / cancelled	—	—	—	—	—
Stock-based compensation - stock options	—	529	—	—	529
Stock-based compensation - restricted stock	—	742	—	—	742
Cash dividends paid on common stock	—	—	(6,896)	—	(6,896)
Stock purchased by directors under director stock plan	531	35	—	—	35
Stock issued in payment of director fees	2,878	188	—	—	188
Stock and stock options issued to Bank of Napa shareholders (net of payment for fractional shares of $14 thousand)	735,264	53,171	—	—	53,171
Balance at December 31, 2017	6,921,542	$143,967	$155,544	$ (2,486)	$297,025
Net income			6,389		6,389
Other comprehensive loss				(4,250)	(4,250)
Reclassification of stranded tax effects in AOCI			638	(638)	—
Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings	47,787	453			453
Stock issued under employee stock purchase plan	152	10			10
Restricted stock granted	18,520				—
Restricted stock surrendered for tax withholdings upon vesting	(401)	(28)			(28)
Restricted stock forfeited / cancelled	(4,077)				—
Stock-based compensation - stock options		316			316
Stock-based compensation - restricted stock		455			455
Cash dividends paid on common stock			(2,015)		(2,015)
Stock purchased by directors under director stock plan	260	18			18
Stock issued in payment of director fees	1,343	91			91
Balance at March 31, 2018	6,985,126	145,282	160,556	(7,374)	298,464

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the three months ended March 31, 2018 and 2017

(in thousands; unaudited)	March 31, 2018	March 31, 2017
Cash Flows from Operating Activities:		
Net income	$6,389	$4,548
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for losses on off-balance sheet commitments	—	165
Noncash director compensation expense - common stock	67	73
Stock-based compensation expense	771	378
Amortization of core deposit intangible	230	118
Amortization of investment security premiums, net of accretion of discounts	762	762
Accretion of discount on acquired loans	(211)	(240)
Accretion of discount on subordinated debentures	33	42
Net change in deferred loan origination costs/fees	(110)	75
Gain on sales of other real estate owned	—	(1)
Depreciation and amortization	547	481
Earnings on bank-owned life insurance policies	(228)	(209)
Net change in operating assets and liabilities:		
Deferred rent and other rent-related expenses	(86)	145
Interest receivable and other assets	(2,339)	1,305
Interest payable and other liabilities	3,374	(674)
Total adjustments	2,810	2,420
Net cash provided by operating activities	9,199	6,968
Cash Flows from Investing Activities:		
Purchase of held-to-maturity securities	(1,989)	(2,991)
Purchase of available-for-sale securities	(109,693)	(5,590)
Proceeds from paydowns/maturities of held-to-maturity securities	3,917	4,001
Proceeds from paydowns/maturities of available-for-sale securities	11,572	8,594
Loans originated and principal collected, net	7,022	8,875
Purchase of premises and equipment	(232)	(297)
Proceeds from sale of other real estate owned or repossessed assets	—	170
Cash paid for low-income housing tax credit investment	(356)	(345)
Net cash (used in) provided by investing activities	(89,759)	12,417
Cash Flows from Financing Activities:		
Net increase in deposits	37,924	6,569
Proceeds from stock options exercised	504	88
Payment of tax withholdings for stock options exercised and vesting of restricted stock	(79)	(60)
Proceeds from stock issued under employee and director stock purchase plans	28	31
Cash dividends paid on common stock	(2,015)	(1,655)
Net cash provided by financing activities	36,362	4,973
Net (decrease) increase in cash and cash equivalents	(44,198)	24,358
Cash and cash equivalents at beginning of period	203,545	48,804
Cash and cash equivalents at end of period	$159,347	$73,162
Supplemental disclosure of cash flow information:		
Cash paid in interest	$543	$373
Supplemental disclosure of noncash investing and financing activities:		
Change in net unrealized gain or loss on available-for-sale securities	$(6,034)	$1,674

Securities transferred from available-for-sale to held-to-maturity	$—	$128,965
Amortization of net unrealized loss on available-for-sale securities transferred to held-to-maturity	$136	$41
Subscription in low income housing tax credit investment	$(3,000)	$—
Stock issued in payment of director fees	$91	$82

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1: Basis of Presentation

The consolidated financial statements include the accounts of Bank of Marin Bancorp (“Bancorp”), a bank holding company, and its wholly-owned bank subsidiary, Bank of Marin (the “Bank”), a California state-chartered commercial bank. References to “we,” “our,” “us” mean Bancorp and the Bank that are consolidated for financial reporting purposes. The accompanying unaudited consolidated interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to those rules and regulations. Although we believe that the disclosures are adequate and the information presented is not misleading, we suggest that these interim financial statements be read in conjunction with the annual financial statements and the notes thereto included in our 2017 Annual Report on Form 10-K. In the opinion of Management, the unaudited consolidated financial statements reflect all adjustments, which are necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in stockholders’ equity, and cash flows for the periods presented. All material intercompany transactions have been eliminated. The results of these interim periods may not be indicative of the results for the full year or for any other period.

