Bank of Marin Bancorp
Form 10-K
March 14, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2016

OR

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

For the transition period from __________________ to __________________

Commission File Number 001-33572

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

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

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

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

None

Securities registered pursuant to section 12(g) of the Act:

Common Stock, No Par Value, and attached Share Purchase Rights	NASDAQ Capital Market
(Title of each class)	(Name of each exchange on which registered)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes o No x

Note - checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under these sections.

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K.
o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller reporting company o

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

As of June 30, 2016, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting common equity held by non-affiliates, based upon the closing price per share of the registrant's common stock as reported by the NASDAQ, was approximately $292 million. For the purpose of this response, directors and certain officers of the Registrant are considered the affiliates at that date.

As of February 28, 2017, there were 6,129,817 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on May 16, 2017 are incorporated by reference into Part III.

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PART I

Forward-Looking Statements

This discussion of financial results includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the "1933 Act") and Section 21E of the Securities Exchange Act of 1934, as amended, (the "1934 Act"). Those sections of the 1933 Act and 1934 Act provide a "safe harbor" for forward-looking statements to encourage companies to provide prospective information about their financial performance so long as they provide meaningful, cautionary statements identifying important factors that could cause actual results to differ significantly from projected results.

Our forward-looking statements include descriptions of plans or objectives of Management for future operations, products or services, and forecasts of revenues, earnings or other measures of economic performance. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include the words "believe," "expect," "intend," "estimate" or words of similar meaning, or future or conditional verbs preceded by "will," "would," "should," "could" or "may."

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues that may affect our earnings in future periods. A number of factors, many of which are beyond Management’s control, could cause future results to vary materially from current Management expectations. Such factors include, but are not limited to, general economic conditions and the economic uncertainty in the United States and abroad, including changes in interest rates, deposit flows, real estate values, and expected future cash flows on loans and securities; integration of acquisitions and competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation; natural disasters; adverse weather conditions; and other economic, competitive, governmental, regulatory and technological factors affecting our operations, pricing, products and services.

Important factors that could cause results or performance to materially differ from those expressed in our prior forward-looking statements are detailed in Item 1A. Risk Factors of this report. Forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

ITEM 1 BUSINESS

Bank of Marin (the “Bank”) was incorporated in August 1989, received its charter from the California Superintendent of Banks (now the California Department of Business Oversight or "DBO") and commenced operations in January 1990. The Bank is an insured bank by the Federal Deposit Insurance Corporation (“FDIC”). On July 1, 2007 (the “Effective Date”), a bank holding company reorganization was completed whereby Bank of Marin Bancorp (“Bancorp”) became the parent holding company for the Bank, the sole and wholly-owned subsidiary of Bancorp. On the Effective Date, each outstanding share of Bank of Marin common stock was converted into one share of Bank of Marin Bancorp common stock. Bancorp is listed at NASDAQ under the ticker symbol BMRC, which was formerly used by the Bank. Prior to the Effective Date, the Bank filed reports and proxy statements with the FDIC pursuant to Section 12 of the 1934 Act. Upon formation of the holding company, Bancorp became subject to regulation under the Bank Holding Company Act of 1956, as amended, and Federal Reserve Board reporting and examination requirements. Bancorp files periodic reports and proxy statements with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended.

References in this report to “Bancorp” mean Bank of Marin Bancorp, parent holding company for the Bank. References to “we,” “our,” “us” mean the holding company and the Bank that are consolidated for financial reporting purposes.

Virtually all of our business is conducted through Bancorp's subsidiary, Bank of Marin, which is headquartered in Novato, California. In addition to our headquarters office, we operate through twenty offices in Marin, Sonoma, San Francisco, Napa and Alameda counties, with a strong emphasis on supporting the local communities. Our customer base is made up of business and personal banking relationships from the communities near the branch office locations. Our business banking focus is on small to medium-sized businesses, professionals and not-for-profit organizations.

We offer a broad range of commercial and retail deposit and lending programs designed to meet the needs of our target markets. Our lending categories include commercial real estate loans, commercial and industrial loans, construction financing, consumer loans, and home equity lines of credit. Merchant card services are available for our business customers. Through third party vendors, we offer a proprietary Visa® credit card product combined with a rewards program to our customers, a Business Visa® program, a leasing program for commercial equipment financing, and cash management sweep services.

We offer a variety of personal and business checking and savings accounts, and a number of time deposit alternatives, including time certificates of deposit, Individual Retirement Accounts ("IRAs"), Health Savings Accounts, Certificate of Deposit Account Registry Service® ("CDARS") and Insured Cash Sweep® ("ICS") accounts. CDARS and ICS are part of a network through which we offer full FDIC insurance coverage in excess of the regulatory maximum by placing deposits in multiple banks participating in the network. For businesses, we now offer another sweep product which also provides full FDIC insurance coverage called Demand Deposit Marketplace, or DDM Sweep. We also offer mobile banking, remote deposit capture, Automated Clearing House services ("ACH"), fraud prevention services including Positive Pay for Checks, ACH, Apple Pay®, peer-to-peer funds transfer, and image lockbox services. A valet deposit pick-up service is available to our professional and business clients.

Automated teller machines ("ATM's") are available at most retail branch locations. Our ATM network is linked to the PLUS, CIRRUS and NYCE networks, as well as to a network of nation-wide surcharge-free ATM's called MoneyPass. We also offer our depositors 24-hour access to their accounts by telephone and through our internet banking products available to personal and business account holders.

We offer Wealth Management and Trust Services ("WMTS") which include customized investment portfolio management, trust administration, estate settlement and custody services. We also offer 401(k) plan services to small and medium-sized businesses through a third party vendor.

We make international banking services available to our customers indirectly through other financial institutions with whom we have correspondent banking relationships.

We hold no patents, licenses (other than licenses required by the appropriate banking regulatory agencies), franchises or concessions. The Bank has registered the service marks "The Spirit of Marin", the words "Bank of Marin", the Bank of Marin logo, and the Bank of Marin tagline "Committed to your business and our community" with the United States Patent & Trademark Office. In addition, Bancorp has registered the service marks for the words "Bank of Marin Bancorp" and for the Bank of Marin Bancorp logo with the United States Patent & Trademark Office.

All service marks registered by Bancorp or the Bank are registered on the United States Patent & Trademark Office Principal Register, with the exception of the words "Bank of Marin Bancorp" which is registered on the United States Patent & Trademark Office Supplemental Register.

Market Area

Our primary market area consists of Marin, San Francisco, Napa, Sonoma and Alameda counties. Our customer base is primarily made up of business, not-for-profit and personal banking relationships within these market areas.

We attract deposit relationships from individuals, merchants, small to medium-sized businesses, not-for-profit organizations and professionals who live and/or work in the communities comprising our market areas. As of December 31, 2016, approximately 66% of our deposits are in Marin County and southern Sonoma County, and approximately 55% of our deposits are from businesses and 45% from individuals.

Competition

The banking business in California generally, and in our market area specifically, is highly competitive with respect to attracting both loan and deposit relationships. The increasingly competitive environment is affected by changes in regulation, interest rates, technology and product delivery systems, and consolidation among financial service providers. The banking industry is seeing strong competition for quality loans, with larger banks expanding their activities to attract businesses that are traditionally community bank customers. In all of our five counties, we have significant competition from nationwide banks with much larger branch networks and greater financial resources, as well as credit unions and

other local and regional banks. Nationwide banks have the competitive advantages of national advertising campaigns and technology infrastructure to achieve economies of scale. Large commercial banks also have substantially greater lending limits and the ability to offer certain services which are not offered directly by us. Other competitors for depositors' funds are money market mutual funds and non-bank financial institutions such as brokerage firms and insurance companies.

In order to compete with the numerous, and often larger, financial institutions in our primary market area, we use, to the fullest extent possible, the flexibility and rapid response capabilities that derive from our local leadership and decision making. Our competitive advantages also include an emphasis on personalized service, extensive community involvement, philanthropic giving, local promotional activities and strong relationships with our customers.

In Marin County, we have the third largest market share of total deposits at 10.2%, based upon the FDIC deposit market share data as of June 30, 2016.[1] A significant driver of our franchise value is the growth and stability of our checking deposits, a low-cost funding source for our loan portfolio.

Employees

At December 31, 2016, we employed 262 full-time equivalent (“FTE”) staff. The actual number of employees, including part-time employees, at year-end 2016 included six executive officers, 106 other corporate officers and 164 staff. None of our employees are presently represented by a union or covered by a collective bargaining agreement. We believe that our employee relations are good. We have consistently been recognized as one of the “Best Places to Work” by the North Bay Business Journal and as a "Top Corporate Philanthropist” by the San Francisco Business Times.

SUPERVISION AND REGULATION

Bank holding companies and banks are extensively regulated under both federal and state law. The following discussion summarizes certain significant laws, rules and regulations affecting Bancorp and the Bank.

Bank Holding Company Regulation

Upon formation of the bank holding company on July 1, 2007, we became subject to regulation under the Bank Holding Company Act of 1956, as amended (“BHCA”) which subjects Bancorp to Federal Reserve Board ("FRB") reporting and examination requirements. Under the FRB's regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks. Under this requirement, we are expected to commit resources to support the Bank, including at times when we may not be in a financial position to provide such resources, and it may not be in our, or our shareholders’ or creditors’, best interests to do so. In addition, any capital loans we make to the Bank are subordinate in right of payment to depositors and to certain other indebtedness of the Bank. The BHCA regulates the activities of holding companies including acquisitions, mergers and consolidations and, together with the Gramm-Leach Bliley Act of 1999, the scope of allowable banking activities. Bancorp is also a bank holding company within the meaning of the California Financial Code. As such, Bancorp and its subsidiaries are subject to examination by, and may be required to file reports with, the DBO.

Bank Regulation

Banking regulations are primarily intended to protect consumers, depositors' funds, federal deposit insurance funds and the banking system as a whole. These regulations affect our lending practices, consumer protections, capital structure, investment practices and dividend policy.

As a state chartered bank, we are subject to regulation, supervision and examination by the DBO. We are also subject to regulation, supervision and periodic examination by the FDIC. If, as a result of an examination of the Bank, the FDIC or the DBO should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of our operations are unsatisfactory, or that we have violated any law or regulation, various remedies are available to those regulators including issuing a “cease and desist” order, monetary penalties, restitution, restricting our growth or removing officers and directors.

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[1] Source: SNL Financial LC of Charlottesville, Virginia

The Bank addresses the many state and federal regulations it is subject to through a comprehensive compliance program that addresses the various risks associated with these issues.

Dividends

The payment of cash dividends by the Bank to Bancorp is subject to restrictions set forth in the California Financial Code (the "Code") in addition to regulations and policy statements of the FRB. Prior to any distribution from the Bank to Bancorp, a calculation is made to ensure compliance with the provisions of the Code and to ensure that the Bank remains within capital guidelines set forth by the DBO and the FDIC. See also Note 8 to the Consolidated Financial Statements, under the heading "Dividends" in Item 8 of this report.

FDIC Insurance Assessments

Our deposits are insured by the FDIC to the maximum amount permitted by law, which is currently $250,000 per depositor, based on the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Our FDIC insurance assessment base is quarterly average consolidated total assets minus average tangible equity, defined as Common Equity Tier 1 Capital. The FDIC has reduced the deposit insurance assessment rates since the Deposit Insurance Fund Reserve Ratio reached its target level as of June 30, 2016. Assessment rates are currently between 1.5 and 40 basis points annually on the assessment base for banks in all risk categories. In deriving the risk categories, the FDIC uses a bank's capital level, supervisory ratios and other financial measures to determine a bank's ability to withstand financial stress.

Community Reinvestment Act

The Community Reinvestment Act ("CRA") was enacted in 1977 to encourage financial institutions to meet the credit needs of the communities where they are chartered. All banks and thrifts have a continuing and affirmative obligation, consistent with safe and sound operations, to help meet the credit needs of their entire communities, including low and moderate income neighborhoods. Regulatory agencies rate each bank's performance in assessing and meeting these credit needs. The Bank is committed to serving the credit needs of the communities in which we do business, and it is our policy to respond to all creditworthy segments of our market. As part of its CRA commitment, the Bank maintains strong philanthropic ties to the community. We invest in affordable housing projects that help economically disadvantaged individuals and residents of low- and moderate-income census tracts, in each case consistent with our long-established prudent underwriting practices. We also donate to and volunteer with organizations in our communities that serve low- and moderate-income individuals, that offer educational and health programs to economically disadvantaged students and families, community development services and affordable housing programs. We provide CRA reportable small business, small farm and community development loans within our assessment areas. The CRA requires a depository institution's primary federal regulator, in connection with its examination of the institution, to assess the institution's record in meeting CRA requirements. The regulatory agency's assessment of the institution's record is made available to the public. This record is taken into consideration when the institution establishes a new branch that accepts deposits, relocates an office, applies to merge or consolidate, or expands into other activities. The FDIC's last CRA performance examination, completed in May 2015, was performed under the large bank requirements and was assigned a rating of "Satisfactory".

