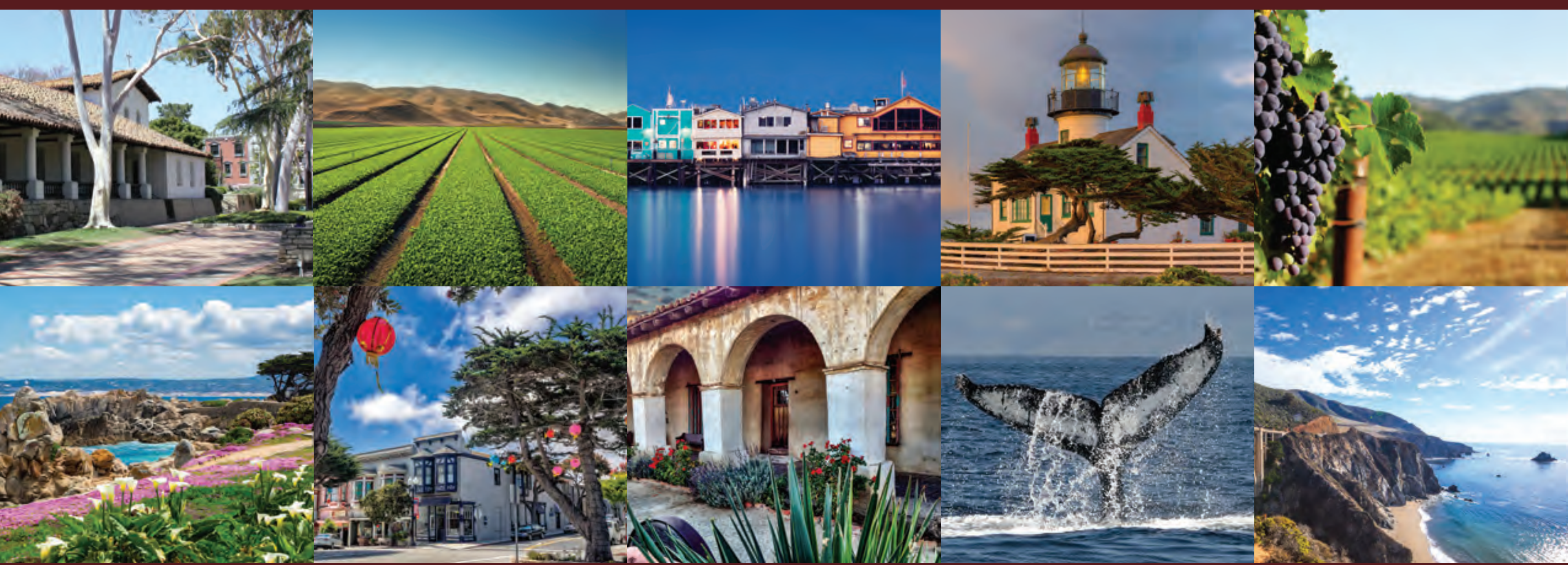
2019 Annual Report



1ST CAPITAL BANK

To Our Shareholders and Clients:

1st Capital Bank achieved another year of growth and increased profitability in 2019, despite an increasingly challenging economic environment. That challenge pales in comparison to the impact of the COVID-19 pandemic we currently are experiencing, but we are confident 1st Capital Bank will prove to be resilient in the face of the many challenges that confront us.

Net loans exceeded $500 million for the first time in 2019, reaching $504 million by year-end, a 4.9% increase over the prior year. Strong growth in the Bank's core commercial and commercial real estate portfolio, which increased 10.6% year over year, drove increased profitability. The Bank's net interest margin expanded from 3.88% to 4.03%, and net income reached a record $7.1 million, up 10.2% compared to 2018. Diluted earnings per share increased from $1.17 in 2018 to $1.27 in 2019.

As we entered the second quarter of 2020, President and Chief Executive Officer Tom Meyer retired, and we welcomed new CEO Sam Jimenez to the Bank, while long-time Chief Lending Officer Jon Ditlevsen was promoted to President, and Monterey Regional President Stuart Tripp was promoted to Chief Lending Officer.

2019 Highlights

In 2019, a clear focus on the fundamentals of our business was the key to our improved operating results.

- Loan principal outstanding grew 4.8% for the year, while the yield on the loan portfolio increased from 4.48% to 4.58%, leading to a 7.0% increase in interest on loans, our most important source of revenue.
- Average earning assets expanded 1.5%, while the yield on earning assets increased from 4.00% to 4.20%, driving a 6.5% increase in total interest income.
- Average noninterest-bearing demand deposit accounts, our preferred source of funding, increased 5.0%, from $253 million in 2018 to $266 million in 2019. At year-end 2019, they totaled $281 million, or 49.1% of total deposits.
- Total deposits increased 2.1% to $572 million, while the Bank limited the increase in its cost of funds to 0.06%, from 0.15% in 2018 to 0.21% in 2019.
- Non-interest income declined slightly, from $1.99 million to $1.91 million, after a 72.1% increase in 2018, as the volume of loan sales decreased and gain on sale of loans fell from $194 thousand to $41 thousand.
- The Bank's efficiency ratio (non-interest expenses divided by total revenues) improved from 63.7% to 62.7% as returns of scale continued to contribute to improved performance.
- Overall, return on average assets increased, from 0.51% in 2017 to 1.07% in 2018 and 1.15% in 2019.
- Return on average equity, after increasing from 5.65% in 2017 to 11.67% in 2018, fell slightly to 11.09% in 2019, as the Bank preserved its capital in anticipation of a more difficult operating environment in 2020.
- Credit quality metrics remained outstanding, with non-accrual loans making up 0.10% of total loans at year-end 2019, compared to 0.56% at year-end 2018. Non-performing assets were 0.08% of total assets at year-end 2019, compared to 0.44% at year-end 2018.

Expanding Our Reach and Building for the Future

In 2019, the Bank expanded its physical presence into Santa Cruz County, opening a loan production office on busy Soquel Drive and creating a home base for veteran Santa Cruz County bankers Jon Ditlevsen, Stuart Tripp, and Dean Austin. A full branch in the same building is nearing completion, which will allow us to tap into the deposit-rich Santa Cruz market.

The Bank leased a much more prominently located branch office in downtown San Luis Obispo, and this facility also will open in the near future. It will be home to newly hired Small Business Administration (SBA) lending specialists Machele DuBois and Hillary Olson, who joined the Bank later in 2019.

We also are delighted to welcome back Senior Relationship Manager Glenna Datta to our Salinas banking office.

2020 Outlook

2020 already has proved challenging. The COVID-19 outbreak led the Federal Open Market Committee to reduce short-term interest rates by 1.50% in the month of March, exacerbating an already difficult interest rate environment, and steps taken by government officials also have placed tremendous pressure on small businesses. 1st Capital Bank has responded by becoming an active participant in the SBA's Paycheck Protection Program that offers loans featuring forgiveness provisions for amounts spent on payrolls for borrowers and guarantees of the full amount of principal lent for lenders. As this is written, 1st Capital Bank had more than $100 million in commitments funded or in process.

The Bank itself also is subject to the ravages of the pandemic, but is coping well, making it possible for all but front-line branch staff to telecommute and offering salary continuation to those affected or obligated to care for family members. The full impact of the abrupt change in economic conditions on the Bank remains to be seen, but we are hopeful that the Bank will be able to continue to achieve the vision of our board of directors: to enhance the financial health and well-being of our communities along California's Central Coast.

We appreciate the continued support of our valued customers, our dedicated employees, and you, our shareholders, in allowing us to carry out our mission as we confront the challenges that lie ahead.

Sincerely,

Kurt J. Gollnick

Chairman of the Board

FINANCIAL HIGHLIGHTS

(amounts in thousands, except per share amounts)

	2017	***2018***	***2019***
For the Year:			
Net interest income before provision for loan losses	$ 19,142	$ 22,732	$ 23,950
Provision for loan losses	$ 175	$ 120	$ --
Other operating income	$ 1,156	$ 1,990	$ 1,912
Non-interest expenses	$ 14,018	$ 15,743	$ 16,208
Income before provision for income taxes	$ 6,105	$ 8,859	$ 9,654
Net income	$ 2,845	$ 6,431	$ 7,087
Diluted Earnings per Share	$ 0.53	$ 1.17	$ 1.27
Average Balances for the Year:			
Gross loans	$ 415,893	$ 466,572	$ 488,996
Interest-earning assets	$ 547,622	$ 588,279	$ 596,940
Interest-bearing liabilities	$ 278,266	$ 292,142	$ 283,001
Deposits	$ 509,206	$ 545,541	$ 549,150
At Year End:			
Total assets	$ 580,231	$ 622,287	$ 645,347
Net loans	$ 421,555	$ 480,842	$ 504,295
Demand deposits	$ 261,706	$ 281,695	$ 280,634
Total deposits	$ 526,076	$ 560,498	$ 572,069
Stockholders’ equity	$ 51,992	$ 59,165	$ 68,015
Market capitalization	$ 72,126	$ 76,587	$ 84,238
Financial Ratios:			
Net interest margin *	3.50%	3.88%	4.03%
Efficiency ratio	69.06%	63.68%	62.67%
Non-interest expenses to average assets	2.49%	2.61%	2.62%
Allowance for loan losses to gross loans	1.49%	1.34%	1.29%
Non-accrual loans to gross loans	0.06%	0.56%	0.10%
Net loan charge-offs (recoveries) to average gross loans	0.02%	-0.01%	-0.01%
Non-performing assets to total assets	0.04%	0.44%	0.08%
Tier 1 leverage ratio	9.14%	9.55%	10.90%
Common equity Tier 1 risk-based capital	12.91%	13.30%	14.04%
Total risk-based capital	14.16%	14.55%	15.29%
Return on average assets	0.51%	1.07%	1.15%
Return on average equity	5.65%	11.67%	11.09%

* Tax equivalent basis

Crowe

Crowe LLP
Independent Member Crowe Global

INDEPENDENT AUDITOR'S REPORT

To the Shareholders and Board of Directors
1st Capital Bank
Salinas, California

Report on the Financial Statements

We have audited the accompanying financial statements of 1st Capital Bank, which comprise the balance sheets as of December 31, 2019 and 2018, and the related statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2019, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of 1st Capital Bank as of December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2019 in accordance with accounting principles generally accepted in the United States of America.

Crowe LLP

Crowe LLP

Sacramento, California
March 24, 2020

1ST CAPITAL BANK

BALANCE SHEETS
DECEMBER 31, 2019 and 2018
(Dollars in Thousands)

	December 31, 2019	December 31, 2018
ASSETS:		
Cash and due from banks	$ 6,198	$ 6,476
Due from Federal Reserve Bank	46,155	45,625
Total cash and cash equivalents	52,353	52,101
Securities available for sale, at fair value	66,095	70,263
Loans receivable held for investment (net of allowance for loan losses of $6,594 at December 31, 2019 and $6,548 at December 31, 2018)	504,295	480,842
Cash surrender value of bank-owned life insurance	8,071	7,866
Federal Home Loan Bank stock, at cost	3,501	3,163
Deferred tax assets, net	2,375	2,907
Premises and equipment, net	2,102	2,087
Accrued interest and dividends receivable	1,698	1,725
Other assets	4,857	1,333
TOTAL ASSETS	$ 645,347	$ 622,287
LIABILITIES AND STOCKHOLDERS' EQUITY:		
LIABILITIES:		
Noninterest-bearing deposits	$ 280,634	$ 281,695
Interest-bearing deposits	291,435	278,803
Total deposits	572,069	560,498
Accrued interest payable	59	48
Other liabilities	5,204	2,576
Total liabilities	577,332	563,122
Commitments and contingencies (Note 12)		
STOCKHOLDERS' EQUITY:		
Preferred stock, no par value, 10,000,000 shares authorized; no shares issued or outstanding at December 31, 2019 and 2018	--	--
Common stock, no par value, 20,000,000 shares authorized; 5,520,179 shares issued and outstanding at December 31, 2019; 5,105,784 shares issued and outstanding at December 31, 2018	63,104	56,831
Retained earnings	4,386	2,830
Accumulated other comprehensive income (loss), net of taxes	525	(496)
Total stockholders' equity	68,015	59,165
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 645,347	$ 622,287

