

BankGuam Holding Co  
Form 10-Q  
August 13, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

or

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

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

Commission file number: 000-54483

BankGuam Holding Company

(Exact name of registrant as specified in its charter)

Guam 66-0770448  
(State or other jurisdiction of (IRS Employer

incorporation or organization) Identification No.)

P.O. Box BW

Hagåtña, Guam 96932

(671) 472-5300

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(Address, including Zip Code, and telephone number, including area code, of the registrant's principal executive offices)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

|                         |                           |
|-------------------------|---------------------------|
| Large accelerated filer | Accelerated filer         |
| Non-accelerated filer   | Smaller reporting company |
| Emerging growth company |                           |

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of August 13, 2018, the registrant had outstanding 9,635,055 shares of common stock.

BANKGUAM HOLDING COMPANY

FORM 10-Q

QUARTERLY REPORT

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Cautionary Note Regarding Forward-Looking Statements

For purposes of this Quarterly Report, the terms the “Company,” “we,” “us” and “our” refer to BankGuam Holding Company and its subsidiaries. This Quarterly Report on Form 10-Q contains statements that are not historical in nature, are predictive in nature, or that depend upon or refer to future events or conditions or contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. These include, among other things, statements regarding:

- Competition for loans and deposits and failure to attract or retain deposits and loans;
- Local, regional, national and global economic conditions and events, and the impact they may have on us and our customers, and our assessment of that impact on our estimates, including the allowance for loan losses and fair value measurements;
- Risks associated with concentrations in real estate related loans;
- Changes in the level of nonperforming assets and charge-offs and other credit quality measures, and their impact on the adequacy of our allowance for loan losses and our provision for loan losses;
- The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board;
- Stability of funding sources and continued availability of borrowings;
- The effect of changes in laws and regulations with which the Company and Bank of Guam must comply, including any change in Federal Deposit Insurance Corporation insurance premiums;
- Our ability to raise capital or incur debt on reasonable terms;
- Regulatory limits on Bank of Guam’s ability to pay dividends to the Company;
- The impact of the Dodd Frank Wall Street Reform and Consumer Protection Act and the implementation of its associated rules and regulations;
- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;
- Changes in the deferred tax asset valuation allowance in future quarters;
- The costs and effects of legal and regulatory developments, including resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations or reviews;
- The ability to increase market share and control expenses; and,
- Our success in managing the risks involved in the foregoing items, as well as other statements regarding our future operations, financial condition and prospects, and business strategies.

We are not able to predict all of the factors that may affect future results. Forward-looking statements may be preceded by, followed by or include the words “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “v designed to” and similar expressions. We claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 for all forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to risks, uncertainties and assumptions about our business that could affect our future results and could cause those results or other outcomes to differ materially from those expressed or implied in the forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in “Risk Factors” included in filings we make from time to time with the U.S. Securities and Exchange Commission (SEC), including our Annual Report on Form 10-K for our fiscal year ended December 31, 2017, and our Quarterly Reports on Form 10-Q filed by us in fiscal 2018. We have no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or risks, except to the extent required by applicable securities laws. If we do update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements. New information, future events or risks could cause the forward-looking statements we discuss in this Quarterly Report not to occur. You should not place undue reliance on these forward-looking statements, which reflect our opinions only as of the date of this Quarterly Report.



## PART I. FINANCIAL INFORMATION

## Item 1. Condensed Consolidated Financial Statements (Unaudited)

## BankGuam Holding Company

## Unaudited Condensed Consolidated Statements of Condition

(in Thousands, Except Par Value)

|  | June 30,<br>2018 | December 31,<br>2017 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Cash and due from banks  | \$31,522         | \$ 29,033            |
| Interest bearing deposits in banks   | 75,477           | 97,094               |
| Total cash and cash equivalents  | 106,999          | 126,127              |
| Restricted cash  | 400              | 400                  |
| Investment in unconsolidated subsidiary                                    | 3,215            | 3,167                |
| Investment securities available-for-sale, at fair value                    | 410,194          | 460,788              |
| Investment securities held-to-maturity, at amortized cost                  |                  |                      |
| (Fair Value \$78,569 at 6/30/18 and \$89,999 at 12/31/17)                  | 79,288           | 89,677               |
| Federal Home Loan Bank stock, at cost                                      | 2,356            | 2,303                |
| Loans, net of allowance for loan losses                                    |                  |                      |
| (\$18,806 at 6/30/18 and \$17,279 at 12/31/17)                             | 1,235,542        | 1,209,824            |
| Accrued interest receivable  | 5,834            | 5,728                |
| Premises and equipment, net  | 18,636           | 17,842               |
| Other assets   | 46,483           | 50,090               |
| Total assets   | \$1,908,947      | \$ 1,965,946         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                |                  |                      |
| <b>Liabilities:</b>  |                  |                      |
| <b>Deposits:</b>   |                  |                      |
| Non-interest bearing   | \$559,743        | \$ 508,149           |
| Interest bearing   | 1,187,376        | 1,307,983            |
| Total deposits   | 1,747,119        | 1,816,132            |
| Accrued interest payable   | 124              | 131                  |
| Other liabilities  | 17,542           | 11,536               |
| Total liabilities  | 1,764,785        | 1,827,799            |
| Commitments and contingencies (Note 6)                                     |                  |                      |
| <b>Stockholders' equity:</b>   |                  |                      |
| Common stock \$0.2083 par value; 48,000 shares authorized; 9,667 and 9,446 | 2,015            | 1,969                |

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shares issued and 9,635 and 9,414 shares outstanding at 6/30/18 and

12/31/17, respectively

Preferred stock \$100 par value; 300 shares authorized; 9.8 shares issued

|   |             |              |
|---|-------------|--------------|
| and outstanding                               | 980         | 980          |
| Additional paid-in capital, Common stock      | 24,105      | 21,472       |
| Additional paid-in capital, Preferred stock   | 8,803       | 8,803        |
| Retained earnings                             | 114,228     | 108,900      |
| Accumulated other comprehensive loss          | (5,679 )    | (3,687 )     |
| Common stock in treasury, at cost (32 shares) | (290 )      | (290 )       |
| Total stockholders' equity                    | 144,162     | 138,147      |
| Total liabilities and stockholders' equity    | \$1,908,947 | \$ 1,965,946 |

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



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BankGuam Holding Company

Unaudited Condensed Consolidated Statements of Income

(Dollar and Share Amounts in Thousands, Except Per Share Data)

|  | Three Months<br>Ended June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2018                           | 2017     | 2018                         | 2017     |
| <b>Interest income:</b>                              |                                |          |                              |          |
| Loans  | \$20,067                       | \$18,079 | \$39,258                     | \$35,231 |
| Investment securities                                | 2,551                          | 1,941    | 4,986                        | 3,693    |
| Deposits with banks                                  | 124                            | 248      | 372                          | 431      |
| Total interest income                                | 22,742                         | 20,268   | 44,616                       | 39,355   |
| <b>Interest expense:</b>                             |                                |          |                              |          |
| Savings deposits                                     | 510                            | 514      | 1,020                        | 1,006    |
| Time deposits  | 28                             | 38       | 59                           | 76       |
| Other borrowed funds                                 | 9                              | -        | 10                           | -        |
| Total interest expense                               | 547                            | 552      | 1,089                        | 1,082    |
| Net interest income                                  | 22,195                         | 19,716   | 43,527                       | 38,273   |
| Provision for loan losses                            | 2,099                          | 1,184    | 4,838                        | 2,367    |
| Net interest income, after provision for loan losses | 20,096                         | 18,532   | 38,689                       | 35,906   |
| <b>Non-interest income:</b>                          |                                |          |                              |          |
| Service charges and fees                             | 1,754                          | 1,452    | 3,438                        | 2,850    |
| Loss on sale of investment securities                | (362 )                         | -        | (413 )                       | (13 )    |
| Income from merchant services, net                   | 485                            | 598      | 1,177                        | 1,188    |
| Cardholders income, net                              | 171                            | 191      | 179                          | 359      |
| Trustee fees   | 879                            | 259      | 1,079                        | 455      |
| Other income   | 916                            | 678      | 1,799                        | 1,378    |
| Total non-interest income                            | 3,843                          | 3,178    | 7,259                        | 6,217    |
| <b>Non-interest expense:</b>                         |                                |          |                              |          |
| Salaries and employee benefits                       | 9,251                          | 8,555    | 18,056                       | 16,925   |
| Occupancy  | 1,815                          | 1,695    | 3,611                        | 3,251    |
| Equipment and depreciation                           | 2,543                          | 2,116    | 4,857                        | 4,138    |
| Insurance  | 423                            | 404      | 854                          | 809      |
| Telecommunications                                   | 487                            | 412      | 980                          | 849      |
| FDIC assessment                                      | 339                            | 343      | 709                          | 739      |
| Professional services                                | 946                            | 485      | 1,528                        | 937      |
| Contract services                                    | 422                            | 453      | 833                          | 957      |
| Other real estate owned                              | 21                             | 11       | 43                           | 66       |
| Stationery and supplies                              | 185                            | 223      | 379                          | 418      |
| Training and education                               | 348                            | 362      | 540                          | 668      |
| General, administrative and other                    | 2,208                          | 2,198    | 4,135                        | 4,655    |
| Total non-interest expense                           | 18,988                         | 17,257   | 36,525                       | 34,412   |
| Income before income taxes                           | 4,951                          | 4,453    | 9,423                        | 7,711    |
| Income tax expense                                   | 1,054                          | 1,184    | 1,898                        | 2,157    |
| Net income   | 3,897                          | 3,269    | 7,525                        | 5,554    |
| Preferred stock dividend                             | (136 )                         | (136 )   | (271 )                       | (276 )   |

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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Net income attributable to common stockholders | \$3,761 | \$3,133 | \$7,254 | \$5,278 |
| Earnings per common share:                     |         |         |         |         |
| Basic  | \$0.39  | \$0.34  | \$0.76  | \$0.57  |
| Diluted  | \$0.39  | \$0.34  | \$0.76  | \$0.57  |
| Dividends declared per common share            | \$0.10  | \$0.10  | \$0.20  | \$0.20  |
| Basic weighted average common shares           | 9,635   | 9,274   | 9,590   | 9,271   |
| Diluted weighted average common shares         | 9,635   | 9,274   | 9,590   | 9,271   |

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

## BankGuam Holding Company

## Unaudited Condensed Consolidated Statements of Comprehensive Income

(in Thousands)

|   | Three Months<br>Ended June 30, |         | Six Months<br>Ended June 30, |         |
|---|--------------------------------|---------|------------------------------|---------|
|   | 2018                           | 2017    | 2018                         | 2017    |
| Net income  | \$3,897                        | \$3,269 | \$7,525                      | \$5,554 |
| Other comprehensive (loss) income:                              |                                |         |                              |         |
| Unrealized holding (loss) gain on available-for-sale securities |                                |         |                              |         |
| arising during the period, net of tax                           | (599 )                         | 286     | (2,681)                      | 431     |
| Reclassification for loss realized on                           |                                |         |                              |         |
| available-for-sale securities                                   | 362                            | -       | 413                          | 13      |
| Amortization of post-transfer unrealized holding loss on        |                                |         |                              |         |
| held-to-maturity securities during the period, net of tax       | 155                            | 107     | 276                          | 215     |
| Total other comprehensive (loss) income                         | (82 )                          | 393     | (1,992)                      | 659     |
| Total comprehensive income                                      | \$3,815                        | \$3,662 | \$5,533                      | \$6,213 |

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

## BankGuam Holding Company

## Unaudited Condensed Consolidated Statements of Cash Flows

(in Thousands)

|  | Six Months Ended<br>June 30, |           |
|--|------------------------------|-----------|
|  | 2018                         | 2017      |
| <b>Cash flows from operating activities:</b>   |                              |           |
| Net income   | \$7,525                      | \$5,554   |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                              |           |
| Provision for loan losses  | 4,838                        | 2,367     |
| Depreciation   | 1,797                        | 1,642     |
| Amortization of fees, discounts and premiums   | 710                          | 663       |
| (Loss) gain on sales of other real estate owned, net                                     | (17 )                        | 18        |
| Proceeds from sales of loans held for sale   | 6,210                        | 8,473     |
| Origination of loans held for sale   | (6,210 )                     | (8,473 )  |
| Increase (decrease) in mortgage servicing rights   | 30                           | (12 )     |
| Realized loss on sale of available-for-sale securities                                   | 413                          | 13        |
| Realized gain on sale of premises and equipment  | -                            | (23 )     |
| Income from equity investment in unconsolidated subsidiary                               | (225 )                       | (46 )     |
| Dividends received from unconsolidated subsidiary  | 177                          | 115       |
| <b>Net change in operating assets and liabilities:</b>                                   |                              |           |
| Accrued interest receivable  | (106 )                       | (166 )    |
| Other assets   | 3,429                        | (6,328 )  |
| Accrued interest payable   | (7 )                         | (6 )      |
| Other liabilities  | 6,011                        | 1,337     |
| Net cash provided by operating activities  | 24,575                       | 5,128     |
| <b>Cash flows from investing activities:</b>   |                              |           |
| Purchases of available-for-sale securities   | (65,459 )                    | (59,280 ) |
| Proceeds from sales of available-for-sale securities                                     | 78,775                       | 12,896    |
| Maturities, prepayments and calls of available-for-sale securities                       | 34,078                       | 25,337    |
| Maturities, prepayments and calls of held-to-maturity securities                         | 10,473                       | 3,269     |
| Loan originations and principal collections, net   | (30,556 )                    | 11,317    |
| Costs of FHLB stock purchase   | (53 )                        | (448 )    |
| Proceeds from sales of other real estate owned   | 162                          | 322       |
| Purchases of premises and equipment  | (2,590 )                     | (1,993 )  |
| Net cash provided by (used in) investing activities                                      | 24,830                       | (8,580 )  |
| <b>Cash flows from financing activities:</b>   |                              |           |
| Net (decrease) increase in deposits  | (69,013 )                    | 40,493    |
| Proceeds from issuance of common stock   | 2,678                        | 125       |
| Dividends paid   | (2,198 )                     | (2,131 )  |
| Net cash (used in) provided by financing activities                                      | (68,533 )                    | 38,487    |
| Net change in cash, cash equivalents and restricted cash                                 | (19,128 )                    | 35,035    |
| Cash, cash equivalents and restricted cash at beginning of period                        | 126,527                      | 177,051   |
| Cash, cash equivalents and restricted cash at end of period                              | \$107,399                    | \$212,086 |

Supplemental disclosure of cash flow information:

Cash paid during the period for:

|   |            |          |
|---|------------|----------|
| Interest  | \$1,084    | \$1,087  |
| Income taxes  | \$2,202    | \$3,665  |
| Supplemental disclosure of noncash investing and financing activities:            |            |          |
| Net change in unrealized loss on held-to-maturity securities, net of tax          | \$276      | \$215    |
| Net change in unrealized (loss) gain on available-for-sale securities, net of tax | \$(2,267 ) | \$444    |
| Other real estate owned transferred from loans, net                               | \$-        | \$260    |
| Other real estate owned transferred to loans, net                                 | \$-        | \$(116 ) |

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

BankGuam Holding Company

Notes to Condensed Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

Note 1 – Nature of Business

Organization

The accompanying condensed consolidated financial statements include the accounts of BankGuam Holding Company (“Company”) and its wholly-owned subsidiaries, Bank of Guam (“Bank”) and BankGuam Investment Services (“BGIS”). The Company is a Guam corporation organized on October 29, 2010, to act as a holding company of the Bank, a Guam banking corporation, a 22-branch bank serving the communities in Guam, the Commonwealth of the Northern Mariana Islands (“CNMI”), the Federated States of Micronesia (“FSM”), the Republic of the Marshall Islands (“RMI”), the Republic of Palau (“ROP”), and San Francisco, California. BankGuam Investment Services was incorporated in Guam in 2015 and initially capitalized during the first quarter of 2016. The Company executed an agreement to purchase up to 70% of ASC Trust Corporation through 2021, including its initial 25% investment made in July 2016.

Other than holding the shares of the Bank, BGIS and ASC Trust Corporation, the Company conducts no significant activities, although it is authorized, with the prior approval of its principal regulator, the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”), to engage in a variety of activities related to the business of banking. Currently, substantially all of the Company’s operations are conducted and substantially all of the assets are owned by the Bank, which accounts for substantially all of our consolidated revenues, expenses and operating income. The Bank provides a variety of financial services to individuals, businesses and governments through its branches. The Bank’s headquarters is located in Hagåtña, Guam. The Bank currently has eleven branches in Guam, four in the CNMI, four in the FSM, one in the RMI, one in the ROP, and one in San Francisco, California. Its primary deposit products are demand deposits, savings and time certificate accounts, and its primary lending products are consumer, commercial and real estate loans.

For ease of reference we will sometimes refer to the Company as “we”, “us” or “our”.

Note 2 – Summary of Significant Accounting Policies and Recent Accounting Pronouncements

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all footnotes that would be required for a full presentation of financial condition, results of operations, changes in cash flows and comprehensive income in accordance with generally accepted accounting principles in the United States (“GAAP”). However, these interim financial statements reflect all adjustments (consisting of normal recurring adjustments and accruals) which, in the opinion of our management, are necessary for a fair presentation of our financial condition, results of operations and cash flows for the interim periods presented.

These unaudited condensed consolidated financial statements have been prepared on a basis consistent with prior periods, and should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2017, and the notes thereto, included in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission (“SEC”) under the Securities Exchange Act of 1934 on June 29, 2018.

Our condensed consolidated financial condition at June 30, 2018, and the condensed consolidated results of operations for the three and six months ended June 30, 2018, are not necessarily indicative of what our financial condition will be at December 31, 2018, or of the results of our operations that may be expected for the full year ending December 31, 2018.

#### Use of Estimates

The preparation of condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the reported amounts of income and expenses during the periods presented. Actual results could differ from those estimates.

#### Restricted Cash

Interest-bearing deposits in banks that mature within one year are carried at cost. \$150 thousand of these deposits are held jointly under the names of Bank of Guam and the Guam Insurance Commissioner, and serve as a bond for the Bank of Guam Trust Department, and \$250 thousand of these deposits are held under the Bank of Guam and are pledged for the Banker’s Loan Processing (“BLP”) program.

#### Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers”. Among other objectives, it is intended to provide more useful information to the users of financial statements by making the definition and recognition of revenue more comparable across reporting entities, industries, jurisdictions and capital markets. The Company’s revenue is primarily comprised of net interest income on financial assets less interest paid on financial liabilities, which are excluded from the scope of ASU No. 2014-09. The Company adopted ASU 2014-09 effective January 1, 2018, and it did not have a material impact on the Company’s consolidated financial position, cash flows, or results of operation. No cumulative adjustment was required upon adoption.

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities”, to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information and to address certain aspects of the recognition, measurement, presentation and disclosure of the fair value, including impairment assessments, of financial instruments. The Company has an equity investment in ASC Trust Company that is accounted for under the equity method and is excluded from the scope of ASU 2016-01. We adopted ASU 2016-01 on January 1, 2018, and its adoption did not have a significant impact on the Company’s consolidated financial statements as all of the Company’s investment securities are classified as available-for-sale and held-to-maturity debt securities.

In March 2016, the FASB issued ASU 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting”, which simplifies the principles applied to income taxes on stock compensation, including the timing of recognition, the classification of tax benefits or deficiencies on the statement of cash flows, the treatment of those taxes on the income statement, and the measurement of liability-classified awards at fair value or intrinsic value. Although this standard was adopted effective January 1, 2017, the Company has issued no stock options or phantom stock options to date; accordingly this update has had no impact on our consolidated financial position or results of operations at this time.

In November 2016, the FASB issued ASU 2016-18, “Statement of Cash Flows (Topic 230)”, which requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash. Therefore, amounts generally described as restricted cash should be included with cash and cash equivalents when reconciling the beginning-of-period- and end-of-period total amounts shown on the condensed consolidated statement of cash flows. The Company adopted ASU 2016-18 effective January 1, 2018, and it did not have a material impact on the Company’s consolidated financial position, or cash flows.

In January 2017, the FASB issued ASU 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment”, which amends ASU 2014-02 by eliminating Step 2 from the goodwill impairment test, which had required a quantitative measure of each reporting unit’s goodwill by comparing the implied fair value to the carrying amount of that goodwill. As the Company has never had to conduct a Step 2 evaluation of goodwill, this update had no effect on our consolidated financial position or results of operations at this time. Although adoption of this standard is not required of the Company until January 1, 2020, we adopted the update effective March 31, 2017.

In March 2017, the FASB issued ASU 2017-07, “Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost”. This update requires that the service cost component of the Bank’s Supplemental Executive Retirement Program (SERP) be recorded and reported separately from the other cost component(s), in the same line item as other compensation costs related to services rendered by the beneficiary employees during the reporting period. The Company currently reports both the service cost and the other cost component(s) as a portion of General, administrative and other expense, whereas this update will require that the service cost component be reported as a portion of Salaries and employee benefits. This update also requires that the details of the components of the SERP be reported for the interim periods, in addition to the annual reporting of these costs. We adopted ASU 2017-07 effective January 1, 2018, and it had no material impact on our consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, “Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting”, which clarifies the application of the guidance in Topic 718 on stock compensation in order to reduce the diversity in practice and to reduce the cost and complexity of applying the Topic to a change in the terms or conditions of a share-based payment award. Although this standard was adopted effective January 1, 2018, the Company has issued no stock options or phantom stock options to date; accordingly this update did not have an impact on our consolidated financial position or results of operation.

In February 2018, the FASB issued ASU 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220)”. This update allows a reclassification from accumulated other income to retained earnings for stranded tax effects



related to the Tax Cuts and Jobs Act of December 22, 2017, and is intended to improve the usefulness of information reported to the users of financial statements. The effective date of this update is for fiscal years beginning after December 15, 2018. Although adoption of this standard is not required of the Company until January 1, 2020, early adoption is permitted, and we reclassified \$495 thousand from other comprehensive income to retained earnings at March 31, 2018.

#### Recently Issued but Not Yet Adopted Accounting Pronouncements

In March 2017, the FASB issued ASU 2017-08, “Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities”. This update shortens the amortization period of a callable security that is held at a premium to the earliest call date of that security instead of the contractual life of the security. Although the Company does not currently hold any callable securities at a premium, we may do so in the future. Unless such securities are purchased by us, we do not believe that ASU 2017-08 will have an impact on our consolidated financial statements effective beginning January 1, 2019.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)”, a new Topic intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements on the basis that it is important that users of financial statements have a complete and understandable picture of an entity’s leasing activities. We do not believe that our current leasing activities will require complicated disclosure, but we are continuing to evaluate the impact of ASU 2016-02 on our consolidated financial statements. ASU 2016-02 will be effective beginning January 1, 2019.

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326)”, to amend the standards for the measurement of credit losses on financial instruments by replacing the historical incurred loss impairment methodology of determining the level of the allowance for loan and lease losses (“ALLL”), including losses associated with available-for-sale securities, with a more decision-useful methodology that reflects expected credit losses over the life of a financial instrument based upon historical experience, current conditions, and reasonable and supportable forecasts in determining the ALLL level, as well as the reserve for off-balance-sheet credit exposures. The Company is currently evaluating the provisions of ASU 2016-13 to determine the potential impact the new standard will have on our condensed consolidated financial statements, and has taken steps for implementation when it becomes effective beginning January 1, 2020, such as gathering pertinent data, consulting with outside professionals and evaluating its current IT systems. Management expects to recognize a one-time cumulative effect adjustment to the allowance for loan 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 Company’s financial position, results of operations or cash flows.