Anti Money-Laundering Regulations

A series of banking laws and regulations beginning with the Bank Secrecy Act in 1970 requires banks to prevent, detect, and report illicit or illegal financial activities to the federal government to prevent money laundering, international drug trafficking, and terrorism. Under the Uniting and Strengthening America by Providing Appropriate

Tools Required to Intercept and Obstruct Terrorism Act of 2001, financial institutions are subject to prohibitions against specified financial transactions and account relationships, requirements regarding the Customer Identification Program, as well as enhanced due diligence and “know your customer” standards in their dealings with high risk customers, foreign financial institutions, and foreign individuals and entities.

Privacy and Data Security

The Gramm-Leach Bliley Act (“GLBA”) of 1999 imposes requirements on financial institutions with respect to consumer privacy. The GLBA generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. Financial institutions are further required to disclose their privacy policies to consumers annually. The GLBA also directs federal regulators, including the FDIC, to prescribe standards for the security of consumer information. We are subject to such standards, as well as standards for notifying consumers in the event of a security breach. We must disclose our privacy policy to consumers and permit consumers to “opt out” of having non-public customer information disclosed to third parties. We are required to have an information security program to safeguard the confidentiality and security of customer information and to ensure proper disposal of information that is no longer needed. Customers must be notified when unauthorized disclosure involves sensitive customer information that may be misused.

Consumer Protection Regulations

Our lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the CRA, Home Mortgage Disclosure Act, Fair Credit Reporting Act, Fair Lending, Fair Debt Collection Practices Act, Flood Disaster Protection Act, Equal Credit Opportunity Act, the Fair Housing Act, Truth-in-Lending Act ("TILA"), and the Real Estate Settlement Procedures Act ("RESPA"). Our deposit operations are also subject to laws and regulations that protect consumer rights including Expedited Funds Availability, Truth in Savings, and Electronic Funds Transfers. Other regulatory requirements include: the Unfair, Deceptive or Abusive Acts and Practices ("UDAAP"), Dodd-Frank Act, Right To Financial Privacy and Privacy of Consumer Financial Information. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records.

Restriction on Transactions between Bank's Affiliates

Transactions between Bancorp and the Bank are quantitatively and qualitatively restricted under Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W. Section 23A places restrictions on the Bank's “covered transactions” with Bancorp, including loans and other extensions of credit, investments in the securities of, and purchases of assets from Bancorp. Section 23B requires that certain transactions, including all covered transactions, be on market terms and conditions. Federal Reserve Regulation W combines statutory restrictions on transactions between the Bank and Bancorp with FRB interpretations in an effort to simplify compliance with Sections 23A and 23B.

Capital Requirements

The FRB and the FDIC have adopted risk-based capital guidelines for bank holding companies and banks. Bancorp's ratios exceed the required minimum ratios for capital adequacy purposes and the Bank meets the definition for "well capitalized." Undercapitalized depository institutions may be subject to significant restrictions. Payment of dividends could be restricted or prohibited, with some exceptions, if the Bank were categorized as "critically undercapitalized" under applicable FDIC regulations.

In July 2013, the federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III. The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. We became subject to the new rule on January 1, 2015 and certain provisions of the new rule will be phased in over the period of 2015 through 2019. We have modeled our ratios under the finalized Basel III rules and we do not expect that we will be required to raise

additional capital when the new rules fully phase in. For further information on our risk-based capital positions and the effect of the new Basel III rules, see Note 15 to the Consolidated Financial Statements in Item 8 of this report.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act, a landmark financial reform bill comprised of voluminous new rules and restrictions on bank operations, included provisions aimed at preventing a repeat of the 2008 financial crisis and a new process for winding down failing, systemically important institutions in a manner as close to a controlled bankruptcy as possible. Among

other things, the Dodd-Frank Act established new government oversight responsibilities, enhanced capital adequacy requirements for certain institutions, established consumer protection laws and regulations, and placed limitations on certain banking activities. The new Presidential Administration ("Administration") has indicated a desire to reform the Dodd-Frank Act in order to reduce the regulatory burden on U.S. companies, including financial institutions. At this time, no details on the proposed reforms have been published and we are uncertain whether the intended deregulation will have a significant impact on us.

Notice and Approval Requirements Related to Control

Banking laws impose notice, approval and ongoing regulatory requirements on any shareholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution. These laws include the BHCA and the Change in Bank Control Act. Among other things, these laws require regulatory filings by a shareholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution or bank holding company. The determination whether an investor "controls" a depository institution is based on all of the facts and circumstances surrounding the investment. As a general matter, a party is deemed to control a depository institution or other company if the party owns or controls 25% or more of any class of voting stock. Subject to rebuttal, a party may be presumed to control a depository institution or other company if the investor owns or controls 10% or more of any class of voting stock. Ownership by family members, affiliated parties, or parties acting in concert, is typically aggregated for these purposes. If a party's ownership of the Company were to exceed certain thresholds, the investor could be deemed to "control" the Company for regulatory purposes. This could subject the investor to regulatory filings or other regulatory consequences.

In addition, except under limited circumstances, bank holding companies are prohibited from acquiring, without prior approval:

- control of any other bank or bank holding company or all or substantially all the assets thereof; or
- more than 5% of the voting shares of a bank or bank holding company which is not already a subsidiary.

Incentive Compensation

The Dodd-Frank Act required federal bank regulators and the Securities and Exchange Commission ("SEC") to establish joint regulations or guidelines prohibiting incentive-based payment arrangements that encourage inappropriate risks by providing an executive officer, employee, director or principal stockholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. These regulations apply to institutions having at least $1 billion in total assets. In addition, regulators must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The agencies proposed such regulations in April 2011, but the regulations have not been finalized. If the regulations are adopted in the form initially proposed, they will impose limitations on the manner in which we may structure compensation for our executives.

The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as us, that are not “large, complex banking organizations.” These reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization’s supervisory ratings, which can affect the organization’s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk management control or governance processes, pose a risk to the organization’s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Available Information

On our Internet web site, www.bankofmarin.com, we post the following filings as soon as reasonably practical after they are filed with or furnished to the Securities and Exchange Commission: Annual Report to Shareholders, Form 10-K, Proxy Statement for the Annual Meeting of Shareholders, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934. The text of the Code of Ethical Conduct for Bancorp and the Bank is also included on the website. All such materials on our website are available free of charge. This website address is for information only

and is not intended to be an active link, or to incorporate any website information into this document. In addition, copies of our filings are available by requesting them in writing or by phone from:

Corporate Secretary
Bank of Marin Bancorp
504 Redwood Boulevard, Suite 100
Novato, CA 94947
415-763-4523

ITEM 1A RISK FACTORS

We assume and manage a certain degree of risk in order to conduct our business. The material risks and uncertainties that Management believes may affect our business are listed below and in Item 7A, Quantitative and Qualitative Disclosure about Market Risk. The list is not exhaustive; additional risks and uncertainties that Management is not aware of, or focused on, or currently deems immaterial may also impair business operations. If any of the following risks, or risks that have not been identified, actually occur, our financial condition, results of operations, and stock trading price could be materially and adversely affected. We manage these risks by promoting sound corporate governance practices, which includes but is not limited to, establishing policies and internal controls, and implementing internal review processes. Before making an investment decision, investors should carefully consider the risks, together with all of the other information included or incorporated by reference in this Annual Report on Form 10-K and our other filings with the SEC. This report is qualified in its entirety by these risk factors.

Earnings are Significantly Influenced by General Business and Economic Conditions

Our success depends, to a certain extent, on local, national and global economic and political conditions. While the unemployment rates and consumer sentiments in the U.S. and local economies have improved over recent years, these improvements are uneven and corporate investment growth is still sluggish. There can be no assurance that the improvements are sustainable. The pro-growth fiscal policy by the new Administration could cause the inflation rate to rise faster than expected, which may force the U.S. central bank to raise interest rates rapidly to combat rising inflation, even though economic activity remains uneven. Such stagflation risk may disrupt the financial market and may ultimately push the economy back to recession. In addition, oil price volatility, the level of U.S. debt and global economic conditions can continue to have a destabilizing effect on financial markets.

Weakness in commercial and residential real estate values and home sale volumes, financial stress on borrowers, increases in unemployment rates[1], and customers' inability to pay debt could adversely affect our financial condition and results of operations in the following ways:

- Demand for our products and services may decline;
- Low cost or non-interest bearing deposits may decrease;
- Collateral for our loans, especially real estate, may decline in value;
- Loan delinquencies, problem assets and foreclosures may increase as a result of a deterioration of our borrowers' creditworthiness;
- Investment securities may become impaired.

Interest Rate Risk is Inherent in Our Business

Our earnings are largely dependent upon our net interest income, which is the difference between interest income earned on interest-earning assets, such as loans and securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Interest rates are sensitive to many factors outside of our control, including general economic conditions and the policies of various governmental and regulatory agencies and, in particular, the FRB, which regulates the supply of money and credit in the United States. Changes in monetary policy, including changes in interest rates, can influence not only the interest we receive on loans and securities and interest we pay on deposits and borrowings, but can also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the average duration of our securities and loan portfolios. Our portfolio of loans and securities will generally decline in value if market interest rates increase, and increase in value if market interest rates decline. In addition, our loans and mortgage-backed securities are also subject to prepayment risk when interest rates fall, and the borrowers' credit risk may increase in rising rate environments.

In December 2016, the Federal Open Market Committee of the FRB (“FOMC”) increased the federal funds target rate by 25 basis points (basis points are equal to one hundredth of a percentage point) for the second time since 2008 to a range of 0.50% to 0.75%. While there was no interest rate action in the first meeting of 2017, the FOMC indicated that it may consider additional increases in 2017 upon further strengthening of labor markets and reaching the targeted two percent inflation rate. Additionally, other factors such as productivity, oil prices, the strength of the U.S. dollar, and

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[1] According to the California Employment Development Department's December 2016 labor reports, the unemployment rates in Marin, San Francisco, Sonoma, Napa and Alameda counties were 2.9%, 3.0%, 3.7%, 4.4% and 3.8%, respectively, compared to the state of California of 5.2%.

global demand play a role in the FOMC's consideration of future rate hikes. Our net interest income is vulnerable to a falling or flat rate environment and will benefit if the prevailing market interest rates increase.

However, a rise in index rates leads to lower debt service coverage of variable rate loans if the borrower's operating cash flow does not also rise. This creates a paradox of an improving economy (leading to higher interest rates) with increased credit risk as short-term rates move up faster than the cash flow or income of the borrowers. Higher interest rates may also depress loan demand, making it more difficult for us to grow loans.

See the sections captioned “Net Interest Income” in Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and Quantitative and Qualitative Disclosures about Market Risk in Item 7A of this report for further discussion related to management of interest rate risk.

Banks and Bank Holding Companies are Subject to Extensive Government Regulation and Supervision

Bancorp and the Bank are subject to extensive federal and state governmental supervision, regulation and control. Holding company regulations affect the range of activities in which Bancorp is engaged. Banking regulations affect the Bank's lending practices, capital structure, investment practices and dividend policy, and compliance costs among other things. Future legislative changes or interpretations may also alter the structure and competitive relationship among financial institutions.

Disruptions in the financial marketplace during the most recent recession have lead to additional regulations in an attempt to reform financial markets. This reform included, among other things, regulations over consumer financial products, capital adequacy, and the creation of a regime for regulating systemic risk across all types of financial service firms. Further restrictions on financial service companies may adversely affect our results of operations and financial condition, as well as increase our compliance risk. While there is discussion to deregulate the financial industry under the new Administration, the nature and extent of future legislative and regulatory changes from both the federal and California legislatures affecting us are unpredictable at this time.

Compliance risk is the current and prospective risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards set forth by regulators. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of our clients may be ambiguous or untested. This risk exposes Bancorp and the Bank to potential fines, civil money penalties, payment of damages and the voiding of contracts. Compliance risk can lead to diminished reputation, reduced franchise value, limited business opportunities, reduced expansion potential and an inability to enforce contracts.