The NorCal Community Bancorp Trusts I and II, respectively (the "Trusts") were formed for the sole purpose of issuing trust preferred securities. Bancorp is not considered the primary beneficiary of the Trusts (variable interest entities), therefore the Trusts are not consolidated in our consolidated financial statements, but rather the subordinated debentures are shown as a liability on our consolidated statements of condition (See Note 6, Borrowings). Bancorp's investment in the securities of the Trusts is accounted for under the equity method and is included in interest receivable and other assets on the consolidated statements of condition.

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

(in thousands, except per share data)	Three months ended March 31, 2018	March 31, 2017
Weighted average basic shares outstanding	6,914	6,092
Potentially dilutive common shares related to:		
Stock options	75	62
Unvested restricted stock awards	17	18
Weighted average diluted shares outstanding	7,006	6,172
Net income	$6,389	$ 4,548
Basic EPS	$0.92	$ 0.75

Diluted EPS	$0.91	$ 0.74
Weighted average anti-dilutive shares not included in the calculation of diluted EPS	32	13

Note 2: Recently Adopted and Issued Accounting Standards

Accounting Standards Adopted in 2018

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

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

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

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

- Debit card interchange fees - We issue debit cards to our consumer and small business customers that allow them to purchase goods and services from merchants in person, online, or via mobile devices using funds held in their demand deposit accounts held with us. Debit cards issued to our customers are part of global electronic payment networks (such as Visa) who pass a portion of the merchant interchange fees to debit card-issuing member banks like us when our customers make purchases through their networks. Performance obligations for debit card services are satisfied, and revenue is recognized, daily as transactions are processed by the payment networks. Because we act in an agent capacity, we determined that network costs previously recorded as a component of non-interest expense should be netted with interchange fees recorded in non-interest income starting in the second quarter of 2018. Network costs were immaterial for the three months ended March 31, 2018 and 2017.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this ASU make improvements to accounting standards related to financial instruments, including the following:

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

We adopted the requirements of this ASU effective January 1, 2018, which did not have a material impact on our financial condition and results of operations. The fair value of our loans held for investment, which is recorded at amortized cost, now incorporates the exit price notion reflecting factors such as a liquidity premium. See Note 3, Fair Value of Assets and Liabilities.

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

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

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

In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This amendment helps organizations address certain stranded income tax effects in accumulated other comprehensive income (AOCI) resulting from the enactment of the Tax Cuts and Jobs Act of 2017. The ASU requires financial statement preparers to disclose a description of the accounting policy for releasing income tax effects from AOCI, whether or not they elect to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act of 2017, and information about the other income tax effects that are reclassified. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The amendments in this ASU should be applied in either the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate tax rate in the Tax Cuts and Jobs Act of 2017 is recognized. We early adopted this ASU in the first quarter of 2018. See Note 7, Stockholders' Equity.

Accounting Standards Not Yet Effective

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The amendments in this ASU intend to increase transparency and comparability among organizations by recognizing an asset, which represents the right to use the asset for the lease term, and a lease liability, which is a lessee's obligation to make lease payments measured on a discounted basis. This ASU generally applies to leasing arrangements exceeding a twelve month term. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective method of adoption. Early application of the amendments is permitted. We intend to adopt this ASU during the first quarter of 2019, as required. We are continuing to evaluate our lease agreements and potential accounting software solutions as they become available. As of March 31, 2018, our undiscounted operating lease obligations that were off-balance sheet totaled $17.7 million (See Note 8, Commitments and Contingencies). Upon adoption of this ASU, the present values of leases currently classified as operating leases will be recognized as lease assets and liabilities on our consolidated balance sheets. Additional disclosures of key information about our leasing arrangements will also be required. We do not expect that the ASU will have a material impact on our capital ratios or return on average assets when adopted and we are currently evaluating the effect that the ASU will have on other components of our financial condition and results of operations.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Under the new guidance, entities will be required to measure expected credit losses by utilizing forward-looking information to assess an entity's allowance for credit losses. The measurement of expected credit losses will be based on historical experience, current conditions and reasonable and supportable forecasts that affect the collectability of a credit over its remaining life. In addition, the ASU amends the accounting for potential credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We have formed an internal Current Expected Credit Loss ("CECL") committee and are working with our third party vendor to determine the appropriate methodologies and resources to utilize in preparation for transition to the new accounting standards.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This amendment changes both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. It is intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting, and increase transparency as to the scope and results of hedging programs. The ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amended presentation and disclosure guidance will be required prospectively. We expect this amendment to affect the presentation of our hedging activities, but we do not expect it to have a material impact on our financial condition or results of operations.

