

**FEDERAL DEPOSIT INSURANCE CORPORATION  
WASHINGTON, D.C. 20429  
FORM 10-Q**

**(Mark One)**

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2019
- or
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

FDIC Certificate No. 32203

**Summit State Bank**

(Exact Name of Registrant as Specified in its Charter)

California 94-2878925  
(State or Other Jurisdiction of Incorporation or Organization) (I.R.S. Employer Identification No.)

500 Bicentennial Way, Santa Rosa, CA 95403  
(Address of Principal Executive Offices) (Zip Code)

707-568-6000  
(Registrant's Telephone Number, Including Area Code)

N/A  
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No   
**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock	SSBI	The NASDAQ Stock Market LLC

APPLICABLE ONLY TO CORPORATE ISSUERS

As of August 8, 2019, there were 6,067,975 shares of common stock outstanding.

## Summit State Bank

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**Part I Financial Information**  
**Item 1 Financial Statements**

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands except share data)

	<u>June 30, 2019</u> (unaudited)	<u>December 31, 2018</u> (1)
<b>ASSETS</b>		
Cash and due from banks	\$ 12,104	\$ 21,693
Total cash and cash equivalents	12,104	21,693
Investment securities:		
Held-to-maturity, at amortized cost	7,995	7,991
Available-for-sale (at fair value; amortized cost of \$59,450 in 2019 and \$72,716 in 2018)	59,853	70,174
Total investment securities	67,848	78,165
Loans, less allowance for loan losses of \$6,328 in 2019 and \$6,029 in 2018	536,674	504,549
Bank premises and equipment, net	6,324	5,803
Investment in Federal Home Loan Bank stock, at cost	3,341	3,085
Goodwill	4,119	4,119
Accrued interest receivable and other assets	5,212	4,690
Total assets	<u>\$ 635,622</u>	<u>\$ 622,104</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Demand - non interest-bearing	\$ 119,535	\$ 120,011
Demand - interest-bearing	65,227	65,652
Savings	25,419	25,817
Money market	99,585	104,060
Time deposits that meet or exceed the FDIC insurance limit	85,315	83,071
Other time deposits	137,176	102,578
Total deposits	532,257	501,189
Federal Home Loan Bank advances	29,300	56,800
Junior subordinated debt	5,862	-
Accrued interest payable and other liabilities	3,462	2,595
Total liabilities	570,881	560,584
Commitments and contingencies (Note 3)		
Shareholders' equity		
Preferred stock, no par value; 20,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, no par value; shares authorized - 30,000,000 shares; issued and outstanding 6,067,975 in 2019 and 6,066,475 in 2018	36,974	36,967
Retained earnings	27,483	26,342
Accumulated other comprehensive income (loss), net	284	(1,789)
Total shareholders' equity	64,741	61,520
Total liabilities and shareholders' equity	<u>\$ 635,622</u>	<u>\$ 622,104</u>

(1) Information derived from audited consolidated financial statements.

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

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(In thousands except earnings per share data)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2019</u> <u>(unaudited)</u>	<u>June 30, 2018</u> <u>(unaudited)</u>	<u>June 30, 2019</u> <u>(unaudited)</u>	<u>June 30, 2018</u> <u>(unaudited)</u>
Interest income:				
Interest and fees on loans	\$ 6,630	\$ 5,399	\$ 13,081	\$ 10,709
Interest on deposits with banks	32	58	133	126
Interest on federal funds sold	-	8	-	14
Interest on investment securities	476	601	1,066	1,215
Dividends on FHLB stock	53	53	108	108
Total interest income	<u>7,191</u>	<u>6,119</u>	<u>14,388</u>	<u>12,172</u>
Interest expense:				
Deposits	1,581	818	3,052	1,526
Federal Home Loan Bank advances	111	61	290	92
Total interest expense	<u>1,692</u>	<u>879</u>	<u>3,342</u>	<u>1,618</u>
Net interest income before provision for loan losses	5,499	5,240	11,046	10,554
Provision for loan losses	180	150	280	300
Net interest income after provision for loan losses	<u>5,319</u>	<u>5,090</u>	<u>10,766</u>	<u>10,254</u>
Non-interest income:				
Service charges on deposit accounts	219	194	409	387
Rental income	81	149	172	296
Net gain on loan sales	-	155	167	447
Net securities (loss) gain	(7)	9	(7)	16
Other income	47	35	92	158
Total non-interest income	<u>340</u>	<u>542</u>	<u>833</u>	<u>1,304</u>
Non-interest expense:				
Salaries and employee benefits	2,303	2,078	4,960	4,105
Occupancy and equipment	434	387	857	784
Other expenses	1,258	1,092	2,390	2,209
Total non-interest expense	<u>3,995</u>	<u>3,557</u>	<u>8,207</u>	<u>7,098</u>
Income before provision for income taxes	1,664	2,075	3,392	4,460
Provision for income taxes	492	614	795	1,259
Net income	<u>\$ 1,172</u>	<u>\$ 1,461</u>	<u>\$ 2,597</u>	<u>\$ 3,201</u>
Basic earnings per common share	\$ 0.19	\$ 0.24	\$ 0.43	\$ 0.53
Diluted earnings per common share	\$ 0.19	\$ 0.24	\$ 0.43	\$ 0.53
Basic weighted average shares of common stock outstanding	6,069	6,066	6,068	6,063
Diluted weighted average shares of common stock outstanding	6,075	6,074	6,071	6,070

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

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(In thousands)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2019</u> <u>(unaudited)</u>	<u>June 30, 2018</u> <u>(unaudited)</u>	<u>June 30, 2019</u> <u>(unaudited)</u>	<u>June 30, 2018</u> <u>(unaudited)</u>
Net income	\$ 1,172	\$ 1,461	\$ 2,597	\$ 3,201
Change in securities available-for-sale:				
Unrealized holding gains (losses) on available-for-sale securities arising during the period	1,316	(356)	2,938	(1,892)
Reclassification adjustment for loss (gains) realized in net income on available-for-sale securities	<u>7</u>	<u>(9)</u>	<u>7</u>	<u>(16)</u>
Net unrealized gains (losses), before provision for income tax	1,323	(365)	2,945	(1,908)
Provision for income tax (expense) benefit	<u>(391)</u>	<u>108</u>	<u>(872)</u>	<u>566</u>
Total other comprehensive income (loss), net of tax	<u>932</u>	<u>(257)</u>	<u>2,073</u>	<u>(1,342)</u>
Comprehensive income	<u>\$ 2,104</u>	<u>\$ 1,204</u>	<u>\$ 4,670</u>	<u>\$ 1,859</u>

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

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
For the Three Months Ended March 31, 2018, June 30, 2018, September 30, 2018,  
December 31, 2018, March 31, 2019 and June 30, 2019 (Unaudited)  
(In thousands except per share data)

	<u>Common Stock</u>		<u>Retained</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Earnings</u>	<u>Other</u>	<u>Shareholders'</u>
				<u>Comprehensive</u>	<u>Equity</u>
				<u>Income (Loss)</u>	
Balance, January 1, 2018	6,041	\$ 36,847	\$ 23,427	\$ (597)	\$ 59,677
Net income			1,740		1,740
Other comprehensive loss, net				(1,085)	(1,085)
Exercise of stock options	25	120			120
Cash dividends - \$0.12 per share			(729)		(729)
Balance, March 31, 2018	6,066	\$ 36,967	\$ 24,438	\$ (1,682)	\$ 59,723
Net income			1,461		1,461
Other comprehensive loss, net				(257)	(257)
Cash dividends - \$0.12 per share			(728)		(728)
Balance, June 30, 2018	6,066	\$ 36,967	\$ 25,171	\$ (1,939)	\$ 60,199
Net income			1,505		1,505
Other comprehensive loss, net				(478)	(478)
Cash dividends - \$0.12 per share			(727)		(727)
Balance, September 30, 2018	6,066	\$ 36,967	\$ 25,949	\$ (2,417)	\$ 60,499
Net income			1,121		1,121
Other comprehensive income, net				628	628
Cash dividends - \$0.12 per share			(728)		(728)
Balance, December 31, 2018	6,066	\$ 36,967	\$ 26,342	\$ (1,789)	\$ 61,520
Balance, January 1, 2019	6,066	\$ 36,967	\$ 26,342	\$ (1,789)	\$ 61,520
Net income			1,425		1,425
Other comprehensive income, net				1,141	1,141
Exercise of stock options	2	7			7
Cash dividends - \$0.12 per share			(728)		(728)
Balance, March 31, 2019	6,068	\$ 36,974	\$ 27,039	\$ (648)	\$ 63,365
Net income			1,172		1,172
Other comprehensive income, net				932	932
Cash dividends - \$0.12 per share			(728)		(728)
Balance, June 30, 2019	6,068	\$ 36,974	\$ 27,483	\$ 284	\$ 64,741

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

**SUMMIT STATE BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)	<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,597	\$ 3,201
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	443	170
Securities amortization and accretion, net	40	92
Accretion of deferred loan fees	(748)	(592)
Provision for loan losses	280	300
Net securities loss (gains)	7	(16)
Net gain on loan sales	(167)	(447)
Net change in accrued interest receivable and other assets	(145)	(1,429)
Net change in accrued interest payable and other liabilities	(382)	(1,041)
Tax benefit from stock-based compensation	-	(61)
Net cash from operating activities	1,925	177
<b>Cash flows from investing activities:</b>		
Proceeds from calls and maturities of available-for-sale investment securities	4,156	3,966
Loan origination and principal collections, net	(34,590)	(31,484)
Proceeds from sales of loans other than loans originated for resale	3,100	5,961
Purchases of bank premises and equipment, net	(964)	(42)
Net cash used in investing activities	(19,495)	(21,599)

(Continued)

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Six Months Ended June 30,</b>	
(In thousands)	<b>2019</b>	<b>2018</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
Cash flows from financing activities:		
Net change in demand, savings and money market deposits	(5,774)	(22,463)
Net change in certificates of deposit	36,842	6,268
Net change in short term Federal Home Loan Bank advances	(27,500)	6,800
Repayment of long term Federal Home Loan Bank advances	-	(15,000)
Dividends paid on common stock	(1,456)	(1,457)
Proceeds from exercise of stock options	7	120
Net cash from (used in) financing activities	2,119	(25,732)
Net change in cash and cash equivalents	(15,451)	(47,154)
Cash and cash equivalents at beginning of year	21,693	70,814
Cash and cash equivalents at end of period	\$ 6,242	\$ 23,660
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ 3,266	\$ 1,578
Income taxes	\$ 880	\$ 2,190
Non-Cash Investing and Financing Activities:		
Net unrealized gains (losses) on available-for-sale securities	\$ 2,945	\$ (1,908)
Initial Recognition of Lease Right-of-Use Assets	\$ 1,249	\$ -
Initial Recognition of Lease Liabilities	\$ 1,249	\$ -

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



**SUMMIT STATE BANK AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*General*

On January 15, 1999, Summit State Bank (the “Bank” or “the Bank”) received authority to transact business as a California state-chartered commercial bank and is subject to regulation, supervision and examination by the State of California Department of Business Oversight and the Federal Deposit Insurance Corporation. The Bank was incorporated on December 20, 1982 under the name Summit Savings. The Bank provides a variety of banking services to individuals and businesses in its primary service area of Sonoma County, California. The Bank’s branch locations include Santa Rosa, Petaluma, Rohnert Park and Healdsburg. The Bank offers depository and lending services primarily to meet the needs of its business, nonprofit organization and individual clientele. These services include a variety of transaction, money market, savings and time deposit account alternatives. The Bank’s lending activities are directed primarily towards commercial real estate, construction and business loans.

The consolidated financial statements as of June 30, 2019 and for the three and six months ended June 30, 2019 and 2018 are unaudited. In the opinion of management, these unaudited consolidated financial statements contain all adjustments, consisting only of normal recurring accruals necessary to present fairly the consolidated financial statements of the Bank.

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles for interim financial information and Article 8 of Regulation S-X of the Securities and Exchange Commission. Operating results for the three and six month periods ended June 30, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019. These unaudited consolidated financial statements do not include all disclosures associated with the Bank’s consolidated annual financial statements and notes thereto and accordingly, should be read in conjunction with the consolidated financial statements and notes thereto included in the Bank’s Annual Report for the year ended December 31, 2018 on Form 10-K on file with the FDIC (Form 10-K may be found at [www.summitstatebank.com](http://www.summitstatebank.com)).

The accompanying accounting and reporting policies of the Bank and subsidiary conform to U.S. Generally Accepted Accounting Principles and prevailing practices within the banking industry.

*Use of Estimates*

The preparation of financial statements in conformity with U.S. Generally Accepted Accounting Principles requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The allowance for loan losses, goodwill impairment, valuation of other real estate owned, and fair values of investment securities are particularly subject to change.

*Revenue Recognition*

The Bank records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, “Revenue from Contracts with Customers” (“Topic 606”). Under Topic 606, the Bank must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Bank satisfies a performance obligation.

Most of our revenue-generating transactions are not subject to Topic 606, including revenue generated from financial instruments, such as our loans and investment securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, gains on sales of loans, financial guarantees, derivatives, and certain credit card fees are also not in scope of the new guidance. The Bank’s noninterest revenue streams are largely based

on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Bank satisfies its performance obligation and revenue is recognized. The Bank does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of June 30, 2019, the Bank did not have any significant contract balances. The Bank has evaluated the nature of its revenue streams and determined that further disaggregation of revenue into more granular categories beyond what is presented on the consolidated statements of income was not necessary. The following are descriptions of revenues within the scope of ASC 606.