### Note 3 – Earnings Per Common Share

Basic earnings per common share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Potential common shares that may be issued by the Company relate to shares subscribed but not yet issued in 2018 and 2017 under the Employee Stock Purchase Plan, and are reported as dilutive options. No shares were subscribed but not issued at the end of the three and six months ended June 30, 2018 and 2017.

Earnings per common share are computed based on reported net income, preferred stock dividends and the following common share data:

|  | Three Months<br>Ended June 30, |         | Six Months<br>Ended June 30, |         |
|--|--------------------------------|---------|------------------------------|---------|
|  | 2018                           | 2017    | 2018                         | 2017    |
| Net income   | \$3,897                        | \$3,269 | \$7,525                      | \$5,554 |
| Less preferred stock dividends                                 | (136 )                         | (136 )  | (271 )                       | (276 )  |
| Net income available for common stockholders                   | 3,761                          | 3,133   | 7,254                        | 5,278   |
| Weighted average number of common shares outstanding           | 9,635                          | 9,274   | 9,590                        | 9,271   |
| Effect of dilutive options                                     | -                              | -       | -                            | -       |
| Weighted average number of common shares outstanding - used to |                                |         |                              |         |
| calculate diluted earnings per common share                    | 9,635                          | 9,274   | 9,590                        | 9,271   |
| Earnings per common share:                                     |                                |         | -                            | -       |
| Basic  | \$0.39                         | \$0.34  | \$0.76                       | \$0.57  |
| Diluted  | \$0.39                         | \$0.34  | \$0.76                       | \$0.57  |

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Note 4 – Investment Securities

The amortized cost and fair value of investment securities, with gross unrealized gains and losses, follows:

|   | June 30, 2018     |              |                    |                  |
|---|-------------------|--------------|--------------------|------------------|
|   | Gross             |              | Gross              |                  |
|   | Amortized         | Unrealized   | Unrealized         | Estimated        |
|   | Cost              | Gains        | Losses             | Fair             |
|   |                   |              |                    | Value            |
| <b>Securities Available-for-Sale</b>            |                   |              |                    |                  |
| U.S. government agency and government sponsored |                   |              |                    |                  |
| enterprise (GSE) debt securities                | \$100,454         | \$ -         | \$ (2,163 )        | \$98,291         |
| U.S. government agency pool securities          | 231,130           | 4            | (1,314 )           | 229,820          |
| U.S. government agency or GSE residential       |                   |              |                    |                  |
| mortgage-backed securities                      | 84,646            | -            | (2,563 )           | 82,083           |
| <b>Total</b>                                    | <b>\$416,230</b>  | <b>\$ 4</b>  | <b>\$ (6,040 )</b> | <b>\$410,194</b> |
| <b>Securities Held-to-Maturity</b>              |                   |              |                    |                  |
| U.S. government agency and government sponsored |                   |              |                    |                  |
| enterprise (GSE) debt securities                | \$42,812          | \$ 26        | \$ (164 )          | \$42,674         |
| U.S. government agency pool securities          | 10,624            | 9            | (18 )              | 10,615           |
| U.S. government agency or GSE residential       |                   |              |                    |                  |
| mortgage-backed securities                      | 25,852            | 33           | (605 )             | 25,280           |
| <b>Total</b>                                    | <b>\$79,288</b>   | <b>\$ 68</b> | <b>\$ (787 )</b>   | <b>\$78,569</b>  |
| <br>  |                   |              |                    |                  |
|   | December 31, 2017 |              |                    |                  |
|   | Gross             |              | Gross              |                  |
|   | Amortized         | Unrealized   | Unrealized         | Estimated        |
|   | Cost              | Gains        | Losses             | Fair             |
|   |                   |              |                    | Value            |
| <b>Securities Available-for-Sale</b>            |                   |              |                    |                  |
| U.S. government agency and government sponsored |                   |              |                    |                  |
| enterprise (GSE) debt securities                | \$105,407         | \$ -         | \$ (1,380 )        | \$104,027        |
| U.S. government agency pool securities          | 283,611           | 51           | (1,319 )           | 282,343          |
| U.S. government agency or GSE residential       |                   |              |                    |                  |
| mortgage-backed securities                      | 75,560            | -            | (1,142 )           | 74,418           |
| <b>Total</b>                                    | <b>\$464,578</b>  | <b>\$ 51</b> | <b>\$ (3,841 )</b> | <b>\$460,788</b> |
| <b>Securities Held-to-Maturity</b>              |                   |              |                    |                  |
| U.S. government agency and government sponsored |                   |              |                    |                  |
| enterprise (GSE) debt securities                | \$45,178          | \$ 505       | \$ (113 )          | \$45,570         |
| U.S. government agency pool securities          | 11,756            | 33           | (35 )              | 11,754           |

|   |          |        |           |          |
|---|----------|--------|-----------|----------|
| U.S. government agency or GSE residential |          |        |           |          |
| mortgage-backed securities                | 32,743   | 243    | (311 )    | 32,675   |
| Total                                     | \$89,677 | \$ 781 | \$ (459 ) | \$89,999 |

At June 30, 2018, and December 31, 2017, investment securities with a carrying value of \$294.9 million and \$307.3 million, respectively, were pledged to secure various government deposits and to meet other public requirements.

Proceeds and gross realized gains (losses) from the sales or calls of investment securities for the three and six months ended June 30, 2018 and 2017, are shown below:

|                                  | Three Months<br>Ended June 30, |      |
|----------------------------------|--------------------------------|------|
|                                  | 2018                           | 2017 |
| Proceeds from sales              | \$60,460                       | \$-  |
| Gross realized gains from sales  | \$-                            | \$-  |
| Gross realized losses from sales | \$(362 )                       | \$-  |

  

|                                  | Six Months Ended<br>June 30, |          |
|----------------------------------|------------------------------|----------|
|                                  | 2018                         | 2017     |
| Proceeds from sales              | \$78,775                     | \$12,896 |
| Gross realized gains from sales  | \$-                          | \$1      |
| Gross realized losses from sales | \$(413 )                     | \$(14 )  |

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The amortized cost and estimated fair value of investment securities by contractual maturity at June 30, 2018, and December 31, 2017, are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or borrowers the right to prepay obligations with or without call or prepayment penalties. At June 30, 2018, obligations of U.S. government corporations and agencies with amortized costs totaling \$495.5 million consist predominantly of Small Business Administration agency pool securities totaling \$241.7 million and residential mortgage-backed securities totaling \$101.9 million whose contractual maturity, or principal repayment, will follow the repayment of the underlying small business loans or mortgages. For purposes of the following table, the entire outstanding balance of these SBA Pools and mortgage-backed securities issued by U.S. government corporations and agencies is categorized based on final maturity date. At June 30, 2018, the Bank estimates the average remaining life of these SBA Pools and mortgage-backed securities to be approximately 3.5 years and 3.9 years, respectively.

|                                     | June 30, 2018                   |                         |                               |                         |
|-------------------------------------|---------------------------------|-------------------------|-------------------------------|-------------------------|
|                                     | Available-for-Sale<br>Amortized |                         | Held-to-Maturity<br>Amortized |                         |
|                                     | Cost                            | Estimated<br>Fair Value | Cost                          | Estimated<br>Fair Value |
| Due within one year                 | \$68                            | \$ 68                   | \$9,006                       | \$ 8,957                |
| Due after one but within five years | 104,717                         | 102,535                 | 43,849                        | 43,753                  |
| Due after five but within ten years | 73,671                          | 72,554                  | 16,410                        | 16,144                  |
| Due after ten years                 | 237,774                         | 235,037                 | 10,023                        | 9,715                   |
| Total                               | \$416,230                       | \$ 410,194              | \$79,288                      | \$ 78,569               |

|                                     | December 31, 2017               |                         |                               |                         |
|-------------------------------------|---------------------------------|-------------------------|-------------------------------|-------------------------|
|                                     | Available-for-Sale<br>Amortized |                         | Held-to-Maturity<br>Amortized |                         |
|                                     | Cost                            | Estimated Fair<br>Value | Cost                          | Estimated Fair<br>Value |
| Due within one year                 | \$336                           | \$ 336                  | \$7,004                       | \$ 6,978                |
| Due after one but within five years | 111,443                         | 110,041                 | 53,451                        | 54,044                  |
| Due after five but within ten years | 51,861                          | 51,450                  | 18,336                        | 18,262                  |
| Due after ten years                 | 300,938                         | 298,961                 | 10,886                        | 10,715                  |
| Total                               | \$464,578                       | \$ 460,788              | \$89,677                      | \$ 89,999               |

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Temporarily Impaired Securities

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2018, and December 31, 2017.

|  | June 30, 2018                                 |                            | More Than Twelve Months |                            | Total              |                            |
|--|---|----------------------------|-------------------------|----------------------------|--------------------|----------------------------|
|  | Less Than Twelve Months<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Unrealized<br>Loss      | Estimated<br>Fair<br>Value | Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <b>Securities Available for Sale</b>       |   |                            |                         |                            |                    |                            |
| U.S. government agency and government      |   |                            |                         |                            |                    |                            |
| sponsored enterprise (GSE) debt securities | \$ (539 )                                     | \$ 29,347                  | \$ (1,623 )             | \$ 68,945                  | \$ (2,162 )        | \$ 98,292                  |
| U.S. government agency pool securities     | (174 )  | 67,242                     | (1,141 )                | 155,676                    | (1,315 )           | 222,918                    |
| U.S. government agency or GSE residential  |   |                            |                         |                            |                    |                            |
| mortgage-backed securities                 | (1,117 )                                      | 35,641                     | (1,446 )                | 46,442                     | (2,563 )           | 82,083                     |
| <b>Total</b>                               | <b>\$ (1,830 )</b>                            | <b>\$ 132,230</b>          | <b>\$ (4,210 )</b>      | <b>\$ 271,063</b>          | <b>\$ (6,040 )</b> | <b>\$ 403,293</b>          |

| <b>Securities Held to Maturity</b>         |                  |                  |                    |                  |                    |                  |
|--|------------------|------------------|--------------------|------------------|--------------------|------------------|
| U.S. government agency and government      |                  |                  |                    |                  |                    |                  |
| sponsored enterprise (GSE) debt securities | \$ (80 )         | \$ 21,487        | \$ (840 )          | \$ 11,436        | \$ (920 )          | \$ 32,923        |
| U.S. government agency pool securities     | (17 )            | 1,832            | (2 )               | 2,082            | (19 )              | 3,914            |
| U.S. government agency or GSE residential  |                  |                  |                    |                  |                    |                  |
| mortgage-backed securities                 | (334 )           | 14,379           | (271 )             | 4,235            | (605 )             | 18,614           |
| <b>Total</b>                               | <b>\$ (431 )</b> | <b>\$ 37,698</b> | <b>\$ (1,113 )</b> | <b>\$ 17,753</b> | <b>\$ (1,544 )</b> | <b>\$ 55,451</b> |

|  | December 31, 2017                             |                            | More Than Twelve Months |                            | Total              |                            |
|--|---|----------------------------|-------------------------|----------------------------|--------------------|----------------------------|
|  | Less Than Twelve Months<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Unrealized<br>Loss      | Estimated<br>Fair<br>Value | Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <b>Securities Available for Sale</b>       |   |                            |                         |                            |                    |                            |
| U.S. government agency and government      |   |                            |                         |                            |                    |                            |
| sponsored enterprise (GSE) debt securities | \$ (273 )                                     | \$ 29,582                  | \$ (1,107 )             | \$ 74,445                  | \$ (1,380 )        | \$ 104,027                 |
| U.S. government agency pool securities     | (241 )  | 91,519                     | (1,078 )                | 168,164                    | (1,319 )           | 259,683                    |
| U.S. government agency or GSE residential  |   |                            |                         |                            |                    |                            |
| mortgage-backed securities                 | (321 )  | 35,384                     | (821 )                  | 39,034                     | (1,142 )           | 74,418                     |
| <b>Total</b>                               | <b>\$ (835 )</b>                              | <b>\$ 156,485</b>          | <b>\$ (3,006 )</b>      | <b>\$ 281,643</b>          | <b>\$ (3,841 )</b> | <b>\$ 438,128</b>          |

| <b>Securities Held to Maturity</b>    |          |          |          |           |           |           |
|---------------------------------------|----------|----------|----------|-----------|-----------|-----------|
| U.S. government agency and government |          |          |          |           |           |           |
|                                       | \$ (33 ) | \$ 4,002 | \$ (80 ) | \$ 11,946 | \$ (113 ) | \$ 15,948 |

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|  |          |          |           |           |          |          |
|--|----------|----------|-----------|-----------|----------|----------|
| sponsored enterprise (GSE) debt securities |          |          |           |           |          |          |
| U.S. government agency pool securities     | (10 )    | 5,422    | (25 )     | 3,201     | (35 )    | 8,623    |
| U.S. government agency or GSE residential  |          |          |           |           |          |          |
| mortgage-backed securities                 | (101 )   | 8,478    | (210 )    | 5,371     | (311 )   | 13,849   |
| Total                                      | \$(144 ) | \$17,902 | \$ (315 ) | \$ 20,518 | \$(459 ) | \$38,420 |

The investment securities that were in an unrealized loss position as of June 30, 2018, which comprised a total of 164 securities, were not other-than-temporarily impaired. Specifically, the 164 securities are comprised of the following: 91 Small Business Administration (“SBA”) Pool securities, 19 mortgage-backed securities issued by the Government National Mortgage Association (“GNMA”), 24 mortgage-backed securities issued by the Federal National Mortgage Association (“FNMA”), 7 agency securities issued by the Federal Home Loan Bank (“FHLB”), 4 mortgage-backed securities and 1 step up bond issued by the Federal Home Loan Mortgage Corporation (“FHLMC”), 1 agency security issued by the Federal Farm Credit Banks (“FFCB”), and 17 U.S. Treasuries.

Total gross unrealized losses were primarily attributable to changes in market interest rates, relative to when the investment securities were purchased, and not due to any change in the credit quality of the investment securities. The Company does not intend to sell the investment securities that were in an unrealized loss position and it is not likely that the Company will be required to sell the investment securities before recovery of their amortized cost, which may be at maturity. However, the Company may elect to sell certain investment securities with an unrealized loss position in its “available for sale” portfolio as needed to replenish its cash liquidity.

## Investment in Unconsolidated Subsidiary

In May 2016, the Company entered into a Stock Purchase Agreement to acquire 25% of ASC Trust Corporation, a Guam trust company. In July 2016, subsequent to the approval of the Federal Reserve Bank of San Francisco in June 2016, the purchase was executed. The Agreement provides for the acquisition of an additional 20% of the stock of ASC Trust Corporation in April 2019, and another 25% in April 2021, with both future purchases subject to regulatory approval. The Agreement contains customary warranties, representations and indemnification provisions. The ASC Trust Corporation stock is subject to the equity method of accounting in our condensed consolidated statements of condition. During the six months ended June 30, 2018, the Company's recorded investment in ASC Trust Corporation increased by \$48 thousand, based upon the earnings of ASC Trust Corporation that are attributed to the Company's ownership, less the amount received in dividends during the six months ended June 30, 2018.

## Note 5 – Loans Held for Sale, Loans and Allowance for Loan Losses

### Loans Held for Sale

In its normal course of business, the Bank originates mortgage loans held for sale to the Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac"). The Bank has elected to measure its residential mortgage loans held for sale at cost. Origination fees and costs are recognized in earnings at the time of origination. Loans are sold to Freddie Mac at par.

During the six months ended June 30, 2018 and 2017, the Bank originated and sold approximately \$6.2 million and \$8.5 million, respectively, in FHLMC mortgage loans.

Mortgage loans serviced for others are not included in the accompanying condensed consolidated statements of condition. The unpaid principal balances of mortgage loans serviced for others were \$200.2 million and \$206.4 million at June 30, 2018, and December 31, 2017, respectively. The decrease of \$6.1 million (3.0%) during the six months ended June 30, 2018 was due to scheduled principal payments and prepayments.

We retain mortgage servicing rights on mortgage loans that we sell. Such rights represent the net positive cash flows generated from the servicing of such mortgage loans and we recognize such rights as assets on our statements of financial condition based on their estimated fair values. We receive servicing fees, less any subservicing costs, on the unpaid principal balances of such mortgage loans. Those fees are collected from the monthly payments made by the mortgagors or from the proceeds of the sale or foreclosure and liquidation of the underlying real property collateralizing the loans. At June 30, 2018, and December 31, 2017, mortgage servicing rights totaled \$1.9 million and \$1.9 million, respectively, and are included in other assets in the accompanying condensed consolidated statements of condition. The Bank accounts for mortgage servicing rights at fair value with changes in fair value recorded in the condensed consolidated statements of income.

### Loans

Outstanding loan balances are presented net of unearned income, deferred loan fees, and unamortized discount and premium. Loans subject to ASC 310-30 are presented net of the related accretable yield.

The loan portfolio consisted of the following at:

June 30, 2018

December 31, 2017



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|                                   | Amount      | Percent | Amount      | Percent |
|-----------------------------------|-------------|---------|-------------|---------|
| <b>Commercial</b>                 |             |         |             |         |
| Commercial & industrial           | \$254,528   | 20.2 %  | \$256,022   | 20.8 %  |
| Commercial mortgage               | 579,902     | 46.1 %  | 553,125     | 45.0 %  |
| Commercial construction           | 23,657      | 1.9 %   | 10,157      | 0.8 %   |
| Commercial agriculture            | 702         | 0.1 %   | 716         | 0.1 %   |
| Total commercial                  | 858,789     | 68.3 %  | 820,020     | 66.7 %  |
| <b>Consumer</b>                   |             |         |             |         |
| Residential mortgage              | 136,284     | 10.8 %  | 137,962     | 11.2 %  |
| Home equity                       | 1,137       | 0.1 %   | 545         | 0.0 %   |
| Automobile                        | 29,503      | 2.3 %   | 30,490      | 2.5 %   |
| Other consumer loans <sup>1</sup> | 231,517     | 18.4 %  | 240,863     | 19.6 %  |
| Total consumer                    | 398,441     | 31.7 %  | 409,860     | 33.3 %  |
| Gross loans                       | 1,257,230   | 100.0 % | 1,229,880   | 100.0 % |
| Deferred loan (fees) costs, net   | (2,882 )    |         | (2,777 )    |         |
| Allowance for loan losses         | (18,806 )   |         | (17,279 )   |         |
| Loans, net                        | \$1,235,542 |         | \$1,209,824 |         |

<sup>1</sup>Comprised of other revolving credit, installment loans, and overdrafts.

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## Allowance for Loan Losses

The allowance for loan losses is evaluated on a quarterly basis by Bank management, and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available or conditions change.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. ASC 310-10 defines an impaired loan as one for which there is uncertainty concerning collection of all principal and interest per the original contractual terms of the loan. For those loans that are classified as impaired, an allowance is established when the discounted cash flow (or the collateral value or the observable market price) of the impaired loan is lower than the carrying value of the loan. The general component covers unimpaired loans, and is estimated using a loss migration analysis based on historical charge-off experience and expected loss, given the default probability derived from the Bank's internal risk rating process. The loss migration analysis tracks twelve rolling quarters of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain consumer loans. These calculated loss factors are then applied to outstanding loan balances for all non-impaired loans. Additionally, a qualitative factor that is determined utilizing external economic factors and internal assessments is applied to each homogeneous loan pool. We also conduct individual loan review analyses, as part of the allowance for loan loss allocation process, applying specific monitoring policies and procedures in analyzing the existing loan portfolio.

Set forth below is a summary of the Bank's activity in the allowance for loan losses during the three and six months ended June 30, 2018 and 2017, and the year ended December 31, 2017:

|   | Three<br>Months<br>Ended<br>June 30,<br>2018 | Three<br>Months<br>Ended<br>June 30,<br>2017 | Six<br>Months<br>Ended<br>June 30,<br>2018 | Six<br>Months<br>Ended<br>June 30,<br>2017 | Year Ended<br>December 31,<br>2017 |
|---|--|--|--|--|------------------------------------|
| Balance, beginning of period                  | \$ 18,057                                    | \$ 15,335                                    | \$ 17,279                                  | \$ 15,435                                  | \$ 15,435                          |
| Provision for loan losses                     | 2,099  | 1,184  | 4,838                                      | 2,367                                      | 7,519                              |
| Recoveries on loans previously<br>charged off | 478  | 460  | 936  | 797  | 1,604                              |
| Charged off loans                             | (1,828 )                                     | (1,608 )                                     | (4,247 )                                   | (3,228 )                                   | (7,279 )                           |
| Balance, end of period                        | \$ 18,806                                    | \$ 15,371                                    | \$ 18,806                                  | \$ 15,371                                  | \$ 17,279                          |

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Set forth below is information regarding loan balances and the related allowance for loan losses, by portfolio type, for the three and six months ended June 30, 2018 and 2017, and the year ended December 31, 2017, respectively.

|  | Residential            |            |            |             |
|--|------------------------|------------|------------|-------------|
|  | Commercial             | Mortgages  | Consumer   | Total       |
|  | (Dollars in thousands) |            |            |             |
| <b>Six Months Ended June 30, 2018</b>          |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | \$7,623                | \$ 1,409   | \$8,247    | \$17,279    |
| Charge-offs                                    | (302 )                 | -          | (3,945 )   | (4,247 )    |
| Recoveries                                     | 27                     | 3          | 906        | 936         |
| Provision                                      | 3,857                  | 174        | 807        | 4,838       |
| Balance at end of period                       | \$11,205               | \$ 1,586   | \$6,015    | \$18,806    |
| <b>Three Months Ended June 30, 2018</b>        |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | 10,602                 | 1,278      | 6,177      | 18,057      |
| Charge-offs                                    | 11                     | -          | (1,839 )   | (1,828 )    |
| Recoveries                                     | 6                      | 2          | 470        | 478         |
| Provision                                      | 586                    | 306        | 1,207      | 2,099       |
| Ending balance                                 | \$11,205               | \$ 1,586   | \$6,015    | \$18,806    |
| Allowance balance at end of period related to: |                        |            |            |             |
| Loans individually evaluated for impairment    | \$64                   | \$ 102     | \$ 1,675   | \$ 1,841    |
| Loans collectively evaluated for impairment    | 11,141                 | 1,484      | 4,340      | 16,965      |
| Ending balance                                 | \$11,205               | \$ 1,586   | \$6,015    | \$18,806    |
| Loan balances at end of period:                |                        |            |            |             |
| Loans individually evaluated for impairment    | \$8,444                | \$ 5,125   | \$ 2,066   | \$15,635    |
| Loans collectively evaluated for impairment    | 850,345                | 132,296    | 258,954    | 1,241,595   |
| Ending balance                                 | \$858,789              | \$ 137,421 | \$ 261,020 | \$1,257,230 |
| <b>Six Months Ended June 30, 2017</b>          |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | \$7,264                | \$ 1,773   | \$6,398    | \$15,435    |
| Charge-offs                                    | -                      | (30 )      | (3,198 )   | (3,228 )    |
| Recoveries                                     | 30                     | 3          | 764        | 797         |
| Provision                                      | 200                    | 6          | 2,161      | 2,367       |
| Ending balance                                 | \$7,494                | \$ 1,752   | \$6,125    | \$15,371    |
| <b>Three Months Ended June 30, 2017</b>        |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | \$8,685                | \$ 1,879   | \$4,771    | \$15,335    |
| Charge-offs                                    | -                      | (29 )      | (1,579 )   | (1,608 )    |
| Recoveries                                     | 20                     | 1          | 439        | 460         |
| Provision                                      | (1,211 )               | (99 )      | 2,494      | 1,184       |
| Ending balance                                 | \$7,494                | \$ 1,752   | \$6,125    | \$15,371    |

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|  |           |           |           |             |
|--|-----------|-----------|-----------|-------------|
| Allowance balance at end of period related to: |           |           |           |             |
| Loans individually evaluated for impairment    | \$3       | \$6       | \$1,062   | \$1,071     |
| Loans collectively evaluated for impairment    | 7,491     | 1,746     | 5,063     | 14,300      |
| Ending balance                                 | \$7,494   | \$1,752   | \$6,125   | \$15,371    |
| Loan balances at end of period:                |           |           |           |             |
| Loans individually evaluated for impairment    | \$6,643   | \$6,269   | \$1,390   | \$14,302    |
| Loans collectively evaluated for impairment    | 770,882   | 133,960   | 243,519   | 1,148,361   |
| Ending balance                                 | \$777,525 | \$140,229 | \$244,909 | \$1,162,663 |

## Residential

|  | Commercial             | Mortgages  | Consumer   | Total       |
|--|------------------------|------------|------------|-------------|
|  | (Dollars in thousands) |            |            |             |
| Year Ended December 31, 2017                 |                        |            |            |             |
| Allowance for loan losses:                   |                        |            |            |             |
| Balance at beginning of year                 | \$7,264                | \$ 1,773   | \$ 6,398   | \$15,435    |
| Charge-offs                                  | (172 )                 | (145 )     | (6,962 )   | (7,279 )    |
| Recoveries                                   | 47                     | 6          | 1,551      | 1,604       |
| Provision                                    | 484                    | (225 )     | 7,260      | 7,519       |
| Ending balance                               | \$7,623                | \$ 1,409   | \$ 8,247   | \$17,279    |
| Allowance balance at end of year related to: |                        |            |            |             |
| Loans individually evaluated for impairment  | \$28                   | \$ 90      | \$ 1,747   | \$ 1,865    |
| Loans collectively evaluated for impairment  | 7,595                  | 1,319      | 6,500      | 15,414      |
| Ending balance                               | \$7,623                | \$ 1,409   | \$ 8,247   | \$17,279    |
| Loan balances at end of year:                |                        |            |            |             |
| Loans individually evaluated for impairment  | \$7,094                | \$ 5,442   | \$ 2,237   | \$14,773    |
| Loans collectively evaluated for impairment  | 812,926                | 133,065    | 269,116    | 1,215,107   |
| Ending balance                               | \$820,020              | \$ 138,507 | \$ 271,353 | \$1,229,880 |

Impairment is measured on a loan-by-loan basis for commercial and real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral (if the loan is collateral-dependent). Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. The Bank performs direct write-downs of impaired loans with a charge to the allocated component of the allowance, therefore reducing the allocated component of the allowance to zero at the end of each reporting period.