Note 3: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

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

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

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

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

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

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

(in thousands) Description of Financial Instruments	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Measurement Categories: Changes in Fair Value Recorded In[1]
March 31, 2018					
Securities available-for-sale:					
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies	$262,666	$ —	$262,666	$ —	OCI
SBA-backed securities	33,538	—	33,373	165	OCI
Debentures of government sponsored agencies	27,336	—	27,336	—	OCI
Privately-issued collateralized mortgage obligations	1,390	—	1,390	—	OCI
Obligations of state and political subdivisions	93,414	—	93,414	—	OCI
Corporate bonds	5,538	—	5,538	—	OCI
Derivative financial assets (interest rate contracts)	239	—	239	—	NI
Derivative financial liabilities (interest rate contracts)	376	—	376	—	NI
December 31, 2017					

Securities available-for-sale:					
Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies	$ 188,061	$ —	$ 188,061	$ —	OCI
SBA-backed securities	25,982		25,817	165	OCI
Debentures of government sponsored agencies	12,938	—	12,938	—	OCI
Privately-issued collateralized mortgage obligations	1,431	—	1,431	—	OCI
Obligations of state and political subdivisions	97,491	—	97,491	—	OCI
Corporate bonds	6,564	—	6,564	—	OCI
Derivative financial assets (interest rate contracts)	74	—	74	—	NI
Derivative financial liabilities (interest rate contracts)	740	—	740	—	NI

[1] Other comprehensive income ("OCI") or net income ("NI").

Securities available-for-sale are recorded at fair value on a recurring basis. When available, quoted market prices (Level 1) are used to determine the fair value of securities available-for-sale. If quoted market prices are not available, we obtain pricing information from a reputable third-party service provider, who may utilize valuation techniques that use current market-based or independently sourced parameters, such as bid/ask prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, probability of default, loss severity and credit spreads (Level 2). Level 2 securities include obligations of state and political subdivisions, U.S. agencies or government-sponsored agencies' debt securities, mortgage-backed securities, government agency-issued, privately-issued collateralized mortgage obligations, and corporate bonds. As of March 31, 2018 and December 31, 2017, there were no securities that were considered Level 1 securities. As of March 31, 2018, we had one available-for-sale security that was considered a Level 3 security. The security is a U.S. government agency obligation collateralized by a small number of business equipment loans guaranteed by the Small Business Administration ("SBA") program. The security is not actively traded and is owned only by a few investors. The significant unobservable data that is reflected in the fair value measurement include dealer quotes, projected prepayment speeds/average life and credit information, among other things. The unrealized loss on this SBA-guaranteed security recorded as part of other comprehensive income remained at $2 thousand at both March 31, 2018 and December 31, 2017.

Securities held-to-maturity may be written down to fair value (determined using the same techniques discussed above for securities available-for-sale) as a result of other-than-temporary impairment, and we did not record any write-downs during the quarter ended March 31, 2018 or year ended December 31, 2017.

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

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets, such as impaired loans that are collateral dependent and other real estate owned ("OREO"). As of March 31, 2018 and December 31, 2017, we do not carry any assets measured at fair value on a non-recurring basis.

Disclosures about Fair Value of Financial Instruments

The following table summarizes fair value estimates for financial instruments as of March 31, 2018 and December 31, 2017, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note). The carrying amounts in the following table are recorded in the consolidated statements of condition under the indicated captions. Further, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements such as bank-owned life insurance policies ("BOLI") and non-maturity deposit liabilities. Additionally, we hold shares of FHLB stock and Visa Inc. Class B common stock at cost. These shares are restricted from resale, except among member banks, and their values are discussed in Note 4, Investment Securities.