**Deposit service charges** - The Bank earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied, and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposit accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

**Debit and ATM interchange fee income and expenses** - Debit and ATM interchange income represent fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied, and the fees are earned when the cost of the transaction is charged to the cardholders' debit card. Certain expenses directly associated with the credit and debit card are recorded on a net basis with the interchange income.

**Rental Income** – Leases originated by the Bank are recorded as rental income and included in the other non-interest income category. Rental income is recognized in the month in which the revenue covers. Leasehold improvements and operational expenses associated with the rental proper are recorded separate from the income as an expense.

**Gain/loss on other real estate owned, net** - The Bank records a gain or loss from the sale of other real estate owned when control of the property transfers to the buyer, which generally occurs at the time of an executed deed of trust. When the Bank finances the sale of other real estate owned to the buyer, the Bank assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the other real estate owned asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on sale, the Bank adjusts the transaction price and related gain or loss on sale if a significant financing component is present

### ***Junior Subordinated Debt***

On June 28, 2019 the Bank completed the private placement of \$6,000,000 in fixed-to-floating rate subordinated notes (the "Notes") to support organic growth and for general corporate purposes. The Notes are for a 10-year term, due June 30, 2029, and have been structured to qualify as Tier 2 capital for regulatory purposes. The Notes will bear interest at a fixed rate of 6.0% per annum until June 30, 2024. For the remainder of the term, through June 30, 2029, the Notes will bear interest at a rate equal to 3-month Libor plus 362 basis points. The subordinated notes are redeemable by the Bank at its option, in whole or in part, on or after June 30, 2024, or in whole but not in part under certain other circumstances. The Notes are reported net of any debt issuance cost which totaled \$138,000 at June 30, 2019.

### ***Alto Service Corporation Dissolution***

Alto Service Corporation ("Alto") was originally established to act as the Trustee for Deeds of Trust and is wholly owned by Summit. In June 2019 the Bank began the process to dissolve Alto in accordance with the Bank's Plan of Dissolution which included paying off all of its liabilities, which total \$0, and distribute its net assets to the Bank. A Certificate of Dissolution was filed with the State of California and Alto was dissolved effective July 17, 2019.

### ***Recently Adopted Accounting Standards***

In February of 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. This Update was issued to increase transparency and comparability among organizations by recognizing the right to use lease assets for the lease term, and a lease liability on the balance sheet, including disclosing key information about leasing arrangements. The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leasing arrangements exceeding a twelve-month term. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, Elements of Financial Statements, and therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases. For public companies, the amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Lease commitments will be reflected on the balance sheet as lease assets and lease liabilities. In July 2018, the FASB issued two amendments to ASU 2016-02: ASU No. 2018-10, Codification Improvements to Topic 842, Leases, which provides various corrections and clarifications to ASU 2016-02; and ASU No. 2018-11, Leases (Topic 842): Targeted Improvements, which provides an optional transition method and provides a lessor with practical expedients for separating lease and non-lease components of a lease. Entities can apply a full retrospective approach at the beginning of the first historical period presented or a modified retrospective approach at the beginning of the period of adoption. The Bank adopted this standard effective January 1, 2019 using the modified retrospective adoption method. The Bank also elected certain relief options offered in ASU 2016-02 including the package of practical expedients and the option not to separate lease and non-lease components and instead to account for them as a single lease component.

In March 2017, the FASB issued ASU No. 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities*. Under current GAAP, entities normally amortize the premium as an adjustment of yield over the contractual life of the instrument. This guidance shortens the amortization period for certain callable debt securities held at a premium to the earliest call date. This update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of this ASU did not have a material impact on the Bank's consolidated financial statements.

### ***Accounting Standards Pending Adoption***

In June of 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments are intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users to better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting guidance for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We currently have a CECL model in place that will run parallel to the existing practice. At the end of the test period (year-end 2019) the model will be live and the impact the new standard will have on our consolidated financial statements will be provided at that time.

In January of 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The amendments are intended to simplify the subsequent measurement of goodwill, and the amendments eliminate Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however,

the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax-deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The amendments should be applied on a prospective basis. The nature of and reason for the change in accounting principle should be disclosed upon transition. The amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Management does not anticipate any potential impact from the new standard on our consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. The amendments in this update remove, modify or add disclosure requirements for fair value measurements to improve the effectiveness of disclosures. The update is effective for the Bank on January 1, 2020, with early adoption permitted, and allows for either the prospective or retrospective adoption method. Management is currently evaluating the potential impact of adoption to the Bank's consolidated financial statements.

In April 2019, the FASB issued ASU No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments - Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*. With respect to Topic 815, Derivatives and Hedging, ASU 2019-04 clarifies that the reclassification of a debt security from held-to-maturity ("HTM") to available-for-sale ("AFS") under the transition guidance in ASU 2017-12 would not (1) call into question the classification of other HTM securities, (2) be required to actually designate any reclassified security in a last-of-layer hedge, or (3) be restricted from selling any reclassified security. As part of the transition of ASU 2019-04, entities may reclassify securities that would qualify for designation as the hedged item in a last-of-layer hedging relationship from HTM to AFS; however, entities that already made such a reclassification upon their adoption of ASU 2017-12 are precluded from reclassifying additional securities. ASU 2019-04 has the same effective date as ASU 2016-13 (i.e., first quarter 2020). Management does not anticipate any potential impact from this new standard. The Bank will continue evaluating the potential impact of this standard in connection with the adoption of ASU 2016-13.

In May 2019, the FASB issued ASU No. 2019-05, *Financial Instruments - Credit Losses (Topic 326); Targeted Transition Relief*. This ASU allows entities to irrevocably elect, upon adoption of ASU 2016-13, the fair value option on financial instruments that (1) were previously recorded at amortized cost and (2) are within the scope of ASC 326-20 if the instruments are eligible for the fair value option under ASC 825-10. The fair value option election does not apply to held-to-maturity debt securities. Entities are required to make this election on an instrument-by-instrument basis. ASU 2019-05 has the same effective date as ASU 2016-13 (i.e., the first quarter of 2020). Management does not anticipate any potential impact from the new standard on our consolidated financial statements.

### ***Earnings Per Common Share***

Basic earnings per common share (EPS), which excludes dilution, is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which share in the earnings of the Bank. Dilutive EPS is computed by dividing income available to common shareholders by the weighted-average common shares outstanding plus the weighted-average number of dilutive shares for the period. The number of potential common shares included in the quarterly diluted EPS is computed using the average market price during the three months included in the reporting period under the treasury stock method. Stock options for 4,000 and 6,000 shares of common stock for the three and six months ended June 30, 2019 were not considered in computing diluted earnings per share because they were anti-dilutive. Stock options for 3,000 shares of common stock for the three and six months ended June 30, 2018 were not considered in computing diluted earnings per share because they were anti-dilutive.

The factors used in the earnings per common share computation follow:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
(in thousands except earnings per share)	<u>June 30, 2019</u>	<u>June 30, 2018</u>	<u>June 30, 2019</u>	<u>June 30, 2018</u>
<b>Basic</b>				
Net income	\$ 1,172	\$ 1,461	\$ 2,597	\$ 3,201
Weighted average common shares outstanding	6,069	6,066	6,068	6,063
Basic earnings per common share	\$ 0.19	\$ 0.24	\$ 0.43	\$ 0.53
<b>Diluted</b>				
Net income	\$ 1,172	\$ 1,461	\$ 2,597	\$ 3,201
Weighted average common shares outstanding for basic earnings per common share	6,069	6,066	6,068	6,063
Add: Dilutive effects of assumed exercises of stock options	6	8	3	7
Average shares and dilutive potential common shares	6,075	6,074	6,071	6,070
Diluted earnings per common share	\$ 0.19	\$ 0.24	\$ 0.43	\$ 0.53

## 2. SHAREHOLDERS' EQUITY

### Regulatory Capital

The Bank's actual and required capital amounts and ratios consisted of the following:

(in thousands)	June 30, 2019		December 31, 2018	
	Amount	Ratio	Amount	Ratio
<u>Common Equity Tier 1 Capital Ratio</u>				
Summit State Bank	\$ 60,004	10.7%	\$ 58,915	10.5%
Minimum requirement with capital conservation buffer (1)	\$ 39,188	7.0%	\$ 39,316	7.0%
Minimum requirement for "Well-Capitalized" institution	\$ 36,389	6.5%	\$ 36,508	6.5%
Minimum regulatory requirement	\$ 25,193	4.5%	\$ 25,275	4.5%
<u>Tier 1 Capital Ratio</u>				
Summit State Bank	\$ 60,004	10.7%	\$ 58,915	10.5%
Minimum requirement with capital conservation buffer (1)	\$ 47,586	8.5%	\$ 47,741	8.5%
Minimum requirement for "Well-Capitalized" institution	\$ 44,787	8.0%	\$ 44,933	8.0%
Minimum regulatory requirement	\$ 33,590	6.0%	\$ 33,700	6.0%
<u>Total Capital Ratio</u>				
Summit State Bank	\$ 72,526	13.0%	\$ 65,188	11.6%
Minimum requirement with capital conservation buffer (1)	\$ 58,783	10.5%	\$ 58,975	10.5%
Minimum requirement for "Well-Capitalized" institution	\$ 55,984	10.0%	\$ 56,166	10.0%
Minimum regulatory requirement	\$ 44,787	8.0%	\$ 44,933	8.0%
<u>Tier 1 Leverage Ratio</u>				
Summit State Bank	\$ 60,004	9.5%	\$ 58,915	9.9%
Minimum requirement for "Well-Capitalized" institution	\$ 31,559	5.0%	\$ 29,874	5.0%
Minimum regulatory requirement	\$ 25,247	4.0%	\$ 23,899	4.0%

(1) Includes 2.5% capital conservation buffer effective January 1, 2019.

### Share-Based Compensation Plans

The shareholders approved the 2013 Equity Incentive Plan ("Plan") on July 29, 2013. The Plan allows for various equity-based incentives such as stock appreciation rights, restricted stock awards, stock grants and qualified performance-based awards. The Plan reserved 187,500 shares of common stock for issuance to Bank employees and directors. The Plan requires that the option exercise price may not be less than the fair value of the stock at the date the option is granted. Option awards have vesting periods of 5 years unless otherwise approved by the Board of Directors. The option expiration dates are determined by the Board of Directors but may not be later than ten years from the date of grant. No options were granted during the three and six months ended June 30, 2019 and June 30,

2018. As of June 30, 2019, 187,500 shares remain available for future grants under the Plan. There were 9,125 options outstanding as of June 30, 2019, which includes options granted under prior stock option plans.

The Bank has granted Stock Appreciation Rights (“SARs”) in 2018, 2017 and 2016 to key employees and directors. There were no SAR grants for the three and six months ended June 30, 2019. The SARs provide long-term incentives to the employees and directors by providing a cash payment of the difference between the market price of the Bank’s common stock at time of exercise and the price at the grant date. The SARs expire ten years from the date of grant, and each has an annual vesting of 20% for the first five years. The obligations associated with the SARs are accounted for as liabilities and are included in accrued interest payable and other liabilities on the consolidated balance sheets. The total compensation expense accrued for the three and six months ended June 30, 2019 related to the SARs totaled \$17,000 and \$34,000 and totaled \$7,000 and \$13,000 for the three and six months ended June 30, 2018. As of June 30, 2019, and December 31, 2018, there were SAR agreements based on 135,000 common shares.

### 3. COMMITMENTS AND CONTINGENCIES

The Bank is subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the consolidated financial condition or results of operations of the Bank.

The Bank's business activity is primarily with clients located within Northern California. Although the Bank has a diversified loan portfolio, a significant portion of its clients' ability to repay loans is dependent upon the real estate market and various economic factors within Sonoma County. Generally, loans are secured by various forms of collateral. The Bank's loan policy requires sufficient collateral to be obtained as necessary to meet the Bank's relative risk criteria for each borrower. The Bank's collateral for the lending portfolio consists primarily of real estate, accounts receivable, inventory and other financial instruments. At June 30, 2019, loans with real estate collateral approximated \$489,390,000 or 90% of the loan portfolio.

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its clients and to reduce its own exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the consolidated balance sheets. The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and standby letters of credit as it does for loans included on the consolidated balance sheet.

Commitments to extend credit, which totaled \$87,689,000 and \$85,304,000 at June 30, 2019 and December 31, 2018, are agreements to lend to a client as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of the credit, is based on management's credit evaluation of the borrower. Collateral held relating to these commitments varies, but may include securities, equipment, accounts receivable, inventory and deeds of trust on residential real estate and owner-occupied or income-producing commercial properties.

Standby letters of credit, which totaled \$1,660,000 and \$3,707,000 at June 30, 2019 and December 31, 2018, are conditional commitments issued by the Bank to guarantee the performance of a client to a first party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to clients. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at June 30, 2019 and December 31, 2018. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

#### 4. FAIR VALUE

Accounting standards establish a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of most securities available for sale are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The fair value of impaired loans that are collateral dependent are generally based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Estimated fair values are disclosed for financial instruments for which it is practicable to estimate fair value. These estimates are made at a specific point in time based on relevant market data and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering the Bank's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these 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. Changes in assumptions could significantly affect the fair values presented.