## Credit Quality

The following table provides a summary of the delinquency status of the Bank's loans by portfolio type:

|                             | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days and<br>Greater<br>Non-Accrual | 90 Days and<br>Greater<br>Still<br>Accruing | Total Past<br>Due | Current            | Total Loans<br>Outstanding |
|-----------------------------|------------------------|------------------------|---------------------------------------|---|-------------------|--------------------|----------------------------|
| <b>June 30, 2018</b>        |                        |                        |                                       |   |                   |                    |                            |
| <b>Commercial</b>           |                        |                        |                                       |   |                   |                    |                            |
| Commercial & industrial     | \$ 675                 | \$ 88                  | \$ 132                                | \$ -  | \$ 895            | \$253,633          | \$254,528                  |
| Commercial mortgage         | 2,449                  | 141                    | 1,587                                 | 301   | 4,478             | 575,424            | 579,902                    |
| Commercial construction     | -                      | -                      | -                                     | -   | -                 | 23,657             | 23,657                     |
| Commercial agriculture      | -                      | -                      | -                                     | -   | -                 | 702                | 702                        |
| <b>Total commercial</b>     | <b>3,124</b>           | <b>229</b>             | <b>1,719</b>                          | <b>301</b>                                  | <b>5,373</b>      | <b>853,416</b>     | <b>858,789</b>             |
| <b>Consumer</b>             |                        |                        |                                       |   |                   |                    |                            |
| Residential mortgage        | 4,295                  | 3,976                  | 1,396                                 | 31  | 9,698             | 126,586            | 136,284                    |
| Home equity                 | -                      | 94                     | -                                     | -   | 94                | 1,043              | 1,137                      |
| Automobile                  | 1,385                  | 310                    | -                                     | 112   | 1,807             | 27,696             | 29,503                     |
| Other consumer <sup>1</sup> | 3,025                  | 1,620                  | 229                                   | 1,530                                       | 6,404             | 225,113            | 231,517                    |
| <b>Total consumer</b>       | <b>8,705</b>           | <b>6,000</b>           | <b>1,625</b>                          | <b>1,673</b>                                | <b>18,003</b>     | <b>380,438</b>     | <b>398,441</b>             |
| <b>Total</b>                | <b>\$ 11,829</b>       | <b>\$ 6,229</b>        | <b>\$ 3,344</b>                       | <b>\$ 1,974</b>                             | <b>\$ 23,376</b>  | <b>\$1,233,854</b> | <b>\$1,257,230</b>         |
| <b>December 31, 2017</b>    |                        |                        |                                       |   |                   |                    |                            |
| <b>Commercial</b>           |                        |                        |                                       |   |                   |                    |                            |
| Commercial & industrial     | \$ 155                 | \$ 546                 | \$ -                                  | \$ 20                                       | \$ 721            | \$255,301          | \$256,022                  |
| Commercial mortgage         | -                      | 803                    | 364                                   | -   | 1,167             | 551,958            | 553,125                    |
| Commercial construction     | -                      | -                      | -                                     | -   | -                 | 10,157             | 10,157                     |
| Commercial agriculture      | -                      | -                      | -                                     | -   | -                 | 716                | 716                        |
| <b>Total commercial</b>     | <b>155</b>             | <b>1,349</b>           | <b>364</b>                            | <b>20</b>                                   | <b>1,888</b>      | <b>818,132</b>     | <b>820,020</b>             |
| <b>Consumer</b>             |                        |                        |                                       |   |                   |                    |                            |
| Residential mortgage        | 5,804                  | 3,046                  | 2,373                                 | -   | 11,223            | 126,739            | 137,962                    |
| Home equity                 | 7                      | 96                     | -                                     | -   | 103               | 442                | 545                        |
| Automobile                  | 1,512                  | 415                    | -                                     | 201   | 2,128             | 28,362             | 30,490                     |
| Other consumer <sup>1</sup> | 3,513                  | 2,157                  | 257                                   | 1,725                                       | 7,652             | 233,211            | 240,863                    |
| <b>Total consumer</b>       | <b>10,836</b>          | <b>5,714</b>           | <b>2,630</b>                          | <b>1,926</b>                                | <b>21,106</b>     | <b>388,754</b>     | <b>409,860</b>             |
| <b>Total</b>                | <b>\$ 10,991</b>       | <b>\$ 7,063</b>        | <b>\$ 2,994</b>                       | <b>\$ 1,946</b>                             | <b>\$ 22,994</b>  | <b>\$1,206,886</b> | <b>\$1,229,880</b>         |

<sup>1</sup> Comprised of other revolving credit, installment loans, and overdrafts.

Generally, the accrual of interest on a loan is discontinued when principal or interest payments become more than 90 days past due, unless management believes the loan is adequately collateralized and is in the process of collection, with the exception of automobile and other consumer loans which, rather than being placed on non-accrual status, are charged off once they become 120 days delinquent. When a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of cash are applied as principal reductions when received, except when the ultimate collectability of principal is probable, in which case interest payments are credited to income. Non-accrual loans may be restored to accrual status when principal and interest become current and full repayment is expected.

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The following table provides information as of June 30, 2018, and December 31, 2017, with respect to loans on non-accrual status, by portfolio type:

|                                | June 30,<br>2018 | December 31,<br>2017 |
|--------------------------------|------------------|----------------------|
| (Dollars in thousands)         |                  |                      |
| <b>Non-accrual loans:</b>      |                  |                      |
| <b>Commercial</b>              |                  |                      |
| Commercial & industrial        | \$388            | \$ 426               |
| Commercial mortgage            | 7,172            | 6,554                |
| Commercial construction        | -                | -                    |
| Commercial agriculture         | -                | -                    |
| <b>Total commercial</b>        | <b>7,560</b>     | <b>6,980</b>         |
| <b>Consumer</b>                |                  |                      |
| Residential mortgage           | \$5,094          | \$ 6,063             |
| Home equity                    | -                | -                    |
| Automobile                     | -                | -                    |
| Other consumer <sup>1</sup>    | 424              | 311                  |
| <b>Total consumer</b>          | <b>5,518</b>     | <b>6,374</b>         |
| <b>Total non-accrual loans</b> | <b>\$13,078</b>  | <b>\$ 13,354</b>     |

<sup>1</sup> Comprised of other revolving credit, installment loans, and overdrafts.

Credit Quality Indicators

The Bank uses several credit quality indicators to manage credit risk, including an internal credit risk rating system that categorizes loans into pass, special mention, substandard, formula classified, doubtful or loss categories. Credit risk ratings are applied individually to those classes of loans that have significant or unique credit characteristics and that benefit from a case-by-case evaluation. These are typically loans to businesses or individuals in the classes which comprise the commercial portfolio segment. Groups of loans that are underwritten and structured using standardized criteria and characteristics, such as statistical models (e.g., credit scoring or payment performance), are typically risk-rated and monitored collectively. These are typically loans to individuals in the classes which comprise the consumer portfolio segment.

The following are the definitions of the Bank's credit quality indicators:

Pass (A): Exceptional: Essentially risk-free credit. These are loans of the highest quality that pose virtually no risk of loss to the Bank. This includes loans fully collateralized by means of a savings account(s) and time certificate(s) of deposit, and by at least 110% of the loan amount. Borrowers should have strong financial statements, good liquidity and excellent credit.

Pass (B): Standard: Multiple, strong sources of repayment. These are loans to borrowers with a demonstrated history of financial and managerial performance. The risk of loss is considered to be low. Loans are well-structured, with clearly identified primary and readily available secondary sources of repayment. These loans may be secured by an equal amount of funds in a savings account or time certificate of deposit. These loans may also be secured by marketable collateral whose value can be reasonably determined through outside appraisals. The borrower characteristically has well supported cash flows and low leverage.



Pass (C): Acceptable: Good primary and secondary sources of repayment. These are loans to borrowers of average financial condition, stability and management expertise. The borrower should be a well-established individual or company with adequate financial resources to withstand short-term fluctuations in the marketplace. The borrower's financial ratios and trends are favorable. The loans may be unsecured or supported by non-real estate collateral for which the value is more difficult to determine, represent a reasonable credit risk and require an average amount of account officer attention. The borrower's ability to repay unsecured credit is to be of unquestionable strength.

Pass (D): Monitor: Sufficient primary sources of repayment and an acceptable secondary source of repayment. Acceptable business or individual credit, but the borrower's operations, cash flows or financial conditions carry average levels of risk. These loans are considered to be collectable in full, but may require a greater-than-average amount of loan officer monitoring. Borrowers are capable of absorbing normal setbacks without failing to meet the terms of the loan agreement.

Special Mention: A Special Mention asset has potential weaknesses that deserve a heightened degree of monitoring. These potential weaknesses may result in a deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. The Special Mention classification should neither be a compromise between a pass grade and substandard, nor should it be a "catch all" grade to identify any loan that has a policy exception.

Substandard: A Substandard asset is inadequately protected by the current sound worth and payment capacity of the obligor or the collateral pledged. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Assets classified as substandard are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Formula Classified:** Formula Classified loans are all loans and credit cards delinquent 90 days and over which have yet to be formally classified Special Mention, Substandard or Doubtful by the Bank's Loan Committee. In most instances, the monthly formula total is comprised primarily of residential real estate loans, consumer loans, credit cards and commercial loans under \$250 thousand. However, commercial loans are typically formally classified by the Loan Committee no later than their 90-day delinquency, and those do not become part of the formula classification. Real estate loans 90-days delinquent that are in the foreclosure process, which is typically completed within another 60 days, are not formally classified during this period.

**Doubtful:** A loan with weaknesses well enough defined that eventual repayment in full, on the basis of currently existing facts, conditions and values, is highly questionable, even though certain factors may be present which could improve the status of the loan. The probability of some loss is extremely high, but because of certain known factors that may work to the advantage of strengthening of the assets (i.e. capital injection, perfecting liens on additional collateral, refinancing plans, etc.), its classification as an estimated loss is deferred until its more exact status can be determined.

**Loss:** Loans classified as "Loss" are considered uncollectible, and are either unsecured or are supported by collateral that is of little to no value. As such, their continuance as recorded assets is not warranted. While this classification does not mandate that a loan has no ultimate recovery value, losses should be taken in the period during which these loans are deemed to be uncollectible. Loans identified as loss are immediately approved for charge-off. The Bank may refer loans to outside collection agencies, attorneys, or its internal collection division to continue collection efforts. Any subsequent recoveries are credited to the Allowance for Loan Losses.

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The Bank classifies its loan portfolios using internal credit quality ratings, as discussed above under Allowance for Loan Losses. The following table provides a summary of loans by portfolio type and the Bank's internal credit quality ratings as of June 30, 2018, and December 31, 2017:

|                             | June 30,<br>2018 | December 31,<br>2017 | Increase<br>(Decrease) |
|-----------------------------|------------------|----------------------|------------------------|
| (Dollars in thousands)      |                  |                      |                        |
| <b>Pass:</b>                |                  |                      |                        |
| Commercial & industrial     | \$222,055        | \$ 222,662           | \$ (607 )              |
| Commercial mortgage         | 538,224          | 511,702              | 26,522                 |
| Commercial construction     | 23,657           | 10,157               | 13,500                 |
| Commercial agriculture      | 702              | 716                  | (14 )                  |
| Residential mortgage        | 130,830          | 131,743              | (913 )                 |
| Home equity                 | 1,137            | 538                  | 599                    |
| Automobile                  | 29,391           | 30,289               | (898 )                 |
| Other consumer              | 229,563          | 238,827              | (9,264 )               |
| Total pass loans            | \$1,175,559      | \$ 1,146,634         | \$ 28,925              |
| <b>Special Mention:</b>     |                  |                      |                        |
| Commercial & industrial     | \$2,105          | \$ 20,528            | \$ (18,423 )           |
| Commercial mortgage         | 4,946            | 32,723               | (27,777 )              |
| Commercial construction     | -                | -                    | -                      |
| Commercial agriculture      | -                | -                    | -                      |
| Residential mortgage        | 1                | 139                  | (138 )                 |
| Home equity                 | -                | -                    | -                      |
| Automobile                  | -                | -                    | -                      |
| Other consumer              | -                | -                    | -                      |
| Total special mention loans | \$7,052          | \$ 53,390            | \$ (46,338 )           |
| <b>Substandard:</b>         |                  |                      |                        |
| Commercial & industrial     | \$30,353         | \$ 12,810            | \$ 17,543              |
| Commercial mortgage         | 36,431           | 8,700                | 27,731                 |
| Commercial construction     | -                | -                    | -                      |
| Commercial agriculture      | -                | -                    | -                      |
| Residential mortgage        | 726              | 645                  | 81                     |
| Home equity                 | -                | -                    | -                      |
| Automobile                  | -                | -                    | -                      |
| Other consumer              | -                | -                    | -                      |
| Total substandard loans     | \$67,510         | \$ 22,155            | \$ 45,355              |
| <b>Formula Classified:</b>  |                  |                      |                        |
| Commercial & industrial     | \$15             | \$ 22                | \$ (7 )                |
| Commercial mortgage         | 301              | -                    | 301                    |
| Commercial construction     | -                | -                    | -                      |
| Commercial agriculture      | -                | -                    | -                      |
| Residential mortgage        | 4,727            | 5,435                | (708 )                 |
| Home equity                 | -                | 7                    | (7 )                   |
| Automobile                  | 112              | 201                  | (89 )                  |

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|                                |         |          |           |
|--------------------------------|---------|----------|-----------|
| Other consumer                 | 1,954   | 2,036    | (82 )     |
| Total formula classified loans | \$7,109 | \$ 7,701 | \$ (592 ) |

Doubtful:

|                                |             |              |           |
|--------------------------------|-------------|--------------|-----------|
| Commercial & industrial        | \$-         | \$ -         | \$ -      |
| Commercial mortgage            | -           | -            | -         |
| Commercial construction        | -           | -            | -         |
| Commercial agriculture         | -           | -            | -         |
| Residential mortgage           | -           | -            | -         |
| Home equity                    | -           | -            | -         |
| Automobile                     | -           | -            | -         |
| Other consumer                 | -           | -            | -         |
| Total doubtful loans           | \$-         | \$ -         | \$ -      |
| Total outstanding loans, gross | \$1,257,230 | \$ 1,229,880 | \$ 27,350 |

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As the above table indicates, the Bank's total gross loans approximated \$1.26 billion at June 30, 2018, up from \$1.23 billion at December 31, 2017. The disaggregation of the portfolio by risk rating in the table reflects the following changes between December 31, 2017, and June 30, 2018:

Loans rated "pass" increased by \$28.9 million to \$1.18 billion at June 30, 2018, up from \$1.15 billion at December 31, 2017. The increase was primarily in commercial mortgage loans, which grew by \$26.5 million, commercial construction, which rose by \$13.5 million and home equity loans, which were up by \$599 thousand. These increases were primarily offset by decreases in other consumer loans by \$9.3 million, residential mortgages by \$913 thousand, automobile loans by \$898 thousand and commercial & industrial loans by \$607 thousand. The increases in commercial mortgage loans and home equity loans are due to new loans, and the increase in commercial construction loans is due to new loans and additional disbursements. The decrease in other consumer loans of \$9.3 million was due to pay offs, pay downs, charge offs and loans reclassified from "pass" to "formula classified".

The "special mention" category decreased by \$46.3 million, from \$53.4 million to \$7.1 million between December 31, 2017 and June 30, 2018. This is attributed to a decrease in special mention commercial mortgage loans by \$27.8 million, primarily as a result of one loan relationship that was reclassified from "special mention" to "substandard." Additionally, there was a decrease in special mention commercial & industrial loans by \$18.4 million, principally due to paydowns, pay offs and the reassignment of risk reclassifications.

Loans classified "substandard" increased by \$45.4 million, to \$67.5 million at June 30, 2018, from \$22.2 million at December 31, 2017. The increase was the result of the reclassification of one loan relationship in commercial mortgage notes, as mentioned above, and one loan relationship in commercial & industrial of \$16.9 million reclassified to "substandard" from "special mention."

The "formula classified" category decreased by \$592 thousand, to \$7.1 million at June 30, 2018, from \$7.7 million at December 31, 2017, primarily due to a decrease of \$708 thousand in residential mortgage loans in this category.

There were no loans classified as "doubtful" at either June 30, 2018, or December 31, 2017.

### Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal and interest when due according to the original contractual terms of the loan agreement. 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. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impaired loans include loans that are in non-accrual status and other loans that have been modified in Troubled Debt Restructurings (TDRs), where economic concessions have been granted to borrowers experiencing financial difficulties. These concessions typically result from the Bank's loss mitigation actions, and could include reductions in the interest rate, payment extensions, forbearance, or other actions taken with the intention of maximizing collections.

The following table sets forth information regarding non-accrual loans and restructured loans, at June 30, 2018, and December 31, 2017:

|                     | June 30,<br>2018       | December 31,<br>2017 |
|---------------------|------------------------|----------------------|
|                     | (Dollars in thousands) |                      |
| Impaired loans:     |                        |                      |
| Restructured loans: |                        |                      |

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|   |          |           |
|---|----------|-----------|
| Non-accruing restructured loans             | \$5,067  | \$ 5,265  |
| Accruing restructured loans                 | 259      | 305       |
| Total restructured loans                    | 5,326    | 5,570     |
| Other impaired loans                        | 10,309   | 9,203     |
| Total impaired loans                        | \$15,635 | \$ 14,773 |
| Impaired loans less than 90 days delinquent |          |           |
| and included in total impaired loans        | \$10,316 | \$ 6,651  |

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The table below contains additional information with respect to impaired loans, by portfolio type, at June 30, 2018, and December 31, 2017:

|   | Unpaid<br>Recorded     | Principal<br>Balance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|---|------------------------|----------------------|-----------------------------------|----------------------------------|
|   | (Dollars in thousands) |                      |                                   |                                  |
| <b>June 30, 2018, With no related allowance recorded:</b>     |                        |                      |                                   |                                  |
| Commercial & industrial                                       | \$784                  | \$ 784               | \$ 637                            | \$ 2                             |
| Commercial mortgage   | 6,947                  | 6,947                | 6,520                             | -                                |
| Commercial construction                                       | -                      | -                    | -                                 | -                                |
| Commercial agriculture  | -                      | -                    | -                                 | -                                |
| Residential mortgage  | 27                     | 27                   | 27                                | 1                                |
| Home equity   | -                      | -                    | -                                 | -                                |
| Automobile  | -                      | -                    | -                                 | -                                |
| Other consumer  | -                      | -                    | -                                 | -                                |
| <b>Total impaired loans with no related allowance</b>         | <b>\$7,758</b>         | <b>\$ 7,758</b>      | <b>\$ 7,184</b>                   | <b>\$ 3</b>                      |
| <b>June 30, 2018, With a related allowance recorded:</b>      |                        |                      |                                   |                                  |
| Commercial & industrial                                       | \$187                  | \$ 383               | \$ 219                            | \$ -                             |
| Commercial mortgage   | 526                    | 551                  | 473                               | 5                                |
| Commercial construction                                       | -                      | -                    | -                                 | -                                |
| Commercial agriculture  | -                      | -                    | -                                 | -                                |
| Residential mortgage  | 5,097                  | 5,148                | 5,153                             | -                                |
| Home equity   | -                      | -                    | -                                 | -                                |
| Automobile  | 65                     | 65                   | 92                                | 1                                |
| Other consumer  | 2,002                  | 1,751                | 1,999                             | 15                               |
| <b>Total impaired loans with a related allowance</b>          | <b>\$7,877</b>         | <b>\$ 7,898</b>      | <b>\$ 7,936</b>                   | <b>\$ 21</b>                     |
| <b>December 31, 2017, With no related allowance recorded:</b> |                        |                      |                                   |                                  |
| Commercial & industrial                                       | \$515                  | \$ 515               | \$ 532                            | \$ 1                             |
| Commercial mortgage   | 6,192                  | 6,192                | 5,767                             | -                                |
| Commercial construction                                       | -                      | -                    | -                                 | -                                |
| Commercial agriculture  | -                      | -                    | -                                 | -                                |
| Residential mortgage  | -                      | -                    | -                                 | -                                |
| Home equity   | -                      | -                    | -                                 | -                                |
| Automobile  | -                      | -                    | -                                 | -                                |
| Other consumer  | -                      | -                    | -                                 | -                                |
| <b>Total impaired loans with no related allowance</b>         | <b>\$6,707</b>         | <b>\$ 6,707</b>      | <b>\$ 6,299</b>                   | <b>\$ 1</b>                      |
| <b>December 31, 2017, With a related allowance recorded:</b>  |                        |                      |                                   |                                  |
| Commercial & industrial                                       | \$180                  | \$ 351               | \$ 113                            | \$ 1                             |
| Commercial mortgage   | 208                    | 233                  | 264                               | -                                |
| Commercial construction                                       | -                      | -                    | -                                 | -                                |
| Commercial agriculture  | -                      | -                    | -                                 | -                                |
| Residential mortgage  | 5,435                  | 5,448                | 5,644                             | -                                |
| Home equity   | 7                      | 7                    | 7                                 | -                                |

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|   |         |          |          |       |
|---|---------|----------|----------|-------|
| Automobile                                    | 201     | 211      | 108      | 3     |
| Other consumer                                | 2,035   | 2,035    | 1,629    | 17    |
| Total impaired loans with a related allowance | \$8,066 | \$ 8,285 | \$ 7,765 | \$ 21 |

Impairment is measured on a loan-by-loan basis for commercial and real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral (if the loan is collateral-dependent). Large groups of smaller-balance, homogeneous loans are collectively evaluated for impairment. The Bank performs direct write-downs of impaired loans with a charge to the allocated component of the allowance for loan losses, thereby reducing the allocated component of the allowance to zero at the end of each reporting period.