(in thousands)	March 31, 2018 Carrying Amounts	Fair Value	Fair Value Hierarchy	December 31, 2017 Carrying Amounts	Fair Value	Fair Value Hierarchy
Financial assets (recorded at amortized cost)						
Cash and cash equivalents	$159,347	$159,347	Level 1	$203,545	$203,545	Level 1
Investment securities held-to-maturity	149,013	145,818	Level 2	151,032	151,032	Level 2
Loans, net	1,655,969	1,622,552	Level 3	1,663,246	1,650,198	Level 3
Interest receivable	7,087	7,087	Level 2	7,501	7,501	Level 2
Financial liabilities (recorded at amortized cost)						
Time deposits	145,942	145,212	Level 2	160,116	159,540	Level 2
Subordinated debentures	5,772	6,820	Level 3	5,739	5,118	Level 3
Interest payable	172	172	Level 2	191	191	Level 2

Commitments - The value of unrecognized financial instruments is estimated based on the fee income associated with the commitments which, in the absence of credit exposure, is considered to approximate their settlement value. The fair value of commitment fees was not material at March 31, 2018 and December 31, 2017.

Note 4: Investment Securities

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

	March 31, 2018				December 31, 2017			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
(in thousands)	Cost	Value	Gains	(Losses)	Cost	Value	Gains	(Losses)
Held-to-maturity:								
Obligations of state and political subdivisions	$19,599	$19,857	$278	$(20)	$19,646	$19,998	$383	$(31)
MBS pass-through securities issued by FHLMC and FNMA	97,222	94,735	12	(2,499)	100,376	100,096	234	(514)
CMOs issued by FHLMC	32,192	31,226	1	(967)	31,010	30,938	2	(74)
Total held-to-maturity	149,013	145,818	291	(3,486)	151,032	151,032	619	(619)
Available-for-sale:								
Securities of U.S. government agencies:								
MBS pass-through securities issued by FHLMC and FNMA	93,915	92,029	22	(1,908)	65,559	65,262	126	(423)
SBA-backed securities	33,809	33,538	8	(279)	25,979	25,982	58	(55)
CMOs issued by FNMA	34,210	33,613	9	(606)	35,340	35,125	33	(248)
CMOs issued by FHLMC	123,007	120,374	60	(2,693)	70,514	69,889	3	(628)
CMOs issued by GNMA	17,173	16,650	5	(528)	17,953	17,785	26	(194)
Debentures of government- sponsored agencies	27,446	27,336	6	(116)	12,940	12,938	3	(5)
Privately issued CMOs	1,389	1,390	3	(2)	1,432	1,431	1	(2)

Obligations of state and political subdivisions	95,395	93,414	99	(2,080)	98,027	97,491	298	(834)
Corporate bonds	5,527	5,538	27	(16)	6,541	6,564	26	(3)
Total available-for-sale	431,871	423,882	239	(8,228)	334,285	332,467	574	(2,392)
Total investment securities	$580,884	$569,700	$530	$(11,714)	$485,317	$483,499	$1,193	$(3,011)

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

	March 31, 2018				December 31, 2017			
	Held-to-Maturity		Available-for-Sale		Held-to-Maturity		Available-for-Sale	
(in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	$3,230	$3,256	$10,291	$10,281	$2,151	$2,172	$10,268	$10,272
After one but within five years	14,458	14,599	77,606	76,619	15,577	15,791	71,576	71,237
After five years through ten years	53,048	51,589	225,526	220,904	54,641	54,554	129,723	128,954
After ten years	78,277	76,374	118,448	116,078	78,663	78,515	122,718	122,004
Total	$149,013	$145,818	$431,871	$423,882	$151,032	$151,032	$334,285	$332,467

Pledged investment securities are shown in the following table:

(in thousands)	March 31, 2018	December 31, 2017
Pledged to the State of California:		
Secure public deposits in compliance with the Local Agency Security Program	$102,738	$107,829
Collateral for trust deposits	754	761
Total investment securities pledged to the State of California	$103,492	$108,590
Collateral for Wealth Management and Trust Services ("WMTS") checking account	$2,018	$2,026

As part of our ongoing review of our investment securities portfolio, we reassessed the classification of certain MBS pass-through and CMOs securities issued by FHLMC and FNMA. During 2017, we transferred $129 million of these securities, which we intend and have the ability to hold to maturity, from available-for-sale securities to held-to-maturity at fair value. The net unrealized pre-tax loss of $3.0 million at the date of transfer remained in accumulated other comprehensive income and are amortized over the remaining lives of the securities. Amortization of the net unrealized pre-tax losses totaled $136 thousand and $41 thousand in the first quarter of 2018 and 2017, respectively.