The following table presents a summary of the carrying value and fair value by level of financial instruments on the Bank's consolidated balance sheet at June 30, 2019 and December 31, 2018:

(in thousands)	June 30, 2019			December 31, 2018		
	Carrying Amount	Fair Value	Fair Value Hierarchy	Carrying Amount	Fair Value	Fair Value Hierarchy
<b>Financial assets:</b>						
Cash and due from banks	\$ 12,104	\$ 12,104	Level 1	\$ 21,693	\$ 21,693	Level 1
Investment securities - held-to-maturity	7,995	7,902	Level 2	7,991	7,612	Level 2
Investment securities - available-for-sale	59,853	59,853	Level 2	70,174	70,174	Level 2
Loans, net of allowance	536,674	533,402	Level 3	504,549	492,112	Level 3
Investment in Federal Home Loan Bank stock	3,341	3,341	Level 2	3,085	3,085	Level 2
Accrued interest receivable	1,916	1,916	Level 1	1,831	1,831	Level 1
<b>Financial liabilities:</b>						
Deposits	\$ 532,257	\$ 529,488	Level 2	\$ 501,189	\$ 498,428	Level 2
Federal Home Loan Bank advances	29,300	29,300	Level 2	56,800	56,803	Level 2
Junior subordinated debt	5,862	5,862	Level 3	-	-	Level 3

### Assets and Liabilities Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

	Fair Value Measurements at June 30, 2019 (In thousands)			
	June 30, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Securities available-for-sale:				
Government agencies	\$ 41,692	\$ -	\$ 41,692	\$ -
Mortgage-backed securities - residential	10,294	-	10,294	-
Corporate debt	7,867	-	7,867	-
Total securities available-for-sale	<u>\$ 59,853</u>	<u>\$ -</u>	<u>\$ 59,853</u>	<u>\$ -</u>
<b>Fair Value Measurements at December 31, 2018 (In thousands)</b>				
	December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Securities available-for-sale:				
Government agencies	\$ 39,330	\$ -	\$ 39,330	\$ -
Mortgage-backed securities - residential	10,972	-	10,972	-
Corporate debt	19,872	-	19,872	-
Total securities available-for-sale	<u>\$ 70,174</u>	<u>\$ -</u>	<u>\$ 70,174</u>	<u>\$ -</u>

There were no liabilities measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 or Level 3 during the three and six months ended June 30, 2019 or 2018.

## Assets and Liabilities Measured on a Non-Recurring Basis

There were no assets or liabilities measured at fair value on a non-recurring basis at June 30, 2019 and December 31, 2018.

### 5. INVESTMENT SECURITIES

The amortized costs and estimated fair value of investment securities are reflected in the tables below:

<b>June 30, 2019</b>				
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Held-to-maturity:</b>				
Government agencies	\$ 7,995	\$ -	\$ (93)	\$ 7,902
<b>Available-for-sale:</b>				
Government agencies	\$ 41,425	\$ 578	\$ (311)	\$ 41,692
Mortgage-backed securities - residential	10,247	58	(11)	10,294
Corporate debt	7,778	112	(23)	7,867
Total available-for-sale	<u>59,450</u>	<u>748</u>	<u>(345)</u>	<u>59,853</u>
Total investment securities	<u>\$ 67,445</u>	<u>\$ 748</u>	<u>\$ (438)</u>	<u>\$ 67,755</u>
<b>December 31, 2018</b>				
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Held-to-maturity:</b>				
Government agencies	\$ 7,991	\$ -	\$ (379)	\$ 7,612
<b>Available-for-sale:</b>				
Government agencies	\$ 41,365	\$ -	\$ (2,035)	\$ 39,330
Mortgage-backed securities - residential	11,217	1	(246)	10,972
Corporate debt	20,134	134	(396)	19,872
Total available-for-sale	<u>72,716</u>	<u>135</u>	<u>(2,677)</u>	<u>70,174</u>
Total investment securities	<u>\$ 80,707</u>	<u>\$ 135</u>	<u>\$ (3,056)</u>	<u>\$ 77,786</u>

The activity related to recorded gross gains and losses of investment securities is reflected in the table below:

(in thousands)	Three Months Ended		Six Months Ended	
	<u>June 30, 2019</u>	<u>June 30, 2018</u>	<u>June 30, 2019</u>	<u>June 30, 2018</u>
Proceeds from sales	\$ 9,059	\$ -	\$ 9,059	\$ -
Proceeds from calls	215	443	215	867
Gross realized gains on sales and calls	112	9	112	16
Gross realized losses on sales and calls	(119)	-	(119)	-

There were thirteen investment securities in a continuous unrealized loss position greater than 12 months at June 30, 2019 and forty-two at December 31, 2018. At June 30, 2019 the Bank held no investment securities in an unrealized loss position for less than twelve months and at December 31, 2018 the Bank held twelve investment securities in an unrealized loss for less than twelve months. The interest rate volatility over the past year resulted in many investment securities ending the period in an unrealized loss position. At June 30, 2019 long-term rates substantially decreased and as a result this reduced the Bank's unrealized loss on investments.

Management periodically evaluates each investment security for other-than-temporary impairment (OTTI), relying primarily on industry analyst reports and observation of market conditions and interest rate fluctuations. All of the impairment appearing in the investment securities portfolio valuations is considered to be temporary. The measured impairment in the securities values is primarily attributable to changes in short term interest rates, market shifts of the Treasury yield curve and other variable market and economic conditions. The measured impairment in securities values did not result from any significant or persistent deterioration in the underlying credit quality of any of the investments. The securities portfolio consists primarily of debt securities with non-contingent contractual cash flows. Full realization of the principal balance is expected upon final maturity. Management has the intent and ability to hold the securities until recovery of the carrying value, which could be at the final maturity. There was no OTTI recorded in 2019 or 2018.

Investment securities with unrealized losses are summarized and classified according to the duration of the loss period as follows:

<b>June 30, 2019</b>						
(in thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
Held-to-maturity:						
Government agencies	\$ -	\$ -	\$ 7,902	\$ (93)	\$ 7,902	\$ (93)
Available-for-sale:						
Government agencies	\$ -	\$ -	\$ 17,995	\$ (311)	\$ 17,995	\$ (311)
Mortgage-backed securities - residential	-	-	2,387	(11)	2,387	(11)
Corporate debt	-	-	699	(23)	699	(23)
Total available-for-sale	-	-	21,081	(345)	21,081	(345)
Total investment securities	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 28,983</u>	<u>\$ (438)</u>	<u>\$ 28,983</u>	<u>\$ (438)</u>

<b>December 31, 2018</b>						
(in thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
Held-to-maturity:						
Government agencies	\$ -	\$ -	\$ 7,612	\$ (379)	\$ 7,612	\$ (379)
Available-for-sale:						
Government agencies	\$ 10,230	\$ (190)	\$ 29,100	\$ (1,845)	\$ 39,330	\$ (2,035)
Mortgage-backed securities - residential	235	(5)	7,047	(241)	7,282	(246)
Corporate debt	1,400	(16)	5,933	(380)	7,333	(396)
Total available-for-sale	<u>11,865</u>	<u>(211)</u>	<u>42,080</u>	<u>(2,466)</u>	<u>53,945</u>	<u>(2,677)</u>
Total investment securities	<u>\$ 11,865</u>	<u>\$ (211)</u>	<u>\$ 49,692</u>	<u>\$ (2,845)</u>	<u>\$ 61,557</u>	<u>\$ (3,056)</u>

The amortized cost and estimated fair value of investment securities by contractual maturity at June 30, 2019 are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

(in thousands)	Held to Maturity		Available-for-Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	\$ -	\$ -	\$ 2,503	\$ 2,516
After one year through five years	-	-	7,257	7,352
After five years through ten years	3,000	2,970	33,452	33,889
After ten years	4,995	4,932	5,991	5,802
	7,995	7,902	49,203	49,559
Investment securities not due at a single maturity date:				
Mortgage-backed securities - residential	-	-	10,247	10,294
	<u>\$ 7,995</u>	<u>\$ 7,902</u>	<u>\$ 59,450</u>	<u>\$ 59,853</u>

## 6. LOANS

Outstanding loans are summarized as follows:

(in thousands)	June 30, 2019	December 31, 2018
Commercial & agricultural	\$ 131,103	\$ 107,910
Real estate - commercial	286,350	287,841
Real estate - construction and land	34,257	24,330
Real estate - single family	56,620	56,648
Real estate - multifamily	34,591	33,623
Consumer & lease financing	81	226
	543,002	510,578
Allowance for loan losses	(6,328)	(6,029)
	<u>\$ 536,674</u>	<u>\$ 504,549</u>

Changes in the allocation of allowance for loan losses by loan class for the three and six months ended June 30, 2019 and 2018 are as follows:

(in thousands)	Three Months Ended June 30, 2019				
	Balance at March 31, 2019	Provision (reversal)	Charge-offs	Recoveries	Balance at June 30, 2019
Commercial & agricultural	\$ 945	\$ 18	\$ -	\$ 9	\$ 972
Real estate - commercial	2,805	(60)	-	-	2,745
Real estate - construction and land	838	114	-	-	952
Real estate - single family	740	18	-	-	758
Real estate - multifamily	282	38	-	-	320
Consumer & lease financing	1	1	-	-	2
Unallocated	528	51	-	-	579
Total	<u>\$ 6,139</u>	<u>\$ 180</u>	<u>\$ -</u>	<u>\$ 9</u>	<u>\$ 6,328</u>

(in thousands)

## Six Months Ended June 30, 2019

	Balance at December 31, 2018	Provision (reversal)	Charge-offs	Recoveries	Balance at June 30, 2019
Commercial & agricultural	\$ 904	\$ 49	\$ -	\$ 19	\$ 972
Real estate - commercial	2,830	(85)	-	-	2,745
Real estate - construction and land	705	247	-	-	952
Real estate - single family	684	74	-	-	758
Real estate - multifamily	308	12	-	-	320
Consumer & lease financing	6	(4)	-	-	2
Unallocated	592	(13)	-	-	579
Total	\$ 6,029	\$ 280	\$ -	\$ 19	\$ 6,328

(in thousands)

## Three Months Ended June 30, 2018

	Balance at March 31, 2018	Provision (reversal)	Charge-offs	Recoveries	Balance at June 30, 2018
Commercial & agricultural	\$ 534	\$ (58)	\$ -	\$ 26	\$ 502
Real estate - commercial	2,483	(211)	-	-	2,272
Real estate - construction and land	459	220	-	-	679
Real estate - single family	633	(36)	-	9	606
Real estate - multifamily	246	29	-	-	275
Consumer & lease financing	2	-	-	-	2
Unallocated	1,233	206	-	-	1,439
Total	\$ 5,590	\$ 150	\$ -	\$ 35	\$ 5,775

(in thousands)

## Six Months Ended June 30, 2018

	Balance at December 31, 2017	Provision (reversal)	Charge-offs	Recoveries	Balance at June 30, 2018
Commercial & agricultural	\$ 682	\$ (207)	\$ -	\$ 27	\$ 502
Real estate - commercial	2,697	(425)	-	-	2,272
Real estate - construction and land	443	236	-	-	679
Real estate - single family	595	(178)	-	189	606
Real estate - multifamily	319	(44)	-	-	275
Consumer & lease financing	14	(35)	-	23	2
Unallocated	486	953	-	-	1,439
Total	\$ 5,236	\$ 300	\$ -	\$ 239	\$ 5,775

The following table presents the balance in the allowance for loan losses and loan balances by class and based on impairment method as of June 30, 2019 and December 31, 2018:

June 30, 2019						
(in thousands)	Allowance for Loan Losses			Loans		
	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total Ending Allowance Balance	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Ending Loans Balance
Commercial & agricultural	\$ 355	\$ 617	\$ 972	\$ 963	\$ 130,140	\$ 131,103
Real estate - commercial	-	2,745	2,745	1,305	285,045	286,350
Real estate - construction and land	-	952	952	-	34,257	34,257
Real estate - single family	3	755	758	1,070	55,550	56,620
Real estate - multifamily	-	320	320	-	34,591	34,591
Consumer & lease financing	-	2	2	-	81	81
Unallocated	-	579	579	-	-	-
<b>Total</b>	<b>\$ 358</b>	<b>\$ 5,970</b>	<b>\$ 6,328</b>	<b>\$ 3,338</b>	<b>\$ 539,664</b>	<b>\$ 543,002</b>

  

December 31, 2018						
(in thousands)	Allowance for Loan Losses			Loans		
	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total Ending Allowance Balance	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Ending Loans Balance
Commercial & agricultural	\$ 351	\$ 553	\$ 904	\$ 718	\$ 107,192	\$ 107,910
Real estate - commercial	-	2,830	2,830	1,538	286,303	287,841
Real estate - construction and land	-	705	705	-	24,330	24,330
Real estate - single family	-	684	684	1,098	55,550	56,648
Real estate - multifamily	-	308	308	-	33,623	33,623
Consumer & lease financing	-	6	6	-	226	226
Unallocated	-	592	592	-	-	-
<b>Total</b>	<b>\$ 351</b>	<b>\$ 5,678</b>	<b>\$ 6,029</b>	<b>\$ 3,354</b>	<b>\$ 507,224</b>	<b>\$ 510,578</b>

The recorded investment in the aforementioned disclosure and the next several disclosures do not include accrued interest receivable and net deferred fees because such amounts are not considered material. Accrued interest receivable for the total loan portfolio was \$1,582,000 and \$1,353,000 and net deferred loan fees (costs) were \$(125,000) and \$131,000 as of June 30, 2019 and December 31, 2018, respectively. Loans with balances less than \$250,000 that are identified as impaired and are not considered a troubled debt restructuring are not measured individually for impairment on the basis they represent small-balance loans that are collectively evaluated for impairment.