See Notes to Financial Statements

1ST CAPITAL BANK

STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	2019	2018	2017
INTEREST AND DIVIDEND INCOME:			
Loans receivable	$ 22,385	$ 20,921	$ 17,860
Taxable securities available for sale	1,372	1,195	980
Tax-exempt securities available for sale	393	395	151
Federal Home Loan Bank stock	239	273	235
Interest-bearing deposits in other financial institutions	1	52	204
Interest-bearing balances due from Federal Reserve Bank	703	722	332
Total interest and dividend income	25,093	23,558	19,762
INTEREST EXPENSE:			
Deposits	1,143	823	620
Borrowings	--	3	--
Total interest expense	1,143	826	620
NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES	23,950	22,732	19,142
PROVISION FOR LOAN LOSSES	--	120	175
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	23,950	22,612	18,967
NON-INTEREST INCOME:			
Service charges and fees	323	299	243
Bank-owned life insurance dividend income	205	212	221
Gain on sale of loans	41	194	266
Gain on sale of investment securities	60	--	--
Other income	1,283	1,285	426
Total non-interest income	1,912	1,990	1,156
NON-INTEREST EXPENSE:			
Compensation and employee benefits	9,963	10,069	8,712
Occupancy	1,335	1,169	1,057
Item and data processing	773	645	600
Professional services	616	550	722
Equipment and furniture	617	502	485
Marketing and business development	265	286	229
Other non-interest expense	2,639	2,522	2,213
Total non-interest expense	16,208	15,743	14,018

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1ST CAPITAL BANK

STATEMENTS OF INCOME (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	2019	2018	2017
INCOME BEFORE PROVISION FOR INCOME TAXES	9,654	8,859	6,105
PROVISION FOR INCOME TAXES	2,567	2,428	3,260
NET INCOME	$ 7,087	$ 6,431	$ 2,845
BASIC EARNINGS PER SHARE	$ 1.29	$ 1.19	$ 0.54
Weighted average shares used in basic earnings per share calculation	5,486,515	5,394,965	5,309,554
DILUTED EARNINGS PER SHARE	$ 1.27	$ 1.17	$ 0.53
Weighted average shares used in diluted earnings per share calculation	5,571,351	5,498,673	5,391,914

See Notes to Financial Statements

1ST CAPITAL BANK

STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	2019	2018	2017
NET INCOME	$ 7,087	$ 6,431	$ 2,845
Other comprehensive income (loss):			
Unrealized gains (losses) on securities available for sale:			
Unrealized holding gains (losses)	1,513	(467)	542
Less: Reclassification for net gain included in net income	(60)	--	--
Other comprehensive income (loss), before tax	1,453	(467)	542
Tax effect	432	(150)	223
Total other comprehensive income (loss), net of tax	1,021	(317)	319
COMPREHENSIVE INCOME	$ 8,108	$ 6,114	$ 3,164

See Notes to Financial Statements

1ST CAPITAL BANK

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	Common Stock		Retained	Accumulated Other Comprehensive Income	Total Stockholders'
	Shares	Amount	Earnings	(Loss)	Equity
Balance at January 1, 2017	4,350,721	$ 45,510	$ 2,601	$ (466)	$ 47,645
Stock options exercised & tax benefit	64,596	552			552
Vested restricted stock awards issued	48,427	--			--
Share based compensation expense		635			635
5% stock dividend	222,777	3,413	(3,413)		--
Cash paid in lieu of fractional shares			(4)		(4)
Net income			2,845		2,845
Reclassification of stranded tax effects			32	(32)	--
Net change in unrealized loss on Other comprehensive income				319	319
Balance at December 31, 2017	4,686,521	50,110	2,061	(179)	51,992
Stock options exercised	34,326	301			301
Vested restricted stock awards issued	53,542	--			--
Share based compensation expense		765			765
7% stock dividend	331,395	5,655	(5,655)		--
Cash paid in lieu of fractional shares			(7)		(7)
Net income			6,431		6,431
Net change in unrealized loss on Other comprehensive income				(317)	(317)
Balance at December 31, 2018	5,105,784	$ 56,831	$ 2,830	$ (496)	$ 59,165

Continued on the following page

1ST CAPITAL BANK

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	Common Stock		Retained	Accumulated Other Comprehensive Income	Total Stockholders'
	Shares	Amount	Earnings	(Loss)	Equity
Balance at December 31, 2018	5,105,784	$ 56,831	$ 2,830	$ (496)	$ 59,165
Stock options exercised	2,539	15			15
Vested restricted stock awards issued	52,089	--			--
Share based compensation expense		736			736
7% stock dividend	359,767	5,528	(5,528)		--
Cash paid in lieu of fractional shares			(3)		(3)
Net income			7,087		7,087
Net change in unrealized gain on Other comprehensive income				1,015	1,015
Balance at December 31, 2019	5,520,179	$ 63,110	$ 4,386	$ 519	$ 68,015

1ST CAPITAL BANK

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	2019	2018	2017
OPERATING ACTIVITIES:			
Net income	$ 7,087	$ 6,431	$ 2,845
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of premises and equipment	627	588	542
Amortization of security premiums, net of accretion of discounts	345	458	454
(Increase) decrease in deferred loan fees, costs, premiums, and discounts, net	(690)	183	553
Provision for loan losses	--	120	175
Gain on sale of investment securities	(60)	--	--
Gain on sale of loans	(41)	(194)	(266)
Origination of loans held for sale	(550)	(3,906)	(3,808)
Proceeds from sale of loans held for sale	607	4,146	4,136
(Increase) decrease in loan servicing rights	27	(8)	(38)
(Increase) decrease in discount on retained interests in loans	91	(6)	(123)
Compensation expense related to stock compensation plans	736	765	635
(Increase) decrease in accrued interest and dividends receivable	27	(232)	(216)
Provision for deferred income taxes	94	(337)	711
Change in reserve for uncertain tax positions	(73)	--	(70)
Bank-owned life insurance dividend income	(205)	(212)	(221)
(Increase) in other assets	(154)	(335)	(479)
Increase (decrease) in accrued interest payable	11	30	(3)
Increase (decrease) in other liabilities	(696)	431	506
Net cash provided by operating activities	7,183	7,922	5,333
INVESTING ACTIVITIES:			
Net increase in loans receivable held for investment	(22,869)	(59,630)	(23,183)
Purchases of securities available for sale	(10,686)	(7,667)	(12,764)
Principal repayments on securities available for sale	8,534	11,408	15,797
Proceeds from sales of securities available for sale	7,488	--	--
Purchases of premises and equipment	(642)	(367)	(1,376)
Proceeds from the sale of premises and equipment	--	--	5
Purchases of Federal Home Loan Bank stock	(338)	--	(224)
Decrease in interest-bearing deposits in other financial institutions, net	--	1,743	747
Net cash used in investing activities	(18,513)	(54,513)	(20,998)

Continued on the following page

1ST CAPITAL BANK

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2019, 2018, and 2017
(Dollars in Thousands)

	2019	2018	2017
FINANCING ACTIVITIES:			
Net increase in transaction and savings deposits	9,429	29,298	26,369
Net increase (decrease) in certificates of deposit	2,141	5,124	(914)
Cash paid in lieu of fractional shares – stock dividend	(3)	(7)	(4)
Cash proceeds from exercise of stock options	15	301	552
Net cash provided by financing activities	11,582	34,716	26,003
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	252	(11,875)	10,338
CASH & CASH EQUIVALENTS AT BEGINNING OF YEAR	52,101	63,976	53,638
CASH & CASH EQUIVALENTS AT END OF YEAR	$ 52,353	$ 52,101	$ 63,976
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the period for:			
Interest expense	$ 1,132	$ 797	$ 624
Income taxes	$ 2,200	$ 2,200	$ 3,062
Supplemental noncash disclosures:			
Initial recognition of right-of-use assets	$ 3,317	$ --	$ --
Initial recognition of lease liabilities	$ (3,317)	$ --	$ --

See Notes to Financial Statements

1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Nature of Operations

1st Capital Bank (the "Bank") opened for business on April 16, 2007. The Bank is chartered by the state of California and is subject to regulation by the California Department of Business Oversight (the "DBO") and the Federal Deposit Insurance Corporation (the "FDIC"). It is not a member of the Federal Reserve System. The Bank primarily markets to businesses, professionals, real estate investors, family commercial entities, and individuals located along the Central Coast region of California. The Bank's primary business is attracting checking, money market, savings, and certificate of deposit accounts through its branch facilities, remote branch deposit, and various electronic means, and investing such deposits and other available funds into loans, including real estate mortgages, commercial business loans, and construction loans. In addition, the Bank invests in securities and may utilize various sources of wholesale borrowings. The Bank also provides a range of fee-based services, including an array of treasury management services. The Bank operates full-service branch offices in Monterey, Salinas, King City, and San Luis Obispo – all located in Monterey County or San Luis Obispo County, California – and a loan production office in Santa Cruz County. The Bank supplements its physical locations with a wide range of financial service delivery options including remote check scanning, remote branch deposit, on-line banking, telephone banking, courier service, electronic bill payment, remote ACH origination, mobile banking, and remote wire transfer request. The Bank's corporate offices are located at 150 Main Street, Suite 150, Salinas, California 93901. The Bank's website is www.1stCapital.bank. The main telephone number is 831.264.4000, and the main facsimile number is 831.264.4001.

Deposits in the Bank are insured by the FDIC up to applicable legal limits.

The accounting and reporting policies of the Bank conform with accounting principles generally accepted in the United States of America ("GAAP") and prevailing practices within the banking industry.

Summary of Significant Accounting Policies

Subsequent Events – In December 2019, a novel strain of coronavirus surfaced in Wuhan, China, and has spread around the world, with resulting business and social disruption. The coronavirus was declared a Public Health Emergency of International Concern by the World Health Organization on January 30, 2020 and on March 11, 2020 was declared a pandemic. The operations and business results of the Company could be materially adversely affected. Significant estimates as disclosed in Note 1, including the allowance for loan losses may be materially adversely impacted by local, state and national restrictions and events designed to contain the coronavirus. The magnitude of the impact is likely dependent upon the length and severity of the disruption. The Company has evaluated the effects of subsequent events for recognition and disclosure through March 24, 2020, which is the date the consolidated financial statements were available to be issued.

Stock Dividend – On September 30, 2019, the Bank's Board of Directors declared a 7.00% stock dividend, which was distributed on December 20, 2019 to shareholders of record as of November 22, 2019. All share and per-share information disclosed in the notes to the financial statements has been retroactively adjusted to reflect the stock dividend.

Use of Estimates –The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and contingent assets and liabilities as of the balance sheet date and revenues and expenses for the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents – Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold, interest-bearing transaction deposits in other financial institutions, securities purchased under agreements to resell with original maturities of three months or less, and certificates of deposit with original maturities of three months or less. Generally, federal funds are sold on an overnight basis. For purposes of the Statements of Cash Flows, net cash flows are reported for client loans held for investment, client deposit accounts, securities purchased under agreements to resell, and certificates of deposit with original maturities greater than three months. At December 31, 2019, the Bank maintained "due from" noninterest-bearing account balances at its correspondent banks (excluding the Federal Reserve Bank of San Francisco, or "FRB," and excluding the Federal Home Loan Bank of San Francisco, or "FHLB") of $2.7

million, of which $2.1 million was not fully FDIC insured. The Bank earns interest on its deposit balances maintained at the FRB and FHLB.

Restrictions on Cash – Cash on hand or on deposit with the Federal Reserve Bank was used to meet regulatory reserve requirements of $17.9 million and $16.8 million at December 31, 2019 and 2018, respectively.

Debt Securities Available for Sale **–** Debt securities to be held for indefinite periods of time, including debt securities that management intends to use as part of its asset / liability management strategy that may be sold in response to changes in interest rates, loan prepayments, or other factors, are classified as available for sale. Debt securities available for sale are carried at fair value. Gains or losses on the sale of debt securities are determined using the specific identification method. Premiums and discounts are recognized in interest income using the interest method over the period to contractual maturity, except for debt securities with early call provisions, in which case premiums are recognized in interest income using the interest method over the period to the first call date and discounts are recognized in interest income using the interest method over the period to the contractual maturity date. For mortgage-backed securities and collateralized mortgage obligations, the amortization or accretion is based on the estimated lives of the debt securities. The lives of these debt securities can fluctuate based on the amount of prepayments received on the underlying collateral of the securities. Unrealized holding gains or losses, net of tax, for debt securities available for sale are reported within accumulated other comprehensive income, which is a separate component of stockholders' equity, until realized.