## Troubled Debt Restructurings

In accordance with FASB's Accounting Standards Update No. 2011-02, "A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring" (ASU No. 2011-02), the Bank had \$5.3 million of troubled debt restructurings (TDRs) as of June 30, 2018, down by \$244 thousand from \$5.6 million at December 31, 2017, and entirely in commercial mortgage loans. The restructured loans recorded with the Bank have been modified for the purpose of alleviating temporary impairments to the borrower's financial condition. The modifications that the Bank has extended to borrowers have come in the form of a change in the amortization terms, a reduction in the interest rate, and interest-only payments. The workout plan between the borrower and the Bank is designed to provide a bridge for cash flow shortfalls in the near term. As the borrower works through the near-term issues, in most cases, the original contractual terms will be reinstated.

Additional information regarding performing and nonperforming TDRs at June 30, 2018, and December 31, 2017, is set forth in the following table:

|                            | Number of<br>Loans | Pre-Modification        |                            | Post-Modification       |                       | Outstanding Balance |  |
|----------------------------|--------------------|-------------------------|----------------------------|-------------------------|-----------------------|---------------------|--|
|                            |                    | Outstanding<br>Recorded | Principal<br>Modifications | Outstanding<br>Recorded | June 30, December 31, |                     |  |
|                            |                    | Investment              |                            | Investment              | 2018                  | 2017                |  |
| <b>Performing</b>          |                    |                         |                            |                         |                       |                     |  |
| Residential mortgage       | -                  | \$ -                    | \$ -                       | \$ -                    | \$-                   | \$ -                |  |
| Commercial mortgage        | 2                  | 369                     | -                          | 369                     | 259                   | 305                 |  |
| Automobile                 | -                  | -                       | -                          | -                       | -                     | -                   |  |
| Consumer                   | -                  | -                       | -                          | -                       | -                     | -                   |  |
| Total performing           | 2                  | \$ 369                  | \$ -                       | \$ 369                  | \$259                 | \$ 305              |  |
| <b>Nonperforming</b>       |                    |                         |                            |                         |                       |                     |  |
| Residential mortgage       | -                  | \$ -                    | \$ -                       | \$ -                    | \$-                   | \$ -                |  |
| Commercial mortgage        | 8                  | 7,939                   | -                          | 7,939                   | 5,067                 | 5,265               |  |
| Automobile                 | -                  | -                       | -                          | -                       | -                     | -                   |  |
| Consumer                   | -                  | -                       | -                          | -                       | -                     | -                   |  |
| Total nonperforming        | 8                  | \$ 7,939                | \$ -                       | \$ 7,939                | \$5,067               | \$ 5,265            |  |
| <b>Total Troubled</b>      |                    |                         |                            |                         |                       |                     |  |
| <b>Debt Restructurings</b> |                    |                         |                            |                         |                       |                     |  |
| (TDRs)                     | 10                 | \$ 8,308                | \$ -                       | \$ 8,308                | \$5,326               | \$ 5,570            |  |

Principal modification includes principal forgiveness at the time of modification, contingent principal forgiveness granted over the life of the loan based on borrower performance, and principal that has been legally separated and deferred to the end of the loan, with zero percent contractual interest rate.

During the six months ended June 30, 2018 and 2017, no loans were modified as troubled debt restructurings.

There were no defaults on troubled debt restructurings within twelve months following the modification during the six months ended June 30, 2018 and 2017.

Note 6 – Commitments and Contingencies

The Bank is involved in certain legal actions and claims that arise in the ordinary course of business. Management believes that, as a result of its legal defenses and insurance arrangements, none of these matters is expected to have a material adverse effect on the Bank's, BGIS's or the Company's financial condition, results of operations or cash flows.

Note 7 – Regulatory Capital Requirements

The Bank is subject to various regulatory capital requirements administered by the United States federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's, BGIS's and the Company's condensed consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items, as calculated under regulatory accounting practices.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). As of June 30, 2018, and December 31, 2017, the Bank met all capital adequacy requirements to which it is subject.

In December 2010, the Basel Committee on Bank Supervision ("Basel Committee") released its final framework for strengthening international capital and liquidity regulation, now officially identified as "Basel III," which, when fully phased-in, would require bank holding companies and their bank subsidiaries to maintain substantially more capital than had previously been required, with a greater emphasis on common equity.

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In July 2013, the U.S. banking regulatory agencies approved the U.S. version of Basel III. The agencies-adopted version of Basel III revises the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to make them consistent with Basel III and to meet the requirements of the Dodd-Frank Act. Although many of the rules contained in these final regulations are applicable only to large, internationally active banks, some of them apply on a phased-in basis to all banking organizations, including the Company and the Bank. Among other things, the rules establish a new minimum common equity Tier 1 ratio (4.5% of risk-weighted assets), a higher minimum Tier 1 risk-based capital requirement (6.0% of risk-weighted assets) and a minimum non-risk-based leverage ratio (4.0%, eliminating a 3.0% exception for higher rated banks). The new additional capital conservation buffer of 2.5% of risk weighted assets over each of the required capital ratios are being phased in from 2016 to 2019 (1.875% in 2018 and 1.25% in 2017) and must be met to avoid limitations on the ability of the Company and the Bank to pay dividends, repurchase shares or pay discretionary bonuses. An additional “countercyclical capital buffer” is required for larger and more complex institutions. The new rules assign higher risk weighting to exposures that are more than 90 days past due or are on nonaccrual status and certain commercial real estate facilities that finance the acquisition, development or construction of real property. The rules also change the permitted composition of Tier 1 capital to exclude trust preferred securities, mortgage servicing rights and certain deferred tax assets, and include unrealized gains and losses on available-for-sale debt and equity securities (through a one-time opt out option for Standardized Banks (banks with less than \$250 billion of total consolidated assets and less than \$10 billion of foreign exposures) which the Company and the Bank elected at March 31, 2015). The rules, including alternative requirements for smaller community financial institutions like the Company and the Bank, will be phased in through 2019.

As of June 30, 2018, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum Total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank’s category. The Bank’s actual capital amounts and ratios as of June 30, 2018, and December 31, 2017, are also presented in the table below.

|                                   | Actual     |          | Purposes             |         | To Be Well Capitalized      |          |
|-----------------------------------|------------|----------|----------------------|---------|-----------------------------|----------|
|                                   |            |          | For Capital Adequacy |         | Under Prompt Corrective     |          |
|                                   | Amount     | Ratio    | Amount               | Ratio   | Action Provisions<br>Amount | Ratio    |
| <b>At June 30, 2018:</b>          |            |          |                      |         |                             |          |
| <b>Total capital (to Risk</b>     |            |          |                      |         |                             |          |
| Weighted Assets)                  | \$ 160,255 | 12.860 % | \$ 123,053           | 9.875 % | \$ 124,611                  | 10.000 % |
| <b>Tier 1 capital (to Risk</b>    |            |          |                      |         |                             |          |
| Weighted Assets)                  | \$ 144,638 | 11.607 % | \$ 98,131            | 7.875 % | \$ 99,689                   | 8.000 %  |
| <b>Tier 1 capital (to Average</b> |            |          |                      |         |                             |          |
| Assets)                           | \$ 144,638 | 7.426 %  | \$ 77,905            | 4.000 % | \$ 97,381                   | 5.000 %  |
| <b>Common Equity Tier 1</b>       |            |          |                      |         |                             |          |
| <b>Capital (to Risk Weighted</b>  |            |          |                      |         |                             |          |
| Assets)                           | \$ 139,638 | 11.206 % | \$ 79,439            | 6.375 % | \$ 80,997                   | 6.500 %  |

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At December 31, 2017:

Total capital (to Risk

|                  |            |         |            |         |            |          |
|------------------|------------|---------|------------|---------|------------|----------|
| Weighted Assets) | \$ 151,699 | 12.490% | \$ 112,347 | 9.250 % | \$ 121,456 | 10.000 % |
|------------------|------------|---------|------------|---------|------------|----------|

Tier 1 capital (to Risk

|                  |            |         |           |         |           |         |
|------------------|------------|---------|-----------|---------|-----------|---------|
| Weighted Assets) | \$ 136,521 | 11.240% | \$ 88,056 | 7.250 % | \$ 97,165 | 8.000 % |
|------------------|------------|---------|-----------|---------|-----------|---------|

Tier 1 capital (to Average

|         |            |         |           |         |           |         |
|---------|------------|---------|-----------|---------|-----------|---------|
| Assets) | \$ 136,521 | 6.968 % | \$ 78,373 | 4.000 % | \$ 97,967 | 5.000 % |
|---------|------------|---------|-----------|---------|-----------|---------|

Common Equity Tier 1

Capital (to Risk Weighted

|         |            |         |           |         |           |         |
|---------|------------|---------|-----------|---------|-----------|---------|
| Assets) | \$ 131,521 | 10.829% | \$ 69,837 | 5.750 % | \$ 78,946 | 6.500 % |
|---------|------------|---------|-----------|---------|-----------|---------|

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In addition, the Company's actual capital amounts and ratios as of June 30, 2018, and December 31, 2017, are also presented in the table below.

|                              | Actual     |         | For Capital Adequacy Purposes |         | To Be Well Capitalized Under Prompt Corrective Action Provisions |          |
|------------------------------|------------|---------|-------------------------------|---------|--|----------|
|                              | Amount     | Ratio   | Amount                        | Ratio   | Amount   | Ratio    |
| <b>At June 30, 2018:</b>     |            |         |                               |         |  |          |
| Total capital (to Risk       |            |         |                               |         |  |          |
| Weighted Assets)             | \$ 164,719 | 13.184% | \$ 123,377                    | 9.875 % | \$ 124,939   | 10.000 % |
| Tier 1 capital (to Risk      |            |         |                               |         |  |          |
| Weighted Assets)             | \$ 149,062 | 11.931% | \$ 98,389                     | 7.875 % | \$ 99,951  | 8.000 %  |
| Tier 1 capital (to Average   |            |         |                               |         |  |          |
| Assets)                      | \$ 149,062 | 7.641 % | \$ 78,032                     | 4.000 % | \$ 97,540  | 5.000 %  |
| Common Equity Tier 1         |            |         |                               |         |  |          |
| Capital (to Risk Weighted    |            |         |                               |         |  |          |
| Assets)                      | \$ 139,280 | 11.148% | \$ 79,648                     | 6.375 % | \$ 81,210  | 6.500 %  |
| <b>At December 31, 2017:</b> |            |         |                               |         |  |          |
| Total capital (to Risk       |            |         |                               |         |  |          |
| Weighted Assets)             | \$ 156,300 | 12.834% | \$ 112,648                    | 9.250 % | \$ 121,781   | 10.000 % |
| Tier 1 capital (to Risk      |            |         |                               |         |  |          |
| Weighted Assets)             | \$ 141,052 | 11.582% | \$ 88,291                     | 7.250 % | \$ 97,425  | 8.000 %  |
| Tier 1 capital (to Average   |            |         |                               |         |  |          |
| Assets)                      | \$ 141,052 | 7.187 % | \$ 78,504                     | 4.000 % | \$ 98,130  | 5.000 %  |
| Common Equity Tier 1         |            |         |                               |         |  |          |
| Capital (to Risk Weighted    |            |         |                               |         |  |          |
| Assets)                      | \$ 131,269 | 10.779% | \$ 70,024                     | 5.750 % | \$ 79,158  | 6.500 %  |

Stock Purchase Plan

Under the Bank's 2011 Employee Stock Purchase Plan, eligible employees can purchase, through payroll deductions, shares of common stock at a discount. The right to purchase stocks is granted to eligible employees during a quarterly offer period that is established from time to time by the Board of Directors of the Company. Eligible employees cannot accrue the right to purchase more than \$25 thousand worth of stock at the fair market value at the beginning of each offer period. Eligible employees also may not purchase more than one thousand five hundred (1,500) shares of

stock in any one offer period. The shares are purchased at 85% of the fair market price of the stock on the enrollment date. The Plan was suspended on April 4, 2018, due to the delayed filing of our 2017 report on Form 10-K, and will resume when our filings with the Securities and Exchange Commission are completed within the specified filing period.

#### Non-Cumulative Perpetual Preferred Stock

At June 30, 2018, the Company had outstanding 9,783 shares of its non-voting Series A Non-Cumulative Perpetual Preferred Stock (the "Series A Preferred Stock"). The shares of Series A Preferred Stock have an initial fixed yield of 5.5% per annum, but the yield becomes floating at June 30, 2021, after which the annual yield will be the three-month LIBOR rate plus 4.825%. The Series A Preferred Stock carries a liquidation preference of \$1 thousand per share.

#### Note 8 – Off-Balance-Sheet Activities

The Bank is a party to credit-related financial instruments with off-balance-sheet risk to meet the financing needs of its customers in the normal course of business. These financial instruments include commitments to extend credit, standby letters of credit, and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in addition to the amount reflected in the condensed consolidated financial statements.

The Bank's exposure to credit loss, in the event of nonperformance by the other parties to financial instruments for loan commitments and letters of credit, is represented by the contractual amount of these instruments. The Bank follows the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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A summary of financial instruments with off-balance-sheet risk at June 30, 2018, and December 31, 2017, is as follows:

|                              | June 30,<br>2018 | December 31,<br>2017 |
|------------------------------|------------------|----------------------|
| Commitments to extend credit | \$ 138,550       | \$ 159,767           |
| Letters of credit:           |                  |                      |
| Standby letters of credit    | \$ 56,755        | \$ 54,707            |
| Commercial letters of credit | 3,911            | 2,601                |
| Total                        | \$ 60,666        | \$ 57,308            |

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. The commitments for some lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the customer. There was \$27 thousand in reserve liabilities associated with these commitments at June 30, 2018.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party or the shipment of merchandise from a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. The majority of all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers, and similar credit underwriting standards are applied. The Bank generally holds collateral supporting those commitments.

The Bank considers its standby and other letters of credit to be payment guarantees. At June 30, 2018, the maximum undiscounted future payments that the Bank could be required to make for all outstanding letters of credit were \$60.7 million. All of these arrangements mature within one year. The Bank has recourse to recover from the customer any amounts paid under these guarantees. Most of the guarantees are fully collateralized; however, several are unsecured. The Bank had recorded \$27 thousand in reserve liabilities associated with these guarantees at June 30, 2018.

### Note 9 – Income Taxes

We record an amount equal to the tax credits, tax loss carry-forwards and tax deductions (“tax benefits”) that we believe will be available to us to offset or reduce the amounts of our income taxes in future periods as a deferred tax asset on our condensed consolidated statements of condition. Under applicable federal and state income tax laws and regulations in the United States, such tax benefits will expire if not used within specified periods of time. Accordingly, the ability to fully use our deferred tax asset depends on the amount of taxable income that we generate during those time periods. At least once each year, or more frequently if warranted, we make estimates of future taxable income that we believe we are likely to generate during those future periods. If we conclude, on the basis of those estimates and the amount of the tax benefits available to us, that it is more likely than not that we will be able to fully utilize those tax benefits prior to their expiration, we recognize the deferred tax asset in full on our balance sheet. On the other hand, if we conclude on the basis of those estimates and the amount of the tax benefits available to us that it has

become more likely than not that we will be unable to utilize those tax benefits in full prior to their expiration, then we would establish a (or increase any existing) valuation allowance to reduce the deferred tax asset on our balance sheet to the amount which we believe we are more likely than not to be able to utilize. Such a reduction is implemented by recognizing a non-cash charge that would have the effect of increasing the provision, or reducing any credit, for income taxes that we would otherwise have recorded in our consolidated statements of income. The determination of whether and the extent to which we will be able to utilize our deferred tax asset involves significant management judgments and assumptions that are subject to period-to-period changes as a result of changes in tax laws, changes in the market, or economic conditions that could affect our operating results or variances between our actual operating results and our projected operating results, as well as other factors.

A valuation allowance of \$2.0 million has been provided at June 30, 2018, and December 31, 2017, to reduce the deferred tax asset because, in management's opinion, it is more likely than not that less than the entire amount will be realized. The portion of the deferred tax asset with valuation allowance is attributable to a cumulative net operating loss carry forward from the Bank's CNMI operations, which losses management anticipates will continue. The charge from the net operating loss has already been realized in the accompanying condensed consolidated statements of income as a result of the Guam income tax code.

The difference between the effective income tax expense and the income tax expense computed at the Guam statutory rate was due to nontaxable interest income earned on loans to the Government of Guam.

In addition to filing a federal income tax return in Guam, the Bank files income tax returns in the CNMI and the State of California. The Bank is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2011.

#### Note 10 – Fair Value Measurements

The Bank uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with ASC Topic 820 "Fair Value Measurements and Disclosures", the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances there are no quoted market prices for the Bank's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The fair value guidance of ASC Topic 820 provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under then-current market conditions. If there has been a significant decrease in the volume and



level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under then-current market conditions depends on the facts and circumstances, and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under then-current market conditions.

#### Fair Value Hierarchy

In accordance with the guidance of ASC Topic 820, the Bank groups its financial assets and financial liabilities generally measured at fair value in 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.

Level Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity

1: has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market, as well as certain U.S. Treasury securities that are highly liquid and are actively traded in over-the-counter markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Financial assets measured at fair value on a recurring basis as of June 30, 2018, and December 31, 2017, are as follows:

|  | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    |
|--|--|---|--|----------|
| <b>At June 30, 2018</b>  |  |   |  |          |
| U.S. treasury notes and bonds  | \$ 53,874  | \$ -  | \$ -   | \$53,874 |
| U.S. government agency and sponsored<br>enterprise (GSE) debt securities | -  | 44,417  | -  | 44,417   |
| U.S. government agency pool securities                                   | -  | 229,820   | -  | 229,820  |
| U.S. government agency or GSE  | -  | 82,083  | -  | 82,083   |
| Other assets:  |  |   |  |          |

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|  |           |            |          |            |
|--|-----------|------------|----------|------------|
| MSRs   | -         | -          | 1,873    | 1,873      |
| Total fair value   | \$ 53,874 | \$ 356,320 | \$ 1,873 | \$ 412,067 |
| At December 31, 2017   |           |            |          |            |
| U.S. treasury notes and bonds  | \$ 59,169 | \$ -       | \$ -     | \$ 59,169  |
| U.S. government agency and sponsored<br>enterprise (GSE) debt securities | -         | 44,858     | -        | 44,858     |
| U.S. government agency pool securities                                   | -         | 282,343    | -        | 282,343    |
| U.S. government agency or GSE  | -         | 74,418     | -        | 74,418     |
| Other assets:  |           |            |          |            |
| MSRs   | -         | -          | 1,903    | 1,903      |
| Total fair value   | \$ 59,169 | \$ 401,619 | \$ 1,903 | \$ 462,691 |

There were no liabilities measured at fair value on a recurring basis as of June 30, 2018, and December 31, 2017.

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During the six months ended June 30, 2018 and 2017, the changes in Level 3 assets measured at fair value on a recurring basis are as follows:

|  | Six Months<br>Ended June 30, |         |
|--|------------------------------|---------|
|  | 2018                         | 2017    |
| Beginning balance                      | \$1,903                      | \$1,527 |
| Realized and unrealized net gains:     |                              |         |
| Included in net income                 | (30 )                        | (12 )   |
| Included in other comprehensive income | -                            | -       |
| Purchases, issuance and settlements    |                              |         |
| Purchases                              | -                            | -       |
| Issuances                              | -                            | -       |
| Settlements                            | -                            | -       |
| Ending balance                         | \$1,873                      | \$1,515 |

The valuation technique used for Level 3 mortgage servicing rights (“MSRs”) is their discounted cash flow. Inputs considered in determining Level 3 pricing include the anticipated prepayment rates, discount rates, and cost to service. Significant increases or decreases in any of those inputs in isolation would result in a significantly lower or higher fair value measurement.

The following table presents quantitative information about the valuation technique and unobservable inputs applied to Level 3 fair value measurements for financial instruments measured at fair value on a recurring basis:

|                       | Estimated<br>Fair<br>Value | Valuation<br>Technique | Unobservable Inputs  | Range<br>of<br>Inputs | Weighted<br>Average<br>Rate |
|-----------------------|----------------------------|------------------------|--|-----------------------|-----------------------------|
| June 30, 2018         |                            |                        |  |                       |                             |
| Financial instrument: |                            |                        |  |                       |                             |
|                       |                            | Discounted             |  | 6.50%                 |                             |
|                       |                            |                        | Discount Rate  | -                     | 8.00%                       |
| MSRs                  | \$ 1,873                   | Cash Flow              |  | 9.25%                 |                             |
|                       |                            |                        | Weighted Average Prepayment Rate (Public Securities Association) | 125%                  |                             |
| December 31, 2017     |                            |                        |  |                       |                             |
| Financial instrument: |                            |                        |  |                       |                             |
|                       |                            | Discounted             |  | 6.50%                 |                             |
|                       |                            |                        | Discount Rate  | -                     | 8.00%                       |
| MSRs                  | \$ 1,903                   | Cash Flow              |  | 9.25%                 |                             |
|                       |                            |                        | Weighted Average Prepayment Rate (Public Securities Association) | 125%                  |                             |

There were no transfers into or out of the Bank's Level 3 financial instruments for the periods ended June 30, 2018 and December 31, 2017.

Nonrecurring Fair Value Measurements

Under certain circumstances, the Bank makes adjustments to fair value for assets and liabilities even though they are not measured at fair value on an ongoing basis. The following table presents the financial instruments carried on the condensed consolidated statements of condition by caption and by level in the fair value hierarchy at June 30, 2018, and December 31, 2017, for which a nonrecurring change in fair value has been recorded:

|                          | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total   |
|--------------------------|--|---|--|---------|
| <b>June 30, 2018</b>     |  |   |  |         |
| Financial assets:        |  |   |  |         |
| Loans, net               |  |   |  |         |
| Impaired loans           | \$ -   | \$ -  | \$ -   | \$-     |
| Other assets             |  |   |  |         |
| Other real estate owned  | \$ -   | \$ -  | \$ 2,298   | \$2,298 |
| <b>December 31, 2017</b> |  |   |  |         |
| Financial assets:        |  |   |  |         |
| Loans, net               |  |   |  |         |
| Impaired loans           | \$ -   | \$ -  | \$ -   | \$-     |
| Other assets             |  |   |  |         |
| Other real estate owned  | \$ -   | \$ -  | \$ 2,466   | \$2,466 |

The fair value of loans subject to write downs is estimated using the appraised value of the underlying collateral, discounted as necessary due to management's estimates of changes in economic conditions.

Additionally, the Bank also makes adjustments to nonfinancial assets and liabilities even though they are not measured at fair value on an ongoing basis. With the exception of other real estate owned, the Bank does not have nonfinancial assets or liabilities for which a nonrecurring change in fair value has been recorded during the periods ended June 30, 2018, and December 31, 2017.