The following table presents total impaired loans evaluated for impairment by class of loans:

(in thousands)	Commercial & agricultural	Real estate - commercial	Real estate - construction and land	Real estate - single family	Real estate - multifamily	Consumer & lease financing	Total
<b>June 30, 2019</b>							
<b>Recorded investment in impaired loans:</b>							
With no related allowance recorded	\$ 515	\$ 1,476	\$ -	\$ 982	\$ 102	\$ -	\$ 3,075
With an allowance recorded	449	-	-	88	-	-	537
Total recorded investment in impaired loans	<u>\$ 964</u>	<u>\$ 1,476</u>	<u>\$ -</u>	<u>\$ 1,070</u>	<u>\$ 102</u>	<u>\$ -</u>	<u>\$ 3,612</u>
<b>Unpaid principal balance of impaired loans:</b>							
With no related allowance recorded	\$ 638	\$ 1,736	\$ -	\$ 1,034	\$ 173	\$ -	\$ 3,581
With an allowance recorded	449	-	-	88	-	-	537
Total unpaid principal balance of impaired loans	<u>\$ 1,087</u>	<u>\$ 1,736</u>	<u>\$ -</u>	<u>\$ 1,122</u>	<u>\$ 173</u>	<u>\$ -</u>	<u>\$ 4,118</u>
Allowance for loan losses allocation	\$ 355	\$ -	\$ -	\$ 3	\$ -	\$ -	\$ 358
Average recorded investment in impaired loans during the quarter ended June 30, 2019	1,270	1,484	-	1,073	103	-	3,930
Interest income recognized on impaired loans during the quarter ended June 30, 2019	17	16	-	13	-	-	46
Average recorded investment in impaired loans during the six months ended June 30, 2019	1,138	1,494	-	1,078	106	-	3,816
Interest income recognized on impaired loans during the six months ended June 30, 2019	30	31	-	25	-	-	86
<b>December 31, 2018</b>							
<b>Recorded investment in impaired loans:</b>							
With no related allowance recorded	\$ 540	\$ 1,904	\$ -	\$ 1,292	\$ 111	\$ -	\$ 3,847
With an allowance recorded	351	-	-	-	-	-	351
Total recorded investment in impaired loans	<u>\$ 891</u>	<u>\$ 1,904</u>	<u>\$ -</u>	<u>\$ 1,292</u>	<u>\$ 111</u>	<u>\$ -</u>	<u>\$ 4,198</u>
<b>Unpaid principal balance of impaired loans:</b>							
With no related allowance recorded	\$ 663	\$ 2,136	\$ -	\$ 1,400	\$ 177	\$ -	\$ 4,376
With an allowance recorded	351	-	-	-	-	-	351
Total unpaid principal balance of impaired loans	<u>\$ 1,014</u>	<u>\$ 2,136</u>	<u>\$ -</u>	<u>\$ 1,400</u>	<u>\$ 177</u>	<u>\$ -</u>	<u>\$ 4,727</u>
Allowance for loan losses allocation	\$ 351	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 351
<b>June 30, 2018</b>							
Allowance for loan losses allocation	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Average recorded investment in impaired loans during the quarter ended June 30, 2018	604	2,014	-	1,492	122	-	4,232
Interest income recognized on impaired loans during the quarter ended June 30, 2018	6	5	-	13	-	-	24

The following table presents the recorded investment in nonaccrual loans and loans past due over 90 days still accruing by class of loans as of June 30, 2019 and December 31, 2018:

(in thousands)	<b>June 30, 2019</b>		<b>December 31, 2018</b>	
	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Nonaccrual	Loans Past Due Over 90 Days Still Accruing
Commercial & agricultural	\$ -	\$ -	\$ -	\$ -
Real estate - commercial	342	-	1,528	-
Real estate - construction and land	-	-	-	-
Real estate - single family	271	-	485	-
Real estate - multifamily	102	-	111	-
Consumer & lease financing	-	-	-	-
Total	<u>\$ 715</u>	<u>\$ -</u>	<u>\$ 2,124</u>	<u>\$ -</u>

The following table presents the aging of the recorded investment in past due loans, inclusive of nonaccrual loans, as of June 30, 2019 by class of loans:

(in thousands)	30 - 59	60 - 89	Greater Than	Total	Loans Not	Total
	Days	Days	90 Days			
	Past Due	Past Due	Past Due	Past Due	Past Due	
Commercial & agricultural	\$ -	\$ -	\$ -	\$ -	\$ 131,103	\$ 131,103
Real estate - commercial	-	-	172	172	286,178	286,350
Real estate - construction and land	-	-	-	-	34,257	34,257
Real estate - single family	-	-	88	88	56,532	56,620
Real estate - multifamily	-	-	-	-	34,591	34,591
Consumer & lease financing	-	-	-	-	81	81
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 260</u>	<u>\$ 260</u>	<u>\$ 542,742</u>	<u>\$ 543,002</u>

The following table presents the aging of the recorded investment in past due loans, inclusive of nonaccrual loans, as of December 31, 2018 by class of loans:

(in thousands)	30 - 59	60 - 89	Greater Than	Total	Loans Not	Total
	Days	Days	90 Days			
	Past Due	Past Due	Past Due	Past Due	Past Due	
Commercial & agricultural	\$ -	\$ -	\$ -	\$ -	\$ 107,910	\$ 107,910
Real estate - commercial	188	-	177	365	287,476	287,841
Real estate - construction and land	-	-	-	-	24,330	24,330
Real estate - single family	-	-	291	291	56,357	56,648
Real estate - multifamily	-	-	-	-	33,623	33,623
Consumer & lease financing	-	-	-	-	226	226
Total	<u>\$ 188</u>	<u>\$ -</u>	<u>\$ 468</u>	<u>\$ 656</u>	<u>\$ 509,922</u>	<u>\$ 510,578</u>

A loan is considered past due if a scheduled payment of interest or principal that is due is unpaid for 30 days or more.



## **Troubled Debt Restructurings**

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where such modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR"). At June 30, 2019 and December 31, 2018, loans modified in a TDR totaled \$2,802,000 and \$3,370,000 which are included in the impaired loan disclosures above. The total TDRs includes \$353,000 and \$1,647,000 that are also included in nonperforming loans at June 30, 2019 and December 31, 2018. TDRs had specific loss allocations of \$0 as of June 30, 2019, December 31, 2018 and June 30, 2018.

During the three and six months ended June 30, 2019 there was one real estate – commercial loan modified as troubled debt restructurings with a pre-modification and post-modification balance of \$170,000. There were no loans modified as troubled debt restructurings during the three months ended June 30, 2018. During the six months ended June 30, 2018, there were three loans modified as troubled debt restructurings. One real estate – commercial loan with a pre-modification balance of \$923,000 and one real estate – single family loan with a pre-modification balance of \$107,000 were restructured into one real estate – commercial loan with a post-modification balance of \$1,250,000. The new loan was made at current market rates; however, the term was for ten years. Additional monies were for property taxes and other expenses. One commercial & agricultural loan was restructured to extend the maturity by 5 years at below market rates. The restructured loan had a pre-modification and post-modification balance of \$190,000.

There were no loans modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three and six months ended June 30, 2019 and 2018. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

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

## **Credit Quality Indicators**

The Bank categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Bank analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for loans in excess of \$250,000. Smaller balances are graded at origination and updated based on payment status and other information obtained from borrowers. The Bank uses the following definitions for risk ratings:

**PASS** - Loans not meeting any of the three criteria below that are analyzed individually as part of the above described process are considered to be pass rated loans.

**SPECIAL MENTION** - Loans in this category are considered "criticized" from a regulatory point of view but are not considered "classified" until the risk classification becomes substandard or worse. Loans in this category represent above average risk and potential weakness which may, if not corrected, weaken the loan and threaten repayment at some future date.

**SUBSTANDARD** - Loans in this category have well defined weakness that jeopardize full repayment of the debt, although loss may not seem likely. Loss potential does not have to exist in individual loans in the Substandard classification but will be apparent in the aggregate. Typically, these loans have not met repayment plans as agreed. The primary source of repayment may have failed to materialize; repayment may be dependent on collateral liquidation or other secondary sources. Bankrupt borrowers and those with continuously past due payments are considered substandard.

**DOUBTFUL** - Loans in this category have all the characteristics of substandard loans with the added weakness that payment in full or liquidation in full is highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the strengthening

of the loan, its classification as an estimated loss is deferred until the amount of the loss may be more accurately determined.

The risk category of loans by class of loans as of June 30, 2019 is as follows:

(in thousands)	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Commercial & agricultural	\$ 121,501	\$ -	\$ 9,602	\$ -	\$ 131,103
Real estate - commercial	285,924	84	342	-	286,350
Real estate - construction and land	34,257	-	-	-	34,257
Real estate - single family	56,074	-	546	-	56,620
Real estate - multifamily	34,489	-	102	-	34,591
Consumer & lease financing	81	-	-	-	81
Total	<u>\$ 532,326</u>	<u>\$ 84</u>	<u>\$ 10,592</u>	<u>\$ -</u>	<u>\$ 543,002</u>

The risk category of loans by class of loans as of December 31, 2018 is as follows:

(in thousands)	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Commercial & agricultural	\$ 98,368	\$ -	\$ 9,542	\$ -	\$ 107,910
Real estate - commercial	286,228	86	1,527	-	287,841
Real estate - construction and land	24,330	-	-	-	24,330
Real estate - single family	56,163	-	485	-	56,648
Real estate - multifamily	33,512	-	111	-	33,623
Consumer & lease financing	226	-	-	-	226
Total	<u>\$ 498,827</u>	<u>\$ 86</u>	<u>\$ 11,665</u>	<u>\$ -</u>	<u>\$ 510,578</u>

## 7. FHLB ADVANCES

The Bank adjusts its level of FHLB advances outstanding to manage balance sheet liquidity. Each advance is payable at its maturity date, with a prepayment penalty for fixed rate advances. The advances were collateralized by \$317,830,000 and \$317,896,000 of loans under a blanket lien arrangement at June 30, 2019 and December 31, 2018. Based on this collateral the Bank was eligible to borrow up to a total of \$198,405,000 and \$199,680,000 of which \$154,105,000 and \$127,880,000 was available for additional advances as of June 30, 2019 and December 31, 2018. Below is the advance outstanding at June 30, 2019.

<u>Maturity</u>	<u>Amount (in thousands)</u>	<u>Rate</u>
7/1/2019	\$ 29,300	2.52%
	<u>\$ 29,300</u>	

## 8. LEASES

A lease is defined as a contract, or part of a contract, that conveys the right to control the use of identified property, plan or equipment for a period of time in exchange for consideration. On January 1, 2019, the Bank adopted ASU No. 2016-02 "Leases" (Topic 842) and all subsequent ASUs that modified Topic 842. For the Bank, Topic 842 primarily affected the accounting treatment for operating lease agreements in which the Bank is the lessee.

## Lessee Accounting

The types of leases where the Bank is a lessee are real estate properties for four branches located in Healdsburg, Rohnert Park, Petaluma and Santa Rosa, office spaces in Santa Rosa, a lending office in Roseville and photocopier equipment. These leases have variable terms maturing prior to 2025. A majority of the leases are classified as operating leases and were previously not recognized on the Bank's consolidated statements of condition. With the adoption of Topic 842, operating lease agreements are required to be recognized on the consolidated statements of condition as a right-of-use ("ROU") asset and a corresponding lease liability.

The calculated amount of the ROU assets and lease liabilities in the table below are calculated by discounting the minimum contractual balance due of all future payments through the end of the current term to present value. When the Bank determines exercising the renewal option for any lease agreement is reasonably certain, it will include the extended term in the calculation of the ROU asset and lease liability.

As it pertains to the discount rate, Topic 842 requires the use of the rate implicit in the lease whenever this rate is readily determinable. As this rate is rarely determinable, the Bank uses its incremental borrowing rate in calculating the discounted present value.

The following table represents the consolidated statements of condition classification of the Bank's ROU assets and lease liabilities. The Bank elected not to include short-term leases (i.e., leases with initial terms of twelve months or less) on the consolidated statements of condition.

(in thousands)		June 30, 2019
<b>Operating Leases</b>		
	<b>Classification</b>	
Lease right-of-use assets	Accrued Int Rec & Other Assets	\$ 1,137
Lease liabilities	Accrued Int Payable & Other Liabilities	1,145
<b>Financing Leases</b>		
Lease right-of-use assets	Bank Premises & Equip	\$ 42
Lease liabilities	Accrued Int Payable & Other Liabilities	42

The following table represents lease costs for the six months ended June 30, 2019:

(in thousands)	June 30, 2019
<b>Lease Costs</b>	
Operating lease cost	\$ 252
Financing lease cost	
Interest on lease liabilities	1
Amortization of right-of-use assets	8
Sublease income	(172)
<b>Net lease cost</b>	<u>\$ 89</u>

(in thousands)	June 30, 2019
<b>Other Information</b>	
<b>Cash paid for amounts included in the measurement of lease liabilities:</b>	
Operating cash flows from operating leases	\$ 244
Operating cash flows from finance leases	1
Financing cash flows from finance leases	8

	<u>June 30, 2019</u>
<b>Weighted-average remaining lease term</b>	
Operating leases	4.0 years
Financing leases	3.3 years
<b>Weighted-average discount rate</b>	
Operating leases	2.85%
Financing leases	2.87%

Rent expense for the six months ended June 30, 2018 was \$236,000.