Management determines the appropriate classification of its debt securities at the time of purchase and may only change the classification in certain limited circumstances. All transfers between classifications are accounted for at fair value. At December 31, 2019 and 2018, the Bank did not have any debt securities classified as held to maturity or trading. During the years ended December 31, 2019, 2018, and 2017, there were no transfers of debt securities between classifications.

A debt security is impaired when its carrying value is greater than its fair value. Debt securities that are impaired are evaluated on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether such a decline in their fair value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Bank to retain its investment in the debt securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value are not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, and management does not intend to sell the debt security or it is more likely than not that the Bank will not be required to sell the debt security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the debt security or it is more likely than not that the Bank will be required to sell the debt security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Loans Held for Sale **–** Loans held for sale are carried at the lower of aggregate net cost, including qualified deferred fees and costs, or fair value, grouped by category. Unrealized losses by category are recognized via a charge against earnings. Realized gains and losses on loans held for sale are accounted for under the specific identification method. Qualified deferred loan origination fees and costs are not amortized during the period the loans are held for sale. Transfers of loans held for sale to the held-for-investment portfolio are recorded at the lower of cost or estimated market value on the transfer date. The Bank did not have any loans held for sale at December 31, 2019 or 2018.

Loans Receivable Held for Investment **–** Loans receivable held for investment are those loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff. Loans receivable held for investment are stated at unpaid principal balances less undisbursed loan funds, unearned discounts, deferred loan origination fees, and allowances for loan losses, plus deferred direct loan origination costs and unamortized premiums.

Interest Income on Loans **–** Interest income on loans is accrued and credited to income as it is earned. However, interest generally is not accrued on loans over 90 days contractually delinquent. In addition, interest is not accrued on loans that are less than 90 days contractually delinquent, but where management has identified concern over future collection. Accrued interest income is reversed when a loan is placed on non-accrual status. Discounts, premiums, deferred loan origination fees and deferred direct loan origination costs are amortized into interest income over the contractual lives of the related loans using the interest method, except when a loan is in non-accrual status. When a loan is paid off or is sold, any unamortized balance of any related premiums, discounts, loan origination fees, and direct loan origination costs is recognized in income. Payments received on non-accrual loans may be allocated between principal and interest or may be recorded entirely as reductions in principal based upon management's opinion of the ultimate risk of loss on the individual loan. Loans are returned to accrual status when all of the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Sales of Loans and Servicing Rights – The Bank accounts for the transfer of financial assets based on the financial assets it controls and liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. Gains or losses resulting from sales of loans are recorded at the time of sale and are determined by the difference between: (i) the net sales proceeds plus the estimated fair value of any interests retained in the loans, and (ii) the carrying value of the assets sold. The difference between the adjusted carrying value of the interests retained and the face amount of the interests retained is amortized to operations over the estimated remaining life of the associated loans using the interest method. The fair value of any interests retained is periodically evaluated, with any shortfall in estimated fair value versus carrying amount being charged to operations. The Bank serviced loans for others in the amount of $7.4 million and $8.0 million at December 31, 2019 and 2018, respectively.

When loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in gain on sale of loans. Fair value is based on market prices for comparable servicing contracts, when available or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. All classes of servicing assets are subsequently measured using an amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to the carrying amount. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Bank later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds, default rates, and losses. In addition, other than temporary impairments of servicing rights are recognized in earnings. No valuation allowance was deemed necessary at December 31, 2019 and 2018.

Servicing fee income, which is reported on the income statement within Other Income, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of servicing rights is netted against loan servicing fee income. Gross servicing fees totaled $86 thousand and $84 thousand for the years ended December 31, 2019 and 2018, respectively. Net servicing fees totaled $52 thousand and $39 thousand for the years ended December 31, 2019 and 2018, respectively. Late fees and ancillary fees related to loan servicing are not material.

Troubled Debt Restructurings – A loan is considered a troubled debt restructuring ("TDR") when the Bank, for economic or legal reasons related to the borrower's financial difficulties, provides the borrower certain concessions that it would not normally consider. The concessions are provided with the objective of maximizing the recovery of the Bank's investment. A troubled debt restructuring includes situations in which the Bank accepts a note (secured or unsecured) from a third party in payment of its receivable from the borrower, other assets in payment of the loan, an equity interest in the borrower or its assets in lieu of the Bank's receivable under which the value received is less than the face amount of the debt, or a modification of the terms of the debt including, but not limited to: (i) a reduction in the stated interest rate to a below-market rate; (ii) an extension of maturity at an interest rate or other terms below market; (iii) a reduction in the face amount of the debt; and / or (iv) a reduction in the accrued interest receivable. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment as described below. The Bank had no loans considered to be troubled debt restructurings at December 31, 2019, and $55 thousand considered to be troubled debt restructurings at December 31, 2018.

Impaired Loans **–** The Bank considers a loan to be impaired when it is deemed probable by management that the Bank will be unable to collect all contractual interest and contractual principal payments in accordance with the terms of the original loan agreement. In evaluating whether a loan is considered impaired, insignificant delays or shortfalls in payments in the absence of other facts and circumstances would not alone lead to the conclusion that a loan is impaired. Factors considered in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due.

The Bank includes among impaired loans all loans that: (i) are contractually delinquent 90 days or more; (ii) meet the definition of a troubled debt restructuring; (iii) are classified in part or in whole as either doubtful or loss; and (iv) have been placed on non-accrual status. The Bank may also classify other loans as impaired based upon their specific circumstances. Loans identified as impaired are evaluated and have a specific loss allowance applied to adjust the loan to fair value, or the impaired amount is charged off.

The Bank accounts for impaired loans, except those loans that are accounted for at market value or at the lower of cost or market value, at the present value of the expected future cash flows discounted at the loan's effective interest rate at the date of initial impairment, or, as a practical expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. The Bank evaluates the collectability of both contractual interest and contractual principal when assessing the need for a loss accrual for impaired loans. Payments received on impaired non-accrual loans may be allocated between principal and interest or may be recorded entirely as a reduction in principal based upon management's opinion of the ultimate risk of loss on the individual loan. Interest income on other impaired loans is recognized on an accrual basis. The Bank had $0.6 million of impaired loans as of December 31, 2019 and $3.0 million of impaired loans as of December 31, 2018.

The Bank may acquire loans through business combinations or purchases for which differences may exist between the contractual cash flows and the cash flows expected to be collected when due, at least in part due to credit quality, and are classified as purchased credit impaired. When the Bank acquires such loans, the yield that may be accreted is limited to the excess of the expected cash flows at acquisition over the Bank's initial investment in the loan. The excess of contractual cash flows over cash flows expected to be collected may not be recognized as an adjustment to yield, loss, or a valuation allowance. Subsequent increases in cash flows expected to be collected are recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected are recognized as impairments. The Bank does not "carry over" or create a valuation allowance in the initial accounting for loans acquired under these circumstances. The Bank did not have any loans accounted for under these policies as of December 31, 2019 and 2018.

Allowance for Loan Losses **–** The Bank maintains an allowance for loan losses (the "allowance"), which is a valuation allowance, to absorb probable incurred credit losses. The allowance is based on ongoing assessments of the probable estimated losses. Loans are charged against the allowance when management believes the principal to not be recoverable. The allowance is increased by the provision for loan losses. The provision for loan losses is charged against current period earnings. The allowance is decreased by the amount of charge-offs, net of recoveries. While allocations of the allowance for loan losses may be made for specific loans, the entire allowance for loan losses is available for any loan that should be charged off.

The Bank's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula (or general) allowance, specific allowances, and the unallocated allowance.

The determination of the general allowance for loans that are collectively evaluated for impairment is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Bank, its peers, or a combination thereof for a period of forty consecutive quarters prior to the most current year end. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations.

These loss factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

Construction and land, including farmland – Construction and land, including farmland loans, generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified costs and timelines. Trends in the construction industry significantly affect the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly affect the credit quality of these loans, as property values determine the economic viability of construction projects.

Multifamily and commercial and industrial real estate – Multifamily and commercial and industrial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except construction, land, and lot loans. Adverse economic developments or an overbuilt market affect multifamily and commercial and industrial real estate projects and may result in troubled loans. Trends in vacancy rates of multifamily and commercial properties affect the credit quality of these loans. High vacancy rates reduce operating revenues and the ability of properties to produce sufficient cash flow to service debt obligations.

Commercial and industrial – Commercial and industrial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans generally are underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows, and economic trends evidenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Residential one to four unit real estate and home equity lines of credit – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate, and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends evidenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Other – These loans are typically various types of loans to not-for-profit organizations and other miscellaneous categories of loans and as such are vulnerable to risk factors that are largely outside the control of the Bank.

The allowance for loan losses attributable to each portfolio segment, which includes both loans individually evaluated for impairment and loans that are collectively evaluated for impairment, are combined to determine the Bank’s overall allowance, which is included on the balance sheet and available for all loss exposures.

The Bank assigns a risk rating to all loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Bank and by the Bank’s regulators. During the Bank’s internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate, and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings do not differ by portfolio segment, and can be grouped into five major categories, defined as follows:

Pass – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention. A watch loan is a pass graded loan where management has identified the need to monitor the status of the loan on a more frequent basis than would be typical for the type of loan.

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

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

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

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

Specific allowances are established for loans that are deemed impaired if the fair value of the loan or the collateral or the present value of expected future cash flows is estimated to be less than the Bank's investment in the loan. In developing specific valuation allowances, the Bank considers: (i) the estimated cash payments expected to be received by the Bank; (ii) the estimated net sales proceeds from the loan or its collateral; (iii) cost of refurbishment; (iv) certain operating income and expenses; and (v) the costs of acquiring, holding, and disposing of the collateral. The Bank charges off a portion of an impaired loan against the specific allowance when that portion is not considered recoverable.

The unallocated allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating general and specific losses in the credit portfolio. The Bank maintained a $434 thousand unallocated allowance at December 31, 2019 and a $212 thousand unallocated allowance at December 31, 2018.

While management uses currently available information to determine the allowance for loan losses, additions to or recoveries from the allowance may be necessary based upon a number of factors including, but not limited to, changes in economic conditions and credit quality trends, particularly in the real estate market, borrower financial status, the regulatory environment, real estate values, and loan portfolio size and composition. Many of these factors are beyond the Bank's control and, accordingly, periodic provisions for loan losses may vary from time to time. In addition, various regulatory agencies, as an integral part of the examination process, periodically review the Bank's allowance for loan losses. Such regulatory agencies may develop judgments different from those of management and may require the Bank to recognize additional provisions. The Bank's Board of Directors reviews and approves the adequacy of the allowance for loan losses at least quarterly.

Loan Commitments and Related Financial Instruments – Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet client financing needs. The face amount for these items represents the exposure to loss, before considering client collateral or ability to repay. Such financial instruments are recorded when they are funded.

Allowance for Off-Balance Sheet Credit Exposures – The Bank also maintains a separate allowance for off-balance sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance sheet commitments is included in Other Liabilities on the Balance Sheets. The allowance for off-balance sheet commitments was $145 thousand at December 31, 2019 and $163 thousand at December 31, 2018.

Premises and Equipment – Premises and equipment are stated at cost, less accumulated depreciation and amortization. The Bank depreciates or amortizes furniture and equipment on a straight-line basis over the estimated useful lives of the various assets (generally three to seven years) and amortizes leasehold improvements over the shorter of the asset's useful life or the remaining term of the lease including option periods the Bank has the right, capacity, and intent to exercise. Gains and losses on disposition of premises and equipment are accounted for under the specific identification method. The cost of repairs and maintenance is charged to earnings as incurred, whereas expenditures that improve or extend the service lives of assets are capitalized.

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

Federal Home Loan Bank Stock – As a member of the Federal Home Loan Bank System, the Bank is required to maintain an investment in the capital stock of the Federal Home Loan Bank of San Francisco ("FHLB") based upon the size and profile of its balance sheet and the level of its FHLB advances. The Bank's investment in FHLB stock is carried at cost, is classified as a restricted security, and is periodically evaluated for impairment based upon ultimate recovery of par value. Both cash and stock dividends are reported as income. The Bank's investment in FHLB stock was $3.5 million and $3.2 million at December 31, 2019 and 2018, respectively.