The following methods and assumptions were used by the Bank in estimating fair value disclosures for financial instruments:

Cash and Cash Equivalents

The carrying amount of cash and short-term instruments approximates fair value based on the short-term nature of the assets.

### Interest-Bearing Deposits in Banks

Fair values for other interest-bearing deposits are estimated using discounted cash flow analyses based on current interest rates or yields for similar types of deposits.

### Federal Home Loan Bank Stock

The Bank is a member of the Federal Home Loan Bank of Des Moines (“FHLB”). As a member, we are required to own stock of the FHLB, the amount of which is based primarily on the level of our borrowings from that institution. We also have the right to acquire additional shares of stock in the FHLB; however, to date, we have not done so. It is not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability.

### Investment Securities

When quoted prices are available in an active market, the Bank classifies the securities within Level 1 of the valuation hierarchy. Level 1 securities include U.S. Treasury notes and bonds.

If quoted market prices are not available, the Bank estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include U.S. GSE obligations, U.S. government agency pool securities, and other securities. Mortgage-backed securities are included in Level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, the Bank would classify those securities in Level 3. At June 30, 2018, and December 31, 2017, the Bank did not have any Level 3 investment securities.

## Loans

For variable-rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans are estimated using discounted cash flow analyses, based upon interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable. Loans are classified in Level 3.

## Mortgage Servicing Rights

The fair value of MSRs is determined using models which depend on estimates of prepayment rates, discount rates and costs to service. MSRs are classified in Level 3.

## Deposit Liabilities

The fair values disclosed for demand deposits (for example, interest and non-interest checking, passbook savings and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies current market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits. Deposit liabilities are classified in Level 3.

## Short-Term Borrowings

The carrying amounts of federal funds purchased and Federal Home Loan Bank (FHLB) advances maturing within ninety days approximate their fair values.

## Long-Term Borrowings

The fair value of FHLB advances maturing after ninety days is determined based on expected present value techniques using current market interest rates for advances with similar terms and remaining maturities.

## Accrued Interest

The carrying amount of accrued interest approximates fair value.

## Off-Balance Sheet Commitments and Contingent Liabilities

Management does not believe it is practicable to provide an estimate of fair value for off-balance sheet commitments or contingent liabilities because of the uncertainty involved in attempting to assess the likelihood and timing of a commitment being drawn upon, coupled with a lack of an established market for these instruments and the wide diversity of fee structures.

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Fair Value of Other Financial Instruments

The estimated fair values of the Bank's financial instruments, excluding those assets recorded at fair value on a recurring basis on the Bank's condensed consolidated statements of condition, are as follows:

|  | Carrying Amount        | Estimated fair value |           |              |
|--|------------------------|----------------------|-----------|--------------|
|  |                        | Level 1              | Level 2   | Level 3      |
| June 30, 2018                          | (Dollars in thousands) |                      |           |              |
| Financial assets:                      |                        |                      |           |              |
| Cash and cash equivalents              | \$ 106,999             | \$ 106,999           | \$-       | \$-          |
| Restricted cash                        | 400                    | 400                  | -         | -            |
| Federal Home Loan Bank stock           | 2,356                  | -                    | 2,356     | -            |
| Investment securities held-to-maturity | 79,288                 | -                    | 78,569    | -            |
| Loans, net                             | 1,235,542              | -                    | -         | 1,230,182    |
| Total                                  | \$ 1,424,585           | \$ 107,399           | \$ 80,925 | \$ 1,230,182 |
| Financial liabilities:                 |                        |                      |           |              |
| Deposits                               | 1,747,119              | -                    | -         | 1,733,006    |
| Total                                  | \$ 1,747,119           | \$-                  | \$-       | \$ 1,733,006 |
| December 31, 2017                      |                        |                      |           |              |
| Financial assets:                      |                        |                      |           |              |
| Cash and cash equivalents              | \$ 126,127             | \$ 126,127           | \$-       | \$-          |
| Restricted cash                        | 400                    | 400                  | -         | -            |
| Federal Home Loan Bank stock           | 2,303                  | -                    | 2,303     | -            |
| Investment securities held-to-maturity | 89,677                 | -                    | 89,999    | -            |
| Loans, net                             | 1,209,824              | -                    | -         | 1,202,817    |
| Total                                  | \$ 1,428,331           | \$ 126,527           | \$ 92,302 | \$ 1,202,817 |
| Financial liabilities:                 |                        |                      |           |              |
| Deposits                               | \$ 1,816,132           | \$-                  | \$-       | \$ 1,816,773 |
| Total                                  | \$ 1,816,132           | \$-                  | \$-       | \$ 1,816,773 |

Note 11 – Comprehensive Income

The components of accumulated other comprehensive income, including stockholders' equity, are as follows:

|   | Six Months<br>Ended June 30, |           |
|---|------------------------------|-----------|
|   | 2018                         | 2017      |
| Net unrealized loss on available for sale securities          | \$(6,448)                    | \$(2,601) |
| Amounts reclassified from AOCI for loss on sale of investment | 413                          | 13        |



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|   |           |           |
|---|-----------|-----------|
| securities available for sale included in net income                          |           |           |
| Tax effect  | 1,266     | 880       |
| Unrealized holding loss on available for sale securities, net of tax          | (4,769)   | (1,708)   |
| Gross unrealized holding loss on held to maturity securities                  | (1,186)   | (1,620)   |
| Amortization of unrealized holding loss on held to maturity during the period | 276       | 215       |
| Unrealized holding loss on held to maturity securities                        | (910 )    | (1,405)   |
| Accumulated other comprehensive income  | \$(5,679) | \$(3,113) |

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion provides information about the results of operations, financial condition, liquidity, and capital resources of the Company and its wholly-owned subsidiaries, the Bank and BGIS. This information is intended to facilitate the understanding and assessment of significant changes and trends related to our financial condition and the results of operations. This discussion and analysis should be read in conjunction with our condensed consolidated financial statements and the accompanying notes presented elsewhere in this Quarterly Report.

Overview

BankGuam Holding Company (the “Company”) is a Guam corporation organized on October 29, 2010, to act as a holding company of Bank of Guam (the “Bank”), a 22-branch bank serving the communities in Guam, the Commonwealth of the Northern Mariana Islands (“CNMI”), the Federated States of Micronesia (“FSM”), the Republic of the Marshall Islands (“RMI”), the Republic of Palau (“ROP”), and San Francisco, California. On August 15, 2011, the Company acquired all of the outstanding common stock of the Bank in a holding company formation transaction.

In August 2015, the Company chartered a second subsidiary, BankGuam Investment Services (“BGIS”), in an effort to enhance the options and opportunities of our customers to build future income and wealth. BGIS was capitalized in the amount of \$300 thousand during the first quarter of 2016, and was in full operation by the end of May 2016.

In May 2016, the Company entered into a Stock Purchase Agreement to acquire 25% of ASC Trust Corporation, a Guam trust company. In July 2016, subsequent to the approval of the Federal Reserve Bank of San Francisco in June 2016, the purchase was executed. The Agreement provides for the acquisition of an additional 20% of the stock of ASC Trust Corporation in April 2019, and another 25% in April 2021, with both future purchases subject to regulatory approval. The Agreement contains customary warranties, representations and indemnification provisions.

Other than holding the shares of the Bank, BGIS and ASC Trust Corporation, the Company conducts no significant activities, although it is authorized, with the prior approval of its principal regulator, the Board of Governors of the Federal Reserve System, to engage in a variety of activities related to the business of banking. Currently, substantially all of the Company’s operations are conducted and substantially all of its assets are owned by the Bank, which accounts for substantially all of our consolidated revenues, expenses and operating income. The Bank’s headquarters is located in Hagåtña, Guam, and the Bank provides a variety of financial services to individuals, businesses and government entities through its branch network. The Bank’s primary deposit products are demand deposits, savings and time certificates of deposit, and its primary lending products are consumer, commercial and real estate loans. The Bank also provides many other financial services to its customers. BGIS is a registered investment company, primarily involved in providing investment advisory services and trading securities for its customers. ASC Trust Corporation is primarily involved in administering 401(k) retirement plans and other employee benefit programs for its customers.

Summary of Operating Results

The following table provides unaudited comparative information with respect to our results of operations for the three and six months ended June 30, 2018 and 2017, respectively:

| Three Months Ended |        |        | Six Months Ended June 30, |        |        |
|--------------------|--------|--------|---------------------------|--------|--------|
| June 30,           |        |        | June 30,                  |        |        |
| 2018               | 2017   | %      | 2018                      | 2017   | %      |
| Amount             | Amount | Change | Amount                    | Amount | Change |

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|  |          |          |       |   |          |          |       |   |
|--|----------|----------|-------|---|----------|----------|-------|---|
| Interest income                                      | \$22,742 | \$20,268 | 12.2  | % | \$44,616 | \$39,355 | 13.4  | % |
| Interest expense                                     | 547      | 552      | -0.9  | % | 1,089    | 1,082    | 0.6   | % |
| Net interest income before provision for loan losses | 22,195   | 19,716   | 12.6  | % | 43,527   | 38,273   | 13.7  | % |
| Provision for loan losses                            | 2,099    | 1,184    | 77.3  | % | 4,838    | 2,367    | 104.4 | % |
| Net interest income after provision for loan losses  | 20,096   | 18,532   | 8.4   | % | 38,689   | 35,906   | 7.8   | % |
| Non-interest income                                  | 3,843    | 3,178    | 20.9  | % | 7,259    | 6,217    | 16.8  | % |
| Non-interest expense                                 | 18,988   | 17,257   | 10.0  | % | 36,525   | 34,412   | 6.1   | % |
| Income before income taxes                           | 4,951    | 4,453    | 11.2  | % | 9,423    | 7,711    | 22.2  | % |
| Income tax expense                                   | 1,054    | 1,184    | -11.0 | % | 1,898    | 2,157    | -12.0 | % |
| Net income   | \$3,897  | \$3,269  | 19.2  | % | \$7,525  | \$5,554  | 35.5  | % |
| Earnings per common share                            |          |          |       |   |          |          |       |   |
| Basic net income                                     | \$0.39   | \$0.34   |       |   | \$0.76   | \$0.57   |       |   |
| Diluted net income                                   | \$0.39   | \$0.34   |       |   | \$0.76   | \$0.57   |       |   |

As the above table indicates, our net income increased in the three and six months ended June 30, 2018, as compared to the corresponding periods in 2017. In the three months ended June 30, 2018, we recorded net income after taxes of \$3.9 million, an increase of \$628 thousand (or 19.2%) as compared to the same period in 2017. These results were most significantly impacted by higher net interest income, which increased by \$2.5 million, and an increase in non-interest income of \$665 thousand, but these increases were partially offset by an increase of \$1.7 million in our non-interest expense and an increase of \$915 thousand in our provision for loan losses. The increase in net interest income in the three months ended June 30, 2018, as compared to the same period in 2017, was largely attributed to an increase in interest earnings on loans, which went up by \$2.0 million due to higher interest rates and growth of \$94.6 million in our gross loan portfolio, and an increase of \$682 thousand in income from our securities portfolio associated with rising yields that were partially offset by a decrease of \$44.3 million in the portfolio. The \$130 thousand decrease in income tax expense was due to the reduction of corporate income tax rates under the 2017 Tax Cuts and Jobs Act.

In the six months ended June 30, 2018, we recorded an increase in net income after taxes of \$7.5 million, higher by \$2.0 million (35.5%) from the \$5.6 million recorded in the six months ended June 30, 2017. The largest factors in the increase were an increase of \$5.3 million in net interest income, a rise of \$1.0 million in non-interest income and a reduction of \$259 thousand in income taxes, partially offset by an increase of \$2.5 million in our provision for loan losses and an increase of \$2.1 million on our non-interest expense.

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The following table shows the increase in our net interest margin in the three and six months ended June 30, 2018, but it also indicates the impact that the increase in our net income had on our annualized returns on average assets and average equity during that period, as compared to the corresponding three and six months ended June 30, 2017:

|                          | Three Months           |       | Six Months             |       |
|--------------------------|------------------------|-------|------------------------|-------|
|                          | Ended June 30,<br>2018 | 2017  | Ended June 30,<br>2018 | 2017  |
| Net interest margin      | 4.77%                  | 4.19% | 4.66%                  | 4.14% |
| Return on average assets | 0.80%                  | 0.66% | 0.77%                  | 0.58% |
| Return on average equity | 10.86%                 | 9.63% | 10.54%                 | 8.25% |

### Critical Accounting Policies

The Company's significant accounting policies are set forth in Note 2 in the Notes to the Company's Annual Report on Form 10-K for 2017 filed with the SEC on June 29, 2018, and Note 2 of Item 1 in this report. Our unaudited condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") and general practices in the banking industry. Certain of those accounting policies are considered critical accounting policies because they require us to make assumptions and judgments regarding circumstances or trends that could affect the carrying values of our material assets, such as assumptions regarding economic conditions or trends that could impact our ability to fully collect our outstanding loans or ultimately realize the carrying values of certain of our other assets, such as securities that are available for sale. If adverse changes were to occur in the events, trends or other circumstances on which our assumptions or judgments have been based, or other unanticipated events were to happen that might affect our operating results, it could become necessary under GAAP for us to reduce the carrying values of the affected assets in our condensed consolidated statements of condition. In addition, because reductions in the carrying values of assets are sometimes effectuated by or require charges to income, such reductions also may have the effect of reducing our income.

### Results of Operations

#### Net Interest Income

Net interest income, the primary component of the Bank's income, refers to the difference between the interest earned on loans, investment securities and other interest-earning assets, and the interest paid on deposits and other borrowed funds. Our interest income and interest expense are affected by a number of factors, some of which are outside of our control, including national and local economic conditions, the monetary policies of the Federal Reserve's Open Market Committee which affect interest rates, competition in the marketplace for loans and deposits, the demand for loans and the ability of borrowers to meet their payment obligations. Net interest income, when expressed as a percentage of average earning assets, is a banking organization's "net interest margin."

The following table sets forth our interest income, interest expense and net interest income, and our annualized net interest margin for the three and six months ended June 30, 2018 and 2017, respectively:

| Three Months Ended June 30, |      | Six Months Ended June 30, |      |
|-----------------------------|------|---------------------------|------|
| 2018                        | 2017 | 2018                      | 2017 |

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|                     |          |          | %<br>Change |          |          | %<br>Change |
|---------------------|----------|----------|-------------|----------|----------|-------------|
| Interest income     | \$22,742 | \$20,268 | 12.21 %     | 44,616   | \$39,355 | 13.37 %     |
| Interest expense    | 547      | 552      | -0.91 %     | 1,089    | 1,082    | 0.65 %      |
| Net interest income | \$22,195 | \$19,716 | 12.57 %     | \$43,527 | \$38,273 | 13.73 %     |
| Net interest margin | 4.77 %   | 4.19 %   | 0.58 %      | 4.66 %   | 4.14 %   | 0.52 %      |

Net interest income increased by 12.6% and 13.7%, respectively, for the three and six months ended June 30, 2018, as compared to the corresponding periods in 2017.

For the three and six months ended June 30, 2018, net interest income rose by \$2.5 million and \$5.3 million, respectively, as compared to the same periods in 2017. Total interest income also increased by \$2.5 million and \$5.3 million in those same periods, respectively, principally because of a \$2.0 million increase in our loan interest earnings, supplemented by a \$610 thousand increase in interest earned on our investment portfolio during the three months ended June 30, 2018, compared to the previous year, and because of a \$4.0 million increase in our loan interest income and a \$1.3 million rise in the interest earnings from our investment portfolio during the six months ended June 30, 2018, compared to the corresponding period of 2017. The growth in our net interest margin was primarily the result of increases of 0.58% and 0.52% in the yield on our average earning assets, respectively, in the three and six months ended June 30, 2018, as compared to the corresponding periods of 2017, combined with modest changes in our average earning assets of a decrease of 1.2% and an increase of 1.3%, respectively, during those same comparative periods.

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Average Balances

Distribution, Rate and Yield

The following table sets forth information regarding our average balance sheet, annualized yields on interest-earning assets and interest rates on interest-bearing liabilities, the interest rate spread and the interest rate margin for the three and six months ended June 30, 2018 and 2017:

|  | Three Months Ended June 30,<br>2018 |                         |                       | 2017               |                         |                       |  |  |
|--|-------------------------------------|-------------------------|-----------------------|--------------------|-------------------------|-----------------------|--|--|
|  | Average<br>Balance                  | Interest<br>Earned/Paid | Average<br>Yield/Rate | Average<br>Balance | Interest<br>Earned/Paid | Average<br>Yield/Rate |  |  |
| <b>Interest earning assets:</b>            |                                     |                         |                       |                    |                         |                       |  |  |
| Short term investments <sup>1</sup>        | \$71,247                            | \$ 124                  | 0.70 %                | \$157,158          | \$ 248                  | 0.63 %                |  |  |
| Investment Securities <sup>2</sup>         | 529,374                             | 2,551                   | 1.93 %                | 528,129            | 1,941                   | 1.47 %                |  |  |
| Loans <sup>3</sup>                         | 1,258,802                           | 20,067                  | 6.38 %                | 1,196,179          | 18,079                  | 6.05 %                |  |  |
| Total earning assets                       | 1,859,423                           | 22,742                  | 4.89 %                | 1,881,466          | 20,268                  | 4.31 %                |  |  |
| Noninterest earning assets                 | 83,805                              |                         |                       | 87,095             |                         |                       |  |  |
| Total assets                               | \$1,943,228                         |                         |                       | \$1,968,561        |                         |                       |  |  |
| <b>Interest-bearing liabilities:</b>       |                                     |                         |                       |                    |                         |                       |  |  |
| Interest-bearing checking accounts         | \$269,314                           | \$ 86                   | 0.13 %                | \$266,357          | \$ 81                   | 0.12 %                |  |  |
| Money market and savings accounts          | 934,237                             | 424                     | 0.18 %                | 1,002,204          | 433                     | 0.17 %                |  |  |
| Certificates of deposit                    | 33,121                              | 28                      | 0.34 %                | 50,410             | 38                      | 0.30 %                |  |  |
| Other borrowings                           | -                                   | 9                       | 0.00 %                | -                  | -                       | 0.00 %                |  |  |
| Total interest-bearing liabilities         | 1,236,672                           | 547                     | 0.18 %                | 1,318,971          | 552                     | 0.17 %                |  |  |
| Non-interest bearing liabilities           | 563,004                             |                         |                       | 513,739            |                         |                       |  |  |
| Total liabilities                          | 1,799,676                           |                         |                       | 1,832,710          |                         |                       |  |  |
| Stockholders' equity                       | 143,552                             |                         |                       | 135,851            |                         |                       |  |  |
| Total liabilities and stockholders' equity | \$1,943,228                         |                         |                       | \$1,968,561        |                         |                       |  |  |
| <b>Net interest income</b>                 |                                     |                         |                       |                    |                         |                       |  |  |
|  |                                     | \$ 22,195               |                       |                    | \$ 19,716               |                       |  |  |
| <b>Interest rate spread</b>                |                                     |                         |                       |                    |                         |                       |  |  |
|  |                                     |                         | 4.72 %                |                    |                         | 4.14 %                |  |  |
| <b>Net interest margin</b>                 |                                     |                         |                       |                    |                         |                       |  |  |
|  |                                     |                         | 4.77 %                |                    |                         | 4.19 %                |  |  |

|                                     | Six Months Ended June 30,<br>2018 |                         |                       | 2017               |                         |                       |  |  |
|-------------------------------------|-----------------------------------|-------------------------|-----------------------|--------------------|-------------------------|-----------------------|--|--|
|                                     | Average<br>Balance                | Interest<br>Earned/Paid | Average<br>Yield/Rate | Average<br>Balance | Interest<br>Earned/Paid | Average<br>Yield/Rate |  |  |
| <b>Interest earning assets:</b>     |                                   |                         |                       |                    |                         |                       |  |  |
| Short term investments <sup>1</sup> | \$67,794                          | \$ 372                  | 1.10 %                | \$134,051          | \$ 431                  | 0.64 %                |  |  |
| Investment securities <sup>2</sup>  | 547,901                           | 4,986                   | 1.82 %                | 524,487            | 3,693                   | 1.41 %                |  |  |
| Loans <sup>3</sup>                  | 1,251,671                         | 39,258                  | 6.27 %                | 1,188,540          | 35,231                  | 5.93 %                |  |  |
| Total earning assets                | 1,867,366                         | 44,616                  | 4.78 %                | 1,847,078          | 39,355                  | 4.26 %                |  |  |
| Noninterest earning assets          | 85,282                            |                         |                       | 84,203             |                         |                       |  |  |
| Total assets                        | \$1,952,648                       |                         |                       | \$1,931,281        |                         |                       |  |  |

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Interest-bearing liabilities:

|  |              |        |      |   |              |        |      |   |
|--|--------------|--------|------|---|--------------|--------|------|---|
| Interest-bearing checking accounts         | \$ 281,639   | \$ 173 | 0.12 | % | \$ 274,478   | \$ 163 | 0.12 | % |
| Money market and savings accounts          | 947,305      | 847    | 0.18 | % | 973,465      | 843    | 0.17 | % |
| Certificates of deposit                    | 33,844       | 58     | 0.34 | % | 50,683       | 76     | 0.30 | % |
| Other borrowings                           | -            | 11     | 0.00 | % | -            | -      | 0.00 | % |
| Total interest-bearing liabilities         | 1,262,788    | 1,089  | 0.17 | % | 1,298,626    | 1,082  | 0.17 | % |
| Non-interest bearing liabilities           | 547,070      |        |      |   | 497,949      |        |      |   |
| Total liabilities                          | 1,809,858    |        |      |   | 1,796,575    |        |      |   |
| Stockholders' equity                       | 142,790      |        |      |   | 134,706      |        |      |   |
| Total liabilities and stockholders' equity | \$ 1,952,648 |        |      |   | \$ 1,931,281 |        |      |   |

|                     |           |           |
|---------------------|-----------|-----------|
| Net interest income | \$ 43,527 | \$ 38,273 |
|---------------------|-----------|-----------|

|                      |      |   |      |   |
|----------------------|------|---|------|---|
| Interest rate spread | 4.61 | % | 4.09 | % |
| Net interest margin  | 4.66 | % | 4.14 | % |

<sup>1</sup>Short term investments consist of interest-bearing deposits that we maintain with other financial institutions.

<sup>2</sup>Includes all investment securities in the Available-for-Sale and the Held-to-Maturity classifications.

<sup>3</sup>Loans include the average balance of non-accrual loans. Loan interest income includes loan fees of \$749 thousand and \$1.2 million in the three and six months ended June 30, 2018, and \$526 thousand and \$880 thousand during the three and six months ended June 30, 2017.

For the three and six months ended June 30, 2018, our total average earning assets decreased by \$22.0 million and increased by \$20.3 million, respectively, as compared to the same periods in 2017. The decrease during the three months ended June 30, 2018, compared to the same period in 2017, is attributed to the \$62.6 million increase in our average loan portfolio and the \$1.2 million increase in our average investment securities portfolio, more than offset by the \$85.9 million decrease in average short term investments. Average noninterest earning assets decreased by \$3.3 million. In the three and six months ended June 30, 2018, average total interest-bearing liabilities decreased by \$82.3 million and \$35.8 million, respectively, in comparison to the same periods in 2017, comprised of respective \$16.8 million and \$68.0 million decreases in average interest-bearing money market and savings accounts and respective \$17.3 million and \$16.8 million decreases in average certificates of deposit, coupled with respective \$3.0 million and \$7.2 million increases in interest-bearing checking accounts. The overall decreases in average interest-bearing liabilities resulted in part from some large depositors, including government agencies, transferring funds from the Bank into investments through our Trust Department. The partially offsetting increases of \$49.3 million and \$49.1 million, respectively, in average non-interest bearing liabilities during the three and six months ended June 30, 2018, compared to the same periods in 2017, partially in traditional checking accounts, resulted in an overall respective decrease of \$33.0 million and increase of \$13.3 million in average total liabilities. During the three and six months ended June 30, 2018, average stockholders' equity increased by \$7.7 million (5.7%) and \$8.1 million (6.0%), respectively, in comparison to the year-earlier periods.