For further information on supervision and regulation, see the section captioned “Supervision and Regulation” in Item 1 above.

Intense Competition with Other Financial Institutions to Attract and Retain Banking Customers

We are facing significant competition for customers from other banks and financial institutions located in the markets that we serve. We compete with commercial banks, saving banks, credit unions, non-bank financial services companies, including financial technology firms, and other financial institutions operating within or near our service areas. Some of our non-bank competitors and peer-to-peer lenders may not be subject to the same extensive regulations as we are, giving them greater flexibility in competing for business. We anticipate intense competition will continue for the coming year due to the consolidation of many financial institutions and more changes in legislature, regulation and technology. National and regional banks much larger than our size have entered our market through acquisitions and they may be able to benefit from economies of scale through their wider branch networks, more

prominent national advertising campaigns, lower cost of borrowing, capital market access and sophisticated technology infrastructures. Further, intense competition for creditworthy borrowers could lead to loan rate concession pressure and affect our ability to generate profitable loans.

Going forward, we may see continued competition in the industry as competitors seek to expand market share in our core markets. Further, our customers may withdraw deposits to pursue alternative investment opportunities in the recent bullish equity market. Technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments or other deposit accounts such as online virtual banks and non-bank service

providers. Efforts and initiatives we may undertake to retain and increase deposits, including deposit pricing, can increase our costs. Based on our current strong liquidity position, our adjustment to deposit pricing may lag the market in a rising interest rate environment. If our customers move money into higher yielding deposits or alternative investments, we may lose a relatively inexpensive source of funds, thus increasing our funding costs through more expensive wholesale borrowings.

Activities of Our Large Borrowers and Depositors May Cause Unexpected Volatilities in Our Loan and Deposit Balances, as well as Net Interest Margin

The recent rise in real estate values in the Bay Area market motivated our borrowers to sell real estate that collateralized our loans, leading to loan payoff activity. We experienced loan payoffs of $158 million and $169 million in 2016 and 2015, respectively, which approximated eleven percent turnover of our loan portfolio annually. Payoffs of loans originated during a higher interest rate environment may be replaced by new loans with lower interest rates, causing downward pressure on our net interest margin. On the other hand, early payoffs of acquired loans may lead to the acceleration of accretion on purchase discounts that temporarily inflate our net interest margin. Although we expect the gains from the early pay-offs of acquired loans to decline, we cannot predict the timing and their effect on our future net interest margin.

In addition, the top ten depositors account for approximately 10% of our total deposit balances. The business models and cash cycles of some of our large commercial depositors may also cause short-term volatility in their deposit balances held with us. As our customers' businesses grow, the dollar value of their daily activities may also grow leading to larger fluctuations in daily balances. Any long-term decline in deposit funding would adversely affect our liquidity. For additional information on our management of deposit volatility, refer to the Liquidity section of Item 7, Management's Discussion and Analysis, of this report.

Negative Conditions Affecting Real Estate May Harm Our Business and Our Commercial Real Estate ("CRE") Concentration May Heighten Such Risk

Concentration of our lending activities in the California real estate sector could negatively affect our results of operations if adverse changes in our lending area occur or intensify. Although we do not offer traditional first mortgages, nor have sub-prime or Alt-A residential loans or significant amounts of securities backed by such loans in the portfolio, we are not immune to volatility in those markets. Approximately 85% of our loans were secured by real estate at December 31, 2016, of which 65% were secured by CRE and the remaining 20% by residential real estate. Real estate valuations are influenced by demand, and demand is driven by factors such as employment rates and interest rates.

Loans secured by CRE include those secured by office buildings, owner-user office/warehouses, mixed-use residential/commercial properties and retail properties. There can be no assurance that the companies or properties securing our loans will generate sufficient cash flows to allow borrowers to make full and timely loan payments to us. In the event of default, the collateral value may not cover the outstanding amount due to us, especially during real estate market downturns.

Rising CRE lending concentrations may expose institutions like us to unanticipated earnings and capital volatility in the event of adverse changes in the CRE market. In addition, institutions that are exposed to significant CRE concentration risk may be subject to increased regulatory scrutiny. The FDIC regulatory threshold for heightened supervision is a two-part test. The first test applies when the non-owner occupied commercial real estate concentration exceeds 300% of the Bank's capital. As of December 31, 2016, our non-owner occupied CRE concentration was 332% of the Bank's capital, which declined from 354% as of December 31, 2015. Although this concentration exceeds the regulatory guideline, we are below the regulatory threshold for the second part of the test, which measures the

non-owner occupied CRE growth rate during the prior 36 months. Since December 31, 2013, our CRE portfolio has grown 36%, below the 50% regulatory hurdle. We maintain heightened review and analyses of our concentrations and have regular conversations with regulators to avoid unexpected regulatory risk.

Severe Weather, Natural Disasters or Other Climate Change Related Matters Could Significantly Affect Our Business

Our primary market is located in an earthquake-prone zone in northern California, which is also subject to other weather or disasters, such as severe rainstorms, wildfire, drought or flood. These events could interrupt our business operations unexpectedly. Climate-related physical changes and hazards could also pose credit risks for us. For example, our

borrowers may have collateral properties or operations located in coastal areas at risk to rising sea levels and erosion or subject to the risk of drought in California. The properties pledged as collateral on our loan portfolio could also be damaged by tsunamis, landslides, floods, earthquakes or wildfires and thereby the recoverability of loans could be impaired. A number of factors can affect credit losses, including the extent of damage to the collateral, the extent of damage not covered by insurance, the extent to which unemployment and other economic conditions caused by the natural disaster adversely affect the ability of borrowers to repay their loans, and the cost of collection and foreclosure to us. Lastly, there could be increased insurance premiums and deductibles, or a decrease in the availability of coverage, due to severe weather-related losses. The ultimate outcome on our business of a natural disaster, whether or not caused by climate change, is difficult to predict.

We are Subject to Significant Credit Risk and Loan Losses May Exceed Our Allowance for Loan Losses in the Future

We maintain an allowance for loan losses, which is a reserve established through provisions for loan losses charged to expense, that represents Management's best estimate of probable losses that may be incurred within the existing portfolio of loans (the "incurred loss model"). The level of the allowance reflects Management's continuing evaluation of specific credit risks, loan loss experience, current loan portfolio quality and present economic, political and regulatory conditions. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Further, we generally rely on appraisals of the collateral or comparable sales data to determine the level of specific reserve and/or the charge-off amount on certain collateral dependent loans. Inaccurate assumptions in the appraisals or an inappropriate choice of the valuation techniques may lead to an inadequate level of specific reserve or charge-offs.

Changes in economic conditions affecting borrowers, new information regarding existing loans and their collateral, identification of additional problem loans, and other factors may require an increase in our allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs. If charge-offs in future periods exceed the allowance for loan losses or cash flows from acquired loans do not perform as expected, we will need to record additional provision for loan losses.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses, requiring a financial asset measured at amortized cost basis to be presented at the net amount expected to be collected. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which is intended to result in more timely recognition of such losses. This impairment framework is expected to have wide reaching implications to financial institutions and the allowance for loan losses may increase when it becomes effective on January 1, 2020. In March of 2016, we refined our methodology for determining the appropriate level of the allowance for loan losses. We track individual net charge offs at the loan and risk grade level and utilize migration analysis in determining our historical loss rates. We have integrated detailed monthly loan-level data into the new model. As a result, the bank is well-positioned to implement the new guidance. We are in the process of working with our vendor to determine what methodology and assumptions we will use going forward. Refer to Note 1 to the Consolidated Financial Statements in Item 8 for further discussion.

Non-performing Assets Take Significant Time to Resolve and Adversely Affect Results of Operations and Financial Condition.

While our non-performing assets are currently at a low level, there can be no assurance that we will not experience increases in non-performing assets in the future. Generally, interest income is not recognized on non-performing loans

and the administrative costs on these loans are higher than performing loans. We might incur losses if the creditworthiness of our borrowers deteriorate to a point when we need to take collateral in foreclosures and similar proceedings, resulting in possible mark down of the loans to the fair value of the collateral. While we have managed our problem assets through workouts, restructurings and other proactive credit management practices that mitigate credit losses, decreases in the value of the underlying collateral, or deterioration in borrowers' performance or financial conditions, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of non-performing assets can distract Management from other responsibilities.

Securities May Lose Value due to Credit Quality of the Issuers

We invest in significant portions of investment securities issued by government-sponsored enterprises ("GSE"), such as Federal Home Loan Bank ("FHLB"), Federal National Mortgage Association (“FNMA”), Federal Home Loan Mortgage Corporation ("FHLMC"), and Federal Farm Credit Bank. We also hold mortgage-backed securities (“MBS”) securities issued by FNMA and FHLMC. While we consider these securities to have low credit risk as they carry the backing of the U.S. Government, they are not direct obligations of the U.S. Government. GSE debt is sponsored but not guaranteed by the federal government, whereas government agencies such as Government National Mortgage Association ("GNMA") are divisions of the government whose securities are backed by the full faith and credit of the United States.

Since 2008, both FNMA and FHLMC have been under a U.S. Government conservatorship. As a result, securities issued by FNMA and FHLMC have benefited from this government support. However, the new Administration may introduce housing finance reform to end GSE status, which could lead to a decline in the fair value of our securities issued or guaranteed by these entities. Certain FOMC members recently expressed views that reducing the Fed's holdings of U.S. Treasury bonds is another way to normalize monetary policy without relying on rate hikes. If the U.S. Government stops reinvesting or starts selling their holdings in U.S. Treasury or MBS issued by the GSE; if the government support is phased-out or completely withdrawn; or if either FNMA or FHLMC comes under financial stress or suffers creditworthiness deterioration, the value of our investments may be significantly impacted.

We also invest in tax exempt obligations of state and political subdivisions whose value may be negatively impacted by tax rate reductions discussed by the new Administration. Additionally, while we generally seek to minimize our exposure by diversifying the geographic location of our portfolio and investing in investment grade securities, there is no guarantee that the issuers will remain financially sound or continue their payments on these debentures.

Unexpected Early Termination of Interest Rate Swap Agreements May Affect Earnings

We have entered into interest-rate swap agreements, primarily as an asset/liability risk management tool, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. These hedges allow us to offer long-term, fixed-rate loans to customers without assuming the interest rate risk of a long-term asset by swapping our fixed-rate interest stream for a floating-rate interest stream. In the event of default by the borrowers on our hedged loans, we may have to terminate these designated interest-rate swap agreements early, resulting in prepayment penalties charged by our counterparties and negatively affect our earnings.

Growth Strategy or Potential Future Acquisitions May Produce Unfavorable Outcomes

We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals.

Our strategic plan also includes merger and acquisition possibilities that either enhance our market presence or have potential for improved profitability through financial management, economies of scale or expanded services. We may incur significant acquisition related expenses either during the due diligence phase of acquisition targets or during integration of the acquirees. These expenses may negatively impact our earnings prior to realizing the benefits of acquisitions. We may also be exposed to difficulties in combining the operations of acquired institutions into our own operations, which may prevent us from achieving the expected benefits from our acquisition activities. Our earnings,

financial condition and prospects after a merger will depend in part on our ability to integrate the operations and management of the acquired institution while continuing to implement other aspects of our business plan. Inherent uncertainties exist in integrating the operations of an acquired institution and there is no assurance that we will be able to do so successfully. Among the issues that we could face are:

- unexpected problems with operations, personnel, technology or credit;
- loss of customers and employees of the acquiree;
- difficulty in working with the acquiree's employees and customers;
- the assimilation of the acquiree's operations, culture and personnel;

- instituting and maintaining uniform standards, controls, procedures and policies; and
- litigation risk not discovered during the due diligence period.

Undiscovered factors as a result of an acquisition could bring liabilities against us, our management and the management of the institutions we acquire. These factors could contribute to our not achieving the expected benefits from our acquisitions within desired time frames, if at all. Further, although we generally anticipate cost savings from acquisitions, we may not be able to fully realize those savings. Any cost savings that are realized may be offset by losses in revenues or other charges to earnings.

We May Not Be Able to Attract and Retain Key Employees

Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most activities engaged by us has been intense, especially in light of the recent improvement in the job market, and we may not be able to hire skilled people or retain them. We do not have non-compete agreements with any of our senior officers. The unexpected loss of key personnel could have an unfavorable effect on our business because of the skills, knowledge of our market, years of industry experience and difficulty of promptly finding qualified replacement personnel.