Income Taxes – Income tax expense is the total of the current year income tax due or refundable plus the change in deferred tax assets and liabilities. The Bank accounts for income taxes under the asset and liability method. Under this method, deferred tax assets and deferred tax liabilities are recognized for future tax consequences attributable to temporary differences between the financial statement carrying amounts of certain existing assets and liabilities, and their respective bases for Federal income and California franchise taxes. Deferred tax assets and liabilities are calculated by applying current marginal tax rates against future deductible or taxable amounts. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Future tax benefits attributable to temporary differences are recognized to the extent the realization of such benefits is more likely than not.

Accounting for Uncertainty in Income Taxes – The Bank considers all tax positions recognized in its financial statements for the likelihood of realization. When tax returns are filed, it is highly likely that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based upon all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above, if any, is reflected as a liability for unrecognized tax benefits in the accompanying Balance Sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the Statements of Income. The Bank maintained a reserve for uncertain tax positions of $0 at December 31, 2019 and $73 thousand at December 31, 2018.

Earnings Per Share – Basic earnings per share excludes dilution and is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if contracts to issue common stock or securities convertible into common stock were exercised or converted, which currently consist of shares issuable upon the exercise of stock options and the vesting of outstanding restricted stock awards. Dilution resulting from the Bank's Equity Incentive Plan is calculated using the treasury stock method. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

Comprehensive Income – Comprehensive income includes net income and other comprehensive income. The Bank's only source of other comprehensive income is derived from unrealized gains and losses on securities available for sale. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose. Such adjustments are excluded from current period comprehensive income in order to avoid double counting.

Derivative Instruments and Hedging Activities – The Bank did not enter into any freestanding derivative contracts, did not conduct any hedging activities, and did not identify any embedded derivatives requiring bifurcation and separate valuation during 2019 or 2018.

Fair Value of Financial Instruments – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 2. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

Loss Contingencies – Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Concentrations of Credit Risk – Most of the Bank's business activity is with clients located within Monterey, San Luis Obispo, and Santa Cruz Counties. Therefore, the Bank's exposure to credit risk is significantly affected by changes in the economy, business conditions, and real estate values in the Monterey, San Luis Obispo, and Santa Cruz County areas.

Segment Disclosure – The Bank operates a single line of business (financial services) with no client accounting for more than 10% of its revenue and manages its operations under a unified management and reporting structure. Therefore, no additional segment disclosures are provided.

Share-Based Payments – The Bank has one share-based compensation plan, the 1st Capital Bank 2016 Equity Incentive Plan (the "Plan"), which has been approved by its shareholders and permits the grant of stock options and restricted stock awards for up to 722,050 shares of the Bank's common stock. The Plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, the Bank's operating results, and government regulations. New shares are issued upon option exercise or vesting of restricted stock awards. In addition, the Plan requires that the exercise price of options may not be less than the fair market value of the stock at the date the option is granted, and that the exercise price must be paid in full at the time the option is exercised.

Share-based compensation expense is recorded for all stock options and restricted stock awards as the requisite service is rendered based on the grant date fair value of the awards.

Management estimates the fair value of each stock option award as of the date of grant using a Black-Scholes-Merton option pricing formula. Expected volatilities are based on historical volatilities of the Bank's common stock over a preceding period commensurate with the expected term of the options. The Bank uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on this historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected dividend yield was not considered in the option pricing formula since the Bank has no plans to pay cash dividends. In addition to these assumptions, management accounts for forfeitures as they occur.

Restricted share awards are grants of shares of the Bank's common stock that are subject to forfeiture until specific conditions or goals are met. Conditions may be based on continuing employment or service and / or achieving specified performance goals. During the period of restriction, Plan participants holding restricted share awards have no voting or cash dividend rights. The restrictions lapse in accordance with a schedule or with other conditions determined by the Board of Directors as reflected in each award agreement. The restricted stock awards are considered fixed awards as the number of shares and fair value are known at the date of grant. The fair value for restricted stock awards is determined by the market price of the Bank's common stock on the date of grant.

The Bank recognizes the share-based compensation expense over the vesting period of each award of restricted shares based upon the fair value of the common stock at the date of grant, and, if applicable, considering the probability of the performance criteria being achieved. Plan participants have the opportunity to elect tax information reporting of the award of restricted shares within thirty days of grant under Internal Revenue Code Section 83(b). To the extent Plan participants make such elections, the Bank recognizes the expense for tax purposes more quickly than for book purposes, thereby generating a deferred tax liability.

Upon the exercise of each vested stock option and vesting of each restricted share award, the Bank issues the associated common shares from its inventory of authorized common shares. All outstanding stock options and restricted stock awards under the Plan immediately vest in the event of a change in control of the Bank. The shares associated with any stock options that are forfeited or expire unexercised and restricted share awards that fail to vest become available for re-issuance under the Plan.

Reclassifications – Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or shareholders' equity.

Adoption of New Accounting Standards and Newly Issued But Not Yet Effective Accounting Standards

The Bank recently has adopted the following Accounting Standards Updates ("ASU") issued by the Financial Accounting Standards Board ("FASB").

ASU 2016-02, Leases (Topic 842) – In February 2016, the FASB amended existing guidance that requires lessees recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. These amendments are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (i.e., January 1, 2019, for a calendar year entity).

Lessees (for capital and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees may not apply a full retrospective transition approach. The modified retrospective transition method does require lessees to select one of two options: (a) the effective date option, under which the lessee applies the new standard at the effective date and recognizes a cumulative effect adjustment to the opening balance of equity in the period of adoption, and (b) the comparative option, under which the lessee applies the new standard as of the beginning of the earliest period presented and recognizes a cumulative effect adjustment to the opening balance of equity in such period.

The Bank adopted ASU 2016-02 using the modified retrospective approach with the effective date option effective January 1, 2019. On adoption, the Bank recognized \$2.5 million of lease obligations and \$2.4 million of lease right-of-use assets. Because all of the Bank's leases were classified as operating leases, no cumulative effect adjustment to retained earnings was required.

In July 2018, the FASB issued ASU 2018-10, *Codification Improvements to Topic 842, Leases*, and ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. These updates clarify the guidance in ASU 2016-02, which introduced Topic 842, and add an additional transition method for leases.

ASU 2016-13, Financial Instruments – Credit Losses (Topic 326) – In June 2016, the FASB issued guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss ("CECL") model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to-maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor.

For Public Business Entities ("PBE") that meet the definition of a Securities and Exchange Commission ("SEC") filer excluding entities eligible to be smaller reporting companies as defined by the SEC, the standard will be effective for fiscal years beginning after December 15, 2019, including interim periods in those fiscal years. For calendar year-end SEC filers, it is effective for March 31, 2020 interim financial statements. All entities may adopt the standard early for fiscal years beginning after December 15, 2018, including interim periods in those fiscal years, which means that calendar year-end entities may adopt the standard as early as March 31, 2019 interim financial statements.

In November 2019, the FASB issued ASU 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 942)—Effective Dates.* With the issuance of ASU 2019-10, the FASB adopted a philosophy to extend and simplify how effective dates of new pronouncements are staggered between large public companies and other entities, including smaller reporting companies such as the Bank. Under ASU 2019-10, for PBEs that do not meet the definition of an SEC filer excluding entities eligible to be smaller reporting companies as defined by the SEC (the Bank's current status), the standard will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For calendar year-end PBEs that are not SEC filers such as the Bank, it is effective for years beginning after December 31, 2022.

Transition:

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

The Bank has formed a CECL committee that is assessing data and system needs in order to evaluate the impact of adopting the new guidance. Management expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. While the Bank is currently unable to reasonably estimate the impact of adopting this new guidance, management expects the impact of adoption will be significantly influenced by the composition and quality of the Bank's loans as well as the economic conditions as of the date of adoption. The Bank also anticipates significant changes to the processes and procedures for calculating the allowance for credit losses and continues to evaluate the potential impact on our financial statements

In April and May 2019, the FASB issued ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging*, and *Topic 825, Financial Instruments,* and ASU 2019-05, *Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief*, respectively. In November 2019, the FASB issued ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*. These updates clarify the guidance in ASU 2016-13, which introduced Topic 326. ASU 2019-04 clarifies and improves areas of guidance related to the recently issued standards on credit losses, hedging, and recognition and measurement. ASU 2019-05 provides entities that have certain instruments within the scope of subtopic 326-20 with an option to irrevocably elect the fair value option. ASU 2019-11 clarifies the guidance in ASU 2016-13, Topic 326. These ASUs will be effective for the Bank for fiscal years beginning after December 15, 2022. The Bank is assessing the potential disclosure impact for these amendments and will adopt them on January 1, 2023 in conjunction with ASU 2016-13.

2. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants on the measurement date. Assets and liabilities measured at fair value are grouped into 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 1

In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) for identical assets or liabilities in active markets that the Bank has the ability to access as of the measurement date.

Level 2

Fair values determined by Level 2 inputs utilize significant inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 2 inputs also include quoted prices in markets that are not active and other inputs that are observable or that can be corroborated by observable market data.

Level 3

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Level 3 inputs often reflect the Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety.

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

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

The Bank utilized the following methods and significant assumptions to estimate fair value:

Securities Available for Sale – The fair values for securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based upon market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

The following table presents information about the Bank's assets and liabilities measured at fair value on a recurring basis as of December 31, 2019 and 2018. They indicate the hierarchy of valuation techniques utilized by the Bank to determine the fair value of these assets and liabilities.

(Dollars in Thousands)	Fair Value 12/31/2019	Fair Value Measurements on a Recurring Basis at December 31, 2019, Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt Securities Available for Sale:				
Variable-rate US Agency debt securities:				
Residential MBS	$ 270	$ --	$ 270	$ --
Residential CMO	25,599	--	25,599	--
Student loan pools	2,812	--	2,812	--
Subtotal	28,681	--	28,681	--
Fixed-rate US Agency debt securities:				
Residential MBS	18,021	--	18,021	--
Commercial MBS	2,254	--	2,254	--
Subtotal	20,275	--	20,275	--
Fixed-rate obligations of states and political subdivisions	17,139	--	17,139	--
Total debt securities available for sale	$ 66,095	$ --	$ 66,095	$ --

(Dollars in Thousands)	Fair Value 12/31/2018	Fair Value Measurements on a Recurring Basis at December 31, 2018, Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt Securities Available for Sale:				
Variable-rate US Agency debt securities:				
Residential MBS	$ 419	$ --	$ 419	$ --
Residential CMO	30,451	--	30,451	--
Commercial CMO	79	--	79	--
Subtotal	30,949	--	30,949	--
Fixed-rate US Agency debt securities:				
Residential MBS	20,711	--	20,711	--
Commercial MBS	2,355	--	2,355	--
Subtotal	23,066	--	23,066	--
Fixed-rate obligations of states and political subdivisions	16,248	--	16,248	--
Total debt securities available for sale	$ 70,263	$ --	$ 70,263	$ --

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value, which was below cost at the reporting date. There were no assets that were measured at fair value on a non-recurring basis as of December 31, 2019 and 2018.

In 2018, the Bank adopted ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities, which requires PBEs to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. During the years ended December 31, 2019 and 2018, there were no transfers in or out of Levels 1, 2, or 3.

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

(Dollars in Thousands)	Carrying Amount	Fair Value Measurements at December 31, 2019			
		Level 1	Level 2	Level 3	Total
Financial Assets					
Cash and cash equivalents	$ 52,353	$ 52,353	$ --	$ --	$ 52,353
Securities available for sale	66,095	--	66,095	--	66,095
Loans receivable held for investment	510,889	--	--	512,180	512,180
Federal Home Loan Bank stock	3,501	--	--	--	NA
Accrued interest receivable[1]	1,636	--	250	1,386	1,636
Financial Liabilities					
Transaction and savings deposits	$ 552,674	$ 552,674	$ --	$ --	$ 552,674
Certificates of deposit	19,395	--	19,326	--	19,326
Accrued interest payable	59	5	54	--	59

	Carrying Amount	Fair Value Measurements at December 31, 2018			
		Level 1	Level 2	Level 3	Total
Financial Assets					
Cash and cash equivalents	$ 52,101	$ 52,101	$ --	$ --	$ 52,101
Securities available for sale	70,263	--	70,263	--	70,263
Loans receivable held for investment	487,390	--	--	484,524	484,524
Federal Home Loan Bank stock	3,163	--	--	--	NA
Accrued interest receivable[1]	1,670	--	289	1,381	1,670
Financial Liabilities					
Transaction and savings deposits	$ 543,244	$ 543,244	$ --	$ --	$ 543,244
Certificates of deposit	17,254	--	17,076	--	17,076
Accrued interest payable	48	5	43	--	48

1 = Excludes accrued dividends on FHLB stock

The estimated fair value amounts have been determined by the Bank, at a specific point in time, using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Bank could realize in a current market exchange.