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

We have evaluated the credit of our investment securities and their issuers and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired as of March 31, 2018. We do not have the intent and it is more likely than not that we will not have to sell the remaining securities temporarily impaired at March 31, 2018 before recovery of the amortized cost basis.

There were 258 and 198 investment securities in unrealized loss positions at March 31, 2018 and December 31, 2017, respectively. Those securities are summarized and classified according to the duration of the loss period in the following tables:

March 31, 2018	< 12 continuous months		≥ 12 continuous months		Total securities in a loss position	
(in thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity:						
Obligations of state and political subdivisions	$3,636	$(20)	$—	$—	$3,636	$(20)
MBS pass-through securities issued by FHLMC and FNMA	22,570	(611)	69,808	(1,888)	92,378	(2,499)
CMOs issued by FHLMC	16,571	(445)	12,667	(522)	29,238	(967)
Total held-to-maturity	42,777	(1,076)	82,475	(2,410)	125,252	(3,486)
Available-for-sale:						
MBS pass-through securities issued by FHLMC and FNMA	71,449	(1,314)	18,895	(594)	90,344	(1,908)
SBA-backed securities	24,816	(277)	165	(2)	24,981	(279)
CMOs issued by FNMA	28,289	(473)	5,061	(133)	33,350	(606)
CMOs issued by FHLMC	107,801	(2,693)	—	—	107,801	(2,693)
CMOs issued by GNMA	15,955	(528)	—	—	15,955	(528)
Debentures of government- sponsored agencies	12,330	(116)	—	—	12,330	(116)
Privately issued CMOs	862	(2)	—	—	862	(2)
Obligations of state and political subdivisions	63,831	(920)	18,880	(1,160)	82,711	(2,080)
Corporate bonds	4,032	(16)	—	—	4,032	(16)
Total available-for-sale	329,365	(6,339)	43,001	(1,889)	372,366	(8,228)
Total temporarily impaired securities	$372,142	$(7,415)	$125,476	$(4,299)	$497,618	$(11,714)

December 31, 2017	< 12 continuous months		≥ 12 continuous months		Total securities in a loss position	
(in thousands)	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
Held-to-maturity:						
Obligations of state and political subdivisions	$3,648	$(31)	$—	$—	$3,648	$(31)
MBS pass-through securities issued by FHLMC and FNMA	$16,337	$(143)	$46,845	$(371)	$63,182	$(514)
CMOs issued by FHLMC	11,066	(31)	13,824	(43)	24,890	(74)
Total held-to-maturity	31,051	(205)	60,669	(414)	91,720	(619)
Available-for-sale:						
MBS pass-through securities issued by FHLMC and FNMA	32,189	(121)	15,325	(302)	47,514	(423)
SBA-backed securities	11,028	(53)	165	(2)	11,193	(55)
CMOs issued by FNMA	26,401	(171)	5,440	(77)	31,841	(248)
CMOs issued by FHLMC	69,276	(628)	—	—	69,276	(628)
CMOs issued by GNMA	14,230	(194)	—	—	14,230	(194)
Debentures of government- sponsored agencies	2,984	(5)	—	—	2,984	(5)
Privately issued CMO's	1,310	(2)	—	—	1,310	(2)
Obligations of state and political subdivisions	52,197	(288)	19,548	(546)	71,745	(834)
Corporate bonds	3,060	(3)	—	—	3,060	(3)
Total available-for-sale	212,675	(1,465)	40,478	(927)	253,153	(2,392)
Total temporarily impaired securities	$243,726	$(1,670)	$101,147	$(1,341)	$344,873	$(3,011)

As of March 31, 2018, sixty-one investment securities in our portfolio had been in a continuous loss position for twelve months or more. They consisted of one SBA-backed security, four CMOs issued by FHLMC, three CMOs issued by FNMA, twenty-one agency MBS securities and thirty-two obligations of U.S. state and political subdivisions securities. We have evaluated the securities and believe that the decline in fair value is primarily driven by factors other than credit. It is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists on these securities. The debenture of government-sponsored agency security is supported by the U.S. Federal Government, which protects us from credit losses. Based upon our assessment of the credit fundamentals, we concluded that these securities were not other-than-temporarily impaired at March 31, 2018.