Future minimum payments for finance leases and operating leases as of June 30, 2019 were as follows:

(in thousands)

<b>Twelve Months Ended:</b>	<b>Operating Leases</b>	<b>Financing Leases</b>
June 30, 2020	\$ 446	\$ 15
June 30, 2021	237	14
June 30, 2022	160	13
June 30, 2023	165	4
June 30, 2024	170	2
Thereafter	29	-
<b>Total Future Minimum Lease Payments</b>	<u>1,207</u>	<u>48</u>
Amounts Representing Interest	(70)	(2)
<b>Present Value of Net Future Minimum Lease Payments</b>	<u>\$ 1,137</u>	<u>\$ 46</u>

## 9. OTHER EXPENSES

Other expenses consisted of the following:

(in thousands)	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2019</u>	<u>June 30, 2018</u>	<u>June 30, 2019</u>	<u>June 30, 2018</u>
Data processing	\$ 350	\$ 380	\$ 682	\$ 711
Professional fees	210	127	344	282
Director fees and expenses	114	127	243	244
Nasdaq listing and regulatory license expense	37	32	73	69
Advertising and promotion	140	184	341	404
Deposit and other insurance premiums	95	73	173	119
Telephone and postage	21	22	38	42
Other expenses	291	147	496	338
	<u>\$ 1,258</u>	<u>\$ 1,092</u>	<u>\$ 2,390</u>	<u>\$ 2,209</u>

## 10. SUBSEQUENT EVENT

### **Dividend**

On July 22, 2019, the Board of Directors declared a \$0.12 per common share cash dividend to shareholders of record at the close of business on August 16, 2019, to be paid on August 23, 2019.

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

The following discussion provides additional information about the financial condition of the Bank at June 30, 2019 and December 31, 2018, and results of operations for the three and six months ended June 30, 2019 and 2018. The following analysis should be read in conjunction with the consolidated financial statements of the Bank and the notes thereto appearing elsewhere in the report, which were prepared in accordance with U.S. Generally Accepted Accounting Principles. The interim financial information provided as of and for the three and six months ended June 30, 2019 and 2018 are unaudited. In the opinion of management of the Bank, the interim financial information presented reflects all adjustments (consisting solely of normal recurring accruals) considered necessary for a fair representation of the results of such periods.

All references to yields, cost of liabilities and net interest margin are annualized for the periods discussed.

**Forward Looking Statements.** This discussion includes forward-looking statements within the meaning of the “safe harbor” provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are based on the current beliefs of the Bank management as well as assumptions made by and information currently available to the Bank’s management. When used in this discussion, the words “anticipate,” “believe,” “estimate,” “expect,” “should,” “intend,” “project,” “may,” “will,” “would,” variations of such words and words or phrases of similar meaning constitute forward-looking statements. Although the Bank believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to have been correct.

These forward-looking statements relate to, among other things, expectations regarding the business environment in which the Bank operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Bank’s mission and vision. Factors which may cause actual results to vary from forward-looking statements include, but are not limited to, changes in interest rates, general economic and business conditions, changes in business strategy or development plans, changes in credit quality, the availability of capital to fund the expansion of our business, legislative and regulatory changes, government monetary and fiscal policies, real estate valuations, competition in the financial services industry, demographic changes, civil disturbances or terrorist threats or acts, or apprehension about the possible future occurrences of acts of this type, outbreak or escalation of hostilities in which the United States is involved, any declaration of war by the U.S. Congress or any other national or international calamity, crisis or emergency, and other risks referenced in this discussion.

This discussion contains certain forward-looking information about us. All statements other than statements of historical fact are forward-looking statements. Such statements involve inherent risks and uncertainties, many of which are difficult to predict and are generally beyond our control. We caution readers that a number of important factors could cause actual results to differ materially from those expressed in, implied or projected by, such forward-looking statements. Risks and uncertainties include, but are not limited to:

- lower revenues than expected;
- credit quality deterioration which could cause an increase in the provision for credit losses;
- competitive pressure among depository institutions increases significantly;
- the cost of additional capital is more than expected;
- a change in the interest rate environment reduces interest margins;
- asset/liability repricing risks and liquidity risks;
- legislative or regulatory requirements or changes adversely affecting our business;
- changes in the securities markets;
- general economic conditions, either nationally or in the market areas in which we do or anticipate doing business, are less favorable than expected;
- potential weakness of real estate collateral values;

- the economic and regulatory effects of the continuing war on terrorism and other events of war, including the wars in Iraq and Afghanistan;
- our ability to complete any future acquisitions, to successfully integrate acquired entities, or to achieve expected synergies and operating efficiencies within expected time-frames or at all;
- the integration of any future acquired businesses costs more, takes longer or is less successful than expected; and
- regulatory approvals for announced or future acquisitions cannot be obtained on the terms expected or on the anticipated schedule.

Also, other important factors that could cause actual results to differ materially from the Bank's expectations are disclosed under Item 1A. "RISK FACTORS," in our Annual Report on Form 10-K on file with the Federal Deposit Insurance Corporation ("FDIC") and below under this "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – *Critical Accounting Policies*" and elsewhere in this report.

If any of these risks or uncertainties materializes, or if any of the assumptions underlying such forward-looking statements proves to be incorrect, our results could differ materially from those expressed in, implied or projected by, such forward-looking statements. We assume no obligation to update such forward-looking statements.

We caution that these statements are further qualified by important factors, in addition to those under "Risk Factors" in our Annual Report on Form 10-K and elsewhere in this report, which could cause actual results to differ significantly from those in the forward-looking statements, including, among other things, economic conditions and other risks.

Forward-looking statements are not guarantees of performance. By their nature, they involve risks, uncertainties and assumptions. Our future results and shareholder values may differ significantly from those expressed in these forward-looking statements. You are cautioned not to put undue reliance on any forward-looking statement. Any such statement speaks only as of the date of this discussion, regardless of the time of delivery of this document. We do not undertake any obligation to update or release any revisions to any forward-looking statements, to report any new information, future event or other circumstances after the date of this filing or to reflect the occurrence of unanticipated events, except as required by law. However, your attention is directed to any further disclosures made on related subjects in any subsequent reports we may file with the FDIC, including on Forms 10-K, 10-Q and 8-K.

***Government and Regulatory Oversight.*** The Bank is subject to regulatory oversight by the Department of Business Oversight (DBO) from the state of California and the Federal Deposit Insurance Corporation (FDIC). These regulatory bodies periodically perform financial examinations of the Bank. There is a potential that an examination may derive different estimates than those reached by management and could require material adjustments or restatements.

***Critical Accounting Policies.*** The discussion and analysis of the Bank's consolidated results of operations and financial condition are based upon consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires the Bank's management to make estimates and judgments that affect the reported amounts of assets and liabilities, income and expense, and the related disclosures of contingent assets and liabilities at the date of these financial statements.

The Bank believes these estimates and assumptions to be reasonably accurate; however, actual results may differ from these estimates under different assumptions or circumstances. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, consideration of goodwill impairment and consideration of potential other than temporary impairment on investment securities.

***Allowance for Loan Losses.*** The allowance for loan losses is determined first and foremost by promptly identifying potential credit weaknesses that could jeopardize repayment. The Bank's process for evaluating the adequacy of the allowance for loan losses includes determining estimated loss percentages for each credit based on the Bank's historical loss experience and other factors in the Bank's credit grading system and accompanying risk analysis for determining an adequate level of the allowance. The risks are assessed by rating each account based upon paying habits, loan to collateral value ratio, financial condition and level of classifications. The allowance for loan losses was \$6,328,000 at June 30, 2019 compared to \$6,029,000 at December 31, 2018.

The Bank maintains the allowance for loan losses to provide for probable incurred losses in the loan portfolio. Additions to the allowance for loan losses are established through a provision charged to expense. All loans which are judged to be uncollectible are charged against the allowance while any recoveries are credited to the allowance. The

Bank's policy is to charge off any known losses at the time of determination. Any unsecured loan more than 90 days delinquent in payment of principal or interest and not in the process of collection is charged off in total. Secured loans are evaluated on a case by case basis to determine the ultimate loss potential to the Bank subsequent to the liquidation of collateral. In those cases where management believes the Bank is inadequately protected, a charge-off will generally be made to reduce the loan balance to a level equal to the liquidation value of the collateral unless management believes the collateral deficiency may be overcome by borrower cash flows.

The Bank's loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable the Bank to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. The Bank conducts an assessment of the allowance on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors will examine and formally approve the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and any recent regulatory examination, estimated potential loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and nonaccrual loans, trends in loan volume, effects of any changes in lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level and historical losses and recoveries.

**Goodwill.** Management assesses the carrying value of the Bank's goodwill at least annually in order to determine if this intangible asset is impaired. In reviewing the carrying value of the Bank's goodwill, management assesses the recoverability of such assets by evaluating the fair value of the related business unit. If the carrying amount of goodwill exceeds its fair value, an impairment loss is recognized for the amount of the excess and the carrying value of goodwill is reduced accordingly. Any impairment would be required to be recorded during the period identified.

Accounting standards require an annual evaluation of goodwill for impairment using various estimates and assumptions. The fair value of the Bank's common stock at the close of business on June 28, 2019 was \$11.00 per common share compared to a book value of \$10.67 per common share.

**Investment Securities.** Management assesses at each reporting date whether there is an "other-than-temporary" impairment to the Bank's investment securities. Such impairment, if related to credit losses, must be recognized in current earnings rather than in other comprehensive income or loss, net of tax. All individual securities that are in an unrealized loss position at each reporting date are examined for other-than-temporary impairment (OTTI). Specific investment level factors examined to assess impairment include the severity and duration of the unrealized loss, the nature, financial condition and results of operations of the issuers of the securities and whether there has been any cause for default on the securities or any adverse change in the rating of the securities by the various rating agencies, as well as whether the decline in value is credit or liquidity related. Additionally, the Bank's financial resources and overall intent and ability to hold the securities until their fair values recover is determined. There was no OTTI recorded in 2019 or 2018. Investment securities are discussed in more detail under "Investment Portfolio."

**Application of New Accounting Guidance.** In February of 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This Update was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases. For public companies, the amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Lease commitments will be reflected on the balance sheet as lease assets and lease liabilities. The Bank adopted this standard in January 2019.

In June of 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments are intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users to better understand significant estimates

and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting guidance for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. In 2018 the Bank began running the Advanced Risk Consulting Expected Loss Model (ARC ELM) parallel to the current "incurred loss" model. The ARC ELM meets the "current expected credit loss" ("CECL") model standard by projecting expected net losses for loan pools with similar default risks over the lives of the loans under a defined set of short-term and long-term economic variables. The model further uses actual historical nonaccrual rates, gross charge-off rates and recovery rates that are modeled against key economic variables. The Bank began conducting formal tests of the ARC ELM model results against the existing incurred loss model in the first quarter of 2019. Test results for the first two quarters have calculated an aggregate expected net loss CECL Allowance that is within a reasonable level below the existing Allowance for Loan and Lease Losses (ALLL). At the end of the test period (year-end 2019) the model will be live and the impact the new standard will have on our consolidated financial statements will be provided at that time.

In March 2017, the FASB issued ASU No. 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities*. Under current GAAP, entities normally amortize the premium as an adjustment of yield over the contractual life of the instrument. This guidance shortens the amortization period for certain callable debt securities held at a premium to the earliest call date. This update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of this ASU did not have a material impact on the Bank's consolidated financial statements.

In January of 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The amendments are intended to simplify the subsequent measurement of goodwill, and the amendments eliminate Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax-deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The amendments should be applied on a prospective basis. The nature of and reason for the change in accounting principle should be disclosed upon transition. The amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Management does not anticipate any significant impact from the new standard on our consolidated financial statements.

In April 2019, the FASB issued ASU No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments - Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*. With respect to Topic 815, Derivatives and Hedging, ASU 2019-04 clarifies that the reclassification of a debt security from held-to-maturity ("HTM") to available-for-sale ("AFS") under the transition guidance in ASU 2017-12 would not (1) call into question the classification of other HTM securities, (2) be required to actually designate any reclassified security in a last-of-layer hedge, or (3) be restricted from selling any reclassified security. As part of the transition of ASU 2019-04, entities may reclassify securities that would qualify for designation as the hedged item in a last-of-layer hedging relationship from HTM to AFS; however, entities that already made such a reclassification upon their adoption of ASU 2017-12 are precluded from reclassifying additional securities. Management is in the process of evaluating the impact of this standard in connection with its adoption of ASU 2016-13.

In May 2019, the FASB issued ASU No. 2019-05, *Financial Instruments - Credit Losses (Topic 326); Targeted Transition Relief*. This ASU allows entities to irrevocably elect, upon adoption of ASU 2016-13, the fair value option on financial instruments that (1) were previously recorded at amortized cost and (2) are within the scope of ASC 326-20 if the instruments are eligible for the fair value option under ASC 825-10. The fair value option election does not apply to held-to-maturity debt securities. Entities are required to make this election on an instrument-by-instrument basis. ASU 2019-05 has the same effective date as ASU 2016-13 (i.e., the first quarter of 2020). Management does not anticipate any potential impact from the new standard on our consolidated financial statements.