The fair value estimates presented herein are based upon pertinent information available to management as of December 31, 2019 and 2018. The fair value amounts have not been comprehensively reevaluated since the reporting date. Therefore, current estimates of fair value and the amounts realizable in current secondary market transactions may differ significantly from the amounts presented herein.

The estimated fair value amounts do not reflect any premium or discount that might be realized by offering the Bank's entire holdings of a particular financial instrument for sale at one time. The estimated fair value amounts do not attempt to estimate the value of anticipated future business related to the financial instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a potential effect on fair value estimated and have not been considered in any of the estimates.

Because no active market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. The use of different assumptions and / or estimation methodologies could have a material effect on the estimated fair value amounts.

The following methods and assumptions, not previously presented, were utilized by the Bank in computing the estimated fair values:

Cash and Cash Equivalents - Current carrying amounts approximate estimated fair value, resulting in a Level 1 classification.

Loans Receivable Held for Investment – The fair value of loans is estimated on an exit price basis incorporating contractual cash flow, prepayments discount spreads, credit loss and liquidity premiums.

FHLB Stock – It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Accrued Interest Receivable – Current carrying amounts approximate fair value, with the balances distributed according to the Level classification of the associated asset.

Transaction and Savings Deposit Accounts – The estimated fair value of checking, savings, and money market deposit accounts is the amount payable on demand at the reporting date, represented by the carrying value, resulting in a Level 1 classification.

Certificates of Deposit - Fair value has been estimated by discounting the contractual cash flows using current market rates for similar time deposits with comparable remaining terms, resulting in a Level 2 classification.

Accrued Interest Payable – Current carrying amounts approximate fair value, with balances distributed according to the Level classification of the associated liability.

Off-Balance Sheet Instruments – Off-balance sheet commitments to extend credit are primarily for adjustable-rate loans. The fair values of commitments are estimated based on fees currently charged to enter into similar agreements. These fees were not significant as of December 31, 2019 and 2018 and therefore have not been included in the above table.

3. DEBT SECURITIES AVAILABLE FOR SALE

The amortized cost and estimated fair value of debt securities available for sale are presented below. The Bank's debt securities portfolio comprises collateralized mortgage obligations ("CMO"), mortgage-backed securities ("MBS"), and loan pools issued by the Federal National Mortgage Association ("FNMA"), the Federal Home Loan Mortgage Corporation ("FHLMC"), the Government National Mortgage Association ("GNMA"), and the Student Loan Marketing Association ("SLMA"), collectively, ("US Agencies"), and obligations of state and local governments.

(Dollars in Thousands)	December 31, 2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Variable-rate US Agency debt securities:				
Residential CMO	$ 25,578	$ 49	$ (28)	$ 25,599
Student loan pools	2,895	--	(83)	2,812
Residential MBS	259	11	--	270
Subtotal	28,732	60	(111)	28,681
Fixed-rate US Agency debt securities:				
Residential MBS	17,886	145	(10)	18,021
Commercial MBS	2,215	39	--	2,254
Subtotal	20,101	184	(10)	20,275
Fixed-rate obligations of states and political subdivisions	16,525	640	(26)	17,139
Total debt securities available for sale	$ 65,358	$ 884	$ (147)	$ 66,095

Net unrealized gains on available-for-sale debt securities totaling $737 thousand were recorded, net of $218 thousand of tax assets, as accumulated other comprehensive income within stockholders' equity at December 31, 2019.

(Dollars in Thousands)	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Variable-rate US Agency debt securities:				
Residential CMO	$ 30,375	$ 104	$ (28)	$ 30,451
Commercial CMO	79	--	--	79
Residential MBS	402	17	--	419
Subtotal	30,856	121	(28)	30,949
Fixed-rate US Agency debt securities:				
Residential MBS	21,314	40	(643)	20,711
Commercial MBS	2,292	63	--	2,355
Subtotal	23,606	103	(643)	23,066
Fixed-rate obligations of states and political subdivisions	16,517	28	(297)	16,248
Total debt securities available for sale	$ 70,979	$ 252	$ (968)	$ 70,263

Net unrealized losses on available-for-sale debt securities totaling $716 thousand were recorded, net of $220 thousand of tax assets, as accumulated other comprehensive loss within stockholders' equity at December 31, 2018.

Debt securities with unrealized losses at December 31, 2019 are summarized and classified according to the duration of the loss period as follows.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in Thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Variable-rate Agency securities: Residential CMO	$ 10,648	$ (99)	$ 4,429	$ (12)	$ 15,077	$ (111)
Fixed-rate Agency securities: Residential MBS	$ 2,275	$ (10)	--	--	$ 2,275	$ (10)
Fixed-rate obligations of states and political subdivisions	2,185	(26)	--	--	2,185	(26)
Total temporarily impaired debt securities	$ 15,108	$ (135)	$ 4,429	$ (12)	$ 19,537	$ (147)

Securities with unrealized losses at December 31, 2018 are summarized and classified according to the duration of the loss period as follows.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in Thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Variable-rate Agency securities: Residential CMO	$ 689	$ (5)	$ 7,699	$ (23)	$ 8,388	$ (28)
Fixed-rate Agency securities: Residential MBS	$ 983	$ (18)	$ 17,525	$ (625)	$ 18,508	$ (643)
Fixed-rate obligations of states and political subdivisions	7,512	(119)	6,522	(178)	14,034	(297)
Total temporarily impaired debt securities	$ 9,184	$ (142)	$ 31,746	$ (826)	$ 40,930	$ (968)

At December 31, 2019, the Bank held 76 securities, of which:

- Thirteen were variable-rate US Agency commercial CMO debt securities in a loss position that had been in a loss position for less than twelve months.
- Eight were variable-rate US Agency commercial CMO debt securities in a loss position that had been in a loss position for more than twelve months.
- One was a fixed-rate US Agency residential MBS debt security in a loss position that had been in a loss position for less than twelve months.
- Two were fixed-rate obligations of states and political subdivisions in a loss position that had been in a loss position for less than twelve months.

The unrealized losses on the Bank's debt securities at December 31, 2019 were caused by interest rate fluctuations. In the case of the U.S. Agency debt securities, the contractual cash flows of these investments are guaranteed by an agency of the U.S. government. It is expected that the debt securities will not be settled at a price less than the amortized cost of the Bank's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Bank has the ability and intent to hold those debt securities until a recovery of fair value, which may be maturity, the Bank does not consider these debt securities to be other-than-temporarily impaired at December 31, 2019.

The following table shows the amortized cost and estimated fair value of the Bank's securities available for sale by category and by year of contractual maturity. Actual maturities may differ from contractual maturities due to principal prepayments, priority of principal allocation within collateralized mortgage obligations, or rights of issuers to call obligations prior to maturity.

	December 31, 2019	
(Dollars in Thousands)	Amortized Cost	Fair Value
Variable-rate US Agency debt securities:		
Residential CMO		
Due beyond ten years	$ 25,578	$ 25,599
Student Loan Pools		
Due beyond ten years	2,895	2,812
Residential MBS		
Due beyond ten years	259	270
Fixed-rate US Agency debt securities:		
Residential MBS		
Due within one year	5	6
Due in one to five years	--	--
Due in five to ten years	4,063	4,097
Due beyond ten years	13,817	13,916
Commercial MBS		
Due in five to ten years	263	263
Due beyond ten years	1,953	1,992
Fixed-rate obligations of states and political subdivisions:		
Due in one to five years	--	--
Due in five to ten years	1,176	1,232
Due beyond ten years	15,349	15,908
Total	$ 65,358	$ 66,095

At December 31, 2019 and 2018, there were no holdings of debt securities of any one issuer, other than US Agencies, in an amount greater than 10.0% of stockholders' equity.

The Bank from time to time pledges debt securities to the Federal Home Loan Bank as collateral for advances, to the State of California as collateral for certain deposits, to public entities as collateral for certain deposits, to the Federal Reserve Bank as collateral for borrowings, and to other financial institutions or securities dealers as collateral for borrowings.

The following table details the amortized cost and estimated fair value of debt securities pledged for various purposes:

(Dollars in Thousands)	December 31, 2019	
	Amortized Cost	Fair Value
Pledged to the State of California	$ 1,556	$ 1,570
Pledged to public entities	23,605	23,710
	$ 25,161	$ 25,280

	December 31, 2018	
	Amortized Cost	Fair Value
Pledged to the State of California	$ 1,000	$ 1,018
Pledged to public entities	29,543	29,476
	$ 30,543	$ 30,494

4. LOANS RECEIVABLE HELD FOR INVESTMENT

Loans receivable held for investment, net, are summarized as follows:

(Dollars in Thousands)	December 31,	
	2019	2018
Investor commercial real estate	$ 159,350	$ 139,261
Owner-occupied commercial real estate	70,622	62,976
Multifamily	59,830	53,181
Subtotal	289,802	255,418
Residential one to four units	140,623	150,677
Construction and land (including farmland)	19,457	21,353
Home equity lines of credit	6,964	8,008
Commercial and industrial	48,305	46,781
Other loans	5,738	5,153
Total loans receivable held for investment	510,889	487,390
Allowance for loan losses	(6,594)	(6,548)
Total loans receivable held for investment, net	$ 504,295	$ 480,842

The amounts above are shown net of unamortized purchase premiums and discounts, deferred loan fees, and deferred direct origination costs. These items increased the above reported totals by $868 thousand and $268 thousand at December 31, 2019 and 2018, respectively.

The Bank did not have any loans past due 90 days or more and still on accrual status at December 31, 2019 or 2018. The Bank had $634 thousand and $952 thousand of loans 30 or more days past due at December 31, 2019 and 2018, respectively.

The Bank had loans on non-accrual status totaling $492 thousand and $2.7 million as of December 31, 2019 and 2018, respectively. There was no interest foregone on non-accrual loans in 2019 and 2018.

As of December 31, 2019 and 2018, the Bank had no recorded investment in troubled debt restructurings and $55 thousand, respectively. The Bank allocated no allowances and $3 thousand for those loans as of December 31, 2019 and 2018, respectively. The Bank had not committed to lend additional amounts associated with loans that were classified as troubled debt restructurings as of December 31, 2019 and 2018.

There were no loans modified as troubled debt restructurings during the years ended December 31, 2019 and 2018.

The terms of certain other loans were modified during the year ended December 31, 2018 but did not meet the definition of a troubled debt restructuring. The modification of these loans involved either a modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant (defined by the Bank to be 90 days or less). In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's internal credit policy. There were no such loan modifications in 2019.

During the years ended December 31, 2019, 2018 and 2017, no troubled debt restructurings have subsequently defaulted.

Compensation expenses totaling $1,286 thousand, $440 thousand, and $421 thousand were deferred as direct loan origination costs during the years ended December 31, 2019, 2018, and 2017, respectively.

The Bank from time to time pledges certain loans to the Federal Home Loan Bank of San Francisco (“FHLB”) and the Federal Reserve Bank (“FRB”) as collateral for borrowings. The FHLB currently has a blanket lien on a majority of the Bank’s loans, but accepts a subordinated security position for certain loans pledged to the FRB as specified under an inter-creditor agreement. The Bank had loans totaling $510 million pledged to either the FHLB or FRB as of December 31, 2019 and $487 million pledged to either the FHLB or FRB as of December 31, 2018. Loans generally are made on the basis of a secure repayment source, which is based on a detailed cash flow analysis; however, collateral is generally a secondary source of repayment for loan qualification.

5. ALLOWANCE FOR LOAN LOSSES

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ending December 31, 2019.

(Dollars in Thousands) Allowance for Loan Losses	Multifamily and Commercial & Industrial Real Estate	Residential 1 to 4 Units	Construction and Land (Including Farmland)	Home Equity Lines of Credit	Commercial and Industrial	Other	Unallocated	Total
Balance, beginning of period	$ 2,721	$ 1,777	$ 198	$ 78	$ 1,403	$ 159	$ 212	$ 6,548
Provision for loan losses	(370)	(314)	311	(12)	198	(35)	222	--
Charge-offs	--	--	--	--	--	--	--	--
Recoveries	--	--	--	--	46	--	--	46
Balance, end of period	$ 2,351	$ 1,463	$ 509	$ 66	$ 1,647	$ 124	$ 434	$ 6,594

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ending December 31, 2018.