There were one hundred ninety-seven investment securities in our portfolio that had been in temporary loss positions for less than twelve months as of March 31, 2018, and their temporary loss positions mainly arose from changes in interest rates since purchase. They consisted of seven SBA-backed securities, five debentures of a U.S. government-sponsored agency, one hundred one obligations of U.S. state and political subdivisions, thirty-four MBS securities, forty-three CMOs issued by government-sponsored agencies, one privately issued CMO and six corporate bonds. Securities of government-sponsored agencies are supported by the U.S. Federal Government, which protects us from credit losses. Other temporarily impaired securities are deemed creditworthy after internal analysis of the issuers' latest financial information and credit enhancement. Additionally, all are rated as investment grade by at least one major rating agency. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at March 31, 2018.

Non-Marketable Securities

As a member of the FHLB, we are required to maintain a minimum investment in FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can increase in the event we increase our total asset size or borrowings with the FHLB. Shares cannot be purchased or sold except between the FHLB and its members at the $100 per share par value. We held $11.1 million of FHLB stock recorded at cost in other assets on the consolidated statements of condition at both March 31, 2018 and December 31, 2017. The carrying amounts of these investments are reasonable estimates of fair value because the securities are restricted to member banks and they do not have a readily determinable market value. Management does not believe that the FHLB stock is other-than-temporarily-impaired, due to FHLB's current financial condition. On April 26, 2018, FHLB announced a cash dividend to be distributed in mid-May 2018 at an annualized dividend rate of 7.00%. Cash dividends paid on FHLB capital stock are recorded as non-interest income.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock with a carrying value of zero, which is equal to our cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s Covered Litigation escrow account. As a result of the restriction, these shares are not considered available-for-sale and are not carried at fair value. When converting this Class B common stock to Class A common stock based on the conversion rate of 1.6483 and the closing stock price of Class A shares, the value of our shares of Class B common stock would have been $3.3 million and $3.2 million at March 31, 2018 and December 31, 2017, respectively. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. As such, the fair value of these Class B shares can differ significantly from their if-converted values. For further information, see Note 8, Commitments and Contingencies.

We invest in low-income housing tax credit funds as a limited partner, which totaled $5.0 million and $2.1 million recorded in other assets as of March 31, 2018 and December 31, 2017, respectively. In the first three months of 2018, we recognized $110 thousand of low-income housing tax credits and other tax benefits, net of $94 thousand of amortization expense of low-income housing tax credit investment, as a component of income tax expense. As of

March 31, 2018, our unfunded commitments for these low-income housing tax credit funds totaled $3.2 million. We did not recognize any impairment losses on these low-income housing tax credit investments during the first three months of 2018 or 2017, as the value of the future tax benefits exceeds the carrying value of the investments.

Note 5: Loans and Allowance for Loan Losses

Credit Quality of Loans

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

Loan Aging Analysis by Loan Class

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential [1]	Installment and other consumer	Total
March 31, 2018								
30-59 days past due	$ —	$ —	$ —	$ —	$ 385	$ —	$ —	$ 385
60-89 days past due	4	—	—	—	—	—	—	4
90 days or more past due	—	—	—	—	—	—	—	—
Total past due	4	—	—	—	385	—	—	389
Current	231,676	300,377	828,945	64,978	124,314	95,621	25,440	1,671,351
Total loans [3]	$ 231,680	$ 300,377	$ 828,945	$ 64,978	$ 124,699	$ 95,621	$ 25,440	$ 1,671,740
Non-accrual loans [2]	$ —	$ —	$ —	$ —	$ 392	$ —	$ —	$ 392
December 31, 2017								
30-59 days past due	$ —	$ —	$ —	$ —	$ 99	$ 255	$ 330	$ 684
60-89 days past due	1,340	—	—	—	—	—	—	1,340
90 days or more past due	—	—	—	—	307	—	—	307
Total past due	1,340	—	—	—	406	255	330	2,331
Current	234,495	300,963	822,984	63,828	132,061	95,271	27,080	1,676,682
Total loans [3]	$ 235,835	$ 300,963	$ 822,984	$ 63,828	$ 132,467	$ 95,526	$ 27,410	$ 1,679,013
Non-accrual loans [2]	$ —	$ —	$ —	$ —	$ 406	$ —	$ —	$ 406

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

[2] One purchased credit impaired ("PCI") loan with an unpaid balance of $11 thousand and no carrying value was not accreting interest at March 31, 2018. Three PCI loans with unpaid balances totaling $131 thousand and no carrying values were not accreting interest at December 31, 2017. Amounts exclude accreting PCI loans totaling $2.1 million at both March 31, 2018 and December 31, 2017 as we have a reasonable expectation about future cash flows to be collected and we continue to recognize accretable yield on these loans in interest income. There were no accruing loans past due more than ninety days at March 31, 2018 or December 31, 2017.