**Financial Summary**  
(Dollars in thousands except per share data)

	At or for the Three Months Ended		At or for the Six Months Ended	
	June 30, 2019 (Unaudited)	June 30, 2018 (Unaudited)	June 30, 2019 (Unaudited)	June 30, 2018 (Unaudited)
<b>Statement of Income Data:</b>				
Net interest income	\$ 5,499	\$ 5,240	\$ 11,046	\$ 10,554
Provision for loan losses	180	150	280	300
Non-interest income	340	542	833	1,304
Non-interest expense	3,995	3,557	8,207	7,098
Provision for income taxes	492	614	795	1,259
Net income	<u>\$ 1,172</u>	<u>\$ 1,461</u>	<u>\$ 2,597</u>	<u>\$ 3,201</u>
<b>Selected per Common Share Data:</b>				
Basic earnings per common share	\$ 0.19	\$ 0.24	\$ 0.43	\$ 0.53
Diluted earnings per common share	\$ 0.19	\$ 0.24	\$ 0.43	\$ 0.53
Dividend per share	\$ 0.12	\$ 0.12	\$ 0.24	\$ 0.24
Book value per common share (2)	\$ 10.67	\$ 9.92	\$ 10.67	\$ 9.92
<b>Selected Balance Sheet Data:</b>				
Assets	\$ 635,622	\$ 585,950	\$ 635,622	\$ 585,950
Loans, net	536,674	463,856	536,674	463,856
Deposits	532,257	517,318	532,257	517,318
Average assets	622,883	580,611	625,393	579,366
Average earning assets	606,280	568,851	609,179	568,100
Average shareholders' equity	63,855	59,866	63,126	59,814
Nonperforming loans	715	2,606	715	2,606
Total nonperforming assets	715	2,606	715	2,606
Troubled debt restructures (accruing)	2,449	1,591	2,449	1,591
<b>Selected Ratios:</b>				
Return on average assets (1)	0.75%	1.01%	0.84%	1.11%
Return on average common shareholders' equity (1)	7.36%	9.79%	8.30%	10.79%
Efficiency ratio (3)	68.34%	61.61%	69.05%	59.94%
Net interest margin (1)	3.64%	3.69%	3.66%	3.75%
Common equity tier 1 capital ratio	10.7%	11.3%	10.7%	11.3%
Tier 1 capital ratio	10.7%	11.3%	10.7%	11.3%
Total capital ratio	13.0%	12.5%	13.0%	12.5%
Tier 1 leverage ratio	9.5%	10.0%	9.5%	10.0%
Common dividend payout ratio (4)	62.12%	49.83%	56.06%	45.49%
Average shareholders' equity to average assets	10.25%	10.31%	10.09%	10.32%
Nonperforming loans to total loans	0.13%	0.55%	0.13%	0.55%
Nonperforming assets to total assets	0.11%	0.44%	0.11%	0.44%
Allowance for loan losses to total loans	1.17%	1.23%	1.17%	1.23%
Allowance for loan losses to nonperforming loans	885.39%	221.60%	885.39%	221.60%

(1) Annualized.

(2) Total shareholders' equity divided by total common shares outstanding.

(3) Non-interest expenses to net interest and non-interest income, net of securities gains and loss

(4) Common dividends divided by net income available for common shareholders.

## Results of Operations

### *Three and six months ended June 30, 2019 and June 30, 2018*

The Bank's primary source of income is net interest income, which is the difference between interest income and fees derived from earning assets and interest paid on liabilities which fund those assets. Net interest income, expressed as a percentage of total average interest earning assets, is referred to as the net interest margin. The Bank's net interest income is affected by changes in the volume and mix of interest earning assets and interest-bearing liabilities. It is also affected by changes in yields earned on interest earning assets and rates paid on interest bearing deposits and other borrowed funds. The Bank also generates non-interest income, including transactional fees, service charges, office lease income and gains and losses on loans and investment securities. Non-interest expenses consist primarily of employee compensation and benefits, occupancy and equipment expenses and other operating expenses. The Bank's results of operations are also affected by its provision for loan losses. Results of operations may also be significantly affected by other factors including general economic and competitive conditions, mergers and acquisitions of other financial institutions within the Bank's market area, changes in market interest rates, government policies, and actions of regulatory agencies.

## Net Income

A summary of the net income and annualized ratios are as follows:

(Dollars in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2019	June 30, 2018	Change	June 30, 2019	June 30, 2018	Change
Net income	\$ 1,172	\$ 1,461	\$ (289)	\$ 2,597	\$ 3,201	\$ (604)
Earnings per diluted share	\$ 0.19	\$ 0.24	\$ (0.05)	\$ 0.43	\$ 0.53	\$ (0.10)
Annualized return on average assets	0.75%	1.01%	(0.26)%	0.84%	1.11%	(0.27)%
Annualized return on average common shareholders' equity	7.36%	9.79%	(2.43)%	8.30%	10.79%	(2.49)%

## Net Interest Income and Net Interest Margin

Net interest income increased \$259,000 or 5% to \$5,499,000 for the second quarter of 2019 compared to \$5,240,000 for the same quarter of 2018. The annualized net interest margin was 3.64% for the second quarter of 2019, compared to 3.69% for the same period of 2018.

Average earning assets increased 7% to \$606,280,000 for the second quarter of 2019, as compared to \$568,851,000 for the same quarter of 2018. The annualized yield on average earning assets was 4.76% and the annualized cost of average interest-bearing liabilities was 1.56% for the second quarter of 2019, as compared to the annualized yield on average earning assets of 4.31% and annualized cost of interest-bearing liabilities of 0.90% for the same quarter of 2018.

Net interest income increased \$492,000 or 5% to \$11,046,000 for the six months ended June 30, 2019 compared to \$10,554,000 for the same period of 2019. The annualized net interest margin was 3.66% for the first six months of 2018, compared to 3.75% for the same period of 2018.

Average earning assets increased 7% to \$609,179,000 for the first six months of 2019, as compared to \$568,100,000 for the same period of 2018. The annualized yield on average earning assets was 4.76% and the annualized cost of average interest-bearing liabilities was 1.53% for the first six months of 2019, as compared to the annualized yield on average earning assets of 4.32% and annualized cost of interest-bearing liabilities of 0.84% for the same period of 2018.

The increase in net interest income for the quarter was attributable to higher volume of average earning assets and higher average yields on those assets increased more than the increase in interest-bearing liabilities and the cost of interest-bearing liabilities for the second quarter.

The following table presents condensed average balance sheet information for the Bank, together with interest rates earned and paid on the various sources and uses of its funds for each of the periods presented. Average balances are based on daily average balances. Nonaccrual loans are included in loans with any interest collected reflected on a cash basis.

	Three Months Ended June 30, 2019			Three Months Ended June 30, 2018		
	Average Balance	Interest Income/ Expense	Average Rate (4)	Average Balance	Interest Income/ Expense	Average Rate (4)
(Dollars in thousands)						
<b>Assets</b>						
Interest earning assets:						
Federal funds sold	\$ -	\$ -	0.00%	\$ 1,451	\$ 8	2.16%
Interest-bearing deposits with banks	5,125	32	2.50%	16,428	58	1.42%
Taxable investment securities	70,327	476	2.71%	81,697	601	2.95%
Dividends on FHLB Stock	3,277	53	6.49%	3,085	53	6.92%
Loans, net of unearned income (1)	527,551	6,630	5.04%	466,190	5,399	4.65%
Total earning assets/interest income	<u>606,280</u>	<u>7,191</u>	<u>4.76%</u>	<u>568,851</u>	<u>6,119</u>	<u>4.31%</u>
Non-earning assets	22,815			17,449		
Allowance for loan losses	(6,212)			(5,689)		
Total assets	<u>\$ 622,883</u>			<u>\$ 580,611</u>		
<b>Liabilities and Shareholders' Equity</b>						
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand deposits	\$ 64,682	\$ 21	0.13%	\$ 74,708	\$ 20	0.11%
Savings and money market	126,059	258	0.82%	137,098	219	0.64%
Time deposits	227,575	1,302	2.29%	165,381	579	1.41%
FHLB advances	17,476	111	2.55%	12,880	61	1.90%
Subordinated Debt	64	-	0.00%	-	-	0.00%
Total interest-bearing liabilities/interest expense	<u>435,856</u>	<u>1,692</u>	<u>1.56%</u>	<u>390,067</u>	<u>879</u>	<u>0.90%</u>
Non interest-bearing deposits	120,078			129,089		
Other liabilities	3,094			1,589		
Total liabilities	<u>559,028</u>			<u>520,745</u>		
Shareholders' equity	63,855			59,866		
Total liabilities and shareholders' equity	<u>\$ 622,883</u>			<u>\$ 580,611</u>		
Net interest income and margin (2)		<u>\$ 5,499</u>	3.64%		<u>\$ 5,240</u>	3.69%
Net interest spread (3)			3.20%			3.41%

- (1) The net amortization of deferred fees and (costs) on loans included in interest income was \$(109,000) and \$(87,000) for the three months ended June 30, 2019 and 2018.
- (2) Net interest margin is computed by dividing net interest income by average total earning assets.
- (3) Net interest spread is the difference between the average rate earned on average total earning assets and the average rate paid on average total interest-bearing liabilities.
- (4) Annualized.

	Six Months Ended June 30, 2019			Six Months Ended June 30, 2018		
	Average Balance	Interest Income/ Expense	Average Rate (4)	Average Balance	Interest Income/ Expense	Average Rate (4)
(Dollars in thousands)						
<b>Assets</b>						
Interest earning assets:						
Federal funds sold	\$ -	\$ -	0.00%	\$ 1,724	\$ 14	1.69%
Interest-bearing deposits with banks	11,169	133	2.40%	18,709	126	1.35%
Taxable investment securities	74,178	1,066	2.90%	83,505	1,215	2.93%
Dividends on FHLB stock	3,181	108	6.85%	3,085	108	7.04%
Loans, net of unearned income (1)	520,651	13,081	5.07%	461,077	10,709	4.68%
Total earning assets/interest income	<u>609,179</u>	<u>14,388</u>	4.76%	<u>568,100</u>	<u>12,172</u>	4.32%
Non-earning assets	22,365			16,773		
Allowance for loan losses	(6,151)			(5,507)		
Total assets	<u><u>\$ 625,393</u></u>			<u><u>\$ 579,366</u></u>		
<b>Liabilities and Shareholders' Equity</b>						
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand deposits	\$ 64,643	\$ 41	0.13%	\$ 73,928	42	0.11%
Savings and money market	129,148	508	0.79%	138,411	412	0.60%
Time deposits	223,522	2,503	2.26%	164,050	1,072	1.32%
FHLB advances	22,953	290	2.55%	11,262	92	1.65%
Subordinated Debt	32	-	0.00%	-	-	0.00%
Total interest-bearing liabilities/interest expense	<u>440,298</u>	<u>3,342</u>	1.53%	<u>387,651</u>	<u>1,618</u>	0.84%
Non interest-bearing deposits	118,959			130,200		
Other liabilities	3,010			1,701		
Total liabilities	<u>562,267</u>			<u>519,552</u>		
Shareholders' equity	63,126			59,814		
Total liabilities and shareholders' equity	<u><u>\$ 625,393</u></u>			<u><u>\$ 579,366</u></u>		
Net interest income and margin (2)		<u>\$ 11,046</u>	3.66%		<u>\$ 10,554</u>	3.75%
Net interest spread (3)			3.23%			3.48%

- (1) The net amortization of deferred fees and (costs) on loans included in interest income was \$(128,000) and \$(66,000) for the six months ended June 30, 2019 and 2018.
- (2) Net interest margin is computed by dividing net interest income by average total earning assets.
- (3) Net interest spread is the difference between the average rate earned on average total earning assets and the average rate paid on average total interest bearing liabilities.
- (4) Annualized.

The following tables show the change in interest income and interest expense and the amount of change attributable to variances in volume and rates. The unallocated change in rate or volume variance has been allocated between the rate and volume variances in proportion to the absolute dollar amount of the change of each.

Volume and Yield/Rate Variances			
2019 Compared to 2018 for the Three Months Ended			
June 30			
Change Due to			
(Dollars in thousands)	Net	Volume	Yield/Rate
<b>Interest income:</b>			
Federal funds sold	\$ (8)	\$ (8)	\$ -
Interest-bearing deposits with banks	(26)	(25)	(1)
Taxable investment securities	(125)	(88)	(37)
Dividends on FHLB stock	-	3	(3)
Loans, net	1,231	747	484
Total interest income	<u>1,072</u>	<u>629</u>	<u>443</u>
<b>Interest expense:</b>			
Interest-bearing demand deposits	\$ 1	\$ (2)	\$ 3
Savings and money market	39	(17)	56
Time deposits	723	269	454
FHLB advances	50	26	24
Total interest expense	<u>813</u>	<u>276</u>	<u>537</u>
Increase (decrease) in net interest income	<u>\$ 259</u>	<u>\$ 353</u>	<u>\$ (94)</u>

Volume and Yield/Rate Variances			
2019 Compared to 2018 for the Six Months Ended			
June 30			
Change Due to			
(Dollars in thousands)	Net	Volume	Yield/Rate
<b>Interest income:</b>			
Federal funds sold	\$ (14)	\$ (14)	\$ -
Interest-bearing deposits with banks	7	(37)	44
Taxable investment securities	(149)	(137)	(12)
Dividends on FHLB stock	-	3	(3)
Loans, net	2,372	1,453	919
Total interest income	<u>2,216</u>	<u>1,268</u>	<u>948</u>
<b>Interest expense:</b>			
Interest-bearing demand deposits	\$ (1)	\$ (4)	\$ 3
Savings and money market	96	(26)	122
Time deposits	1,431	482	949
FHLB advances	198	130	68
Total interest expense	<u>1,724</u>	<u>582</u>	<u>1,142</u>
Increase (decrease) in net interest income	<u>\$ 492</u>	<u>\$ 686</u>	<u>\$ (194)</u>

## Provision for Loan Losses

The Bank maintains an allowance for loan losses for probable incurred losses that are expected as an incidental part of the banking business. Write-offs of loans are charged against the allowance for loan losses, which is adjusted periodically to reflect changes in the volume of outstanding loans and estimated losses due to changes in the financial condition of borrowers or the value of property securing nonperforming loans, or changes in general economic conditions and other qualitative factors. Additions to the allowance for loan losses are made through a charge against income referred to as the “provision for loan losses” or recoveries of previous write-offs.