Accounting Estimates and Risk Management Processes Rely on Analytical and Forecasting Models

The processes we use to estimate probable loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depends upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use for determining our probable loan losses are inadequate, the allowance for loan losses may not be sufficient to support future charge-offs. If the models we use to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

The Value of Goodwill and Other Intangible Assets May Decline in the Future

As of December 31, 2016, we had goodwill totaling $6.4 million and a core deposit intangible asset totaling $2.6 million from a business acquisition. A significant decline in expected future cash flows, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock could necessitate taking charges in the future related to the impairment of goodwill or other intangible assets. If we were to conclude that a future write-down of goodwill or other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our business, financial condition and results of operations.

We May Take Filing Positions or Follow Tax Strategies That May Be Subject to Challenge

We provide for current and deferred taxes in our consolidated financial statements based on our results of operations, business activities and business combinations, legal structure and federal and state legislation and regulations. We may take filing positions or follow tax strategies that are subject to interpretation of tax statutes. Our net income may

be reduced if a federal, state or local authority were to assess charges for taxes that have not been provided for in our consolidated financial statements. Taxing authorities could change applicable tax laws and interpretations, challenge filing positions or assess new taxes and interest charges. If taxing authorities take any of these actions, our business, results of operations or financial condition could be significantly affected.

We May Be Affected by Changes in Tax Laws and Regulations

Congress and the new Administration have indicated a desire to reform U.S. corporate taxes, including reducing the corporate tax rate. An increase in our on-going net income from a reduction in corporate tax rates may be partially

offset by a write-down in the value of our deferred tax assets upon a tax rate reduction. The one-time impact on our deferred tax assets is dependent on the extent of the tax rate reduction, which remains uncertain at this time.

The Financial Services Industry is Undergoing Rapid Technological Changes and, As a Result, We Have a Continuing Need to Stay Current with Those Changes to Compete Effectively and Increase Our Efficiencies. We May Not Have The Resources to Implement New Technology to Stay Current with These Changes

The financial services industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to providing better client service, the effective use of technology increases efficiency and reduces operational costs. Our future success will depend in part upon our ability to use technology to provide products and services that will satisfy client demands securely and cost-effectively. In connection with implementing new technology enhancements and/or products, we may experience operational challenges (e.g. human error, system error, incompatibility) which could result in us not fully realizing the anticipated benefits from such new technology or require us to incur significant costs to remedy any such challenges in a timely manner.

Risks Associated with Cyber Security Could Negatively Affect Our Earnings and Reputation

Our business requires the secure e-management of sensitive client and bank information. We work diligently through implementing security measures that are intended to make our communications and information systems safe to conduct business. Cyber threats such as social engineering, ransomware, and phishing emails are more prevalent now than ever before. These incidents include intentional and unintentional events that may present threats that are designed to disrupt operations, corrupt data, release sensitive information or cause denial-of-service attacks. A cyber security breach of systems operated by the Bank, merchants, vendors, customers, or externally publicized breaches of other financial institutions may significantly harm our reputation, result in a loss of customer business, subject us to regulatory scrutiny, or expose us to civil litigation and financial liability. While we have systems and procedures designed to prevent security breaches, we cannot be certain that advances in criminal capabilities, physical system or network break-ins or inappropriate access will not compromise or breach the technology protecting our networks or proprietary client information.

We Rely on Third-Party Vendors for Important Aspects of Our Operation

We depend on the accuracy and completeness of information and systems provided by certain key vendors, including but not limited to data processing, payroll processing, technology support, investment safekeeping and accounting. In particular, we outsource core processing to Fidelity Information Services ("FIS") and wire processing to D+H, both of which are leading financial services solution providers, which allow us access to competitive technology offerings without having to directly invest in their development. Our ability to operate, as well as our financial condition and results of operations, could be negatively affected in the event of an interruption of an information system, an undetected error, a cyber breach, or in the event of a natural disaster whereby certain vendors are unable to maintain business continuity.

Failure of Correspondent Banks May Affect Liquidity

Financial services institutions are highly interrelated as a result of clearing and exchange, counterparty, and other business relationships. In particular, the financial services industry in general was materially and adversely affected by the recent credit crisis, including the failure and consolidation of banks in the industry in recent years. While we regularly monitor the financial health of our correspondent banks and we have diverse sources of liquidity, should any one of our correspondent banks become financially impaired, our available credit may decline and/or they may be unable to honor their commitments.

Deterioration of Credit Quality or Insolvency of Insurance Companies May Impede Our Ability to Recover Losses

The financial crisis led certain major insurance companies to be downgraded by rating agencies. We have property, casualty and financial institution risk coverage underwritten by several insurance companies, who may not avoid insolvency risk inherent in the insurance industry. In addition, some of our investments in obligations of state and political subdivisions are insured by insurance companies. While we closely monitor the credit ratings of our insurers and the insurers of our municipal securities and we are poised to make quick changes if needed, we cannot predict

an unexpected inability to honor commitments. We also invest in bank-owned life insurance policies on certain members of Management, which may lose value in the event of a carrier's insolvency. In the event that a bank-owned life insurance policy carrier's credit ratings fall below investment grade, we may exchange policies to other carriers at a cost charged by the original carrier, or we may terminate the policies which may result in adverse tax consequences.

Our loan portfolio is secured primarily by properties located in earthquake or fire-prone zones. In the event of a disaster that causes pervasive damage to the region in which we operate, not only the Bank, but also the loan collateral may suffer losses not recoverable by insurance.

Bancorp Relies on Dividends from the Bank to Pay Cash Dividends to Shareholders

Bancorp is a separate legal entity from its subsidiary, the Bank. Bancorp receives substantially all of its cash stream from the Bank in the form of dividends, which is Bancorp's principal source of funds to pay cash dividends to Bancorp's common shareholders, service subordinated debt, and cover operational expenses of the holding company. Various federal and state laws and regulations limit the amount of dividends that the Bank may pay to Bancorp. In the event that the Bank is unable to pay dividends to Bancorp, Bancorp may not be able to pay dividends to its shareholders or pay interest on the subordinated debentures. As a result, it could have an adverse effect on Bancorp's stock price and investment value.

Under federal law, capital distributions from the Bank would become prohibited, with limited exceptions, if the Bank were categorized as "undercapitalized" under applicable FRB or FDIC regulations. In addition, as a California bank, Bank of Marin is subject to state law restrictions on the payment of dividends. For further information on the distribution limit from the Bank to Bancorp, see the section captioned “Bank Regulation” in Item 1 above and “Dividends” in Note 8 to the Consolidated Financial Statements in Item 8 of this report.

The Trading Volume of Bancorp's Common Stock is Less than That of Other, Larger Financial Services Companies

Our common stock is listed on the NASDAQ Capital Market exchange. Our trading volume is less than that of nationwide or larger regional financial institutions. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence of willing buyers and sellers of common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control. Given the low trading volume of our common stock, significant trades of our stock in a given time, or the expectations of these trades, could cause volatility in the stock price.

We may need to Raise Additional Capital in the Future, and if we Fail to Maintain Sufficient Capital, Whether due to Losses, an Inability to Raise Additional Capital or Otherwise, our Financial Condition, Liquidity and Results of Operations, as well as our Ability to Maintain Regulatory Compliance, Could be Adversely Affected

We face significant capital and other regulatory requirements as a financial institution. We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs, which could include the possibility of financing acquisitions. In addition, Bancorp, on a consolidated basis, and the Bank, on a stand-alone basis, must meet certain regulatory capital requirements and maintain sufficient liquidity. Importantly, as discussed below, regulatory capital requirements could increase from current levels, which could require us to raise additional capital or contract our operations. Our ability to raise additional capital depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities, and on our financial condition and performance. Accordingly, we cannot assure that we will be able to raise additional capital if needed or on terms acceptable to us. If we fail to maintain capital to meet regulatory requirements, our liquidity, business, financial condition and results of operations could be materially and adversely affected.

We may be Subject to more Stringent Capital Requirements in the Future

We are subject to regulatory requirements specifying minimum amounts and types of capital that we must maintain. From time to time, the regulators change these regulatory capital adequacy guidelines. If we fail to meet these minimum capital guidelines and other regulatory requirements, Bancorp or the Bank may be restricted in the types of activities

we may conduct and we may be prohibited from taking certain capital actions, such as paying dividends and repurchasing or redeeming capital securities.

In particular, the capital requirements applicable to us under the Basel III capital framework in the United States, which became effective beginning January 2015, will be fully phased-in by January 2019. As these new rules take effect, we will be required to satisfy additional, more stringent, capital adequacy standards than we have in the past. In addition, if we become subject to annual stress testing requirements, our stress test results may have the effect of requiring us to comply with even greater capital requirements. While we currently meet the requirements of the new Basel III-based capital rules on a fully implemented basis, we may eventually fail to do so. In addition, these requirements could have a negative affect on our ability to lend, grow deposit balances, make acquisitions or make capital distributions in the form of dividends or share repurchases. Higher capital levels could also lower our return on equity.

We may be Subject to Environmental Liabilities in Connection with the Foreclosure on Real Estate Assets Securing our Loan Portfolio

Hazardous or toxic substances or other environmental hazards may be located on the properties that secure our loans. If we acquire such properties as a result of foreclosure or otherwise, we could become subject to various environmental liabilities. For example, we could be held liable for the cost of cleaning up or otherwise addressing contamination at or from these properties. We could also be held liable to a governmental entity or third-party for property damage, personal injury or other claims relating to any environmental contamination at or from these properties. In addition, we own and operate certain properties that may be subject to similar environmental liability risks. Although we have policies and procedures that are designed to mitigate against certain environmental risks, we may not detect all environmental hazards associated with these properties. If we ever became subject to significant environmental liabilities, our business, financial condition and results of operations could be adversely affected.

The Small to Medium-sized Businesses that we Lend to may have Fewer Resources to Weather Adverse Business Developments, which may Impair a Borrower's Ability to Repay a Loan, and such Impairment could Adversely Affect our Results of Operations and Financial Condition

We focus our business development and marketing strategy primarily on small to medium-sized businesses. Small to medium-sized businesses frequently have smaller market shares than their competition, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience substantial volatility in operating results, any of which may impair a borrower's ability to repay a loan. In addition, the success of a small and medium-sized business often depends on the management talents and efforts of one or two people or a small group of people, and the death, disability or resignation of one or more of these people could adversely affect the business and its ability to repay its loan. If general economic conditions negatively affect the California markets in which we operate and small to medium-sized businesses are adversely affected or our borrowers are otherwise affected by adverse business developments, our business, financial condition and results of operations may be negatively affected.

A Lack of Liquidity could Adversely Affect our Operations and Jeopardize our Business, Financial Condition and Results of Operations

Liquidity is essential to our business. We rely on our ability to generate deposits and effectively manage the repayment and maturity schedules of our loans and investment securities, respectively, to ensure that we have adequate liquidity to fund our operations. An inability to raise funds through deposits, borrowings, securities sales, Federal Home Loan Bank advances, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our most important source of funds consists of deposits. Deposit balances can decrease when customers

perceive alternative investments as providing a better risk/return tradeoff. If customers move money out of bank deposits and into other investments, we would lose a relatively low-cost source of funds, increasing our funding costs and reducing our net interest income and net income.

Other primary sources of funds consist of cash flows from operations, investment maturities and sales, loan repayments, and proceeds from the issuance and sale of any equity and debt securities to investors. Additional liquidity is provided by the ability to borrow from the Federal Reserve Bank of San Francisco and the Federal Home Loan Bank and our ability to raise brokered deposits. We also may borrow funds from third-party lenders, such as other financial institutions. Our access to funding sources in amounts adequate to finance or capitalize our activities, or on terms that are acceptable

to us, could be impaired by factors that affect us directly or the bank or non-bank financial services industries or the economy in general, such as disruptions in the financial markets or negative views and expectations about the prospects for the bank or non-bank financial services industries.

Based on past experience, we believe that our deposit accounts are relatively stable sources of funds. If we increase interest rates paid to retain deposits, our earnings may be adversely affected, which could have an adverse effect on our business, financial condition and results of operations.

Any decline in available funding could adversely affect our ability to originate loans, invest in securities, meet our expenses, pay dividends to our shareholders or to fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, financial condition and results of operations.