(Dollars in Thousands) Allowance for Loan Losses	Multifamily and Commercial & Industrial Real Estate	Resi-dential 1 to 4 Units	Construction and Land (Including Farmland)	Home Equity Lines of Credit	Commercial and Industrial	Other	Unallocated	Total
Balance, beginning of period	$ 2,234	$ 1,312	$ 202	$ 403	$ 1,984	$ 180	$ 63	$ 6,378
Provision for loan losses	487	465	(4)	(325)	(631)	(21)	149	120
Charge-offs	--	--	--	--	--	--	--	--
Recoveries	--	--	--	--	50	--	--	50
Balance, end of period	$ 2,721	$ 1,777	$ 198	$ 78	$ 1,403	$ 159	$ 212	$ 6,548

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ending December 31, 2017.

(Dollars in Thousands) Allowance for Loan Losses	Multifamily and Commercial & Industrial Real Estate	Resi-dential 1 to 4 Units	Construction and Land (Including Farmland)	Home Equity Lines of Credit	Commercial and Industrial	Other	Unallocated	Total
Balance, beginning of period	$ 1,805	$ 1,627	$ 498	$ 227	$ 1,789	$ 165	$ 156	$ 6,267
Provision for loan losses	429	(315)	(296)	176	259	15	(93)	175
Charge-offs	--	--	--	--	(112)	--	--	(112)
Recoveries	--	--	--	--	48	--	--	48
Balance, end of period	$ 2,234	$ 1,312	$ 202	$ 403	$ 1,984	$ 180	$ 63	$ 6,378

The following table shows the allocation of the allowance for loan losses and the recorded investment in loans at December 31, 2019 and 2018 by portfolio segment and by impairment methodology. The Bank had $434 thousand unallocated allowance for loan losses at December 31, 2019 and $212 thousand unallocated allowance for loan losses at December 31, 2018.

(Dollars in Thousands)	Multifamily and Commercial & Industrial Real Estate	Residential 1 to 4 Units	Construction and Land (Including Farmland)	Home Equity Lines of Credit	Commercial and Industrial	Other	Unallocated	Total
December 31, 2019								
Allowance for Loan Losses								
Individually evaluated for impairment	$ --	$ --	$ --	$ --	$ 326	$ --	$ --	$ 326
Collectively evaluated for impairment	2,351	1,463	509	66	1,321	124	434	6,268
Total	$ 2,351	$ 1,463	$ 509	$ 66	$ 1,647	$ 124	$ 434	$ 6,594
Loans								
Individually evaluated for impairment	$ --	$ --	$ --	$ --	$ 652	$ --		$ 652
Collectively evaluated for impairment	289,802	140,623	19,457	6,964	47,653	5,738		510,237
Total	$ 289,802	$ 140,623	$ 19,457	$ 6,964	$ 48,305	$ 5,738		$ 510,889

(Dollars in Thousands)	Multifamily and Commercial & Industrial Real Estate	Residential 1 to 4 Units	Construction and Land (Including Farmland)	Home Equity Lines of Credit	Commercial and Industrial	Other	Unallocated	Total
December 31, 2018								
Allowance for Loan Losses								
Individually evaluated for impairment	$ --	$ --	$ --	$ --	$ 13	$ --	$ --	$ 13
Collectively evaluated for impairment	2,721	1,777	198	78	1,390	159	212	6,535
Total	$ 2,721	$ 1,777	$ 198	$ 78	$ 1,403	$ 159	$ 212	$ 6,548
Loans								
Individually evaluated for impairment	$ --	$ --	$ 2,711	$ --	$ 302	$ --		$ 3,013
Collectively evaluated for impairment	255,418	150,677	18,642	8,008	46,479	5,153		484,377
Total	$ 255,418	$ 150,677	$ 21,353	$ 8,008	$ 46,781	$ 5,153		$ 487,390

The following table presents information related to impaired loans by portfolio segment as of and for the years ended December 31, 2019, 2018 and 2017:

(Dollars in Thousands)	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
December 31, 2019						
With no related allowance recorded						
Multifamily and commercial and industrial real estate	$ --	$ --	$ --	$ --	$ --	$ --
Residential one to four units	--	--	--	--	--	--
Construction / land (including farmland)	--	--	--	--	--	--
Home equity lines of credit	--	--	--	--	--	--
Commercial and industrial	--	--	--	--	--	--
Other	--	--	--	--	--	--
Subtotal	--	--	--	--	--	--
With an allowance recorded						
Multifamily and commercial and industrial real estate	--	--	--	--	--	--
Residential one to four units	--	--	--	--	--	--
Construction / land (including farmland)	--	--	--	--	--	--
Home equity lines of credit	--	--	--	--	--	--
Commercial and industrial	652	652	326	755	60	60
Other	--	--	--	--	--	--
Subtotal	652	652	326	755	60	60
Total	$ 652	$ 652	$ 326	$ 755	$ 60	$ 60

(Dollars in Thousands)	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
December 31, 2018						
With no related allowance recorded						
Multifamily and commercial and industrial real estate	$ --	$ --	$ --	$ --	$ --	$ --
Residential one to four units	--	--	--	--	--	--
Construction / land (including farmland)	2,711	2,711	--	2,716	161	161
Home equity lines of credit	--	--	--	--	--	--
Commercial and industrial	--	--	--	--	--	--
Other	--	--	--	--	--	--
Subtotal	2,711	2,711	--	2,716	161	161
With an allowance recorded						
Multifamily and commercial and industrial real estate	--	--	--	--	--	--
Residential one to four units	--	--	--	--	--	--
Construction / land (including farmland)	--	--	--	--	--	--
Home equity lines of credit	--	--	--	--	--	--
Commercial and industrial	300	302	13	386	29	29
Other	--	--	--	--	--	--
Subtotal	300	302	13	386	29	29
Total	$ 3,011	$ 3,013	$ 13	$ 3,102	$ 190	$ 190
December 31, 2017						
With no related allowance recorded						
Multifamily and commercial and industrial real estate	$ 1,687	$ 1,687	$ --	$ 1,739	$ 86	$ 86
Residential one to four units	--	--	--	--	--	--
Construction / land (including farmland)	2,733	2,726	--	4,019	235	235
Home equity lines of credit	--	--	--	--	--	--
Commercial and industrial	308	255	--	310	--	--
Other	--	--	--	--	--	--
Subtotal	4,728	4,668	--	6,068	321	321
With an allowance recorded						
Multifamily and commercial and industrial real estate	200	201	113	202	4	4
Residential one to four units	--	--	--	--	--	--
Construction / land (including farmland)	--	--	--	--	--	--
Home equity lines of credit	--	--	--	--	--	--
Commercial and industrial	330	331	83	366	27	27
Other	--	--	--	--	--	--
Subtotal	530	532	196	568	31	31
Total	$ 5,258	$ 5,200	$ 196	$ 6,636	$ 352	$ 352

The recorded investment in loans includes the unamortized or unaccreted balance of deferred loan origination costs, fees, points, purchase premiums, and purchase discounts, net. The accrued interest receivable component of the loans is not included due to immateriality.

The following table presents the loan portfolio by portfolio segment allocated by internal risk ratings at December 31, 2019 and 2018:

(Dollars in Thousands)	Multifamily and Commercial & Industrial Real Estate	Residential 1 to 4 Units	Construction and Land (Including Farmland)	Home Equity Lines of Credit	Commercial and Industrial	Other	Total
	Credit Exposure Credit Risk Profile by Internally Assigned Grade						
December 31, 2019							
Rating:							
Pass / Watch	$ 288,806	$ 140,623	$ 19,457	$ 6,964	$ 45,991	$ 5,738	$ 507,579
Special Mention	996	--	--	--	--	--	996
Substandard	--	--	--	--	2,314	--	2,314
Total	$ 289,802	$ 140,623	$ 19,457	$ 6,964	$ 48,305	$ 5,738	$ 510,889
December 31, 2018							
Rating:							
Pass / Watch	$ 254,215	$ 147,359	$ 18,642	$ 8,008	$ 44,443	$ 5,153	$ 477,820
Special Mention	--	3,318	--	--	--	--	3,318
Substandard	1,203	--	2,711	--	2,338	--	6,252
Total	$ 255,418	$ 150,677	$ 21,353	$ 8,008	$ 46,781	$ 5,153	$ 487,390

6. FEDERAL HOME LOAN BANK STOCK

As a member of the Federal Home Loan Bank of San Francisco (“FHLB”), the Bank is required to own capital stock in an amount specified by a formula promulgated by the FHLB. As of December 31, 2019 and 2018, the Bank owned 35,009 shares and 31,629 shares of $100 par value FHLB capital stock, respectively. The amount of capital stock owned at December 31, 2019 and 2018 meets the most recent formula determination.

7. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following:

(Dollars in Thousands)	December 31, 2019	December 31, 2018
Furniture and equipment	$ 3,689	$ 3,180
Leasehold improvements	2,450	2,325
Total, at cost	6,139	5,505
Accumulated depreciation and amortization	(4,037)	(3,418)
Premises and equipment, net	$ 2,102	$ 2,087

Depreciation and amortization expense related to the Bank’s leasehold improvements, furniture, and equipment was $627 thousand, $588 thousand, and $542 thousand for the years ended December 31, 2019, 2018, and 2017, respectively.

8. DEPOSITS

Deposits are summarized as follows:

(Dollars in Thousands)	December 31, 2019 Balance	December 31, 2019 Weighted Average Rate	December 31, 2018 Balance	December 31, 2018 Weighted Average Rate
Noninterest-bearing demand deposits	$ 280,634	--	$ 281,695	--
Interest-bearing checking	35,804	0.03%	33,144	0.04%
Savings	107,677	0.35%	99,340	0.32%
Money market	128,559	0.63%	129,065	0.45%
Certificates of deposit, less than $100,000	3,300	0.61%	3,430	0.34%
Certificates of deposit, $100,000 to $250,000	7,029	1.12%	5,777	0.79%
Certificates of deposit, $250,000 or more	9,066	1.42%	8,047	1.50%
	$ 572,069	0.25%	$ 560,498	0.19%

The Bank uses money market deposits acquired through the Insured Cash Sweep (ICS) program to offer its deposit clients full FDIC insurance coverage on their balances by placing them at multiple banks with individual balances not exceeding the FDIC insured limit. In return, the Bank may receive equal amounts of money market deposits through ICS from other institutions and their clients in reciprocal transactions. Reciprocal ICS deposits included above within the money market grouping at December 31, 2019 and 2018 were $28.2 million and $15.1 million, respectively.

The following table sets forth the maturity distribution of certificates of deposit:

(Dollars in Thousands)	December 31, 2019 Balance Less than $100,000	Balance $100,000 to $250,000	Balance $250,000 or More	Total
Three months or less	$ 1,010	$ 315	$ 2,112	$ 3,437
Over three through six months	801	1,746	1,785	4,332
Over six through twelve months	1,120	4,664	4,912	10,696
Over twelve months through two years	369	304	257	930
	$ 3,300	$ 7,029	$ 9,066	$ 19,395

The ten largest depositors at December 31, 2019 maintained balances of $122.5 million, representing 21% of total deposits. The ten largest depositors at December 31, 2018 maintained balances of $141.7 million, representing 25% of total deposits. One client and no clients represented 5.0% or more of the Bank's deposits at December 31, 2019 and 2018, respectively.