The Bank’s loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable management to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. Management conducts an assessment of the allowance for loan losses on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors evaluates and formally approves the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and regulatory examination, estimated probable loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and nonaccrual loans, trends in loan volume, effects of any changes in the lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level, and a migration analysis of historical losses and recoveries for the prior twelve quarters.

There was a provision for loan losses for the three and six months ended June 30, 2019 of \$180,000 and \$280,000 compared to \$150,000 and \$300,000 for the three and six months ended June 30, 2018. The nonperforming loans to total loans ratio declined to 0.13% at June 30, 2019 compared to 0.55% at June 30, 2018. The nonperforming loans were primarily secured by real estate with minimal loss prospects. There were net recoveries of \$9,000 and \$19,000 during the three and six months ended June 30, 2019, compared to net recoveries of \$35,000 and \$239,000 for the three and six months ended June 30, 2018. See Balance Sheet Activity – Nonperforming Assets and Allowance for Loan Losses for additional discussion.

Future provisions for loan losses are dependent on asset quality trends, loan portfolio growth and the general condition of the economy. As a significant portion of the Bank’s loan portfolio is collateralized by real estate, the valuation of the underlying collateral can have a significant impact on the adequacy of the allowance for loan losses and specific allocations for impaired loans, which may require future loan loss provisions.

## Non-interest Income

The following are the sources of non-interest income for the periods indicated:

(in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2019	June 30, 2018	Change	June 30, 2019	June 30, 2018	Change
Service charges on deposit accounts	\$ 219	\$ 194	\$ 25	\$ 409	\$ 387	\$ 22
Rental income	81	149	(68)	172	296	(124)
Net gain on loan sales	-	155	(155)	167	447	(280)
Net securities gains (losses)	(7)	9	(16)	(7)	16	(23)
Other income	47	35	12	92	158	(66)
Total non-interest income	<u>\$ 340</u>	<u>\$ 542</u>	<u>\$ (202)</u>	<u>\$ 833</u>	<u>\$ 1,304</u>	<u>\$ (471)</u>

Rental income decreased in the 2019 period due to one of three leases not being renewed to allow the Bank to take over the additional space. The net gains on loan sales for the six months ended June 30, 2019 were from the sale of SBA guaranteed loans. There were no loan sales for the three months ended June 30, 2019.

## Non-interest Expense

The following are the sources of non-interest expense for the periods indicated:

(in thousands)	Three Months Ended			Six Months Ended		
	June 30, 2019	June 30, 2018	Change	June 30, 2019	June 30, 2018	Change
Salaries and employee benefits	\$ 2,303	\$ 2,078	\$ 225	\$ 4,960	\$ 4,105	\$ 855
Occupancy and equipment	434	387	47	857	784	73
Other expenses	1,258	1,092	166	2,390	2,209	181
Total non-interest expense	<u>\$ 3,995</u>	<u>\$ 3,557</u>	<u>\$ 438</u>	<u>\$ 8,207</u>	<u>\$ 7,098</u>	<u>\$ 1,109</u>

Non-interest operating expenses increased \$438,000 and \$1,109,000 between the second quarters and the six month periods of 2019 and 2018, respectively, due to increased employee levels in a strategic move to promote loan growth. These additional employees increased the personnel expense between 2019 and 2018. Occupancy expense increased due to the remodel and office furniture purchased at Bicentennial to accommodate the additional employees. The difference in other expenses was due to normal fluctuations incurred during the periods.

## Provision for Income Taxes

The Bank accrues income tax expense based on the anticipated annual tax rates during the financial period covered. The provision for income taxes for Federal and State corporate income tax and effective rates for the three and six months ended June 30, 2019 was \$492,000 (29.6%) and \$795,000 (23.4%) compared to \$614,000 (29.6%) and \$1,259,000 (28.2%) for the same periods in 2018. The decline in the effective tax rates in 2019 was due to a one-time tax benefits recorded from the installation of solar panels.

## Balance Sheet Activity

### At June 30, 2019 and December 31, 2018

## Investment Portfolio

Securities classified as available-for-sale for accounting purposes are recorded at their fair value on the consolidated balance sheets. Available-for-sale (AFS) investment securities carried at fair value totaled \$59,853,000 at June 30, 2019 and comprised 9.4% of total assets. At June 30, 2019, the Bank had investment securities classified as held-to-maturity, carried at cost of \$7,995,000 with a fair value of \$7,902,000 and represented 1.3% of total assets. At December 31, 2018, investment securities comprised 12.5% of total assets with AFS investments at a fair value of \$70,174,000 and amortized cost of \$72,716,000. Held-to-maturity investments at December 31, 2018 were carried at amortized cost of \$7,991,000 and had a fair value of \$7,612,000. Changes in the fair value of AFS securities (e.g., unrealized holding gains or losses) are reported as "other comprehensive income (loss)," net of tax, and carried as accumulated other comprehensive income or loss, net of tax, within shareholders' equity until realized, unless any declines in value below amortized cost are the result of other than temporary impairment. The held-to-maturity investments are government agency callable securities with step-up interest rates.

There were no bonds purchased during the six months ended June 30, 2019, \$1,083,000 in bonds called or matured and \$8,895,000 in bonds sold. For the six months ended June 30, 2018, there were no bonds purchased, \$3,966,000 in bonds were called or matured and no bonds sold. There were net losses of \$2,000 on the called bonds and net losses of \$5,000 for the six months ended June 30, 2019. There were net gains of \$16,000 on the called bonds for the six months ended June 30, 2018.

The Bank utilizes the investment portfolio to manage liquidity and attract funding that requires collateralization. At June 30, 2019, investment securities with a fair value of \$28,032,000 were pledged to secure time deposits from the State of California and other public deposits and represented 41% of the investment portfolio. At December 31, 2018, investment securities with a fair value of \$36,514,000, or 47% of the investment portfolio, were pledged. At June 30, 2019 investment securities with a fair value of \$49,822,000 were callable within one year.

The Bank does not own securities of any single issuer (other than U.S. Government agencies) whose aggregate book value was in excess of 10% of the Bank's total shareholders' equity at the time of purchase.

## Loan Portfolio

The following table shows the composition of the loan portfolio by amount, percentage of total loans for each major loan category and the dollar volume and percentage change between the dates indicated.

(in thousands)	<u>June 30, 2019</u>	<u>%</u>	<u>December 31, 2018</u>	<u>%</u>	<u>Net Change</u>	<u>Percent Change</u>
Commercial & agricultural (1)	\$ 131,103	24.1%	\$ 107,910	21.1%	\$ 23,193	21.5%
Real estate - commercial	286,350	52.7%	287,841	56.4%	(1,491)	(0.5)%
Real estate - construction and land	34,257	6.3%	24,330	4.8%	9,927	40.8%
Real estate - single family	56,620	10.4%	56,648	11.1%	(28)	0.0%
Real estate - multifamily	34,591	6.4%	33,623	6.6%	968	2.9%
Consumer & lease financing	81	-	226	0.0%	(145)	(64.2)%
	<u>543,002</u>	<u>100%</u>	<u>510,578</u>	<u>100%</u>	<u>32,424</u>	<u>6.4%</u>
<u>LESS:</u>						
Allowance for Loan Losses	(6,328)		(6,029)		(299)	5.0%
Total Loans, Net	<u>\$ 536,674</u>		<u>\$ 504,549</u>		<u>\$ 32,125</u>	<u>6.4%</u>

(1) Includes loans secured by farmland.

Gross loans increased \$32,424,000 (6.4%) to \$543,002,000 at June 30, 2019 from December 31, 2018. The increase was predominantly in the construction and land real estate secured and commercial and agricultural loan categories.

At June 30, 2019, the Bank had approximately \$87,689,000 in undisbursed loan commitments, of which approximately \$35,686,000 were commercial and agricultural and \$51,979,000 related to real estate loan types. At December 31, 2018, the Bank had approximately \$85,304,000 in undisbursed loan commitments, of which approximately \$36,815,000 were commercial and agricultural and \$46,661,000 related to real estate loan types.

## Nonperforming Assets

Nonperforming assets consist of nonperforming loans and other real estate owned. Nonperforming loans are those for which the borrower fails to perform under the terms of the obligation and consist of nonaccrual loans and accruing loans past due 90 days or more.



The following are the nonperforming assets for the respective periods:

(in thousands)	June 30, 2019	December 31, 2018
Nonaccrual loans	\$ 715	\$ 2,124
Accruing loans past due 90 days or more	-	-
Total nonperforming loans	715	2,124
Other real estate owned	-	-
Total nonperforming assets	<u>\$ 715</u>	<u>\$ 2,124</u>
Nonperforming loans to total loans	0.13%	0.42%
Nonperforming assets to total assets	0.11%	0.34%
Allowance for loan losses to nonperforming loans	885.39%	283.84%

The \$715,000 in nonaccrual loans consist of five loans and are primarily secured by real estate collateral. The nonperforming loans represent 0.11% of total assets at June 30, 2019.

Loans that are classified as TDRs were \$2,661,000 at June 30, 2019, of which \$2,449,000 were considered performing loans and \$353,000 are nonperforming loans and are included in the table above.

Loans that are classified as TDRs were \$3,370,000 at December 31, 2018, of which \$1,723,000 were considered performing loans and \$1,647,000 are nonperforming loans and are included in the table above.

There was no other real estate owned (OREO) at June 30, 2019 or December 31, 2018.

#### **Allowance for Loan Losses**

The Bank maintains the allowance for loan losses to provide for inherent losses in the loan portfolio. Additions to the allowance for loan losses are established through a provision for loan losses charged to expense. All loans which are judged to be uncollectible are charged against the allowance while any recoveries are credited to the allowance. The Bank's policy is to charge off any known losses at the time of determination. Any unsecured loan more than 90 days delinquent in payment of principal or interest and not in the process of collection is charged off in total. Secured loans are evaluated on a case by case basis to determine the ultimate loss potential to us subsequent to the liquidation of collateral. In those cases where we believe we are inadequately protected, a charge off will be made to reduce the loan balance to a level equal to the liquidation value of the collateral.

The Bank's loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable management to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. Management conducts an assessment of the allowance for loan losses on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors evaluates and formally approves the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and regulatory examination, estimated probable incurred loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and nonaccrual loans, trends in loan volume, effects of any changes in lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level and a migration analysis of historical losses and recoveries for the prior twelve quarters.

In addition to the allowance for loan losses, the Bank maintains a reserve for losses for undisbursed loan commitments which is reported in other liabilities on the consolidated balance sheets. This reserve was \$280,000 as of June 30, 2019 and \$244,000 as of December 31, 2018.

The following table summarizes the activity in the Allowance for Loan Losses during the periods indicated.

SUMMARY OF ACTIVITY IN ALLOWANCE FOR LOAN LOSSES

(Dollars in thousands)	Six Months Ended June 30, 2019	Year Ended December 31, 2018
Balance at beginning of period	\$ 6,029	\$ 5,236
Charge-offs:		
Commercial & agricultural	-	(28)
Real estate - commercial	-	-
Real estate - construction and land	-	-
Real estate - single family	-	-
Real estate - multifamily	-	-
Consumer & lease financing	-	-
Total loans charged-off	-	(28)
Recoveries:		
Commercial & agricultural	19	77
Real estate - commercial	-	-
Real estate - construction and land	-	-
Real estate - single family	-	191
Real estate - multifamily	-	-
Consumer & lease financing	-	23
Total recoveries	19	291
Net loans recovered	19	263
Provision for loan losses	280	530
Allowance for loan losses - end of period	\$ 6,328	\$ 6,029
Loans:		
Average loans outstanding during period, net of unearned income	\$ 527,551	\$ 473,922
Total loans at end of period, net of unearned income	\$ 543,002	\$ 510,578
Ratios:		
Net loans recovered to average net loans (1)	0.01%	0.06%
Net loans recovered to total loans (1)	0.01%	0.05%
Allowance for loan losses to average net loans	1.20%	1.27%
Allowance for loan losses to total loans	1.17%	1.18%
Net loans recovered to beginning allowance for loan losses (1)	0.64%	5.02%
Net loans recovered to provision for loan losses	6.79%	49.62%

(1) Annualized

## Allocation of Allowance for Loan Losses

(in thousands)	June 30, 2019		December 31, 2018	
	Allowance Allocation	Amount of Category Loans to Total Loans	Allowance Allocation	Amount of Category Loans to Total Loans
Commercial & agricultural	\$ 972	24.1%	\$ 904	21.1%
Real estate - commercial	2,745	52.7%	2,830	56.4%
Real estate - construction and land	952	6.3%	705	4.8%
Real estate - single family	758	10.4%	684	11.1%
Real estate - multifamily	320	6.4%	308	6.6%
Consumer & lease financing	2	0.0%	6	0.0%
Unallocated	579		592	
Total	<u>\$ 6,328</u>	<u>100%</u>	<u>\$ 6,029</u>	<u>100%</u>

The allowance allocation to real estate loan categories is highly dependent on the estimated real estate collateral values that secure specific troubled loans. The specific loans being evaluated at one period versus another can result in variations in the allocations. The increase in allowance allocated to Real estate - commercial, construction and land loans was attributable to the increase in the amount of loans in each category. The decline in allowance allocated to commercial and agricultural loans was due to the decline in loans with specific allocations.