ITEM 1B UNRESOLVED STAFF COMMENTS

None

ITEM 2 PROPERTIES

We lease our corporate headquarters building in Novato, California, which houses substantial loan production, operations and administration. We also lease other branch or office facilities within our primary market areas in the cities of Corte Madera, San Rafael, Novato, Sausalito, Mill Valley, Tiburon, Greenbrae, Petaluma, Santa Rosa, Sonoma, Napa, San Francisco, Alameda and Oakland. We consider our properties to be suitable and adequate for our needs. For additional information on properties, see Notes 4 and 12 to the Consolidated Financial Statements included in Item 8 of this report.

ITEM 3 LEGAL PROCEEDINGS

We may be party to legal actions which arise from time to time as part of the normal course of our business. We believe, after consultation with legal counsel, that we have meritorious defenses in these actions, and that litigation contingent liability, if any, will not have a material adverse effect on our financial position, results of operations, or cash flows.

We are responsible for our proportionate share of certain litigation indemnifications provided to Visa U.S.A. by its member banks in connection with lawsuits related to anti-trust charges and interchange fees. For further details, see Note 12 to the Consolidated Financial Statements in Item 8 of this report.

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5 MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Bancorp common stock trades on the NASDAQ Capital Market under the symbol BMRC. At February 28, 2017, 6,129,817 shares of Bancorp's common stock, no par value, were outstanding and held by approximately 2,200 holders of record and beneficial owners. The following table sets forth, for the periods indicated, the range of high and low intra-day sales prices of Bancorp's common stock.

Calendar	2016		2015	
Quarter	High	Low	High	Low
1st Quarter	$54.50	$45.65	$52.96	$48.63
2nd Quarter	$51.61	$47.16	$53.00	$45.81
3rd Quarter	$52.47	$47.25	$52.89	$46.81
4th Quarter	$75.05	$49.25	$56.77	$47.75

The table below shows cash dividends paid to common shareholders on a quarterly basis in the last two fiscal years.

Calendar	2016		2015	
Quarter	Per Share	Dollars	Per Share	Dollars
1st Quarter	$0.25	$1,518	$0.22	$1,307
2nd Quarter	$0.25	$1,526	$0.22	$1,313
3rd Quarter	$0.25	$1,528	$0.22	$1,316
4th Quarter	$0.27	$1,651	$0.24	$1,454
	$1.02	$6,223	$0.90	$5,390

On January 20, 2017 the Company declared a quarterly cash dividend of 27 cents per share payable February 10, 2017 to shareholders of record at the close of business on February 3, 2017. For additional information regarding our ability to pay dividends, see discussion in Note 8 to the Consolidated Financial Statements, under the heading “Dividends,” in Item 8 of this report.

There were no purchases made by or on behalf of Bancorp or any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of the Bancorp's common stock during the fourth quarter of 2016.

On July 2, 2007, Bancorp executed a shareholder rights agreement (“Rights Agreement”) designed to discourage takeovers that involve abusive tactics or do not provide fair value to shareholders, which was amended on June 17, 2016. For further information, see Note 8 to the Consolidated Financial Statements, under the heading “Preferred Stock and Shareholder Rights Plan” in Item 8 of this report.

Securities Authorized for Issuance under Equity Compensation Plans

The following table summarizes information as of December 31, 2016, with respect to equity compensation plans. All plans have been approved by the shareholders.

	(A) Shares to be issued upon exercise of outstanding options[1]	(B) Weighted average exercise price of outstanding	(C) Shares remaining available for future issuance (excluding shares in column A) [2]

		options	
Equity compensation plans approved by shareholders	181,789	$ 41.20	269,592

[1] Represents shares of common stock issuable upon exercise of outstanding options under the Bank of Marin 1999 Stock Option Plan and the Bank of Marin Bancorp 2007 Equity Plan.

[2] Represents remaining shares of common stock available for future grants under the 2007 Equity Plan and the 2010 Director Stock Plan, excluding shares to be issued upon exercise of outstanding options.

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Five-Year Stock Price Performance Graph

The following graph, compiled by SNL Financial LC of Charlottesville, Virginia, shows a comparison of cumulative total shareholder return on our common stock during the five fiscal years ended December 31, 2016 compared to the Russell 2000 Stock index and the SNL Bank $1B - $5B Index. The comparison assumes $100 was invested on December 31, 2011 in our common stock and all of the dividends were reinvested. The graph represents past performance and should not be considered to be an indication of future performance. In addition, total return performance results vary depending on the length of the performance period.

	2011	2012	2013	2014	2015	2016
Bank of Marin Bancorp (BMRC)	100	101.52	119.69	147.63	152.61	203.45
Russell 2000 Index	100	116.35	161.52	169.43	161.95	196.45
SNL Bank $1B - $5B Index	100	123.31	179.31	187.48	209.86	301.92

Source: SNL Financial LC of Charlottesville, Virginia

ITEM 6 SELECTED FINANCIAL DATA

The following data has been derived from the audited consolidated financial statements of Bank of Marin Bancorp. For additional information, refer to Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, and Item 8, Financial Statements and Supplementary Data.

	At December 31,				
(in thousands)	2016	2015	2014	2013	2012
Selected financial condition data:					
Total assets	$2,023,493	$2,031,134	$1,787,130	$1,805,194	$1,434,749
Loans, net	1,471,174	1,436,299	1,348,252	1,255,098	1,060,291
Deposits	1,772,700	1,728,226	1,551,619	1,587,102	1,253,289
Borrowings	5,586	72,395	20,185	19,969	15,000
Stockholders' equity	230,563	214,473	200,026	180,887	151,792

	For the Years Ended December 31,				
(dollars in thousands, except per share data)	2016	2015	2014	2013	2012
Selected operating data:					
Net interest income	$73,161	$67,187	$70,441	$58,775	$63,190
(Reversal of) provision for loan losses	(1,850)	500	750	540	2,900
Non-interest income	9,161	9,193	9,041	8,066	7,112
Non-interest expense [1]	47,692	46,949	47,263	44,092	38,694
Net income [1]	23,134	18,441	19,771	14,270	17,817
Net income per common share:					
Basic	$3.81	$3.09	$3.35	$2.62	$3.34
Diluted	$3.78	$3.04	$3.29	$2.57	$3.28

	At or for the Years ended December 31,				
	2016	2015	2014	2013	2012
Performance and other financial ratios:					
Return on average assets	1.15%	0.98%	1.08%	0.96%	1.24%
Return on average equity	10.23%	8.84%	10.31%	8.86%	12.36%
Tax-equivalent net interest margin	3.91%	3.83%	4.13%	4.20%	4.74%
Efficiency ratio	57.93%	61.47%	59.46%	65.97%	55.04%
Loan-to-deposit ratio	83.86%	83.97%	87.87%	79.98%	85.69%
Cash dividend payout ratio on common stock [2]	26.77%	29.10%	23.90%	27.90%	21.00%
Cash dividends per common share	$1.02	$0.90	$0.80	$0.73	$0.70
Asset quality ratios:					
Allowance for loan losses to total loans	1.04%	1.03%	1.11%	1.12%	1.27%
Allowance for loan losses to non-performing loans [3]	106.5 x	6.88x	1.61x	1.22x	0.77x
Non-performing loans to total loans [3]	0.01%	0.15%	0.69%	0.92%	1.64%
Capital ratios:					
Equity to total assets ratio	11.39%	10.60%	11.20%	10.00%	10.60%
Total capital (to risk-weighted assets)	14.32%	13.37%	13.94%	13.21%	13.71%
Tier 1 capital (to risk-weighted assets)	13.37%	12.44%	12.87%	12.18%	12.52%
Tier 1 capital (to average assets)	11.39%	10.67%	10.62%	10.78%	10.30%
Common equity Tier 1 capital (to risk-weighted assets)	13.07%	12.16%	N/A	N/A	N/A
Other data:					
Number of full service offices	20	20	21	21	17
Full time equivalent employees	262	259	260	281	238

[1] 2014 and 2013 included $746 thousand and $3.7 million, respectively, in merger-related expenses.
[2] Calculated as dividends on common shares divided by basic net income per common share.
[3] Non-performing loans include loans on non-accrual status and loans past due 90 days or more and still accruing interest.

ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of financial condition as of December 31, 2016 and 2015 and results of operations for each of the years in the three-year period ended December 31, 2016 should be read in conjunction with our consolidated financial statements and related notes thereto, included in Part II Item 8 of this report. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

Forward-Looking Statements

The disclosures set forth in this item are qualified by important factors detailed in Part I captioned Forward-Looking Statements and Item 1A captioned Risk Factors of this report and other cautionary statements set forth elsewhere in the report.

Executive Summary

Annual earnings increased 25.4% in 2016 to $23.1 million compared to $18.4 million in 2015. Diluted earnings of $3.78 per share for the year ended December 31, 2016 compared to $3.04 per share in the same period of 2015.

The following are highlights of operating and financial performance for the year ended December 31, 2016:

- Record earnings resulted in a return on assets ("ROA") of 1.15% for the year ended December 31, 2016, and a return on equity ("ROE") of 10.23%. Earnings in 2016 benefited from higher earning assets, a large loan recovery in the third quarter that resulted in interest recoveries of $1.4 million and reversal of loan loss reserve of $1.6 million and a $1.0 million increase in gains on payoffs of purchased credit impaired loans.
- Credit quality is very strong and continues to improve. Non-accrual loans continued to trend downward, and decreased to $145.0 thousand at December 31, 2016 from $2.2 million at December 31, 2015, and as a percentage of total loans declined to 0.01% from 0.15% a year ago. Due to our current low level of non-performing loans, going forward we do not anticipate any significant recoveries on problem loans similar to the ones that boosted our earnings this year.
- Our loan to deposit ratio totaled 84% at December 31, 2016. Loans increased by $35.4 million for the year and totaled $1,486.6 million at December 31, 2016 compared to $1,451.2 million at December 31, 2015. New loan volume of approximately $192 million in 2016 resulted primarily from originations of investor commercial real estate, owner occupied commercial real estate and commercial and industrial loans. Loan payoffs of approximately $158 million for the year were down $11 million from 2015 and primarily the result of property sales, cash repayments and successful completion of construction projects.
- Deposits grew $44.5 million, or 2.6%, to $1,772.7 million at December 31, 2016 from $1,728.2 million at December 31, 2015. Non-interest bearing deposits totaled $817.0 million at December 31, 2016, an increase of $46.9 million, or 6.1%, when compared to December 31, 2015. Non-interest bearing deposits represented 46.1% of total deposits as of December 31, 2016 compared to 44.6% at December 31, 2015.
- Net interest income totaled $73.2 million and $67.2 million in 2016 and 2015, respectively. The increase of $6.0 million in 2016 is primarily due to an increase of $120 million in average earning assets, a $1.4 million interest recovery, and greater gains on payoffs and accretion on purchased loans, partially offset by lower average rates on loans and investment securities and prepayment fees of $312 thousand on a Federal Home Loan Bank ("FHLB") advance in the second quarter of 2016. The tax equivalent net interest margin increased to 3.91% in 2016 compared to 3.83% in 2015 for the same reasons.
- Our efficiency ratio (the ratio of non-interest expense divided by the sum of net interest income and non-interest income) was 57.93% and 61.47% in 2016 and 2015, respectively. Our expense discipline allowed for a healthy efficiency ratio, notwithstanding the challenging interest rate, competitive and regulatory environments.
- All of our capital ratios are well above current regulatory requirements for a "well-capitalized" institution. The total risk-based capital ratio for Bancorp was 14.3% at December 31, 2016 compared to 13.4% last year.

Looking forward into 2017, we believe we are well-positioned to grow our loans and deposits with strong loan and deposit pipelines at the end of 2016 despite many market uncertainties and a general expectation of 10% annual loan runoff. We expect to be able to weather economic uncertainties, including but not limited to the interest rate environment and corporate tax rates.

- We have ample liquidity and capital to support organic growth and acquisitions in coming years.
- Acquisitions remain a component of our strategic plan. The Bay Area is an economically attractive area and we intend to expand our footprint through organic growth (including opening new branches and commercial banking offices) and strategic acquisitions. As we build our team and add strategic client-facing staff, we continue our expense control measures to remain an efficient bank.
- Our disciplined credit culture and relationship-focused banking continue to be critical components of our success.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the difference between the interest earned on loans, investments and other interest-earning assets and the interest expense incurred on deposits and other interest-bearing liabilities. Net interest income is affected by changes in general market interest rates and by changes in the amounts and composition of interest-earning assets and interest-bearing liabilities. Interest rate changes can create fluctuations in net interest income and/or margin due to an imbalance in the timing of repricing or maturity of assets or liabilities. We manage interest rate risk exposure with the goal of minimizing the effect of interest rate volatility on net interest income.