Our interest rate spread increased by 0.57% and our net interest margin rose by 0.58% in the three months ended June 30, 2018, as compared to the same period in 2017, and our interest rate spread and our net interest margin both increased by 0.52% during the six months ended June 30, 2018 compared to the first six months of 2017. During the six months ended June 30, 2018, the increase in our interest rate spread is attributed to the 0.52% increase in the average yield on our interest earning assets, while the average cost of our interest-bearing liabilities remained constant at 0.17%, while the increase in our net interest margin resulted from the 13.7% increase in our net interest income exceeding the 1.1% increase in our average total interest-earning assets, due primarily to rising market interest rates.



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The following table provides information regarding the changes in interest income and interest expense, attributable to changes in rates and changes in volumes, that contribute to the total change in net interest income for the three and six months ended June 30, 2018, in comparison to the three and six months ended June 30, 2017:

|                                    | Three Months Ended<br>June 30, 2018 vs. 2017<br>(In thousands) |                |                   |
|------------------------------------|--|----------------|-------------------|
|                                    | Attributable to:   |                |                   |
|                                    | Net<br>Change<br>in  |                |                   |
|                                    | Change   |                |                   |
|                                    | Interest   | in             | Change            |
|                                    | Income/Expense   | Rate           | in                |
|                                    |  |                | Volume            |
| <b>Interest income:</b>            |  |                |                   |
| Short term investments             | \$(124 )   | \$102          | \$(226 )          |
| Investment securities              | 610  | 2,416          | (1,806 )          |
| Loans                              | 1,988  | 3,959          | (1,971 )          |
| <b>Total interest income</b>       | <b>\$2,474</b>   | <b>\$6,477</b> | <b>\$(4,003 )</b> |
| <b>Interest expense:</b>           |  |                |                   |
| Interest-bearing checking accounts | \$5  | \$16           | \$(11 )           |
| Money market and savings accounts  | (9 )   | 87             | (96 )             |
| Certificates of deposit            | (10 )  | 18             | (28 )             |
| Other borrowings                   | 9  | -              | 9                 |
| <b>Total interest expense</b>      | <b>\$(5 )</b>  | <b>\$121</b>   | <b>\$(126 )</b>   |
| <b>Net interest income</b>         | <b>\$2,479</b>   | <b>\$6,356</b> | <b>\$(3,877 )</b> |

|                              | Six Months Ended<br>June 30, 2018 vs. 2017<br>(In thousands) |                |                   |
|------------------------------|--|----------------|-------------------|
|                              | Attributable to:   |                |                   |
|                              | Net<br>Change<br>in  |                |                   |
|                              | Change   |                |                   |
|                              | Interest   | in             | Change            |
|                              | Income/Expense   | Rate           | in                |
|                              |  |                | Volume            |
| <b>Interest income:</b>      |  |                |                   |
| Short term investments       | \$(59 )  | \$609          | \$(668 )          |
| Investment securities        | 1,293  | 2,160          | (867 )            |
| Loans                        | 4,027  | 4,094          | (67 )             |
| <b>Total interest income</b> | <b>\$5,261</b>   | <b>\$6,863</b> | <b>\$(1,602 )</b> |
| <b>Interest expense:</b>     |  |                |                   |

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|                                    |         |         |            |
|------------------------------------|---------|---------|------------|
| Interest-bearing checking accounts | \$10    | \$11    | \$(1 )     |
| Money market and savings accounts  | 4       | 55      | (51 )      |
| Certificates of deposit            | (18 )   | 22      | (40 )      |
| Other borrowings                   | 11      | -       | 11         |
| Total interest expense             | \$7     | \$88    | \$(81 )    |
| Net interest income                | \$5,254 | \$6,775 | \$(1,521 ) |

Provision for Loan Losses

We maintain allowances for probable loan losses that are incurred as a normal part of the banking business. As more fully discussed in Note 5 of the notes to the unaudited condensed consolidated financial statements in Item 1 of this Quarterly Report on Form 10-Q, an allowance for loan losses has been established by management in order to provide for those loans which, for a variety of reasons, may not be repaid in their entirety. The allowance is maintained at a level considered by management to be adequate to provide for probable losses that are accrued as of the balance sheet date and based on methodologies applied on a consistent basis with the prior year. Management's review of the adequacy of the allowance includes, among other things, loan growth, changes in the composition of the loan portfolio, an analysis of past loan loss experience and management's evaluation of the loan portfolio under current economic conditions.

The allowance for loan losses is based on estimates, and ultimate losses will vary from current estimates. The Bank recognizes that credit losses will be experienced and the risk of loss will vary with, among other things: general economic conditions; the type of loan being made; the credit worthiness of the borrower over the term of the loan; and, in the case of a collateralized loan, the quality and valuation of the collateral for such loan. The allowance for loan losses represents the Bank's best estimate of the allowance necessary to provide for probable losses in the portfolio as of the balance sheet date.

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If management determines that it is necessary to increase the allowance for loan losses, a provision for loan losses is recorded. For the three and six months ended June 30, 2018, the Bank's provision for loan losses was \$2.1 million and \$4.8 million, respectively, which was \$915 thousand and \$2.5 million higher than during the corresponding periods of 2017.

Management believes that the provision recorded was sufficient to offset the incremental risk of loss inherent in the gross loan portfolio of \$1.26 billion at June 30, 2018, an increase of \$27.4 million from December 31, 2017, the increase in Substandard Loans from \$22.2 million at December 31, 2017, to \$67.5 million at June 30, 2018, and to replenish the allowance to offset net loan charge-offs of \$3.3 million recorded during the same period. The allowance for loan losses at June 30, 2018, stood at \$18.8 million or 1.50% of total gross loans outstanding as of the balance sheet date, an increase of \$1.5 million from December 31, 2017. We recorded net loan charge-offs of \$3.3 million and \$2.4 million for the six months ended June 30, 2018 and 2017, respectively. See "Analysis of Allowance for Loan Losses" in the Financial Condition Section of Management's Discussion and Analysis of Financial Condition and Results of Operations for more detailed information.

### Non-Interest Income

The table below represents the major components of non-interest income and the changes therein for the three and six months ended June 30, 2018 and 2017:

|   | Three Months Ended June 30, |          |        |         | Six Months Ended June 30, |          |          |          |
|---|-----------------------------|----------|--------|---------|---------------------------|----------|----------|----------|
|   | 2018                        | 2017     | Amount | Percent | 2018                      | 2017     | Amount   | Percent  |
|   | Amount                      | Amount   | Change | Change  | Amount                    | Amount   | Change   | Change   |
| Non-interest income                       |                             |          |        |         |                           |          |          |          |
| Service charges and fees                  | \$ 1,754                    | \$ 1,452 | \$ 302 | 20.8 %  | \$ 3,438                  | \$ 2,850 | \$ 588   | 20.6 %   |
| Investment securities gains (losses), net | (362 )                      | -        | (362 ) | N/A     | (413 )                    | (13 )    | (400 )   | 3076.9 % |
| Income from merchant services             | 485                         | 598      | (113 ) | -18.9 % | 1,177                     | 1,188    | (11 )    | -0.9 %   |
| Income from cardholders, net              | 171                         | 191      | (20 )  | -10.5 % | 179                       | 359      | (180 )   | -50.1 %  |
| Trustee fees                              | 879                         | 259      | 620    | 239.4 % | 1,079                     | 455      | 624      | 137.1 %  |
| Other income                              | 916                         | 678      | 238    | 35.1 %  | 1,799                     | 1,378    | 421      | 30.6 %   |
| Total non-interest income                 | \$ 3,843                    | \$ 3,178 | \$ 665 | 20.9 %  | \$ 7,259                  | \$ 6,217 | \$ 1,042 | 16.8 %   |

For the three and six months ended June 30, 2018, non-interest income totaled \$3.8 million and \$7.3 million, respectively, which represented an increase of \$665 thousand (20.9%) as compared to the three months ended June 30, 2017, and an increase of \$1.0 million (16.8%) from the six months ended June 30, 2017. The growth during the three months ended June 30, 2018, is primarily attributed to the \$620 thousand increase in trustee fees and an increase of \$302 thousand in service charges and fees, partially offset by \$362 thousand in net losses on our investment portfolio. The growth in non-interest income during the six months ended June 30, 2018, was attributed to a \$624 thousand increase in trustee fees, an increase of \$588 thousand in service charges and fees, and an increase of \$421 thousand in other income, partially offset by a net loss of \$400 thousand in our investment portfolio compared to the same period in the previous year.

### Non-interest Expense

The table below represents the major components of non-interest expense and the changes for the three and six months ended June 30, 2018 and 2017:

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|                                   | Three Months Ended June 30, |          |          |         | Six Months Ended June 30, |          |          |         |  |
|-----------------------------------|-----------------------------|----------|----------|---------|---------------------------|----------|----------|---------|--|
|                                   | 2018                        | 2017     | Amount   | Percent | 2018                      | 2017     | Amount   | Percent |  |
|                                   | Amount                      | Amount   | Change   | Change  | Amount                    | Amount   | Change   | Change  |  |
| <b>Non-interest expense:</b>      |                             |          |          |         |                           |          |          |         |  |
| Salaries and employee benefits    | \$9,251                     | \$8,555  | \$ 696   | 8.1 %   | \$18,056                  | \$16,925 | \$ 1,131 | 6.7 %   |  |
| Occupancy                         | 1,815                       | 1,695    | 120      | 7.1 %   | 3,611                     | 3,251    | 360      | 11.1 %  |  |
| Equipment and depreciation        | 2,543                       | 2,116    | 427      | 20.2 %  | 4,857                     | 4,138    | 719      | 17.4 %  |  |
| Insurance                         | 423                         | 404      | 19       | 4.7 %   | 854                       | 809      | 45       | 5.6 %   |  |
| Telecommunications                | 487                         | 412      | 75       | 18.2 %  | 980                       | 849      | 131      | 15.4 %  |  |
| FDIC insurance assessment         | 339                         | 343      | (4 )     | -1.2 %  | 709                       | 739      | (30 )    | -4.1 %  |  |
| Professional services             | 946                         | 485      | 461      | 95.1 %  | 1,528                     | 937      | 591      | 63.1 %  |  |
| Contract services                 | 422                         | 453      | (31 )    | -6.8 %  | 833                       | 957      | (124 )   | -13.0 % |  |
| Other real estate owned           | 21                          | 11       | 10       | 90.9 %  | 43                        | 66       | (23 )    | -34.8 % |  |
| Stationery and supplies           | 185                         | 223      | (38 )    | -17.0 % | 379                       | 418      | (39 )    | -9.3 %  |  |
| Training and education            | 348                         | 362      | (14 )    | -3.9 %  | 540                       | 668      | (128 )   | -19.2 % |  |
| General, administrative and other | 2,208                       | 2,198    | 10       | 0.5 %   | 4,135                     | 4,655    | (520 )   | -11.2 % |  |
| Total non-interest expense        | \$18,988                    | \$17,257 | \$ 1,731 | 10.0 %  | \$36,525                  | \$34,412 | \$ 2,113 | 6.1 %   |  |

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For the three and six months ended June 30, 2018, non-interest expense totaled \$19.0 million and \$36.5 million, respectively, which represented increases of \$1.7 million (10.0%) and \$2.1 million (6.1%), respectively, as compared to the same periods in 2017. The increase during the three months ended June 30, 2018, compared to the three months ended June 30, 2017, is primarily attributed to the \$696 thousand increase in salaries and employee benefits, the \$461 thousand increase in professional services expense and the \$427 thousand increase in equipment and depreciation expense. The increase in salaries and employee benefits was due to normal, recurring merit increases in salaries and an increase in the number of full-time equivalent employees needed to accommodate the growth of the Bank and enhancement of the ways in which we provide services to our customers. The increase in professional services expense was primarily due to audit fees incurred from our current and previous auditors during the year and the increase in equipment and depreciation expense resulted primarily from increases in computer equipment and software expenses of \$316 thousand.

The increase in non-interest expense during the six months ended June 30, 2018, as compared to the six months ended June 30, 2017, was primarily caused by an increase of \$1.1 million in salaries and employee benefits expense, the \$719 thousand increase in equipment and depreciation expense, the \$591 thousand increase in professional services expense and the \$360 thousand in occupancy expense. That net increase in the other expense categories was partially offset by the \$520 thousand decrease in general, administrative and other expense, which primarily occurred because of a temporary increase in the six months ended June 30, 2017, associated with the celebration of the Bank's 45<sup>th</sup> Anniversary last year.

### Income Tax Expense

For the three and six months ended June 30, 2018, the Bank recorded income tax expenses of \$1.1 million and \$1.9 million, respectively. These expenses were \$130 thousand and \$259 thousand lower, respectively, than the income tax expense recorded for the corresponding periods in 2017. Despite increases in pre-tax net income of \$498 thousand and \$1.7 million during the three and six months ended June 30, 2018, respectively, in comparison to the same periods of 2017, the reduced corporate tax rate that resulted from the Tax Cuts and Jobs Act of 2017 lowered our effective tax rate from 26.6% in the second quarter of 2017 to 21.3% during the three months ended June 30, 2018, and from 28.0% during the six months ended June 30, 2017, to 20.1% during the six months ended June 30, 2018. The reduction in the statutory tax rate was partially offset by interest income on loans increasing at a disproportionate rate as compared to interest income that is exempt from tax.

### Financial Condition

#### Assets

As of June 30, 2018, total assets were \$1.91 billion, a decrease of 2.9% from the \$1.97 billion at December 31, 2017. This \$57.0 million decrease was comprised of the \$61.0 million reduction in our investment portfolio, the \$19.1 million drop in our total cash and cash equivalents and the reduction of \$3.6 million in other assets. These decreases were partially offset by the \$25.7 million expansion in our loan portfolio, net of the allowance for loan losses and deferred fee income, and the \$794 thousand increase in net premises and equipment. By devoting more of our assets to net loans, we were able to raise the proportion of net loans to total assets from 61.5% at December 31, 2017 to 64.7% at June 30, 2018. The remainder of the decline in assets was offset by the \$69.0 million decrease in total deposits and the \$2.0 million decrease in accumulated other comprehensive income (loss), partially offset by the increases of \$6.0 million in other liabilities, \$5.3 million in retained earnings and \$2.6 million in additional paid-in common stock.

#### Interest-Earning Assets

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The following table sets forth the composition of our interest-earning assets at June 30, 2018, as compared to December 31, 2017:

|   | June 30,<br>2018 | December 31,<br>2017 | Variance   |
|---|------------------|----------------------|------------|
| Interest-earning deposits with financial institutions (including restricted cash) | \$75,877         | \$ 97,494            | \$(21,617) |
| Federal Home Loan Bank stock, at cost   | 2,356            | 2,303                | 53         |
| Investment securities available for sale  | 410,194          | 460,788              | (50,594)   |
| Investment securities held to maturity  | 79,288           | 89,677               | (10,389)   |
| Loans, gross  | 1,257,230        | 1,229,880            | 27,350     |
| Total interest-earning assets   | \$1,824,945      | \$ 1,880,142         | \$(55,197) |

### Loans

Commercial & industrial loans are loans to businesses to finance capital purchases and improvements, or to provide cash flow for operations. Commercial mortgage loans include loans secured by real property for purposes such as the purchase or improvement of that property, wherein repayment is derived from the income generated by the real property or from business operations. Residential mortgage loans are loans to consumers to finance the purchase, improvement, or refinance of real property secured by 1-4 family housing units. Consumer loans include loans to individuals to finance personal needs and are either closed- or open-ended loans. Automobile loans fall under the consumer loan category, but the bulk of consumer loans is typically unsecured extensions of credit such as credit card debt and personal signature loans.

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A summary of the balances of loans at June 30, 2018, and December 31, 2017, follows:

|                                   | June 30, 2018 |         | December 31, 2017 |         |
|-----------------------------------|---------------|---------|-------------------|---------|
|                                   | Amount        | Percent | Amount            | Percent |
| <b>Commercial</b>                 |               |         |                   |         |
| Commercial & industrial           | \$254,528     | 20.2 %  | \$256,022         | 20.8 %  |
| Commercial mortgage               | 579,902       | 46.1 %  | 553,125           | 45.0 %  |
| Commercial construction           | 23,657        | 1.9 %   | 10,157            | 0.8 %   |
| Commercial agriculture            | 702           | 0.1 %   | 716               | 0.1 %   |
| Total commercial                  | 858,789       | 68.3 %  | 820,020           | 66.7 %  |
| <b>Consumer</b>                   |               |         |                   |         |
| Residential mortgage              | 136,284       | 10.8 %  | 137,962           | 11.2 %  |
| Home equity                       | 1,137         | 0.1 %   | 545               | 0.0 %   |
| Automobile                        | 29,503        | 2.3 %   | 30,490            | 2.5 %   |
| Other consumer loans <sup>1</sup> | 231,517       | 18.4 %  | 240,863           | 19.6 %  |
| Total consumer                    | 398,441       | 31.7 %  | 409,860           | 33.3 %  |
| Gross loans                       | 1,257,230     | 100.0 % | 1,229,880         | 100.0 % |
| Deferred loan (fees) costs, net   | (2,882 )      |         | (2,777 )          |         |
| Allowance for loan losses         | (18,806 )     |         | (17,279 )         |         |
| Loans, net                        | \$1,235,542   |         | \$1,209,824       |         |

<sup>1</sup> Comprised of other revolving credit, installment loans, and overdrafts.

At June 30, 2018, total gross loans increased by \$27.4 million, to \$ 1.26 billion, from \$1.23 billion at December 31, 2017. The increase in loans was largely attributed to a \$38.8 million increase in commercial loans, to \$858.8 million at June 30, 2018, from \$820.0 million at December 31, 2017. The underlying increases were \$26.8 million in commercial mortgage loans and \$13.5 million in commercial constructions loans. The increase in commercial loans was partially offset by an \$11.4 million decrease in consumer loans, to \$398.4 million at June 30, 2018, from \$409.9 million at December 31, 2017. The decrease in consumer loans was primarily due to reductions of \$9.3 million in other consumer loans, \$ 1.7 million in residential mortgage loans and \$987 thousand in automobile loans, partially offset by an increase of \$592 thousand in home equity loans.

At June 30, 2018, loans outstanding were comprised of approximately 67.29% in variable rate loans and 32.71% in fixed rate loans.

Since it first opened in 1972, the Bank has expanded its operations and its branch network, first in Guam, then in the other islands of our region and in San Francisco, California. In the interests of enhancing performance and stability through market and industry diversification, the Bank has increased its focus on growth in the San Francisco area in recent years, adding personnel with experience and expertise in the Bay Area. The following table provides figures for loans, net of allowance and deferred fees, in the Bank's administrative regions for December 31, 2016 and 2017, and June 30, 2018:

|  | December 31, |           | June 30,  |
|--|--------------|-----------|-----------|
|  | 2016         | 2017      | 2018      |
| Guam   | \$720,479    | \$704,666 | \$693,113 |
| Commonwealth of the Northern Mariana Islands | \$75,658     | \$79,489  | \$84,672  |
| The Freely Associated States of Micronesia * | \$76,339     | \$93,560  | \$97,737  |

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|            |              |              |              |
|------------|--------------|--------------|--------------|
| California | \$ 303,531   | \$ 352,165   | \$ 381,708   |
| Total      | \$ 1,176,007 | \$ 1,229,880 | \$ 1,257,230 |

\*The Freely Associated States (FAS) are comprised of the Federated States of Micronesia (Chuuk, Kosrae, Pohnpei and Yap), the Republic of Palau and the Republic of the Marshall Islands.

As the table indicates, the Bank's total gross loans increased by 2.2% during the six months ended June 30, 2018, and by 4.6% during 2017. By way of comparison, loans in the California region increased by 8.4% during the six months ended June 30, 2018, and by 16.0% in 2017. While the Bank's overall loan portfolio continues to grow, the California region has provided continued support for the expansion of the Bank. The continuing recovery of the economy in the Commonwealth of the Northern Mariana Islands has allowed us to increase our lending there by \$5.2 million (6.5%) during the six months ended June 30, 2018, after increasing by \$3.8 million (5.1%) during all of 2017. Loans in the Freely Associated States of Micronesia increased by 4.5% during the six months ended June 30, 2018, and by 22.6% during 2017. In Guam, loans decreased by \$11.6 million (1.6%) during the six months ended June 30, 2018, after having decreased by \$15.8 million (2.2%) during 2017.

#### Interest-Earning Deposits and Investment Securities

In the current lending and interest rate environment, and in order to maintain sufficient liquidity in the ordinary course of business and in anticipation of one large, scheduled withdrawal, the Bank held \$75.5 million in unrestricted interest-earning deposits with financial institutions at June 30, 2018, a decrease of \$21.6 million, or 22.5%, from the \$97.1 million in such deposits at December 31, 2017. From December 31, 2017, to June 30, 2018, the Bank's combined investment portfolio decreased by \$61.0 million, or 11.1%, from \$550.5 million to \$489.5 million. The reduction in the investment portfolio was comprised of a \$50.6 million decrease in the available-for-sale securities, which fell by 11.0%, from \$460.8 million to \$410.2 million, in addition to a \$10.4 million decrease in held-to-maturity securities, which declined from \$89.7 million to \$79.3 million. Management believes that the Bank maintains an adequate level of liquidity.



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Nonperforming Loans and Other Nonperforming Assets

Nonperforming loans consist of (i) loans on non-accrual status because we have ceased accruing interest on these loans; (ii) loans 90 days or more past due and still accruing interest; and (iii) restructured loans. Other nonperforming assets consist of real estate properties (OREO) that have been acquired through foreclosure or similar means and which management intends to offer for sale. Loans are placed on non-accrual status when, in the opinion of management, the full and timely collection of principal or interest is in doubt. Generally, the accrual of interest is discontinued when principal or interest payment becomes 90 days past due, unless the loan is adequately collateralized and the loan is in the process of collection. When a loan is placed in non-accrual status, accrued but unpaid interest is reversed against current income. Subsequently, when payments are received on such loans, the amounts are applied to reduce principal, except when the ultimate collectability of principal is probable, in which case accrued loans may be restored to accrual status when principal and interest becomes current and full repayment is expected. Interest income is recognized on an accrual basis for impaired loans not meeting the non-accrual criteria.