Interest expense on deposits for the years ended December 31, 2019, 2018, and 2017 is summarized as follows:

(Dollars in Thousands)	2019	2018	2017
Interest-bearing checking	$ 12	$ 16	$ 16
Savings	357	306	259
Money market	554	409	309
Certificates of deposit, less than $100,000	20	9	7
Certificates of deposit, $100,000 to $250,000	65	19	10
Certificates of deposit, $250,000 or more	135	64	19
	$ 1,143	$ 823	$ 620

9. INCOME TAXES

Income tax expense for the years ended December 31, 2019, 2018, and 2017 consisted of the following:

(Dollars in Thousands)	2019	2018	2017
Current:			
Federal	$ 1,335	$ 1,845	$ 1,894
State	1,138	920	655
Total	2,473	2,765	2,549
Deferred:			
Federal	211	(328)	(173)
Effect of change in Federal tax rate	--	--	923
State	(117)	(9)	(39)
Total	94	(337)	711
Provision for income taxes	$ 2,567	$ 2,428	$ 3,260

The Tax Cuts and Jobs Act signed into law on December 22, 2017 reduced the corporate tax rate, effective January 1, 2018, from a graduated set of rates with a maximum 35 percent tax rate to a flat 21 percent tax rate. Effective tax rates differ from the Federal statutory tax rate applied to income before income taxes due to the following:

	2019	2018	2017
Federal statutory tax rate	21.0%	21.0%	34.0%
State income taxes (net of Federal income tax benefit)	8.4%	8.1%	6.6%
Bank-owned life insurance dividend income and benefits	(0.4%)	(0.5%)	(1.2%)
Interest on Federally tax-exempt securities	(0.9%)	(0.9%)	(0.8%)
Equity compensation	(0.7%)	(0.7%)	(1.6%)
Effect of change in Federal tax rate	--	--	15.1%
Other	(0.8%)	0.4%	1.3%
Effective tax rate	26.6%	27.4%	53.4%

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and liabilities are as follows:

(Dollars in Thousands)	December 31, 2019	December 31, 2018
Deferred tax assets:		
Allowance for loan losses	$ 1,949	$ 1,936
Lease liabilities	891	--
Accrued expenses	493	592
Deferred loan fees, points, and discounts	353	311
State franchise tax	191	172
Equity-based compensation	147	137
Deferred compensation	138	126
Organization costs and other	48	106
Unrealized loss on securities available for sale	--	220
Total gross deferred tax assets	4,210	3,600
Deferred tax liabilities:		
Right-of-use assets	(768)	--
Deferred loan origination costs and premiums	(761)	(510)
Prepaid expenses	(70)	(137)
Other deferred tax liabilities	(17)	(8)
Premises and equipment accumulated depreciation	(1)	(38)
Unrealized gain on securities available for sale	(218)	--
Total gross deferred tax liabilities	(1,835)	(693)
Net deferred tax assets	$ 2,375	$ 2,907

The Bank has identified certain unrecognized tax benefits. A reconciliation of the beginning and ending amounts of unrecognized tax benefits for the years ended December 31, 2019, 2018, and 2017 is as follows:

(Dollars in Thousands)	2019	2018	2017
Beginning balance	$ 73	$ 73	$ 143
Additions based on tax positions related to the current year	--	--	--
Additions for tax positions of prior years	--	--	--
Reductions for tax positions of prior years	--	--	--
Reductions due to the statute of limitations	--	--	--
Settlements and payments	(73)	--	(70)
Ending balance	$ --	$ 73	$ 73

All unrecognized tax benefits recorded relate to tax years 2013 and 2014 and have been settled in full. The Company does not have any material uncertain tax positions as of December 31, 2019 and does not expect that to materially change in the next twelve months.

The Bank files income tax returns in the United States and California jurisdictions. Federal tax returns for 2016 through 2019 are currently open for examination. State tax returns for 2015 through 2019 are currently open for examination.

10. BORROWINGS

The Bank is a member of the Federal Home Loan Bank of San Francisco ("FHLB"). As of December 31, 2019 and 2018, the Bank had $92.9 million and $94.1 million in untapped borrowing capacity, respectively, available through the FHLB under which overnight and term advances were available. These advances are secured by assets including the Bank's ownership interest in the capital stock of the FHLB and various types of qualifying whole loans. The Bank had no advances outstanding as of December 31, 2019 or 2018.

The Bank had $25.0 million in unsecured and uncommitted federal funds lines of credit from its correspondent banks as of December 31, 2019 and 2018. There were no borrowings outstanding under these federal funds lines of credit at December 31, 2019 or 2018.

The Bank is approved for discount window access from the Federal Reserve Bank of San Francisco ("FRB"). At December 31, 2019, the Bank had available discount window borrowing capacity of $2.9 million. At December 31, 2018, the Bank had an available discount window borrowing capacity of $8.4 million. As of December 31, 2019 and 2018, there were no discount window borrowings outstanding.

Refer to Note 4 regarding loans pledged to secure various potential future borrowings.

11. OPERATING LEASES

The Bank leases its facilities under non-cancelable operating leases for varying periods extending through March 31, 2026. A majority of the leases provide for the payment of taxes, insurance, maintenance, and certain other operating costs associated with the leased premises in addition to the monthly rental payments. Many of the leases contain escalation clauses and extension provisions that could extend certain leases through 2031.

Leases are classified as operating or finance leases at the lease commencement date. Lease expense for operating leases is recognized on a straight-line basis over the lease term. Right-of-use assets represent the right to use an underlying asset for the lease term and lease liabilities represent the obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term. The Bank uses its incremental borrowing rate at lease commencement to calculate the present value of lease payments when the rate implicit in the lease is not known. The Bank's incremental borrowing rate is based on FHLB advance rate adjusted for the relevant lease term.

At December 31, 2019, right-of-use assets and lease liabilities were $2.6 million and $2.8 million, respectively. The right-of-use assets and lease liabilities are included on the balance sheet within the other assets and other liabilities line items, respectively. The weighted average lease term at December 31, 2019 is 3.9 years, and the weighted average discount rate used in the calculations is 1.84%. At December 31, 2019, all of the Bank's leases are operating leases.

Future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2019 are as follows:

(Dollars in Thousands)

2020	$ 817
2021	822
2022	590
2023	426
2024	233
Thereafter	110
Total lease payments	2,998
Less: imputed interest	240
Present value of operating lease liability	$ 2,758

The Bank accounts for the leases on its facilities under the "level yield" method, whereby the average cost over the contracted lease period is recognized each month. Rent expense, including operating costs reimbursed to landlords, totaling $679 thousand, $572 thousand, and $564 thousand was recognized in occupancy expense in the Statements of Income for the years ended December 31, 2019, 2018, and 2017, respectively. The Bank did not have any short term lease costs for the years ended December 31 2019, 2018, and 2017.

12. COMMITMENTS AND CONTINGENCIES

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

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include letters of credit, commitments to originate fixed- and variable-rate loans, lines of credit, and construction loans in process, and involve, to varying degrees, elements of interest-rate risk and credit risk in excess of the amount recognized in the balance sheets. The Bank uses the same credit policies in making commitments to originate loans and lines of credit as it does for on-balance sheet instruments.

Commitments to fund loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have expiration dates or other termination clauses. In addition, external market forces may affect the probability of commitments being exercised; therefore, total commitments outstanding do not necessarily represent future cash requirements.

At December 31, 2019 and 2018, the Bank had commitments outstanding to make the following funds available under various types of loans:

(Dollars in Thousands)	Available Credit Commitments	
Credit Category	**December 31, 2019**	**December 31, 2018**
Commercial and industrial	$ 53,806	$ 62,340
Multifamily and commercial and industrial real estate	5,180	2,596
Home equity lines of credit	9,374	16,162
Construction and land (including farmland)	8,446	4,796
Other	623	1,236
	$ 77,429	$ 87,130

The Bank may issue letters of credit to facilitate international trade ("commercial letters of credit"), guarantee certain payments by customers ("financial standby letters of credit"), and guarantee the performance of a customer to a third party ("performance standby letters of credit"). The Bank had financial standby letters of credit of $180 thousand at December 31, 2019 and 2018.

13. REGULATORY CAPITAL REQUIREMENTS AND OTHER REGULATORY MATTERS

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2019 was 2.500% and the capital conservation buffer for 2018 was 1.875%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital, as the Bank made this election effective January 1, 2015. Management believes as of December 31, 2019, the Bank meets all capital adequacy requirements to which it is subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. As of December 31, 2019 and 2018, the most recent regulatory notifications categorized the Bank as "well capitalized" under the regulatory framework for prompt correction action. There are no conditions or events since that notification that management believes have changed the Bank's category.

The actual regulatory capital amounts and ratios of the Bank as of December 31, 2019 and 2018 are presented in the following table.

(Dollars in Thousands)	Actual		Minimum for Capital Adequacy Purposes		To Be Considered Well Capitalized under PCA Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2019						
Tier 1 Capital to Average Total Assets (Leverage)	$ 67,471	10.90%	$ 24,767	4.00%	$ 30,959	5.00%
Common Equity Tier 1 to Risk Weighted Assets	$ 67,471	14.04%	$ 21,625	4.50%	$ 31,236	6.50%
Tier 1 Capital to Risk Weighted Assets	$ 67,471	14.04%	$ 28,833	6.00%	$ 38,444	8.00%
Total Capital to Risk Weighted Assets	$ 73,487	15.29%	$ 38,444	8.00%	$ 48,055	10.00%
As of December 31, 2018						
Tier 1 Capital to Average Total Assets (Leverage)	$ 59,565	9.55%	$ 24,938	4.00%	$ 31,172	5.00%
Common Equity Tier 1 to Risk Weighted Assets	$ 59,565	13.30%	$ 20,153	4.50%	$ 29,110	6.50%
Tier 1 Capital to Risk Weighted Assets	$ 59,565	13.30%	$ 26,870	6.00%	$ 35,827	8.00%
Total Capital to Risk Weighted Assets	$ 65,177	14.55%	$ 35,827	8.00%	$ 44,784	10.00%

Under California banking laws, cash dividends declared by the Bank may not, without prior regulatory approval, exceed the lesser of: (i) the retained earnings of the Bank, or (ii) the net income of the Bank for its last three fiscal years, less the amount of any distributions made by the Bank to the shareholders of the Bank during such period. At December 31, 2019, the Bank had $4.4 million available for cash dividends under these restrictions.

14. SHARE-BASED PAYMENTS

The Board of Directors approved the 1st Capital Bank 2016 Equity Incentive Plan ("Plan") on June 8, 2016. The Plan replaced the 2007 Equity Incentive Plan. The Plan permits the grant of stock options and restricted share awards for up to 722,050 shares of the Bank's common stock. The Plan will expire on June 8, 2026. No more options or restricted shares may be issued from the 2007 Equity Incentive Plan, but shares may be issued for exercises of outstanding options and for the vesting of restricted shares previously granted from the 2007 Equity Incentive Plan. Stock options may be incentive stock options or nonqualified stock options. Stock option exercise periods may be up to ten years, while the vesting schedule for stock options is based upon each specific option award. Restricted share awards may be time-based, performance-based, or both. Time-based restricted share awards may vest on a specified date or may vest pro-rata in arrears on each annual anniversary of the award date and become fully vested over the applicable time period as determined by the Board of Directors, in both cases typically five years. Vesting of performance-based restricted share awards is dependent upon achievement of criteria established by the Board of Directors for each award.

The Bank accrues share-based compensation expense for stock options and restricted share awards over the vesting period based upon the fair value of the equity award at the date of grant and considering the probability of the performance criteria being achieved, if applicable. There were no performance-based stock options or restricted share awards granted or outstanding during 2019 and 2018.

A summary of the status of the restricted share awards and stock options outstanding under the Plan as of December 31, 2019, 2018, and 2017, and changes and related expense during the years ended December 31, 2019, 2018, and 2017, have been adjusted to reflect the 2019 issuance of a 7% stock dividend and is as follows:

Restricted Share Awards

(In Whole Shares; Dollars in Thousands Except Per Share Amounts)	2019		2018		2017	
	Shares	**Weighted Average Grant Date Fair Value**	**Shares**	**Weighted Average Grant Date Fair Value**	**Shares**	**Weighted Average Grant Date Fair Value**
Awards outstanding at the beginning of the period	192,932	$ 12.25	199,849	$ 10.34	148,553	$ 8.64
Award activity during the period:						
Time-based awards granted	94,972	$ 15.07	65,457	$ 15.32	119,833	$ 11.60
Time-based awards forfeited	(56,855)	$ 11.26	(11,179)	$ 8.89	(10,311)	$ 8.92
Time-based awards vested	(54,523)	$ 13.69	(61,195)	$ 9.91	(58,226)	$ 8.84
Awards outstanding at the end of the period	176,526	$ 13.62	192,932	$ 12.25	199,849	$ 10.34
Restricted share award compensation expense	$ 736		$ 765		$ 635	

Stock Options

(In Whole Shares; Dollars in Thousands Except Per Share Amounts)	2019		2018		2017	
	Shares	**Weighted Average Exercise Price**	**Shares**	**Weighted Average Exercise Price**	**Shares**	**Weighted Average Exercise Price**
Options outstanding at the beginning of the period	16,907	$ 7.80	53,728	$ 8.06	134,932	$ 7.49
Option activity during the period:						
Options exercised	(2,717)	$ 5.46	(36,821)	$ 8.18	(77,654)	$ 7.11
Options forfeited	--	--	--	--	(3,550)	$ 7.04
Options outstanding at the end of the period	14,190	$ 8.25	16,907	$ 7.80	53,728	$ 8.06
Options vested and exercisable	14,190	$ 8.25	16,907	$ 7.80	53,728	$ 8.06
Stock option compensation expense	$ --		$ --		$ --	

Additional information regarding stock options outstanding at December 31, 2019 includes the following:

(In Whole Shares; Dollars in Thousands Except Per Share Amounts)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Stock options outstanding	14,190	$ 8.25	1.95 years	$ 100
Stock options exercisable	14,190	$ 8.25	1.95 years	$ 100
Stock options vested or expected to vest	14,190	$ 8.25	1.95 years	$ 100

The Bank did not award any stock option grants for the years ended December 31, 2019, 2018, and 2017.