Net interest margin is expressed as net interest income divided by average interest-earning assets. Net interest rate spread is the difference between the average rate earned on total interest-earning assets and the average rate incurred on total interest-bearing liabilities. Both of these measures are reported on a taxable-equivalent basis. Net interest margin is the higher of the two because it reflects interest income earned on assets funded with non-interest-bearing sources of funds, which include demand deposits and stockholders' equity.

The following table, Average Statements of Condition and Analysis of Net Interest Income, compares interest income, average interest-earning assets, interest expense, and average interest-bearing liabilities for the periods presented. The table also presents net interest income, net interest margin and net interest rate spread for the years indicated.

Table 1 Average Statements of Condition and Analysis of Net Interest Income

	Year ended December 31, 2016			Year ended December 31, 2015			Year ended December 31, 2014		
(dollars in thousands; unaudited)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Assets									
Interest-bearing due from banks [1]	$38,314	$209	0.54%	$52,004	$135	0.26%	$63,150	$161	0.25%
Investment securities [2, 3]	406,640	8,671	2.13%	370,730	8,255	2.23%	341,787	8,385	2.45%
Loans [1, 3, 4]	1,452,357	68,794	4.66%	1,354,564	62,953	4.58%	1,317,794	65,856	4.93%
Total interest-earning assets [1]	1,897,311	77,674	4.03%	1,777,298	71,343	3.96%	1,722,731	74,402	4.26%
Cash and non-interest-bearing due from banks	42,150			44,543			44,452		
Bank premises and equipment, net	8,836			9,705			9,290		
Interest receivable and other assets, net	59,989			58,201			56,592		
Total assets	$2,008,286			$1,889,747			$1,833,065		
Liabilities and Stockholders' Equity									
Interest-bearing transaction accounts	$94,252	$109	0.12%	$95,662	$115	0.12%	$101,133	$99	0.10%
Savings accounts	151,214	58	0.04%	134,997	50	0.04%	125,169	46	0.04%
Money market accounts	524,989	445	0.08%	505,280	495	0.10%	507,055	550	0.11%
Time accounts, including CDARS	158,878	742	0.47%	156,316	853	0.55%	155,229	917	0.59%
Overnight borrowings [1]	5,383	23	0.42%	784	3	0.38%	4	—	— %
FHLB fixed-rate advances [1]	6,803	456	6.59%	15,000	315	2.07%	15,000	315	2.07%
Subordinated debentures [1]	5,493	436	7.80%	5,288	420	7.94%	5,070	422	8.36%
Total interest-bearing liabilities	947,012	2,269	0.24%	913,327	2,251	0.25%	908,660	2,349	0.26%

Demand accounts	819,916			753,038			717,738		
Interest payable and other liabilities	15,142			14,856			14,934		
Stockholders' equity	226,216			208,526			191,733		
Total liabilities & stockholders' equity	$2,008,286			$1,889,747			$1,833,065		
Tax-equivalent net interest income/margin [1]		$75,405	3.91%		$69,092	3.83%		$72,053	4.13%
Reported net interest income/margin [1]		$73,161	3.79%		$67,187	3.73%		$70,441	4.03%
Tax-equivalent net interest rate spread			3.79%			3.71%			4.00%

[1] Interest income/expense is divided by actual number of days in the period times 360 days to correspond to stated interest rate terms, where applicable.
[2] Yields on available-for-sale securities are calculated based on amortized cost balances rather than fair value, as changes in fair value are reflected as a component of stockholders' equity. Investment security interest is earned on 30/360 day basis monthly.
[3] Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the Federal statutory rate of 35 percent.
[4] Average balances on loans outstanding include non-performing loans. The amortized portion of net loan origination fees is included in interest income on loans, representing an adjustment to the yield.

Table 2 Analysis of Changes in Net Interest Income

The following table presents the effects of changes in average balances (volume) or changes in average rates on net interest income for the years indicated. Volume variances are equal to the increase or decrease in average balances multiplied by prior period rates. Rate variances are equal to the increase or decrease in rates multiplied by prior period average balances. Mix variances are attributable to the change in yields or rates multiplied by the change in average balances.

	2016 compared to 2015				2015 compared to 2014			
(in thousands, unaudited)	Volume	Yield/Rate	Mix	Total	Volume	Yield/Rate	Mix	Total
Interest-bearing due from banks	$(36)	$ 149	$(39)	$74	$(28)	$ 3	$(1)	$(26)
Investment securities [1]	800	(350)	(34)	416	710	(774)	(66)	(130)
Loans [1]	4,545	1,209	87	5,841	1,838	(4,612)	(129)	(2,903)
Total interest-earning assets	5,309	1,008	14	6,331	2,520	(5,383)	(196)	(3,059)
Interest-bearing transaction accounts	(2)	(4)	—	(6)	(5)	23	(1)	17
Savings accounts	6	2	—	8	4	—	—	4
Money market accounts	19	(67)	(3)	(51)	(2)	(53)	—	(55)
Time accounts, including CDARS	14	(123)	(2)	(111)	6	(70)	—	(64)
FHLB borrowings and overnight borrowings	(155)	690	(374)	161	—	—	3	3
Subordinated debentures	17	—	—	17	18	(20)	(1)	(3)
Total interest-bearing liabilities	(101)	498	(379)	18	21	(120)	1	(98)
	$5,410	$ 510	$393	$6,313	$2,499	$ (5,263)	$(197)	$(2,961)

[1] Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the federal statutory rate of 35%.

2016 Compared with 2015

The tax-equivalent net interest margin was 3.91% in 2016, compared to 3.83% in 2015. The increase of eight basis points was primarily due to a $1.4 million interest recovery upon payoff of a problem credit. Other factors that affected the net interest margin during 2016 included greater gains on payoffs and accretion on purchased loans and a shift to higher yielding earning assets, partially offset by lower average rates on loans and investment securities and prepayment fees of $312 thousand on FHLB borrowings. The net interest spread increased eight basis points over the same period for the same reasons.

The yield on average interest-earning assets increased seven basis points in 2016 compared to 2015 for the reasons listed above. The loan portfolio as a percentage of average interest-earning assets, increased to 76.6% in 2016, from 76.2% in 2015. The investment securities were 21.4% and 20.9% of average interest-earning assets in 2016 and 2015, respectively. Total average interest-earning assets increased $120.0 million, or 6.8%, in 2016 compared to 2015.

2015 Compared with 2014

The tax-equivalent net interest margin was 3.83% in 2015, compared to 4.13% in 2014. The decrease of thirty basis points was primarily due to a lower yield on interest-earning assets, mainly relating to a decrease in accretion and gains on payoffs of acquired loans, new loans and investment securities yielding lower rates and downward repricing on renewed loans. The net interest spread decreased twenty nine basis points over the same period for the same reasons.

The yield on average interest-earning assets decreased thirty basis points in 2015 compared to 2014 for the reasons listed above. The loan portfolio as a percentage of average interest-earning assets, decreased to 76.2% in 2015, from

76.5% in 2014. Investment securities were 20.9% and 19.8% of average interest-earning assets in 2015 and 2014, respectively. Total average interest-earning assets increased $54.6 million, or 3.2%, in 2015 compared to 2014.

Market Interest Rates

Market interest rates are, in part, based on the target federal funds interest rate (the interest rate banks charge each other for short-term borrowings) regulated by the Federal Open Market Committee ("FOMC"). In December 2015 and December 2016, the FOMC raised the target federal funds rate by 25 basis points to a range of 0.25% to 0.50% and 0.50% to 0.75%, respectively. The increase in 2016 was only the second rate hike since 2008. The prolonged low interest rate environment has negatively affected our net interest margin and yields on our earning assets and resulted in significant net interest margin compression over the last several years. Our net interest margin may compress due to repricing on loans and securities if the prevailing market interest rates do not increase. If interest rates rise, we anticipate that net interest income will increase.

Impact of Acquired Loans on Net Interest Margin

Early payoffs or prepayments of our acquired loans with significant unamortized purchase discount/premium could result in volatility in our net interest margin. Accretions and gains on payoffs of purchased loans are recorded in interest income. The positive affect on our net interest margin during the past three years was as follows:

	Years ended December 31,					
	2016		2015		2014	
(dollars in thousands; unaudited)	Dollar Amount	Basis point affect on net interest margin	Dollar Amount	Basis point affect on net interest margin	Dollar Amount	Basis point affect on net interest margin
Accretion on PCI loans	$364	2 bps	$495	3 bps	$614	4 bps
Accretion on non-PCI loans	$1,411	7 bps	$1,389	8 bps	$3,292	19 bps
Gains on payoffs of PCI loans	$1,027	5 bps	$44	0 bps	$622	4 bps

Critical Accounting Policies and Estimates

Critical accounting policies are those that are both very important to the portrayal of our financial condition and results of operations and require Management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and imprecise.

Management has determined the following four accounting policies to be critical:

Allowance for Loan Losses: For information regarding our ALLL methodology, the related provision for loan losses, risks related to asset quality and lending activity, see Item 1A - Risk Factors, Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations, and Note 1 - Summary of Significant Accounting Policies and Note 3 - Loans and Allowance for Loan Losses in Item 8 - Financial Statements and Supplementary Data of this Form 10-K.

Other-than-temporary Impairment of Investment Securities: For information regarding our investment securities, investment activity, and related risks, see Item 1A - Risk Factors, Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations, Note 1 - Summary of Significant Accounting Policies and Note 2 - Investment Securities in Item 8 - Financial Statements and Supplementary Data of this Form 10-K.

Accounting for Income Taxes: For information on our tax assets and liabilities, and related provision for income taxes, see Note 1 - Summary of Significant Accounting Policies and Note 11 - Income Taxes in Item 8 - Financial

Statements and Supplementary Data of this Form 10-K.

Fair Value Measurements: For information on our use of fair value measurements and our related valuation methodologies, see Note 1 - Summary of Significant Accounting Policies and Note 9 - Fair Value of Assets and Liabilities in Item 8 - Financial Statements and Supplementary Data of this Form 10-K.

Provision for Loan Losses

Management assesses the adequacy of the allowance for loan losses on a quarterly basis based on several factors including growth of the loan portfolio, analysis of probable losses in the portfolio, historical loss experience and the current economic climate. Actual losses on loans are charged against the allowance, and the allowance is increased by loss recoveries and provisions for loan losses charged to expense. For further discussion, see Note 1 to the Consolidated Financial Statements in Item 8 of this report.

A $1.9 million reversal of the provision for loan losses was recorded in 2016, primarily related to a $2.6 million recovery of a commercial real estate credit and an improvement in credit quality of the portfolio. Provision for loan losses totaled $500 thousand in 2015 and $750 thousand in 2014. The allowance for loan losses totaled 1.04%, 1.03% and 1.11% of loans at December 31, 2016, 2015 and 2014, respectively. Net recoveries of $2.3 million in 2016 primarily related to the resolution of a problem commercial real estate credit (discussed previously), compared to net charge-offs of $600 thousand in the prior year primarily relating to a land development loan sold in 2015. Net recoveries totaled $125 thousand in 2014. See the section captioned “Allowance for Loan Losses” below for further analysis of the provision for loan losses.

Non-interest Income

The table below details the components of non-interest income.
Table 3 Components of Non-Interest Income

(dollars in thousands; unaudited)	Years ended December 31, 2016	2015	2014	2016 compared to 2015 Amount Increase (Decrease)	Percent Increase (Decrease)	2015 compared to 2014 Amount Increase (Decrease)	Percent Increase (Decrease)
Service charges on deposit accounts	$1,789	$1,979	$2,167	$(190)	(9.6)%	$(188)	(8.7)%
Wealth Management and Trust Services	2,090	2,391	2,309	(301)	(12.6)%	82	3.6%
Debit card interchange fees	1,503	1,445	1,378	58	4.0%	67	4.9%
Merchant interchange fees	449	545	803	(96)	(17.6)%	(258)	(32.1)%
Earnings on bank-owned life insurance	844	814	841	30	3.7%	(27)	(3.2)%
Dividends on FHLB stock	1,153	1,003	563	150	15.0%	440	78.2%
Gains on investment securities, net	425	79	80	346	438.0%	(1)	(1.3)%
Other income	908	937	900	(29)	(3.1)%	37	4.1%
Total non-interest income	$9,161	$9,193	$9,041	$(32)	(0.3)%	$152	1.7%

2016 Compared with 2015

Non-interest income totaled $9.2 million in both 2016 and 2015, respectively. Non-interest income in 2016 included higher gains on the sale of investment securities, and higher dividends on FHLB stock, as we purchased $1.8 million in capital stock and received a $347 thousand special dividend, compared to a $305 thousand special dividend in 2015. These increases were offset by lower service charges on business analysis accounts due to higher average deposit balances and lower wealth management and trust related fees due to the settlement of several large estates in 2015 and early 2016. Additionally, merchant interchange fees continue to trend down as we transition our merchant customers to a new service provider with different contract arrangements.