The following table contains information regarding our nonperforming assets as well as restructured loans as of June 30, 2018, and December 31, 2017:

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
| <b>Non-accrual loans:</b>                               |                  |                      |
| Commercial & industrial                                 | \$ 388           | \$ 426               |
| Commercial mortgage                                     | 7,172            | 6,554                |
| Residential mortgage                                    | 5,094            | 6,063                |
| Home equity   | -                | -                    |
| Other consumer <sup>1</sup>                             | 424              | 311                  |
| <b>Total non-accrual loans</b>                          | <b>\$ 13,078</b> | <b>\$ 13,354</b>     |
| <b>Loans past due 90 days and still accruing:</b>       |                  |                      |
| Commercial & industrial                                 | \$-              | \$ 20                |
| Commercial mortgage                                     | 301              | -                    |
| Commercial construction                                 | -                | -                    |
| Residential mortgage                                    | -                | -                    |
| Home equity   | 31               | -                    |
| Automobile  | 112              | 201                  |
| Other consumer <sup>1</sup>                             | 1,530            | 1,725                |
| <b>Total loans past due 90 days and still accruing</b>  | <b>\$ 1,974</b>  | <b>\$ 1,946</b>      |
| <b>Total nonperforming loans</b>                        | <b>\$ 15,052</b> | <b>\$ 15,300</b>     |
| <b>Other real estate owned (OREO):</b>                  |                  |                      |
| Commercial real estate                                  | \$ 2,075         | \$ 2,078             |
| Residential real estate                                 | 223              | 668                  |
| <b>Total other real estate owned</b>                    | <b>\$ 2,298</b>  | <b>\$ 2,746</b>      |
| <b>Total nonperforming assets</b>                       | <b>\$ 17,350</b> | <b>\$ 18,046</b>     |
| <b>Restructured loans:</b>                              |                  |                      |
| Accruing loans  | \$ 259           | \$ 305               |
| Non-accruing loans (included in nonaccrual loans above) | 5,067            | 5,265                |
| <b>Total restructured loans</b>                         | <b>\$ 5,326</b>  | <b>\$ 5,570</b>      |

<sup>1</sup>Comprised of other revolving credit, installment loans, and overdrafts.

The above table indicates that nonperforming loans decreased by \$184 thousand during the six months ended June 30, 2018, which resulted from the decrease in total non-accrual loans by \$276 thousand, from \$13.4 million to \$13.1 million, partially offset by the increase in total loans past due 90 days and still accruing by \$92 thousand, to \$2.0 million, up from \$1.9 million at December 31, 2017. The increase in total loans past due 90 days and still accruing was primarily due to the \$301 thousand increase in commercial mortgage loans, which was partially offset by decreases in real estate loans by \$137 thousand and other consumer loans by \$110 thousand.

At June 30, 2018, the Bank's largest nonperforming loans are two commercial real estate mortgage loan relationships totaling \$4.8 million, both of which are secured by real estate located in Guam. These loans were placed on non-accrual due to deficiencies in the underlying cash flow to service the monthly loan payments and meet operating expenses. At this time, management believes that the collateral and the allowance for loan losses are adequate to cover these loans; however, should property values deteriorate, additional write-downs or additional provisions may be necessary.

### Analysis of Allowance for Loan Losses

The allowance for loan losses was \$18.8 million, or 1.50% of outstanding gross loans as of June 30, 2018, as compared to \$17.3 million, or 1.40% of outstanding gross loans at December 31, 2017. The allowance was \$15.4 million at June 30, 2017, or 1.25% of gross loans.

Management maintains an allowance for loan losses to absorb estimated credit losses associated with the loan portfolio. The adequacy of the allowance is determined by management through ongoing quarterly loan quality assessments.

Management assesses the estimated credit losses inherent in the non-classified and classified portions of our loan portfolio by considering a number of factors or elements including:

- Management's evaluation of the collectability of the loan portfolio;
  - Historical loss experience in the loan portfolio;
  - Levels of and trending in delinquency, classified assets, non-performing and impaired loans;
  - Effects of changes in underwriting standards and other changes in lending policies, procedures and practices;
    - Experience, ability, and depth of lending management and other relevant staff;
  - Local, regional, and national trends and conditions, including industry-specific conditions;
  - The effect of changes in credit concentration; and
  - External factors such as competition, legal and regulatory conditions, as well as typhoon and other natural disasters.
- Management determines the allowance for the classified loan portfolio and for non-classified loans by applying a percentage loss estimate that is calculated based on the above noted factors and trends. Management normally writes down impaired loans after determining the loans' credit and collateral fair value. Our analysis of the adequacy of the allowance incorporates the provisions made for our non-classified loans and classified loans.

While management believes it uses the best information available for calculating the allowance, the results of operation could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. The current qualitative and quantitative factors used to calculate the allowance are inherently subjective. The estimates and assumptions are subject to changes in economic prospects and regulatory guidelines, and other circumstances over which management has no control. The allowance may prove in the future to be insufficient to cover all of the losses the Bank may incur and it may be necessary to increase the allowance from time to time as a result of monitoring its adequacy.

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The following table summarizes the changes in our allowance for loan losses:

|  | Residential            |            |            |             |
|--|------------------------|------------|------------|-------------|
|  | Commercial             | Mortgages  | Consumer   | Total       |
|  | (Dollars in thousands) |            |            |             |
| <b>Six Months Ended June 30, 2018</b>          |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | \$7,623                | \$ 1,409   | \$ 8,247   | \$17,279    |
| Charge-offs                                    | (302 )                 | -          | (3,945 )   | (4,247 )    |
| Recoveries                                     | 27                     | 3          | 906        | 936         |
| Provision                                      | 3,857                  | 174        | 807        | 4,838       |
| Balance at end of period                       | \$11,205               | \$ 1,586   | \$ 6,015   | \$18,806    |
| <b>Three Months Ended June 30, 2018</b>        |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | 10,602                 | 1,278      | 6,177      | 18,057      |
| Charge-offs                                    | 11                     | -          | (1,839 )   | (1,828 )    |
| Recoveries                                     | 6                      | 2          | 470        | 478         |
| Provision                                      | 586                    | 306        | 1,207      | 2,099       |
| Ending balance                                 | \$11,205               | \$ 1,586   | \$ 6,015   | \$18,806    |
| Allowance balance at end of period related to: |                        |            |            |             |
| Loans individually evaluated for impairment    | \$64                   | \$ 102     | \$ 1,675   | \$1,841     |
| Loans collectively evaluated for impairment    | 11,141                 | 1,484      | 4,340      | 16,965      |
| Ending balance                                 | \$11,205               | \$ 1,586   | \$ 6,015   | \$18,806    |
| Loan balances at end of period:                |                        |            |            |             |
| Loans individually evaluated for impairment    | \$8,444                | \$ 5,125   | \$ 2,066   | \$15,635    |
| Loans collectively evaluated for impairment    | 850,345                | 132,296    | 258,954    | 1,241,595   |
| Ending balance                                 | \$858,789              | \$ 137,421 | \$ 261,020 | \$1,257,230 |
| <b>Six Months Ended June 30, 2017</b>          |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | \$7,264                | \$ 1,773   | \$ 6,398   | \$15,435    |
| Charge-offs                                    | -                      | (30 )      | (3,198 )   | (3,228 )    |
| Recoveries                                     | 30                     | 3          | 764        | 797         |
| Provision                                      | 200                    | 6          | 2,161      | 2,367       |
| Ending balance                                 | \$7,494                | \$ 1,752   | \$ 6,125   | \$15,371    |
| <b>Three Months Ended June 30, 2017</b>        |                        |            |            |             |
| Allowance for loan losses:                     |                        |            |            |             |
| Balance at beginning of period                 | \$8,685                | \$ 1,879   | \$ 4,771   | \$15,335    |
| Charge-offs                                    | -                      | (29 )      | (1,579 )   | (1,608 )    |
| Recoveries                                     | 20                     | 1          | 439        | 460         |
| Provision                                      | (1,211 )               | (99 )      | 2,494      | 1,184       |
| Ending balance                                 | \$7,494                | \$ 1,752   | \$ 6,125   | \$15,371    |
| Allowance balance at end of period related to: |                        |            |            |             |

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|   |           |           |           |             |
|---|-----------|-----------|-----------|-------------|
| Loans individually evaluated for impairment | \$3       | \$6       | \$1,062   | \$1,071     |
| Loans collectively evaluated for impairment | 7,491     | 1,746     | 5,063     | 14,300      |
| Ending balance                              | \$7,494   | \$1,752   | \$6,125   | \$15,371    |
| Loan balances at end of period:             |           |           |           |             |
| Loans individually evaluated for impairment | \$6,643   | \$6,269   | \$1,390   | \$14,302    |
| Loans collectively evaluated for impairment | 770,882   | 133,960   | 243,519   | 1,148,361   |
| Ending balance                              | \$777,525 | \$140,229 | \$244,909 | \$1,162,663 |

## Residential

|  | Commercial             | Mortgages  | Consumer   | Total       |
|--|------------------------|------------|------------|-------------|
|  | (Dollars in thousands) |            |            |             |
| Year Ended December 31, 2017                 |                        |            |            |             |
| Allowance for loan losses:                   |                        |            |            |             |
| Balance at beginning of year                 | \$7,264                | \$ 1,773   | \$ 6,398   | \$15,435    |
| Charge-offs                                  | (172 )                 | (145 )     | (6,962 )   | (7,279 )    |
| Recoveries                                   | 47                     | 6          | 1,551      | 1,604       |
| Provision                                    | 484                    | (225 )     | 7,260      | 7,519       |
| Ending balance                               | \$7,623                | \$ 1,409   | \$ 8,247   | \$17,279    |
| Allowance balance at end of year related to: |                        |            |            |             |
| Loans individually evaluated for impairment  | \$28                   | \$ 90      | \$ 1,747   | \$1,865     |
| Loans collectively evaluated for impairment  | 7,595                  | 1,319      | 6,500      | 15,414      |
| Ending balance                               | \$7,623                | \$ 1,409   | \$ 8,247   | \$17,279    |
| Loan balances at end of year:                |                        |            |            |             |
| Loans individually evaluated for impairment  | \$7,094                | \$ 5,442   | \$ 2,237   | \$14,773    |
| Loans collectively evaluated for impairment  | 812,926                | 133,065    | 269,116    | 1,215,107   |
| Ending balance                               | \$820,020              | \$ 138,507 | \$ 271,353 | \$1,229,880 |

Management evaluates all impaired loans for impairment not less than quarterly in conjunction with our calculation and determination of the adequacy of the allowance for loan losses. As of June 30, 2018, the Bank had 332 impaired loans totaling \$15.6 million with a specific allocation of our allowance for loan losses totaling \$1.8 million. There were 31 impaired loans in the commercial loan category totaling \$8.4 million, of which 22 loans totaling \$8.0 million had adequate collateral securing the carrying value of the loan, resulting in no specific allocation being required. Management's evaluation of the remaining nine commercial loans, totaling a combined \$397 thousand, identified the need for \$64 thousand in a specific loan loss allocation.

There were 79 impaired loans totaling \$5.1 million in the real estate loan category that were evaluated for impairment as of June 30, 2018, and for which a specific allocation totaling \$102 thousand was made. The collateral securing one loan was determined to be sufficient to cover the carrying balance of that loan, which totaled \$27 thousand.

Generally, consumer loans are considered impaired when they become more than 90 days past due. There were 221 impaired loans in the consumer loan category as of June 30, 2018, totaling \$2.1 million, to which \$1.7 million in allowances were allocated. The specific allocation on these consumer loans totaled 81.1% at June 30, 2018, as repayment from most consumer loans are based on support from the borrower's cash flows and are not secured by collateral.

As of December 31, 2017, the Bank had 348 impaired loans totaling \$14.8 million, with a specific allowance allocation totaling \$1.9 million. The number of impaired loans in the commercial loan category was 24, totaling \$7.1 million, of which 20 loans totaling \$6.8 million had adequate collateral securing the carrying value of the loan, resulting in no specific reserves being required. Management's evaluation of the remaining four commercial loans, totaling a combined \$327 thousand, indicated the need for \$28 thousand in a specific allowance allocation.

There were 78 impaired loans totaling \$5.4 million in the real estate loan category that were evaluated for impairment as of December 31, 2017, and for which a specific allocation totaling \$90 thousand was made.

There were 247 impaired loans in the consumer loan category as of December 31, 2017, totaling \$2.2 million, for which \$1.7 million in a specific allowance was allocated. The allocation rate for these consumer loans totaled 78.1% at December 31, 2017.

As of June 30, 2017, the Bank had 303 impaired loans, totaling \$14.3 million, with a specific allowance allocation totaling \$1.1 million. The number of impaired loans in the commercial loan category was 24, totaling \$6.6 million, of which 13 loans totaling \$5.9 million had adequate collateral securing the carrying value of the loan, resulting in no specific allocation being required. Management's evaluation of the remaining eleven commercial loans, totaling a combined \$757 thousand, indicated the need for \$3 thousand in a specific allowance allocation.

There were 86 impaired loans totaling \$6.3 million in the real estate loan category that were evaluated for impairment as of June 30, 2017, and for which a specific allocation totaling \$6 thousand was made. The collateral securing one loan was determined to be sufficient to cover the carrying balance of the loan, which totaled \$239 thousand. The \$6 thousand allowance allocation, or 0.10% of the outstanding balance, was for the remaining 85 impaired real estate loans totaling \$6.0 million.

There were 193 impaired loans in the consumer loan category as of June 30, 2017, totaling \$1.4 million, for which \$1.1 million in a specific allocation was made. The allocation rate on all consumer loans totaled 2.6% at June 30, 2017.

Total Cash and Cash Equivalents

Total cash and cash equivalents were \$107.0 million and \$126.1 million at June 30, 2018, and December 31, 2017, respectively. This balance, which is comprised of cash and due from bank balances and interest-bearing deposits that we maintain at other financial institutions (including the Federal Reserve Bank of San Francisco, but excepting restricted cash), will vary depending on daily cash settlement activities, the amount of highly liquid assets needed based on known events such as the repayment of borrowings and scheduled withdrawals, and actual cash on hand in the Bank's branches. The decrease in the balance during the period was primarily attributed to a government agency's transfer of funds from an account with the Bank to an investment account in our Trust Department.

The following table sets forth the composition of our cash and cash equivalent balances at June 30, 2018, and December 31, 2017:

|   | June 30,<br>2018 | December 31,<br>2017 | Variance   |
|---|------------------|----------------------|------------|
| Cash and due from banks                               | \$31,522         | \$ 29,033            | \$2,489    |
| Interest-bearing deposits with financial institutions | 75,477           | 97,094               | (21,617)   |
| Total cash and cash equivalents                       | \$106,999        | \$ 126,127           | \$(19,128) |

Investment Securities

The Bank manages its securities portfolio to provide a source of both liquidity and earnings. The Bank has an Asset/Liability Committee (ALCO) that develops and recommends current investment policies to the Board of Directors based on its operating needs and market circumstances. The Bank's overall investment policy is formally reviewed and approved annually by the Board of Directors, and the Asset/Liability Committee is responsible for monitoring and reporting compliance with the investment policy. Investment portfolio reports are provided to the Board of Directors on a monthly basis.



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At June 30, 2018, the carrying value of the investment securities portfolio (excluding ASC Trust Corporation stock and Federal Home Loan Bank stock) totaled \$489.5 million, which represents a \$61.0 million decrease from the portfolio balance of \$550.5 million at December 31, 2017. The table below sets forth the amortized cost and fair value of our investment securities portfolio, with gross unrealized gains and losses, at June 30, 2018, and December 31, 2017:

|   | June 30, 2018     |                  |                    |                      |
|---|-------------------|------------------|--------------------|----------------------|
|   | Amortized Cost    | Unrealized Gains | Unrealized Losses  | Estimated Fair Value |
| <b>Securities Available-for-Sale</b>            |                   |                  |                    |                      |
| U.S. government agency and government sponsored |                   |                  |                    |                      |
| enterprise (GSE) debt securities                | \$100,454         | \$ -             | \$ (2,163 )        | \$98,291             |
| U.S. government agency pool securities          | 231,130           | 4                | (1,314 )           | 229,820              |
| U.S. government agency or GSE residential       |                   |                  |                    |                      |
| mortgage-backed securities                      | 84,646            | -                | (2,563 )           | 82,083               |
| <b>Total</b>                                    | <b>\$416,230</b>  | <b>\$ 4</b>      | <b>\$ (6,040 )</b> | <b>\$410,194</b>     |
| <b>Securities Held-to-Maturity</b>              |                   |                  |                    |                      |
| U.S. government agency and government sponsored |                   |                  |                    |                      |
| enterprise (GSE) debt securities                | \$42,812          | \$ 26            | \$ (164 )          | \$42,674             |
| U.S. government agency pool securities          | 10,624            | 9                | (18 )              | 10,615               |
| U.S. government agency or GSE residential       |                   |                  |                    |                      |
| mortgage-backed securities                      | 25,852            | 33               | (605 )             | 25,280               |
| <b>Total</b>                                    | <b>\$79,288</b>   | <b>\$ 68</b>     | <b>\$ (787 )</b>   | <b>\$78,569</b>      |
|   | December 31, 2017 |                  |                    |                      |
|   | Amortized Cost    | Unrealized Gains | Unrealized Losses  | Estimated Fair Value |
| <b>Securities Available-for-Sale</b>            |                   |                  |                    |                      |
| U.S. government agency and government sponsored |                   |                  |                    |                      |
| enterprise (GSE) debt securities                | \$105,407         | \$ -             | \$ (1,380 )        | \$104,027            |
| U.S. government agency pool securities          | 283,611           | 51               | (1,319 )           | 282,343              |
| U.S. government agency or GSE residential       |                   |                  |                    |                      |
| mortgage-backed securities                      | 75,560            | -                | (1,142 )           | 74,418               |
| <b>Total</b>                                    | <b>\$464,578</b>  | <b>\$ 51</b>     | <b>\$ (3,841 )</b> | <b>\$460,788</b>     |
| <b>Securities Held-to-Maturity</b>              |                   |                  |                    |                      |
| U.S. government agency and government sponsored |                   |                  |                    |                      |
|   | \$45,178          | \$ 505           | \$ (113 )          | \$45,570             |

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|   |          |        |           |          |
|---|----------|--------|-----------|----------|
| enterprise (GSE) debt securities          |          |        |           |          |
| U.S. government agency pool securities    | 11,756   | 33     | (35 )     | 11,754   |
| U.S. government agency or GSE residential |          |        |           |          |
| mortgage-backed securities                | 32,743   | 243    | (311 )    | 32,675   |
| Total                                     | \$89,677 | \$ 781 | \$ (459 ) | \$89,999 |

At June 30, 2018, and December 31, 2017, investment securities with a carrying value of \$294.9 million and \$307.3 million, respectively, were pledged to secure various government deposits and other public requirements.

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The amortized cost and fair value of investment securities by contractual maturity at June 30, 2018, and December 31, 2017, follows:

|                                     | June 30, 2018                   |                         |                               |                         |
|-------------------------------------|---------------------------------|-------------------------|-------------------------------|-------------------------|
|                                     | Available-for-Sale<br>Amortized |                         | Held-to-Maturity<br>Amortized |                         |
|                                     | Cost                            | Estimated<br>Fair Value | Cost                          | Estimated<br>Fair Value |
| Due within one year                 | \$68                            | \$ 68                   | \$9,006                       | \$ 8,957                |
| Due after one but within five years | 104,717                         | 102,535                 | 43,849                        | 43,753                  |
| Due after five but within ten years | 73,671                          | 72,554                  | 16,410                        | 16,144                  |
| Due after ten years                 | 237,774                         | 235,037                 | 10,023                        | 9,715                   |
| Total                               | \$416,230                       | \$ 410,194              | \$79,288                      | \$ 78,569               |

|                                     | December 31, 2017               |                         |                               |                         |
|-------------------------------------|---------------------------------|-------------------------|-------------------------------|-------------------------|
|                                     | Available-for-Sale<br>Amortized |                         | Held-to-Maturity<br>Amortized |                         |
|                                     | Cost                            | Estimated Fair<br>Value | Cost                          | Estimated Fair<br>Value |
| Due within one year                 | \$336                           | \$ 336                  | \$7,004                       | \$ 6,978                |
| Due after one but within five years | 111,443                         | 110,041                 | 53,451                        | 54,044                  |
| Due after five but within ten years | 51,861                          | 51,450                  | 18,336                        | 18,262                  |
| Due after ten years                 | 300,938                         | 298,961                 | 10,886                        | 10,715                  |
| Total                               | \$464,578                       | \$ 460,788              | \$89,677                      | \$ 89,999               |

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Temporarily Impaired Securities

The following table shows the gross unrealized losses and fair value of investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position at June 30, 2018, and December 31, 2017:

|  | June 30, 2018                                 |   |                            |                            | Total              |                            |
|--|---|---|----------------------------|----------------------------|--------------------|----------------------------|
|  | Less Than Twelve Months<br>Unrealized<br>Loss | More Than Twelve Months<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Estimated<br>Fair<br>Value | Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <b>Securities Available for Sale</b>       |   |   |                            |                            |                    |                            |
| U.S. government agency and government      |   |   |                            |                            |                    |                            |
| sponsored enterprise (GSE) debt securities | \$(539 )                                      | \$29,347                                      | \$ (1,623 )                | \$ 68,945                  | \$(2,162 )         | \$98,292                   |
| U.S. government agency pool securities     | (174 )  | 67,242  | (1,141 )                   | 155,676                    | (1,315 )           | 222,918                    |
| U.S. government agency or GSE residential  |   |   |                            |                            |                    |                            |
| mortgage-backed securities                 | (1,117 )                                      | 35,641  | (1,446 )                   | 46,442                     | (2,563 )           | 82,083                     |
| <b>Total</b>                               | <b>\$(1,830 )</b>                             | <b>\$132,230</b>                              | <b>\$ (4,210 )</b>         | <b>\$ 271,063</b>          | <b>\$(6,040 )</b>  | <b>\$403,293</b>           |

|  | December 31, 2017                             |   |                            |                            | Total              |                            |
|--|---|---|----------------------------|----------------------------|--------------------|----------------------------|
|  | Less Than Twelve Months<br>Unrealized<br>Loss | More Than Twelve Months<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Estimated<br>Fair<br>Value | Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <b>Securities Held to Maturity</b>         |   |   |                            |                            |                    |                            |
| U.S. government agency and government      |   |   |                            |                            |                    |                            |
| sponsored enterprise (GSE) debt securities | \$(80 )                                       | \$21,487                                      | \$ (840 )                  | \$ 11,436                  | \$(920 )           | \$32,923                   |
| U.S. government agency pool securities     | (17 )   | 1,832   | (2 )                       | 2,082                      | (19 )              | 3,914                      |
| U.S. government agency or GSE residential  |   |   |                            |                            |                    |                            |
| mortgage-backed securities                 | (334 )  | 14,379  | (271 )                     | 4,235                      | (605 )             | 18,614                     |
| <b>Total</b>                               | <b>\$(431 )</b>                               | <b>\$37,698</b>                               | <b>\$ (1,113 )</b>         | <b>\$ 17,753</b>           | <b>\$(1,544 )</b>  | <b>\$55,451</b>            |

|  | December 31, 2017                             |   |                            |                            | Total              |                            |
|--|---|---|----------------------------|----------------------------|--------------------|----------------------------|
|  | Less Than Twelve Months<br>Unrealized<br>Loss | More Than Twelve Months<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Estimated<br>Fair<br>Value | Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <b>Securities Available for Sale</b>       |   |   |                            |                            |                    |                            |
| U.S. government agency and government      |   |   |                            |                            |                    |                            |
| sponsored enterprise (GSE) debt securities | \$(273 )                                      | \$29,582                                      | \$ (1,107 )                | \$ 74,445                  | \$(1,380 )         | \$104,027                  |
| U.S. government agency pool securities     | (241 )  | 91,519  | (1,078 )                   | 168,164                    | (1,319 )           | 259,683                    |
| U.S. government agency or GSE residential  |   |   |                            |                            |                    |                            |
| mortgage-backed securities                 | (321 )  | 35,384  | (821 )                     | 39,034                     | (1,142 )           | 74,418                     |
| <b>Total</b>                               | <b>\$(835 )</b>                               | <b>\$156,485</b>                              | <b>\$ (3,006 )</b>         | <b>\$ 281,643</b>          | <b>\$(3,841 )</b>  | <b>\$438,128</b>           |

|  |         |         |          |           |          |          |
|--|---------|---------|----------|-----------|----------|----------|
| <b>Securities Held to Maturity</b>         |         |         |          |           |          |          |
| U.S. government agency and government      |         |         |          |           |          |          |
| sponsored enterprise (GSE) debt securities | \$(33 ) | \$4,002 | \$ (80 ) | \$ 11,946 | \$(113 ) | \$15,948 |

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|  |          |          |           |           |          |          |
|--|----------|----------|-----------|-----------|----------|----------|
| sponsored enterprise (GSE) debt securities |          |          |           |           |          |          |
| U.S. government agency pool securities     | (10 )    | 5,422    | (25 )     | 3,201     | (35 )    | 8,623    |
| U.S. government agency or GSE residential  |          |          |           |           |          |          |
| mortgage-backed securities                 | (101 )   | 8,478    | (210 )    | 5,371     | (311 )   | 13,849   |
| Total                                      | \$(144 ) | \$17,902 | \$ (315 ) | \$ 20,518 | \$(459 ) | \$38,420 |

The Company does not believe that any of the investment securities that were in an unrealized loss position as of June 30, 2018, which included a total of 164 securities, were other-than-temporarily impaired. Specifically, the 164 securities are comprised of the following: 91 Small Business Administration (SBA) Pool securities, 19 mortgage-backed securities issued by the Government National Mortgage Association (GNMA), 24 mortgage-backed securities issued by the Federal National Mortgage Association (FNMA), 7 agency securities issued by the Federal Home Loan Bank (FHLB), 4 mortgage-backed securities and 1 step up bond issued by the Federal Home Loan Mortgage Corporation (FHLMC), and 1 agency security issued by the Federal Farm Credit Banks (FFCB), and 17 U.S. Treasury securities.