[3] Amounts include net deferred loan origination costs of $928 thousand and $818 thousand at March 31, 2018 and December 31, 2017, respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of $1.1 million and $1.2 million at March 31, 2018 and December 31, 2017, respectively.

We generally make commercial loans to established small and mid-sized businesses to provide financing for their growth and working capital needs, equipment purchases and acquisitions. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay obligations as agreed. Commercial loans are made based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral and guarantor support. The cash flows of borrowers, however, may not occur as expected, and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed, such as accounts receivable and inventory, and typically include a personal guarantee. We target stable businesses with guarantors who provide additional sources of repayment and have proven to be resilient in periods of economic stress.

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

We generally make construction loans to developers and builders to finance construction, renovation and occasionally land acquisitions in anticipation of near-term development. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record, and independent appraisals. Significant events can affect the construction industry, including: the inherent volatility of real estate markets and vulnerability to delays due to weather, change orders, inability to obtain construction permits, labor or material shortages, and price changes.

Estimates of construction costs and value associated with the completed project may be inaccurate. Repayment of construction loans is largely dependent on the ultimate success of the project.

Consumer loans primarily consist of home equity lines of credit, other residential loans and floating homes, along with a small number of installment loans. Our other residential loans include tenancy-in-common fractional interest loans ("TIC") located almost entirely in San Francisco County. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. Diversification among consumer loan types, coupled with relatively small loan amounts that are spread across many individual borrowers, mitigates risk.

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

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

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

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

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

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

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

Credit Risk Profile by Internally Assigned Risk Grade

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Purchased credit-impaired	Total
March 31, 2018									
Pass	$ 213,676	$ 279,899	$ 824,867	$ 62,003	$ 122,760	$ 95,621	$ 25,339	$ 1,338	$ 1,625,503
Special Mention	4,761	9,918	2,954	—	—	—	—	797	18,430
Substandard	13,191	9,366	327	2,975	1,847	—	101	—	27,807
Total loans	$ 231,628	$ 299,183	$ 828,148	$ 64,978	$ 124,607	$ 95,621	$ 25,440	$ 2,135	$ 1,671,740
December 31, 2017									
Pass	$ 214,636	$ 281,104	$ 818,570	$ 60,859	$ 130,558	$ 95,526	$ 27,287	$ 1,325	$ 1,629,865
Special Mention	9,318	9,284	1,850	—	—	—	—	790	21,242
Substandard	11,816	9,409	1,774	2,969	1,815	—	123	—	27,906
Total loans	$ 235,770	$ 299,797	$ 822,194	$ 63,828	$ 132,373	$ 95,526	$ 27,410	$ 2,115	$ 1,679,013

Troubled Debt Restructuring

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

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

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

The same Management level that approved the upgrading of the loan classification must approve the removal of TDR status. During the three months ended March 31, 2018, one TIC loan with a recorded investment of $150 thousand was removed from TDR designation after meeting all of the conditions noted above. There were no loans removed from TDR designation during 2017.

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

Recorded investment in Troubled Debt Restructurings [1]	March 31, 2018	December 31, 2017
Commercial and industrial	$ 2,267	$ 2,165
Commercial real estate, owner-occupied	7,007	6,999
Commercial real estate, investor	1,854	2,171
Construction	2,976	2,969
Home equity	347	347
Other residential	992	1,148
Installment and other consumer	712	721

Total	$16,155	$ 16,520

[1] There were no TDR loans on non-accrual status at March 31, 2018 and December 31, 2017.

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

(dollars in thousands)	Number of Contracts Modified	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment at Period End
Troubled Debt Restructurings during the three months ended March 31, 2018:				
None	—	$ —	$ —	$ —
Troubled Debt Restructurings during the three months ended March 31, 2017:				
Installment and other consumer	1	$ 50	$ 50	$ 50

The modification during the three months ended March 31, 2017 primarily involved an interest rate concession and other changes to loan terms. During the first three months of 2018 and 2017, there were no defaults on loans that had been modified in a TDR within the prior twelve-month period. We report defaulted TDRs based on a payment default definition of more than ninety days past due.