The following stock option exercise information is for the years ended December 31, 2019, 2018, and 2017:

(Dollars in Thousands)	2019	2018	2017
Intrinsic value of stock options exercised	$ 27	$ 277	$ 619
Cash received from stock option exercises	$ 15	$ 301	$ 552
Tax benefit realized from stock option exercises	$ --	$ --	$ 56

The tax benefit associated with the stock option exercises during 2017 reduced the associated deferred tax asset.

As of December 31, 2019, there was $1.78 million of total unrecognized compensation cost related to outstanding, unvested restricted shares awards granted under the Plan. This cost is expected to be recognized over the weighted average remaining period of approximately 2.8 years. The total fair value of restricted share awards vested in 2019, 2018, and 2017 was $822 thousand, $924 thousand, and $782 thousand, respectively.

At December 31, 2019, the intrinsic value of the 176,526 outstanding unvested restricted share awards was $2.69 million, based upon a market price of $15.26 per share. At December 31, 2018, the intrinsic value of the 192,932 outstanding unvested restricted share awards was $2.70 million, based upon a market price of $14.02 per share. At December 31, 2017, the intrinsic value of the 199,849 outstanding unvested restricted share awards was $2.69 million, based upon a market price of $13.44 per share.

15. RELATED PARTY TRANSACTIONS

During the normal course of business, the Bank enters into transactions with related parties, including directors, executive officers, and their affiliates.

An analysis of the activity of these loans for the years ended December 31, 2019 and 2018 is as follows:

(Dollars in Thousands)	2019	2018
Principal outstanding, beginning of period	$ 4,339	$ 3,690
New term loans and advances	10,784	20,359
Repayments	(12,055)	(19,710)
Principal outstanding, end of period	$ 3,068	$ 4,339
Credit commitments, end of period	$ 11,750	$ 11,750

Deposits from principal officers, directors, and their affiliates at December 31, 2019 and 2018 were $7.5 million and $3.8 million, respectively.

During the years ended December 31, 2019 and 2018, the Bank did not purchase any goods or services from related parties, other than normal employee and director compensation and benefits and $5 thousand and $4 thousand paid in 2019 and 2018, respectively, for branch architectural services to the architectural firm for which a member of the Bank's board of directors is a principal.

16. REVENUE FROM CONTRACTS WITH CUSTOMERS

All of the Bank's revenue from contracts with customers in the scope of ASC 606 is recognized within Non-Interest Income. The following table presents the Bank's sources of Non-Interest Income for the year ended December 31, 2019 and 2018. Items outside the scope of ASC 606 are noted as such.

(Dollars in Thousands)	2019	2018
Service charges on deposits:		
Account maintenance and analysis fees	$ 158	$ 145
Overdraft fees	64	63
Other	101	91
Bank-owned life insurance dividend income [1]	205	212
Gain on sales of loans [1]	41	194
Gain on sales of investments [1]	60	--
Other income [2]	1,283	1,285
Total non-interest income	$ 1,912	$ 1,990

1 = Not within the scope of ASC 606.
2 = For 2019, includes debit card fees, mortgage referral fees, wire transfer fees, and other income totaling $412 thousand that is within the scope of ASC 606; the remaining balance of $871 thousand represents loan servicing fees and insured cash sweep fees that are outside the scope of ASC 606. For 2018, includes debit card fees, mortgage referral fees, wire transfer fees, and other income totaling $334 thousand that is within the scope of ASC 606; the remaining balance of $950 thousand represents loan servicing fees and insured cash sweep fees that are outside the scope of ASC 606.

A description of the Bank's revenue streams accounted for under ASC 606 follows:

Service Charges on Deposit Accounts – The Bank earns fees from its customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as stop payment charges, debit card transaction fees, statement rendering, and ACH fees, are recognized at the time the transaction is executed, as that is the point in time the Bank fulfills the customer's request. Account maintenance fees and lockbox servicing fees are earned over the course of a month, representing the period over which the Bank satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits generally are withdrawn from the customer's account balance.

Other Income – The Bank earns fees from its customers for certain other transaction-based services and safe deposit box rentals. Transaction-based fees, which include services such as debit card transactions, wire transfers, and other miscellaneous services, are recognized at the time the transaction is executed, as that is the point in time the Bank fulfills the customer's request. Mortgage referral fees are recognized upon loan closing. Such fees may be withdrawn from the customer's account balance or billed separately.

17. OTHER NON-INTEREST EXPENSE

Other non-interest expense for the years ended December 31, 2019, 2018, and 2017 consisted of the following:

(Dollars in Thousands)	2019	2018	2017
Director expenses, including share-based compensation	$ 477	$ 338	$ 288
Customer service expenses	409	363	324
Licensing and software expenses	315	298	195
Telecommunications	264	316	268
Regulatory dues and assessments	180	266	287
Messenger service	157	151	116
Professional education	122	122	128
Operational expenses	119	106	101
Stationery and supplies	106	104	103
Provision for unfunded loan commitments	(18)	8	36
Other expenses	508	450	367
	$ 2,639	$ 2,522	$ 2,213

18. 401(k) RETIREMENT PLAN

The Bank maintains the 1st Capital Bank 401(k) Profit Sharing Plan and Trust ("Plan") to enable employees to save for retirement under a tax-advantaged plan and to furnish employees the opportunity to directly manage their retirement assets through a variety of investment options. The Plan allows eligible employees to elect to contribute up to 92.0% of their eligible compensation to the Plan, subject to the annual contribution limit established by the Internal Revenue Service applicable to each employee. During 2019, the Bank commenced 50% matching of the employee Plan contributions up to 8.0% of their eligible compensation. In addition, all Bank matching contributions immediately became fully vested effective with the transition of the Plan to a safe harbor classification.

The Bank recorded matching contribution expenses under the Plan of $258 thousand, $223 thousand, and $186 thousand during the years ended December 31, 2019, 2018, and 2017, respectively.

19. NONQUALIFIED DEFERRED COMPENSATION PLAN

The Bank established the 1st Capital Bank Nonqualified Deferred Compensation Plan ("Plan") effective December 1, 2012. The Plan is a defined contribution program. Participants in the Plan are general unsecured creditors of the Bank. The Plan was established for the purpose of providing the executive officers and certain other highly compensated employees an opportunity to defer compensation. Participants in the Plan may elect to defer annually any bonus or incentive compensation and any amount of base salary in excess of $3,000 per month. At the time of election to defer compensation, the participants must also elect a distribution date and a distribution method. Participants may elect to receive amounts payable in a lump sum or in annual installments over a designated period not to exceed ten years. The

Bank pays the administrative costs of the Plan, but does not make contributions to the Plan aside from interest credited. The Plan requires the Bank to pay interest on the deferred balances at a rate equal to The Wall Street Journal Prime Rate on November 1 of the preceding year, set annually for each calendar year, subject to a floor of 0.00%. Participants were first eligible to contribute to the Plan on January 1, 2013. The Bank recorded interest expense on deferred compensation of $21 thousand, $16 thousand, and $11 thousand for the years ended December 31, 2019, 2018, and 2017, respectively. The Bank's total liability under the Plan was $467 thousand and $425 thousand at December 31, 2019 and 2018, respectively.

20. EARNINGS PER SHARE

The factors used in the earnings per share computation follow.

(Dollars in Thousands Except Per Share Amounts)

	2019	2018	2017
Basic Earnings Per Share			
Net income	$ 7,087	$ 6,431	$ 2,845
Weighted average common shares outstanding	5,486,515	5,394,965	5,309,554
Basic earnings per common share	$ 1.29	$ 1.19	$ 0.54
Diluted Earnings Per Share			
Net income	$ 7,087	$ 6,431	$ 2,845
Weighted average common shares outstanding for basic earnings per common share	5,486,515	5,394,965	5,309,554
Add: Dilutive effects from equity compensation	84,836	103,708	82,360
Shares for diluted earnings per share	5,571,351	5,498,673	5,391,914
Diluted earnings per common share	$ 1.27	$ 1.17	$ 0.53

Anti-dilutive shares are shares of common stock issuable as a result of the vesting of restricted share awards or the exercise of stock options for which the assumed proceeds per share from the exercise price (in the case of stock options) and future associated compensation expense (in the case of restricted stock awards) are greater than the average market price for the Bank's common stock for the reporting period. Anti-dilutive shares are not included in the computation of diluted earnings per share due to their anti-dilutive effect. The weighted average anti-dilutive shares totaled 1,287 for 2019 and 1,061 for 2018.

1st Capital Bank

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Chief Operating Officer
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Chief Financial Officer

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Executive Vice President
Chief Credit Officer

Stuart M. Tripp
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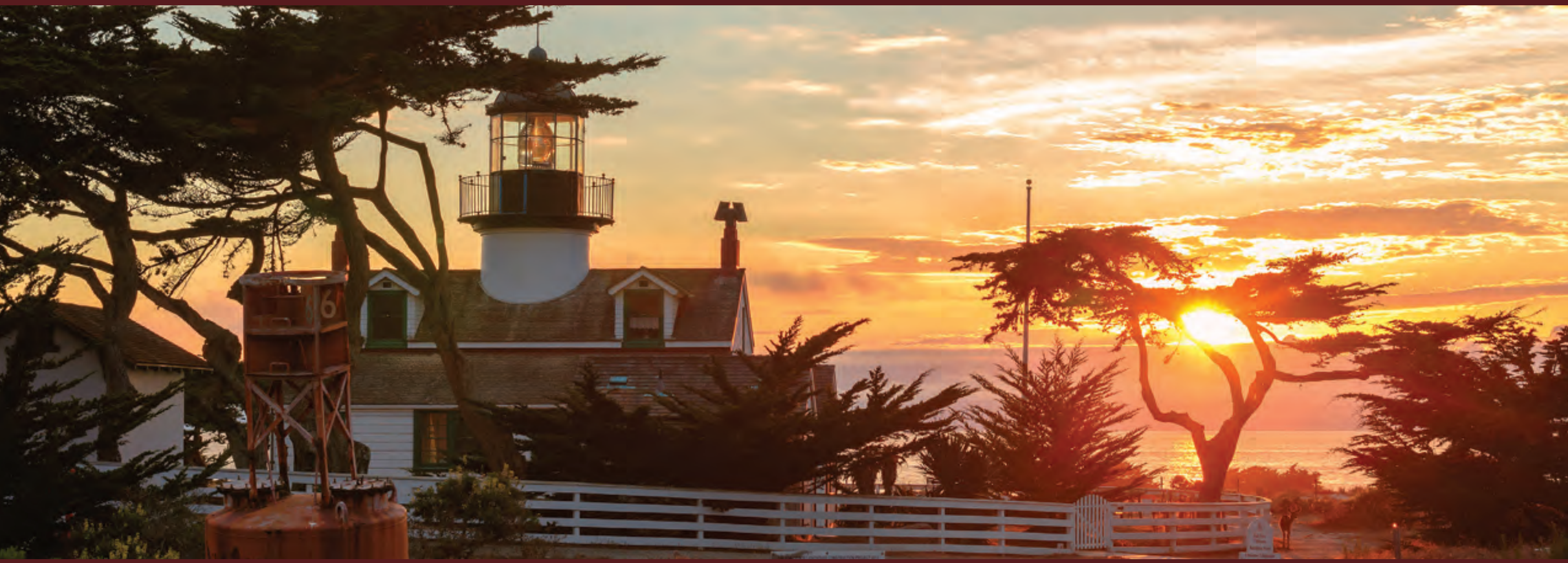

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