Total gross unrealized losses were primarily attributable to changes in interest rates relative to when the investment securities were purchased, and not due to changes in the credit quality of the investment securities. The Company does not intend to sell the investment securities that were in an unrealized loss position and it is not likely that the Company will be required to sell the investment securities before recovery of their amortized cost, which may be at maturity.

## Deposits

At June 30, 2018, total deposit liabilities decreased by \$69.0 million, to \$1.75 billion, as compared to \$1.82 billion in total deposits at December 31, 2017. Interest-bearing deposits decreased by \$120.6 million, to \$1.19 billion at June 30, 2018, down from \$1.31 billion at December 31, 2017, while non-interest bearing deposits increased by \$51.6 million, to \$559.7 million at June 30, 2018, from \$508.1 million at December 31, 2017. The 3.8% decrease in total deposits was primarily due to the transfer of funds by some large depositors, including government agencies, from Bank depository accounts into investments through our Trust Department.

The following table sets forth the composition of our interest-bearing deposit portfolio with the balances and average interest rates at June 30, 2018 and 2017, respectively:

|                                    | June 30, 2018 |              | December 31, 2017 |              |
|------------------------------------|---------------|--------------|-------------------|--------------|
|                                    | Balance       | Average rate | Balance           | Average rate |
| Interest-bearing checking accounts | \$240,954     | 0.12 %       | \$288,977         | 0.11 %       |
| Money market and savings accounts  | 914,588       | 0.18 %       | 978,646           | 0.18 %       |
| Certificates of deposit            | 31,834        | 0.34 %       | 40,360            | 0.33 %       |
| Total interest-bearing deposits    | \$1,187,376   | 0.17 %       | \$1,307,983       | 0.17 %       |

As mentioned earlier, the Bank has expanded its operations and its branch network since it first opened in 1972, first in Guam, then in the other islands of our region and in San Francisco, California. As time has passed, the Bank has gathered market share in each of the islands. In recent years, in order to diversify its geographic market, the Bank has increased its focus on growth in the California region. The following table provides figures for deposits in the Bank's administrative regions for at December 31, 2016 and 2017, and at June 30, 2018:

|  | December 31, |             | June 30,    |
|--|--------------|-------------|-------------|
|  | 2016         | 2017        | 2018        |
| Guam   | \$975,526    | \$936,237   | \$916,280   |
| Commonwealth of the Northern Mariana Islands | \$319,895    | \$343,149   | \$348,911   |
| The Freely Associated States of Micronesia * | \$431,865    | \$491,276   | \$446,376   |
| California                                   | \$51,384     | \$45,470    | \$35,552    |
| Total  | \$1,778,670  | \$1,816,132 | \$1,747,119 |

\*The Freely Associated States (FAS) are comprised of the Federated States of Micronesia (Chuuk, Kosrae, Pohnpei and Yap), the Republic of Palau and the Republic of the Marshall Islands.

During the six months ended June 30, 2018, the Bank's deposits decreased by \$69.0 million, or 3.8%, while in the full year of 2017, deposits increased by a total of \$37.5 million. Our branches in Guam experienced a decrease of \$18.7 million in deposits during the six months ended June 30, 2018, while the deposits in our branches in the CNMI grew by \$5.8 million. Deposits in our FAS branches decreased by \$44.9 million, while our California region deposits decreased by \$9.9 million during the same time period.

## Borrowed Funds

The Bank has a variety of sources from which it may obtain secondary funding. These sources include, among others, the Federal Reserve Bank of San Francisco, the Federal Home Loan Bank of Des Moines, and credit lines established with our correspondent banks. Borrowings are obtained for a variety of reasons which include, but are not limited to, funding loan growth, the purchase of investments in the absence of core deposits, and to provide additional liquidity to meet the demands of depositors.

At June 30, 2018, and at December 31, 2017, the Company had no short-term borrowings.

#### Liquidity

We actively manage our liquidity to ensure that sufficient funds are available to meet our needs for cash, including cash needed to fund new loans and to accommodate deposit withdrawals and other transactions by our customers. We project future sources and uses of funds, and maintain additional liquid funds for unanticipated events. Our primary sources of cash include cash we have in deposits at other financial institutions, the repayment of loans, proceeds from the sale or maturity of investment securities, and increases in deposits. The primary uses of cash include funding new loans and making advances on existing lines of credit, purchasing investments, funding new residential mortgage loans, funding deposit withdrawals, and paying operating expenses. From time to time, we may maintain funds in overnight Federal Funds and other short-term investments to provide for short-term liquidity needs. We also have established, for contingency funding purposes, credit lines with the Federal Reserve Bank of San Francisco, the Federal Home Loan Bank-Seattle, and correspondent commercial banks in the U.S. We believe that our liquid assets, together with our available credit lines, will be sufficient to meet normal operating requirements for at least the next twelve months, including to enable us to meet any increase in withdrawals from depository accounts that might occur in the foreseeable future.

At June 30, 2018, our liquid assets, which include cash and due from banks, interest-earning deposits with financial institutions (excluding restricted cash), and investment securities available for sale totaled \$517.2 million, down \$69.7 million from \$586.9 million at December 31, 2017. This decrease is comprised of the \$21.6 million decline in interest bearing deposits in banks and the reduction of \$50.6 million in available-for-sale securities, partially offset by a \$2.5 million increase in cash and due from banks.

## Contractual Obligations

The Bank utilizes facilities, equipment and land under various operating leases with terms, including renewal options, ranging from 1 to 99 years. Some of these leases include scheduled rent increases. The total amount of the rent is being debited to expense on the straight-line method over the lease terms in accordance with ASU Topic 840 "Leases". The Bank has recorded a deferred obligation of \$1.0 million and \$988 thousand as of June 30, 2018, and December 31, 2017, respectively, which has been included within other liabilities to reflect the excess of rent expense over cash paid on the leases.

At June 30, 2018, annual lease commitments under the above non-cancelable operating leases were as follows:

| Years ending December 31, |          |
|---------------------------|----------|
| 2018                      | \$1,148  |
| 2019                      | 2,314    |
| 2020                      | 2,242    |
| 2021                      | 1,896    |
| 2022 and thereafter       | 23,504   |
| Total lease commitments   | \$31,104 |

The Bank leases certain facilities from two separate entities in which two of its directors have separate ownership interests. Lease payments made to these entities during the six months ended June 30, 2018 and 2017, approximated \$175 thousand and \$190 thousand, respectively. During the three months ended June 30, 2018 and 2017, lease payments made to these entities approximated to \$87 thousand and \$95 thousand, respectively.

Additionally, the Bank leases office space to third parties, with original lease terms ranging from 3 to 5 years with option periods ranging up to 15 years. At June 30, 2018, minimum future rents to be received under non-cancelable operating sublease agreements were \$25 thousand, \$42 thousand, and \$26 thousand for the periods ending December 31, 2018, 2019 and 2020, respectively.

A summary of rental activities for the three and six months ended June 30, 2018 and 2017, respectively, is as follows:

|                        | Three Months        |       | Six Months          |         |
|------------------------|---------------------|-------|---------------------|---------|
|                        | Ended June 30, 2018 | 2017  | Ended June 30, 2018 | 2017    |
| Rent expense           | \$750               | \$698 | \$1,499             | \$1,373 |
| Less: sublease rentals | 47                  | 56    | 95                  | 132     |
| Net rent expense       | \$703               | \$642 | \$1,404             | \$1,241 |

## Off Balance Sheet Arrangements

The Bank is a party to credit-related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of



credit and interest rate risk in excess of the amount reflected in our condensed consolidated financial statements.

The Bank's exposure to credit loss, in the event of nonperformance by the other parties to financial instruments for loan commitments and letters of credit, is represented by the contractual amount of these instruments. The Bank follows essentially the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

A summary of financial instruments with off-balance-sheet risk at June 30, 2018, and December 31, 2017, is as follows:

|                              | June 30,<br>2018 | December 31,<br>2017 |
|------------------------------|------------------|----------------------|
| Commitments to extend credit | \$ 138,550       | \$ 159,767           |
| Letters of credit:           |                  |                      |
| Standby letters of credit    | \$ 56,755        | \$ 54,707            |
| Commercial letters of credit | 3,911            | 2,601                |
| Total                        | \$ 60,666        | \$ 57,308            |

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. The commitments for certain lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the customer.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party or the shipment of merchandise from a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Almost all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is effectively the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments.

The Bank considers its standby and commercial letters of credit to be guarantees. At June 30, 2018, the maximum undiscounted future payments that the Bank could be required to make was \$60.7 million. Almost all of these arrangements mature within one year. The Bank generally has recourse to recover from the customer any amounts paid under these guarantees. Most of the guarantees are fully collateralized; however, several that are extended to the Bank's most creditworthy customers are unsecured. The Bank has recorded \$27 thousand in reserve liabilities associated with commitments to extend credit and letters of credit at June 30, 2018.

Mortgage loans serviced for others are not included in the accompanying condensed consolidated statements of condition. The unpaid principal balances of mortgage loans serviced for others were \$202.1 million and \$205.5 million at June 30, 2018, and December 31, 2017, respectively. At both June 30, 2018, and December 31, 2017, the Bank recorded mortgage servicing rights at their fair value of \$1.9 million.

### Capital Resources

The Company and the Bank are subject to various regulatory capital requirements administered by the United States federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's condensed consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet or exceed specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital and Common Equity Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes that, as of June 30, 2018, and December 31, 2017, the Bank met all capital adequacy requirements to which it is subject.

In December 2010, the Basel Committee on Bank Supervision ("Basel Committee") released its final framework for strengthening international capital and liquidity regulation, now officially identified as "Basel III," which, when fully phased-in, would require bank holding companies and their bank subsidiaries to maintain substantially more capital than had previously been required, with a greater emphasis on common equity.

In July 2013, the U.S. banking regulatory agencies approved the U.S. version of Basel III. The version of Basel III adopted revises the risk-based and leverage capital requirements and the method for calculating risk-weighted assets to make them consistent with Basel III and to meet the requirements of the Dodd-Frank Act. Many of the rules apply on a phased-in basis to all banking organizations, including the Company and the Bank. Among other things, the rules establish a new minimum common equity Tier 1 ratio (4.5% of risk-weighted assets), a higher minimum Tier 1 risk-based capital requirement (6.0% of risk-weighted assets) and a minimum non-risk-based leverage ratio (4.0%). An additional capital conservation buffer of 2.5% of risk weighted assets over each of the required capital ratios will be phased in from 2016 to 2019 (1.875% in 2018 and 1.25% in 2017) and must be met to avoid limitations on the ability of the Company and the Bank to pay dividends, repurchase shares or pay discretionary bonuses. The new rules assign higher risk weighting to credit exposures that are more than 90 days past due or are on nonaccrual status and certain commercial real estate facilities that finance the acquisition, development or construction of real property. The rules also change the permitted composition of Tier 1 capital to exclude trust preferred securities, mortgage servicing

rights and certain deferred tax assets, and include unrealized gains and losses on available-for-sale debt and equity securities (through a one-time opt out option for Standardized Banks (banks with less than \$250 billion of total consolidated assets and less than \$10 billion of foreign exposures) which the Company and the Bank elected at March 31, 2015). The rules, including alternative requirements for smaller community financial institutions like the Company and the Bank, will be phased in through 2019.

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As of June 30, 2018, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There have been no conditions or events since the FDIC notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of June 30, 2018, and December 31, 2017, are also presented in the table.

|                              | To Be Well Capitalized |          |                      |         |                             |          |
|------------------------------|------------------------|----------|----------------------|---------|-----------------------------|----------|
|                              |                        |          | For Capital Adequacy |         | Under Prompt Corrective     |          |
|                              | Actual<br>Amount       | Ratio    | Purposes<br>Amount   | Ratio   | Action Provisions<br>Amount | Ratio    |
| <b>At June 30, 2018:</b>     |                        |          |                      |         |                             |          |
| Total capital (to Risk       |                        |          |                      |         |                             |          |
| Weighted Assets)             | \$ 160,255             | 12.860 % | \$ 123,053           | 9.875 % | \$ 124,611                  | 10.000 % |
| Tier 1 capital (to Risk      |                        |          |                      |         |                             |          |
| Weighted Assets)             | \$ 144,638             | 11.607 % | \$ 98,131            | 7.875 % | \$ 99,689                   | 8.000 %  |
| Tier 1 capital (to Average   |                        |          |                      |         |                             |          |
| Assets)                      | \$ 144,638             | 7.426 %  | \$ 77,905            | 4.000 % | \$ 97,381                   | 5.000 %  |
| Common Equity Tier 1         |                        |          |                      |         |                             |          |
| Capital (to Risk Weighted    |                        |          |                      |         |                             |          |
| Assets)                      | \$ 139,638             | 11.206 % | \$ 79,439            | 6.375 % | \$ 80,997                   | 6.500 %  |
| <b>At December 31, 2017:</b> |                        |          |                      |         |                             |          |
| Total capital (to Risk       |                        |          |                      |         |                             |          |
| Weighted Assets)             | \$ 151,699             | 12.490 % | \$ 112,347           | 9.250 % | \$ 121,456                  | 10.000 % |
| Tier 1 capital (to Risk      |                        |          |                      |         |                             |          |
| Weighted Assets)             | \$ 136,521             | 11.240 % | \$ 88,056            | 7.250 % | \$ 97,165                   | 8.000 %  |
| Tier 1 capital (to Average   |                        |          |                      |         |                             |          |
| Assets)                      | \$ 136,521             | 6.968 %  | \$ 78,373            | 4.000 % | \$ 97,967                   | 5.000 %  |
| Common Equity Tier 1         |                        |          |                      |         |                             |          |
| Capital (to Risk Weighted    |                        |          |                      |         |                             |          |
| Assets)                      | \$ 131,521             | 10.829 % | \$ 69,837            | 5.750 % | \$ 78,946                   | 6.500 %  |

The Company's required and actual capital amounts and ratios as of June 30, 2018, and December 31, 2017, were as follows:

|                              | Actual     |          | For Capital Adequacy |         | To Be Well Capitalized      |          |
|------------------------------|------------|----------|----------------------|---------|-----------------------------|----------|
|                              | Amount     | Ratio    | Purposes<br>Amount   | Ratio   | Under Prompt Corrective     |          |
|                              |            |          |                      |         | Action Provisions<br>Amount | Ratio    |
| <b>At June 30, 2018:</b>     |            |          |                      |         |                             |          |
| Total capital (to Risk       |            |          |                      |         |                             |          |
| Weighted Assets)             | \$ 164,719 | 13.184 % | \$ 123,377           | 9.875 % | \$ 124,939                  | 10.000 % |
| Tier 1 capital (to Risk      |            |          |                      |         |                             |          |
| Weighted Assets)             | \$ 149,062 | 11.931 % | \$ 98,389            | 7.875 % | \$ 99,951                   | 8.000 %  |
| Tier 1 capital (to Average   |            |          |                      |         |                             |          |
| Assets)                      | \$ 149,062 | 7.641 %  | \$ 78,032            | 4.000 % | \$ 97,540                   | 5.000 %  |
| Common Equity Tier 1         |            |          |                      |         |                             |          |
| Capital (to Risk Weighted    |            |          |                      |         |                             |          |
| Assets)                      | \$ 139,280 | 11.148 % | \$ 79,648            | 6.375 % | \$ 81,210                   | 6.500 %  |
| <b>At December 31, 2017:</b> |            |          |                      |         |                             |          |
| Total capital (to Risk       |            |          |                      |         |                             |          |
| Weighted Assets)             | \$ 156,300 | 12.834 % | \$ 112,648           | 9.250 % | \$ 121,781                  | 10.000 % |
| Tier 1 capital (to Risk      |            |          |                      |         |                             |          |
| Weighted Assets)             | \$ 141,052 | 11.582 % | \$ 88,291            | 7.250 % | \$ 97,425                   | 8.000 %  |
| Tier 1 capital (to Average   |            |          |                      |         |                             |          |
| Assets)                      | \$ 141,052 | 7.187 %  | \$ 78,504            | 4.000 % | \$ 98,130                   | 5.000 %  |
| Common Equity Tier 1         |            |          |                      |         |                             |          |
| Capital (to Risk Weighted    |            |          |                      |         |                             |          |
| Assets)                      | \$ 131,269 | 10.779 % | \$ 70,024            | 5.750 % | \$ 79,158                   | 6.500 %  |

Since the formation of BankGuam Holding Company in 2011, our assets have grown by 73.0% (\$805.7 million), while our stockholders' equity has grown by 62.5% (\$55.4 million, including \$42.3 million in retained earnings). The difference between these growth rates has challenged our ability to maintain our historically strong capital ratios.

#### Stock Purchase Plan

The Bank's 2011 Employee Stock Purchase Plan (the "2011 Plan") was adopted by the Bank's Board of Directors and approved by the Bank's Stockholders on May 2, 2011, to replace the Bank's 2001 Non-Statutory Stock Option Plan. This plan was subsequently adopted by the Company after the Reorganization. The 2011 Plan is open to all employees of the Company and the Bank who have met certain eligibility requirements.

Under the 2011 Plan, as amended and restated as of July 1, 2012, eligible employees can purchase, through payroll deductions, shares of common stock at a discount. The right to purchase stocks is granted to eligible employees during a quarterly offer period that is established from time to time by the Board of Directors of the Company. Eligible employees cannot accrue the right to purchase more than \$25 thousand worth of stock at the fair market value at the beginning of each offer period. Eligible employees also may not purchase more than one thousand five hundred (1,500) shares of stock in any one offer period. The shares are purchased at 85% of the fair market price of the stock on the enrollment date. The Plan was suspended on April 4, 2018, due to the delayed filing of our 2017 report on Form 10-K, and resumed in the third quarter of 2018.

#### Contingency Planning and Cybersecurity

The services provided by banks are crucial to the continuing performance of the economy, so it is very important that banks are able to conduct business as usual on an ongoing basis. In light of this, the Bank has developed a comprehensive business continuity plan to address whatever disruptions may directly affect customers or change internal processes, whether caused by man-made or natural events. Training in the plan components is conducted no less frequently than triennially, and risk-based testing of the major processes and procedures within the Bank occur on an annual basis. In modern banking, technology has taken on an increasingly important role, and the Bank also has a technology recovery component incorporated into the business continuity plan that provides specific, detailed procedures for recovering quickly from any technology failure. The technology recovery procedures are actively tested, and are also implemented from time to time. The recovery time objectives for all major technological processes range from eight hours to 80 hours, with the goal of enabling the Bank to maintain or resume operations with a minimum impact on its customers. As the results of testing are analyzed and as technology continues to advance, improvements are made in the Bank's processes and procedures as the plan evolves.

The rapid advances in computing and telecommunications technology over the past several decades have brought with them increasingly sophisticated methods of delivering financial services through electronic channels. Along with these advances, though, have come risks regarding the integrity and privacy of data, and these risks apply to banking, perhaps more than any other industry, falling into the general classification of cybersecurity. The Bank has made substantial investments in multiple systems to ensure both the integrity of its data and the protection of the privacy of its customers' personal financial and identity information. While it is not possible for anyone to give an absolute guarantee that data will not be compromised, the Bank believes that its systems provide a reasonable assurance that the financial and personal data that it holds are secure.

#### Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognized that any system of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rules 13a-15 and 15d-15 under the Exchange Act, in connection with the filing of this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of our management, including our CEO and CFO, of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2018. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. Based on the evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of the end of the period covered by this report due to the following material weaknesses that were previously identified in our Annual Report on Form 10-K for the year ended December 31, 2017:

- The Company does not have formal internal controls to ensure that contracts are reviewed for accounting implications, properly communicated to the appropriate personnel and continually monitored; and
- While the Company's Information Security Officer monitors reports of the production environment to identify authorized and unauthorized usage, as well as employee access to key financial applications, the activity is not reviewed against supporting documentation to ensure that all changes are authorized, and one privileged user account was not adequately monitored.

We are taking steps to remediate these material weaknesses, including the monitoring of contracts for the department that was affected by the first material weakness and, as to the second, the Information Security Officer is reviewing all changes made by all privileged user accounts to the production environment against supporting documents to ensure that all such changes are authorized.

We believe the remediation measures will strengthen our internal control over financial reporting and remediate the material weaknesses identified. However, as we are still assessing the design and operational effectiveness of these measures, the identified material weaknesses have not been fully remediated as of June 30, 2018. We will continue to monitor the effectiveness of these remediation measures and will make any adjustments and take such other actions as are appropriate.

#### Changes in Internal Control over Financial Reporting

Other than the remediation processes noted above, there were no changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibit

| No.    | Exhibit   |
|--------|---|
| 10.01* | <u>Contract Extension dated May 29, 2018 between William D.Leon Guerrero and Bank of Guam (incorporated by reference to Exhibit 10.08 to the Company's Form 10-K for the year ended December 31, 2017)</u>  |
| 31.01  | <u>Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002</u>   |
| 31.02  | <u>Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002</u>   |
| 32.01  | <u>Certification of Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002</u>   |
| 101    | Interactive Data Files Pursuant to Rule 405 of Regulation S-T: (i) Unaudited Condensed Consolidated Statements of Condition as of June 30, 2018, and December 31, 2017, (ii) Unaudited Condensed Consolidated Statements of Income for the three and six months ended June 30, 2018 and 2017, (iii) Unaudited Condensed Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2018 and 2017, (iv) Unaudited Condensed Consolidated Statements of Cash Flows for the three and six months ended June 30, 2018 and 2017, and (v) Notes to Unaudited Condensed Consolidated Financial Statements |

\* Management contract of compensatory plan or arrangement.



SIGNATURES

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

BANKGUAM HOLDING COMPANY

Date: August 13, 2018 By: /s/ JOAQUIN P.L.G. COOK  
Joaquin P.L.G. Cook,

Interim President and Chief Executive Officer

Date: August 13, 2018 By: /s/ FRANCISCO M. ATALIG  
Francisco M. Atalig,

Senior Vice President and Chief Financial Officer