Part of the allocation of the allowance for loan losses is based on other qualitative factors and is attributable to management's assessment of various qualitative factors. Qualitative factors included the size of individual credits, concentrations and general economic conditions. Management also considers these qualitative factors in their evaluation of the adequacy of the allowance for loan losses. An unallocated allowance can arise from fluctuations in the amount of classified and nonperforming loans ("changes in credit grades") between periods. The Internal Asset Review Committee reviews the amount and reasons for unallocated allowances and whether it has arisen due to periodic fluctuations in the credit grades or has arisen due to changes in qualitative factors or changes in lending strategies. If the unallocated allowance has arisen from other than periodic fluctuations in credit grades, then the Internal Asset Review Committee may determine that a portion of the allowance for loan losses should be reversed. Factors used in determining whether the unallocated allowance should be maintained includes the trend in impaired and classified loans, the projected increase in new loans and additional allowance that may be attributed to recoveries of previously charged-off loans.

The unallocated allowance represents temporary changes in allocations resulting from changes in loan volumes, types and quality, as well as other factors. Management assesses the unallocated amount to determine if the amount is due to other than temporary changes in these factors. The unallocated allowance relates to the trend in impaired and classified loans and additional allowance that may be attributed to recoveries of previously charged-off loans.

## Deposits

At June 30, 2019, the Bank had a deposit mix of 42% in time deposits, 23% in money market and savings accounts, and 35% in demand accounts. At December 31, 2018, the Bank had a deposit mix of 37% in time deposits, 26% in money market and savings accounts, and 37% in demand accounts.

At June 30, 2019 and December 31, 2018, the State of California had \$35,500,000 and \$48,500,000 respectively in time deposits with the Bank with maturities of up to 6 months and collateralized by investment securities and mortgage loans. These deposits are received through a program run by the Treasurer of the State of California to place public deposits with community banks. The interest rates are tied to the U.S. Treasury three or six month rate at the origination of the time deposit.

At June 30, 2019, the Bank had \$10,763,000 in wholesale brokered deposits compared to \$3,086,000 at December 31, 2018.

The Bank also obtains time deposits through an internet listing service. These deposits are primarily from other financial institutions. There were \$3,024,000 and \$3,921,000 of internet obtained deposits at June 30, 2019 and December 31, 2018, respectively.

### **Liquidity and Capital Resources**

Maintenance of adequate liquidity requires that sufficient resources be available at all times to meet cash flow requirements of the Bank. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of customers and to take advantage of investment opportunities as they arise. A bank may achieve desired liquidity from both assets and liabilities. Cash and deposits held in other banks, Federal funds sold, other short-term investments, maturing loans and investments, payments of principal and interest on loans and investments, and potential loan and investment securities sales are sources of asset liquidity. Deposit growth and access to credit lines established with correspondent banks, primarily with the FHLB, Federal Reserve and access to brokered certificates of deposit are sources of liability liquidity. The Bank reviews its liquidity position on a regular basis based upon its current position and expected trends of loans and deposits. Management believes that the Bank maintains adequate sources of liquidity to meet its liquidity needs.

The Bank is able to borrow from the Federal Reserve Discount Window by pledging investment securities or loans. The amount that is available is dependent on the value of the assets pledged, as of June 30, 2019 the value of the pledges are approximately \$10,000,000.

The Bank's liquid assets, defined as cash and cash equivalents, deposits with banks, Federal funds sold and the market value of unpledged available-for-sale investment securities, totaled \$62,964,000 and constituted 10% of total assets at June 30, 2019 compared to \$62,964,000 or 10% of total assets at December 31, 2018.

At June 30, 2019, the Bank had \$198,405,000 in borrowing lines of credit from the FHLB and correspondent banks with \$29,300,000 in outstanding advances from the FHLB, subject to certain collateral requirements. At December 31, 2018, these lines of credit available were \$178,573,000 with \$56,800,000 in FHLB advances outstanding.

Cash was primarily provided in the first six months of 2019 by \$36.8 million in certificate of deposits, \$4.2 million in call and maturities of investment securities, \$3.1 million in proceeds from sales of loans and \$2.6 million in net income. Cash was used in the first six months of 2019 to fund \$34.6 million in net changes to loans, payoff \$27.5 million in FHLB advances and \$5.8 million decrease in demand, savings and money market deposits.

Cash was primarily provided in the first six months of 2018 by \$6.8 million in additional borrowings from the FHLB, \$6 million from sales of SBA guaranteed loans and \$6.3 million from increased time deposits. Cash was used in the first six months of 2018 primarily to fund a \$31.5 million net change in loans, reduce long term FHLB borrowings by \$15 million and a reduction in transactional deposits of \$22.5 million.

Additional information on the Bank's cash flows can be reviewed in the *Consolidated Statement of Cash Flows* in Part I, Item 1 of this report.

The following table presents the capital ratios for Summit State Bank and the correspondent regulatory minimum requirements:

(in thousands)	June 30, 2019		December 31, 2018	
	Amount	Ratio	Amount	Ratio
<b>Common Equity Tier 1 Capital Ratio</b>				
Summit State Bank	\$ 60,004	10.7%	\$ 58,915	10.5%
Minimum requirement with capital conservation buffer (1)	\$ 39,188	7.0%	\$ 39,316	7.0%
Minimum requirement for "Well-Capitalized" institution	\$ 36,389	6.5%	\$ 36,508	6.5%
Minimum regulatory requirement	\$ 25,193	4.5%	\$ 25,275	4.5%
<b>Tier 1 Capital Ratio</b>				
Summit State Bank	\$ 60,004	10.7%	\$ 58,915	10.5%
Minimum requirement with capital conservation buffer (1)	\$ 47,586	8.5%	\$ 47,741	8.5%
Minimum requirement for "Well-Capitalized" institution	\$ 44,787	8.0%	\$ 44,933	8.0%
Minimum regulatory requirement	\$ 33,590	6.0%	\$ 33,700	6.0%
<b>Total Capital Ratio</b>				
Summit State Bank	\$ 72,526	13.0%	\$ 65,188	11.6%
Minimum requirement with capital conservation buffer (1)	\$ 58,783	10.5%	\$ 58,975	10.5%
Minimum requirement for "Well-Capitalized" institution	\$ 55,984	10.0%	\$ 56,166	10.0%
Minimum regulatory requirement	\$ 44,787	8.0%	\$ 44,933	8.0%
<b>Tier 1 Leverage Ratio</b>				
Summit State Bank	\$ 60,004	9.5%	\$ 58,915	9.9%
Minimum requirement for "Well-Capitalized" institution	\$ 31,559	5.0%	\$ 29,874	5.0%
Minimum regulatory requirement	\$ 25,247	4.0%	\$ 23,899	4.0%

(1) Includes 2.5% capital conservation buffer effective January 1, 2019.

The Bank's capital is supplemented through the retention of net income less dividends paid. The Bank's common dividend declared on July 22, 2019 is \$0.12 per share or \$728,000.

### Impact of Inflation

The primary impact of inflation on the Bank is its effect on interest rates. The Bank's primary source of income is net interest income, which is affected by changes in interest rates. The Bank attempts to limit the impact of inflation on its net interest margin through management of rate-sensitive assets and liabilities and analyses of interest rate sensitivity. The effect of inflation on premises and equipment as well as on non-interest expenses has not been significant for the periods presented.

### Item 3 Quantitative and Qualitative Disclosures about Market Risk

Proper management of the rate sensitivity and maturities of assets and liabilities is required to provide an optimum and stable net interest margin. Interest rate sensitivity spread management is an important tool for achieving this objective and for developing ways in which to improve profitability. Management has assessed its market risk at June 30, 2019 and believes that there has been no material change since December 31, 2018.

The Bank constantly monitors earning asset and deposit levels, developments and trends in interest rates, liquidity, capital adequacy and marketplace opportunities. Management responds to all of these to protect and possibly enhance net interest income while managing risks within acceptable levels as set forth in the Bank's policies. In addition, alternative business plans and transactions are contemplated for their potential impact. This process is known as asset/liability management and is carried out by changing the maturities and relative proportions of the various types of loans, investments, deposits and borrowings in the ways described above. The Board monitors and establishes target positions for interest rate and market value risks through the Asset Liability Committee of the Board.

The tool most commonly used to manage and analyze the interest rate sensitivity of a bank is known as a computer simulation model. To quantify the extent of risks in both the Bank's current position and in transactions it might make in the future, the Bank uses a model to simulate the impact of different interest rate scenarios on net interest income. The hypothetical impact of an interest rate shock for incremental interest rate changes up to 4.00% is modeled quarterly, representing the primary means the Bank uses for interest rate risk management decisions. The Bank is liability sensitive; that is, more liabilities reprice within one year than assets. The expectation for a liability sensitive bank is that the net interest margin will decline in a rising interest rate environment.

When preparing its modeling, the Bank makes significant assumptions about the lag in the rate of change in various asset and liability categories. The Bank bases its assumptions on past experience and comparisons with other banks and tests the validity of its assumptions by reviewing actual results with projected expectations.

The computer simulation model assumes a static balance sheet, that is, cash flows from various assets and liabilities are reinvested in similar assets and liabilities. It does not model various dynamic changes in the pricing or term of new assets and liabilities that may occur during the year after the interest rate shock. The computer simulation model projects at June 30, 2019 the following changes over a one-year period in net interest income:

#### Interest Rate Risk Simulation Model

(in thousands)

Interest Rate Shock	-3%	-2%	-1%	1%	2%	3%
Net interest income change	\$ (166)	\$ (135)	\$ 47	\$ (628)	\$ (1,256)	\$ (1,886)
Net interest percent change	-0.8%	-0.6%	0.2%	-2.9%	-5.7%	-8.6%

The Bank's investment portfolio has an average maturity of 10.2 years and would be susceptible to a material decline in market value if interest rates were to materially rise. Management monitors this exposure in relation to the Bank's capital ratios and the interaction of the projected changes in other interest sensitive assets and liabilities to reach a desired balance between current earnings and market risk.

### Item 4 Controls and Procedures

Under the supervision and with the participation of the Bank's management, including its Chief Executive Officer and Chief Financial Officer, the Bank conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures as defined by Rule 13a-15(e) under the Securities Exchange Act of 1934.

Based on the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this report the disclosure controls and procedures were adequate and effective, and that the material information required to be included in this report, including information from the Bank's consolidated subsidiary, was properly recorded, processed, summarized and reported, and was made known to the Chief Executive Officer and Chief Financial Officer by others within the Bank in a timely manner, particularly during the period when this quarterly report on Form 10-Q was being prepared.

There was no change in the Bank's internal control over financial reporting that occurred during the most recent fiscal quarter that materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1 Legal Proceedings**

The nature of our business causes us to be involved in legal proceedings from time to time. As of the date of this report, the Bank is not a party to any litigation where management anticipates that the outcome will have a material adverse effect on the consolidated financial position or results of operations.

### **Item 1A Risk Factors**

Risk Factors in Form 10-K incorporated by reference.

### **Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

None.

### **Item 3 Defaults Upon Senior Securities**

None.

### **Item 4 Mine Safety Disclosures**

Not applicable.

### **Item 5 Other Information**

None.

### **Item 6 Exhibits**

The exhibits filed as part of this report are listed on the Exhibit Index filed as part of this report.

## SIGNATURES

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

Summit State Bank  
(registrant)

August 8, 2019

*/s/ James E. Brush*

Date

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James E. Brush  
President and Chief Executive Officer  
(Principal Executive Officer)

August 8, 2019

*/s/ Camille D. Kazarian*

Date

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Camille D. Kazarian  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

## EXHIBIT INDEX

Exhibit Number	Description
31.01	Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002
31.02	Certification of Principal Financial and Accounting Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002
32.01	Certification of Principal Executive Officer and Principal Financial and Accounting Officer pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002



**Exhibit 31.01**

**Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002**

I, James E. Brush, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Summit State Bank (the registrant) for the quarter ended June 30, 2019;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

*August 8, 2019*

*/s/ James E. Brush*

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Date

James E. Brush  
President and Chief Executive Officer  
(Principal Executive Officer)  
Summit State Bank

**Exhibit 31.02**

**Certification of Principal Financial and Accounting Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002**

I, Camille D. Kazarian, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Summit State Bank (the registrant) for the quarter ended June 30, 2019;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 8, 2019

/s/ Camille D. Kazarian

Date

Camille D. Kazarian  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)  
Summit State Bank

**EXHIBIT 32.01**

**Certification of Principal Executive Officer and Principal Financial and Accounting Officer pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002**

In connection with the quarterly report on Form 10-Q of Summit State Bank (the Registrant) for the quarter ended June 30, 2019, as filed with the Federal Deposit Insurance Corporation, the undersigned hereby certify pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

- 1) such Form 10-Q fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
  
- 2) the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

<u>August 8, 2019</u>	<u>/s/ James E. Brush</u>
Date	James E. Brush President and Chief Executive Officer (Principal Executive Officer)

<u>August 8, 2019</u>	<u>/s/ Camille D. Kazarian</u>
Date	Camille D. Kazarian Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)

This certification accompanies each report pursuant to §906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Registrant for purposes of §18 of the Securities Exchange Act of 1934, as amended.