2015 Compared with 2014

Non-interest income totaled $9.2 million and $9.0 million in 2015 and 2014, respectively. The increase compared to the prior year primarily relates to the increase in dividends on FHLB stock, due to a $305 thousand special dividend from the FHLB and higher annualized dividend rates in 2015. The increase was partially offset by lower merchant interchange fees due to decreased transaction volume and lower service charges on deposit accounts compared to 2014.

Non-interest Expense

The table below details the components of non-interest expense.
Table 4 Components of Non-Interest Expense

(dollars in thousands; unaudited)	Years ended December 31, 2016	2015	2014	2016 compared to 2015 Amount Increase (Decrease)	Percent Increase (Decrease)	2015 compared to 2014 Amount Increase (Decrease)	Percent Increase (Decrease)
Salaries and related benefits	$26,663	$25,764	$25,005	$899	3.5 %	$759	3.0 %
Occupancy and equipment	5,081	5,498	5,470	(417)	(7.6)%	28	0.5 %
Depreciation and amortization	1,822	1,968	1,585	(146)	(7.4)%	383	24.2 %
FDIC insurance	825	997	1,032	(172)	(17.3)%	(35)	(3.4)%
Data processing	3,625	3,318	3,665	307	9.3 %	(347)	(9.5)%
Professional services	2,044	2,121	2,230	(77)	(3.6)%	(109)	(4.9)%
Directors' expense	553	826	628	(273)	(33.1)%	198	31.5 %
Information technology	862	736	675	126	17.1 %	61	9.0 %
Provision for (reversal of) losses on off-balance sheet commitments	150	(263)	334	413	(157.0)%	(597)	(178.7)%
Other non-interest expense:							
Advertising	565	334	400	231	69.2 %	(66)	(16.5)%
Amortization of core deposit intangible	533	619	771	(86)	(13.9)%	(152)	(19.7)%
Other expense	4,969	5,031	5,468	(62)	(1.2)%	(437)	(8.0)%
Total other non-interest expense	6,067	5,984	6,639	83	1.4 %	(655)	(9.9)%
Total non-interest expense	$47,692	$46,949	$47,263	$743	1.6 %	$(314)	(0.7)%

2016 Compared with 2015

Non-interest expense increased by $743 thousand to $47.7 million in 2016. The increase primarily relates to higher salaries and benefits due to annual merit increases, higher employee insurance and stock-based compensation expense, partially offset by the effect of job vacancies during the year. The number of average FTE employees totaled 258 in 2016 and 260 in 2015. The increase also relates to a higher reserve for losses on off-balance sheet commitments, as unused commitments increased in 2016, and 2015 included a one-time adjustment (reversal) related to a refinement in methodology (see discussion below). Data processing costs also increased due to higher transaction volume and the addition of new products and services.

These increases were partially offset by a decrease in occupancy and equipment expenses from cost savings related to the relocation of offices in 2016 and lease accounting adjustments recorded in 2015, lower director expense resulting from fewer board members, as well as lower FDIC assessment expense due to lower assessment rates.

2015 Compared with 2014

Non-interest expense decreased by $314 thousand to $46.9 million in 2015. The decrease primarily relates to the reversal of provision for losses on off-balance sheet commitments that was mainly due to a refinement in methodology used in the calculation of the loss reserve on these commitments by incorporating rolling four-quarter and average commitment usage, as well as eliminating outlier data for small commitment categories. Management believes this refined method reflects a better estimate of its credit exposure for unused loan commitments. The decrease also includes a decline in data processing expenses from bank acquisition-related expenses totaling $442 thousand in the first quarter of 2014 related to the system conversion.

The decrease in non-interest expense was partially offset by higher salaries and related benefits mainly due to higher employee benefits and lower deferred loan origination costs (partially off-set by lower salaries, commissions and associated payroll taxes in 2015 mainly related to the absence of acquisition-related personnel costs). The number of average FTE employees totaled 260 in 2015 and 266 in 2014. Depreciation and amortization expense also increased primarily due to non-recurring accounting adjustments in 2015.

Provision for Income Taxes

The provision for income taxes totaled $13.3 million at an effective tax rate of 36.6% in 2016, compared to $10.5 million at an effective tax rate of 36.3% in 2015 and $11.7 million at an effective tax rate of 37.2% in 2014. The increase in both the provision for income taxes and the effective tax rate from the prior year is primarily due to the higher amount of pre-tax income with the effect of diluting the tax benefits from tax-exempt earnings. These provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on qualified municipal securities, bank owned life insurance ("BOLI") and certain tax-exempt loans). Therefore, there are fluctuations in the effective rate from period to period based on the relationship of net permanent differences to income before tax.

Additionally, effective tax rates reflect the adoption of the amended FASB Accounting Standards Codification ("ASC") Topic 323-740 Investments—Equity Method and Joint Ventures—Income Taxes, beginning in 2014. In accordance with the proportional amortization methodology in accounting for low income tax credit investments, the tax credit investment amortization expense is presented as a component of provision for income taxes, as discussed in Note 2 to the Consolidated Financial Statements in Item 8 of this report.

We file a consolidated return in the U.S. Federal tax jurisdiction and a combined return in the State of California tax jurisdiction. There were no ongoing federal or state income tax examinations at the issuance of this report. In June 2015, the State of California completed its examination of the 2011 and 2012 corporate income tax returns, resulting in a minor adjustment. At December 31, 2016 and 2015, neither the Bank nor Bancorp had accruals for interest and penalties related to unrecognized tax benefits.

Although we believe our assumptions, judgments and estimates are reasonable, changes in tax laws could significantly impact the amounts provided for income taxes in our consolidated financial statements. In general, a reduction in the federal statutory tax rate would be a benefit to our future ongoing net income. However, upon the year of tax rate reduction, there would be a one-time write down to our deferred tax assets.

FINANCIAL CONDITION

The balance sheet declined $7.6 million between December 31, 2015 and December 31, 2016. Increases of $44.5 million in deposits and $35.4 million in loans were more than offset by the sale of investment securities and repayment of $67.0 million in FHLB borrowings.

A comparison of average balances between 2015 and 2016 shows healthy trends in loan and deposit growth of $97.8 million and $104.0 million, respectively.

Investment Securities

We maintain an investment securities portfolio to provide liquidity and to generate earnings on funds that have not been loaned to customers. Management determines the maturities and types of securities to be purchased based on liquidity, the interest rate risk position, and the desire to attain a reasonable investment yield balanced with risk exposure. Table 5 shows the composition of the debt securities portfolio by expected maturity at December 31, 2016 and 2015. Expected maturities 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. We estimate and update expected maturity dates regularly based on current and historical prepayment speeds. The weighted average maturity of the portfolio at December 31, 2016 and 2015 was approximately four years.

Table 5 Investment Securities

December 31, 2016	Within 1 Year			1-5 Years			5-10 Years			After 10 Years			Total		
(dollars in thousands; unaudited)	Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Fair Value	Avera Yield[2]
Held-to-maturity:															
State and municipal	$9,954	3.18	%	$18,925	5.33	%	$1,977	6.85	%	$—	—	%	$30,856	$31,544	4.73
Corporate bonds	3,519	1.07		—	—		—	—		—	—		3,519	3,518	1.07
MBS/CMOs issued by U.S. government agencies	—	—		4,051	3.50		6,012	3.32		—	—		10,063	10,035	3.39
Total held-to-maturity	13,473	2.63		22,976	5.01		7,989	4.19		—	—		44,438	45,097	4.14
Available-for-sale:															
MBS/CMOs issued by U.S. government agencies	11,609	1.65		143,216	2.05		103,260	1.92		—	—		258,085	254,041	1.98
State and municipal	4,027	1.93		31,929	2.35		41,980	3.07		1,369	5.46		79,305	77,701	2.76
Debentures of government sponsored agencies	5,000	1.00		30,486	1.13		—	—		—	—		35,486	35,403	1.11
Privately issued CMOs	265	1.62		154	3.01		—	—		—	—		419	419	2.13
Corporate bonds	—	—		3,965	1.97		994	1.99		—	—		4,959	5,016	1.97
Total available-for-sale	20,901	1.55		209,750	1.97		146,234	2.25		1,369	2.31		378,254	372,580	2.06
Total	$34,374	1.97	%	$232,726	2.28	%	$154,223	2.35	%	$1,369	2.31	%	$422,692	$417,677	2.28

December 31, 2015	Within 1 Year			1-5 Years			5-10 Years			After 10 Years			Total		
(dollars in thousands; unaudited)	Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Average Yield[2]		Amortized Cost[1]	Fair Value	Avera Yield[2]
Held-to-maturity:															
State and municipal	$7,795	2.82	%	$28,966	4.42	%	$6,158	6.40	%	$—	—	%	$42,919	$44,146	4.41
Corporate bonds	11,534	2.16		3,538	1.07		—	—		—	—		15,072	15,098	1.90
MBS/CMOs issued by U.S. government agencies	—	—		2,240	4.65		9,406	1.80		—	—		11,646	11,810	2.35
	19,329	2.43		34,744	4.09		15,564	3.62		—	—		69,637	71,054	3.52

Total held-to-maturity																
Available-for-sale:																
MBS/CMOs issued by U.S. government agencies	4,262	2.93		157,982	2.04		27,459	2.41		—	—		189,703	190,093	2.11	
State and municipal	4,673	2.24		32,406	2.25		17,755	3.58		2,276	4.84		57,110	57,673	2.77	
Debentures of government sponsored agencies	19,107	1.00		142,583	1.36		—	—		—	—		161,690	160,892	1.32	
Privately issued CMOs	—	—		980	1.30		2,980	2.20		—	—		3,960	4,150	1.98	
Corporate bonds	—	—		3,954	1.40		993	1.43		—	—		4,947	4,979	1.41	
Total available-for-sale	28,042	1.50		337,905	1.76		49,187	2.80		2,276	4.84		417,410	417,787	1.88	
Total	$47,371	1.88	%	$372,649	1.98	%	$64,751	3.00	%	$2,276	4.84	%	$487,047	$488,841	2.12	

[1] Book value reflects cost, adjusted for accumulated amortization and accretion.
[2] Weighted average yields on tax-exempt basis and weighted average calculation is based on amortized cost of securities.

The amortized cost of our investment securities portfolio decreased $64.4 million or 13.2% during 2016. $163.8 million in securities were purchased in 2016. $2.4 million of the purchased securities were designated as held-to-maturity, and $161.4 million were designated as available-for-sale to provide flexibility for liquidity and interest rate risk management. These purchases were partially offset by $155.4 million of paydowns, calls and maturities, and $69.5 million of sales during 2016 to repay $67.0 million of FHLB borrowings.

During 2016, we purchased $5.0 million in agency debentures issued by FNMA, $103.3 million in mortgage pass-through securities, $28.0 million in municipal securities, and $27.5 million in collateralized mortgage obligations ("CMOs"). We consider agency debentures, mortgage-backed securities, and CMOs issued by U.S. government sponsored entities to have low credit risk as they carry the credit support of the U.S. federal government. We also invest in municipalities with sound credit fundamentals. The debentures and MBS issued by the U.S. government sponsored agencies, state and municipal securities and corporate bonds, made up 71.8%, 26.1% and 2.0% of the portfolio at December 31, 2016, compared to 74.5%, 20.5% and 4.1%, respectively at December 31, 2015. See the discussion in the section captioned “Securities May Lose Value due to Credit Quality of the Issuers” in Item 1A Risk Factors above.

Any investment securities in our portfolio that may be backed by sub-prime or Alt-A mortgages, which account for approximately 0.1% of our total securities portfolio, relate to privately issued CMOs. See Note 2 to the Consolidated Financial Statements in Item 8, for more information on investment securities.