Impaired Loans

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

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
March 31, 2018								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 307	$ —	$ —	$ 2,692	$ 392	$ 992	$ 46	$4,429
With a specific allowance recorded	1,960	7,007	1,854	284	347	—	666	12,118
Total recorded investment in impaired loans	$ 2,267	$ 7,007	$ 1,854	$ 2,976	$ 739	$ 992	$ 712	$16,547
Unpaid principal balance of impaired loans	$ 2,260	$ 6,993	$ 1,847	$ 2,962	$ 736	$ 991	$ 711	$16,500
Specific allowance	35	162	48	11	6	—	92	354
Average recorded investment in impaired loans during the quarter ended March 31, 2018	2,216	7,003	2,012	2,972	746	1,070	717	16,736
Interest income recognized on impaired loans during the quarter ended March 31, 2018[1]	155	66	22	38	5	13	7	306
Average recorded investment in impaired loans during the quarter ended March 31, 2017	2,138	6,997	2,783	3,243	713	1,571	939	18,384
Interest income recognized on impaired loans during the quarter ended March 31, 2017[1]	23	66	23	34	8	19	10	183

[1] Interest income recognized on a cash basis totaled $128 thousand in the first quarter of 2018 and was related to the pay-off of two non-accrual commercial PCI loans. No interest income on impaired loans was recognized on a cash basis during the three months ended March 31, 2017.

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Total
December 31, 2017								
Recorded investment in impaired loans:								
With no specific allowance recorded	$ 309	$ —	$ —	$ 2,689	$ 406	$ 995	$ 46	$4,445
With a specific allowance recorded	1,856	6,999	2,171	280	347	153	675	12,481
Total recorded investment in impaired loans	$ 2,165	$ 6,999	$ 2,171	$ 2,969	$ 753	$ 1,148	$ 721	$16,926
Unpaid principal balance of impaired loans	$ 2,278	$ 6,993	$ 2,168	$ 2,963	$ 750	$ 1,147	$ 720	$17,019
Specific allowance	$ 50	$ 188	$ 159	$ 7	$ 6	$ 1	$ 102	$513

Management monitors delinquent loans continuously and identifies problem loans, generally loans graded Substandard or worse, loans on non-accrual status and loans modified in a TDR, to be evaluated individually for impairment.

Generally, the recorded investment in impaired loans is net of any charge-offs from estimated losses related to specifically identified impaired loans when they are deemed uncollectible. There were no charged-off amounts on impaired loans at March 31, 2018 or December 31, 2017. In addition, the recorded investment in impaired loans is net of purchase discounts or premiums on acquired loans and deferred fees and costs. At March 31, 2018 and December 31, 2017, unused commitments to extend credit on impaired loans, including performing loans to borrowers whose terms have been modified in TDRs, totaled $610 thousand and $935 thousand, respectively.

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

Allowance for Loan Losses Rollforward for the Period

(in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
Three months ended March 31, 2018									
Beginning balance	$ 3,654	$ 2,294	$ 6,475	$ 681	$ 1,031	$ 536	$ 378	$ 718	$ 15,767
Provision (reversal)	35	(214)	(20)	16	(52)	7	(27)	255	—
Charge-offs	—	—	—	—	—	—	—	—	—
Recoveries	4	—	—	—	—	—	—	—	4
Ending balance	$ 3,693	$ 2,080	$ 6,455	$ 697	$ 979	$ 543	$ 351	$ 973	$ 15,771
Three months ended March 31, 2017									
Beginning balance	$ 3,248	$ 1,753	$ 6,320	$ 781	$ 973	$ 454	$ 372	$ 1,541	$ 15,442
Provision (reversal)	1,386	239	(187)	(235)	17	(10)	(11)	(1,199)	—
Charge-offs	(284)	—	—	—	—	—	(3)	—	(287)
Recoveries	63	—	—	—	—	—	1	—	64
Ending balance	$ 4,413	$ 1,992	$ 6,133	$ 546	$ 990	$ 444	$ 359	$ 342	$ 15,219

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands)	Commercial and industrial	Commercial real estate, owner-occupied	Commercial real estate, investor	Construction	Home equity	Other residential	Installment and other consumer	Unallocated	Total
March 31, 2018									
Ending ALLL related to loans collectively evaluated for impairment	$ 3,658	$ 1,918	$ 6,407	$ 686	$ 973	$ 543	$ 259	$ 973	$ 15,417
Ending ALLL related to loans individually evaluated for impairment	35	162	48	11	6	—	92	—	354
Ending ALLL related to purchased credit-impaired loans	—	—	—	—	—	—	—	—	—
Ending balance	$ 3,693	$ 2,080	$ 6,455	$ 697	$ 979	$ 543	$ 351	$ 973	$ 15,771
Recorded Investment:									