At December 31, 2016, distribution of our investment in obligations of state and political subdivisions was as follows:

	December 31, 2016			December 31, 2015		
(dollars in thousands; unaudited)	Amortized Cost	Fair Value	% of state and municipal securities	Amortized Cost	Fair Value	% of state and municipal securities
Within California:						
General obligation bonds	$15,777	$15,660	14.3 %	$18,642	$18,830	18.6 %
Revenue bonds	10,895	11,127	9.9	15,453	15,767	15.5
Tax allocation bonds	4,043	4,178	3.7	5,411	5,603	5.4
Total within California	30,715	30,965	27.9	39,506	40,200	39.5
Outside California:						
General obligation bonds	71,534	70,376	64.9	51,920	52,990	51.9
Revenue bonds	7,913	7,904	7.2	8,603	8,629	8.6
Total outside California	79,447	78,280	72.1	60,523	61,619	60.5
Total obligations of state and political subdivisions	$110,162	$109,245	100.0 %	$100,029	$101,819	100.0 %

The portion of the portfolio outside the state of California is distributed among 20 states. The largest concentrations outside California are in Washington (11.9%), Minnesota (11.8%), and Texas (11.4%). Revenue bonds, both within and outside California, primarily consisted of bonds relating to essential services (such as roads, public transportation and utilities).

Investments in states, municipalities and political subdivisions are subject to an initial pre-purchase credit assessment and ongoing monitoring. Key considerations include:

- The soundness of a municipality’s budgetary position and stability of its tax revenues
- Debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority of the issuer
- Local demographics/economics including unemployment data, largest local taxpayers and employers, income indices and home values
- For revenue bonds, the source and strength of revenue for municipal authorities including obligors' financial condition and reserve levels, annual debt service and debt coverage ratio, and credit enhancement (such as insurer’s strength)
- Credit ratings by major credit rating agencies.

Loans

Table 6 Loans Outstanding by Type at December 31

(in thousands; unaudited)	2016	2015	2014	2013	2012
Commercial loans	$218,615	$219,452	$210,223	$183,291	$176,431
Real estate					
Commercial owner-occupied	247,713	242,309	230,605	241,113	196,406
Commercial investor	724,228	715,879	673,499	625,019	509,006
Construction	74,809	65,495	48,413	31,577	30,665
Home equity	117,207	112,300	110,788	98,469	93,237
Other residential [1]	78,549	73,154	73,035	72,634	49,432
Installment and other consumer loans	25,495	22,639	16,788	17,219	18,775
Total loans	1,486,616	1,451,228	1,363,351	1,269,322	1,073,952
Allowance for loan losses	(15,442)	(14,999)	(15,099)	(14,224)	(13,661)
Total net loans	$1,471,174	$1,436,229	$1,348,252	$1,255,098	$1,060,291

[1] Our residential loan portfolio includes no sub-prime loans, nor is it our normal practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or collateral compositions reflecting high loan-to-value ratios. Substantially all of our residential loans are indexed to Treasury Constant Maturity Rates and have provisions to reset five years after their origination dates.

We continued to strengthen market presence throughout our footprint in 2016. New loan volume totaled approximately $192 million in 2016, compared to approximately $252 million in 2015. Approximately 85% of our outstanding loans were secured by real estate at both December 31, 2016 and 2015. Also see Item 1A, Risk Factors, regarding our loan concentration risk.

The following table summarizes our commercial real estate loan portfolio by the geographic location in which the property is located as of December 31, 2016 and 2015.

Table 7 Commercial Real Estate Loans Outstanding by Geographic Location

	December 31, 2016		December 31, 2015	
(dollars in thousands; unaudited)	Amount	% of Commercial real estate loans	Amount	% of Commercial real estate loans
Marin	$ 310,286	31.9 %	$ 317,035	33.1 %
Sonoma	155,066	16.0	132,592	13.8
San Francisco	143,975	14.8	130,164	13.6
Alameda	121,467	12.5	135,835	14.2
Napa	79,872	8.2	76,409	8.0
Contra Costa	41,808	4.3	40,084	4.2
San Mateo	22,360	2.3	21,756	2.3
El Dorado	14,146	1.5	14,414	1.5
Sacramento	11,083	1.1	17,592	1.8
Other	71,878	7.4	72,307	7.5
Total	$ 971,941	100.0 %	$ 958,188	100.0 %

Commercial real estate loans increased by $13.8 million in 2016 and $54.1 million in 2015. Of the commercial real estate loans at December 31, 2016 and 2015, 75% were non-owner occupied and 25% were owner occupied. Almost all of our commercial real estate loan portfolio is comprised of term loans for which the primary source of repayment

is the operating cash flow from the leasing activities of the real estate collateral. Originated loans are subject to our conservative credit underwriting standards and both the acquired and originated loans are actively managed.

The following table shows an analysis of construction loans by type and location as of December 31, 2016 and 2015.

Table 8 Construction Loans Outstanding by Type and Geographic Location

(dollars in thousands; unaudited)	December 31, 2016			December 31, 2015		
Construction loans by type	Amount	% of Construction Loans		Amount	% of Construction Loans	
1-4 Single family residential	$41,106	55.0	%	$39,444	60.2	%
Commercial real estate	19,861	26.6		17,962	27.4	
Apartments and multifamily	9,088	12.1		3,127	4.8	
Land - improved	3,245	4.3		3,224	4.9	
Land - unimproved	1,509	2.0		1,738	2.7	
Total	$74,809	100.0	%	$65,495	100.0	%

(dollars in thousands; unaudited)	December 31, 2016			December 31, 2015		
Construction loans by geographic location	Amount	% of Construction Loans		Amount	% of Construction Loans	
San Francisco	$31,256	41.8	%	$26,120	39.9	%
Marin	19,354	25.9		15,921	24.3	
Alameda	14,905	19.9		1,305	2.0	
San Mateo	—	—		9,327	14.2	
Napa	3,363	4.5		7,749	11.8	
Riverside	3,224	4.3		3,224	4.9	
Sonoma	2,609	3.5		1,725	2.6	
Other	98	0.1		124	0.3	
Total	$74,809	100.0	%	$65,495	100.0	%

Construction loans increased by $9.3 million in 2016 and $17.1 million in 2015. The increase in 2016 was due to draws on both new and existing single family development construction projects as well as on mixed-use commercial and owner-occupied construction projects. The increases in construction fundings were partially offset by payoffs related to completed construction projects. The increase in 2015 was due to substantial draws on existing single family development construction projects as they approached completion and origination of new construction loans. The improving economy resulted in a number of new financing opportunities for existing customers who had successfully completed construction projects in the past.

At December 31, 2016 and 2015, respectively, approximately 2.0% and 1.5% of our total loans contained an interest-only feature as part of the loan terms. All of these loans were current with their payments as of December 31, 2016. Except for two loans to one borrowing relationship totaling $7.0 million as of December 31, 2016 and 2015, all were considered to have low credit risk (graded "Pass").

As of December 31, 2016 and 2015, approximately $48.7 million and $43.4 million, respectively, of our loans had interest reserves, all of which were construction loans. When we determine a loan is impaired before the interest reserve has been depleted, the interest funded by the interest reserve is applied against loan principal. As of December 31, 2016 and 2015, no loans having interest reserve balances were determined to be impaired.

The following table presents the maturity distribution of our commercial and construction loans as of December 31, 2016 based on their contractual maturity dates and does not include scheduled payments or potential prepayments.

Table 9A Commercial and Construction Loan Maturity Distribution

(in thousands; unaudited)	Due within 1 year	Due after 1 but within 5 years	Due after 5 years	Total
Maturity distribution:				
Commercial	$75,278	$72,146	$71,191	$218,615
Construction	53,128	2,606	19,075	74,809
Total	$128,406	$74,752	$90,266	$293,424

The following table shows the mix of variable-rate loans to fixed-rate loans for commercial and construction loans. The large majority of the variable-rate loans are tied to independent indices (such as the Wall Street Journal prime rate or a Treasury Constant Maturity Rate). Most loans with original terms of more than five years have provisions for the fixed rates to reset, or convert to variable rates, after one, three or five years. These loans are included in variable rate balances.

Table 9B Commercial and Construction Loan Interest Rate Sensitivity

(in thousands; unaudited)	Fixed	Variable	Total
Commercial	$99,992	$118,623	$218,615
Construction	1,412	73,397	74,809
Total	$101,404	$192,020	$293,424

Allowance for Loan Losses

Credit risk is inherent in the business of lending. As a result, we maintain an allowance for loan losses to absorb probable losses in our loan portfolio through a provision for loan losses charged against earnings. All specifically identifiable and quantifiable losses are charged off against the allowance. The balance of our allowance for loan losses is Management's best estimate of the remaining probable losses in the portfolio. The ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the real estate market, changes in interest rates and economic and political environments. Based on the current conditions of the loan portfolio, Management believes that the $15.4 million allowance for loan losses at December 31, 2016 is adequate to absorb losses in our loan portfolio. No assurance can be given, however, that adverse economic conditions or other circumstances will not result in increased losses in the portfolio.

The Components of the Allowance for Loan Losses

As stated in Note 1 to the Consolidated Financial Statements in Item 8 of this report, the overall allowance consists of 1) specific allowances for individually identified impaired loans ("ASC 310-10") and 2) general allowances for pools of loans ("ASC 450-20"), which incorporate quantitative (e.g., loan loss rates) and qualitative risk factors (e.g., portfolio growth and trends, credit concentrations, economic and regulatory factors, etc.).

The first component, specific allowances, results from the analysis of identified problem credits and the evaluation of sources of repayment including collateral, as applicable. These loans are evaluated for impairment individually by Management. Management considers an originated loan to be impaired when it is probable we will be unable to

collect all amounts due according to the contractual terms of the loan agreement. For PCI loans, specific allowances are established to account for credit deterioration subsequent to acquisition if we have probable decreases in cash flows expected to be collected. For loans determined to be impaired, the extent of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate at origination (for originated loans), based on the loan's observable market price, or based on the fair value of the collateral if the loan is collateral dependent or if foreclosure is imminent. Generally with problem credits that are collateral dependent, we obtain appraisals of the collateral at least annually. We may obtain appraisals more frequently if we believe the collateral is subject to market volatility, if a specific event has occurred to the collateral, or if we believe foreclosure is imminent. Impaired loan balances decreased to $18.3 at December 31, 2016 from $21.2 million at December 31, 2015. The

decrease primarily relates to the resolution and pay-off of a $1.9 million commercial real estate credit and paydowns of several other impaired loans. The specific allowance decreased slightly to $991 thousand at December 31, 2016 from $1.2 million at December 31, 2015.

The second component is an estimate of the probable inherent losses in each loan pool with similar risk characteristics. This analysis encompasses the entire loan portfolio, excluding individually identified impaired loans and acquired loans whose purchase discount has not been fully accreted. Under our allowance model, loans are evaluated on a pool basis by federal regulatory reporting codes ("CALL codes" or "segments"), which are further delineated by assigned credit risk ratings, as described in Note 3 to the Consolidated Financial Statements in Item 8 of this report. At December 31, 2016 and 2015, the allowance allocated for the second component totaled $14.5 million and $13.8 million, respectively. The increase from 2015 to 2016 primarily relates to a $63.6 million increase in loans subject to general allowances for pools of loans.

Table 10 shows the allocation of the allowance by loan type as well as the percentage of total loans in each of the same loan types.

Table 10 Allocation of Allowance for Loan Losses

(dollars in thousands; unaudited)	December 31, 2016			December 31, 2015			December 31, 2014			December 31, 2013			December 31, 2012		
	Allowance balance allocation	Loans as a percent of total loans		Allowance balance allocation	Loans as a percent of total loans		Allowance balance allocation	Loans as a percent of total loans		Allowance balance allocation	Loans as a percent of total loans		Allowance balance allocation	Loans as a percent of total loans	
Commercial loans	$3,248	14.7	%	$3,023	15.1	%	$2,837	15.4	%	$3,056	14.4	%	$4,100	16.4	%
Real Estate:															
Commercial, owner-occupied	1,753	16.7		2,249	16.7		1,924	16.9		2,012	19.0		1,313	18.3	
Commercial, investor	6,320	48.7		6,178	49.4		6,672	49.4		6,196	49.2		4,372	47.4	
Construction	781	5.0		724	4.5		839	3.6		633	2.5		611	2.9	
Home Equity	973	7.9		910	7.7		859	8.1		875	7.8		1,264	8.7	
Other residential	454	5.3		394	5.0		433	5.4		317	5.7		551	4.6	
Installment and other consumer	372	1.7		425	1.6		566	1.2		629	1.4		1,231	1.7	
Unallocated allowance	1,541	N/A		1,096	N/A		969	N/A		506	N/A		219	N/A	
Total allowance for loan losses	$15,442			$14,999			$15,099			$14,224			$13,661		
Total percent		100.0	%		100.0	%		100.0	%		100.0	%		100.0	%