PACIFIC MERCANTILE BANCORP
Form 10-Q
August 05, 2016
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 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 0-30777

PACIFIC MERCANTILE BANCORP
(Exact name of Registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	33-0898238 (I.R.S. Employer Identification No.)
949 South Coast Drive, Suite 300, Costa Mesa, California (Address of principal executive offices)	92626 (Zip Code)

(714) 438-2500
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
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 definitions of "large accelerated filer," "accelerated filer," "non-accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer x
Non-accelerated filer o Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Securities Exchange Act Rule 12b-2). Yes ¨ No x
As of August 3, 2016, there were 22,996,587 shares of Common Stock outstanding.

1

Table of Contents

PACIFIC MERCANTILE BANCORP
QUARTERLY REPORT ON FORM 10Q
FOR THE QUARTER ENDED JUNE 30, 2016
TABLE OF CONTENTS

Table of Contents

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Dollars in thousands, except for per share data)
(Unaudited)

	June 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$11,546	$10,645
Interest bearing deposits with financial institutions	119,986	103,276
Cash and cash equivalents	131,532	113,921
Interest-bearing time deposits with financial institutions	3,917	4,665
Federal Reserve Bank of San Francisco and Federal Home Loan Bank Stock, at cost	8,170	8,170
Securities available for sale, at fair value	49,263	52,249
Loans (net of allowances of $13,429 and $12,716, respectively)	872,198	849,733
Other real estate owned	—	650
Accrued interest receivable	2,377	2,266
Premises and equipment, net	1,084	1,142
Net deferred tax assets	20,507	17,576
Other assets	11,867	12,017
Total assets	$1,100,915	$1,062,389
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	$294,153	$249,676
Interest-bearing	642,516	644,164
Total deposits	936,669	893,840
Borrowings	10,000	10,000
Accrued interest payable	180	255
Other liabilities	5,517	6,851
Junior subordinated debentures	17,527	17,527
Total liabilities	969,893	928,473
Commitments and contingencies (Note 10)		
Shareholders' equity:		
Common stock, no par value, 85,000,000 shares authorized; 22,984,453 and 22,820,332 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively	148,104	147,202
Accumulated deficit	(16,902)	(12,476)
Accumulated other comprehensive loss	(180)	(810)
Total shareholders' equity	131,022	133,916
Total liabilities and shareholders' equity	$1,100,915	$1,062,389

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

Table of Contents

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except for per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Interest income:				
Loans, including fees	$9,254	$ 9,175	$18,702	$ 18,194
Securities available for sale and stock	369	558	719	932
Interest-bearing deposits with financial institutions	212	80	369	159
Total interest income	9,835	9,813	19,790	19,285
Interest expense:				
Deposits	1,186	1,144	2,273	2,269
Borrowings	169	180	334	378
Total interest expense	1,355	1,324	2,607	2,647
Net interest income	8,480	8,489	17,183	16,638
Provision for loan and lease losses	8,720	—	9,140	—
Net interest income after provision for loan and lease losses	(240)	8,489	8,043	16,638
Noninterest income				
Service fees on deposits and other banking services	267	234	522	446
Net gain on sale of small business administration loans	—	—	40	—
Other noninterest income	597	382	1,056	1,052
Total noninterest income	864	616	1,618	1,498
Noninterest expense				
Salaries and employee benefits	5,506	5,423	11,193	11,330
Occupancy	793	752	1,538	1,412
Equipment and depreciation	450	430	873	823
Data processing	287	255	602	491
FDIC expense	251	339	446	692
Other real estate owned expense, net	—	59	(70)	161
Professional fees	774	744	1,325	1,372
Business development	201	198	344	392
Loan related expense	73	170	113	239
Insurance	76	88	152	175
Other operating expense	482	509	932	995
Total noninterest expense	8,893	8,967	17,448	18,082
Income (loss) before income taxes	(8,269)	138	(7,787)	54
Income tax (benefit) provision	(3,559)	—	(3,361)	—
Net (loss) income	(4,710)	138	(4,426)	54
Accumulated undeclared dividends on preferred stock	—	(309)	—	(618)
Net (loss) income allocable to common shareholders	$(4,710)	$ (171)	$(4,426)	$ (564)
Basic income (loss) per common share:				
Net (loss) income available to common shareholders	$(0.21)	$ (0.01)	$(0.19)	$ (0.03)
Diluted (loss) income per common share:				
Net (loss) income available to common shareholders	$(0.21)	$ (0.01)	$(0.19)	$ (0.03)
Weighted average number of common shares outstanding:				
Basic	22,962,106	19,773,799	22,917,680	19,695,679
Diluted	22,962,106	19,773,799	22,917,680	19,695,679

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

Table of Contents

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net (loss) income	$(4,710)	$138	$(4,426)	$54
Other comprehensive income (loss), net of tax:				
Change in unrealized gain (loss) on securities available for sale	118	(327)	630	(139)
Total comprehensive loss	$(4,592)	$(189)	$(3,796)	$(85)

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

Table of Contents

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Shares and dollars in thousands)
(Unaudited)
For the Six Months Ended June 30, 2016

	Common stock		Retained earnings (accumulated deficit)	Accumulated other comprehensive income (loss)	Total
	Number of shares	Amount			
Balance at December 31, 2015	22,820	$147,202	$ (12,476)	$ (810)	$133,916
Issuance of restricted stock, net	84	—	—	—	—
Tax effect from vesting of restricted stock	(3)	(16)	—	—	(16)
Common stock based compensation expense	—	553	—	—	553
Common stock options exercised	83	365	—	—	365
Net loss	—	—	(4,426)	—	(4,426)
Other comprehensive income	—	—	—	630	630
Balance at June 30, 2016	22,984	$148,104	$ (16,902)	$ (180)	$131,022

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

Table of Contents

PACIFIC MERCANTILE BANCORP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW
(Dollars in thousands)
(Unaudited)

	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Cash Flows From Operating Activities:		
Net (loss) income	$(4,426)	$54
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	238	261
Provision for loan and lease losses	9,140	—
Amortization of premium on securities	142	163
Net amortization of deferred fees and unearned income on loans	(193)	(332)
Net gain on sales of other real estate owned	(107)	—
Net gain on sale of premises and equipment	—	(27)
Net gain on sale of small business administration loans	(40)	—
Small business administration loan originations	(806)	—
Proceeds from sale of small business administration loans	840	—
Stock-based compensation expense	553	683
Tax effect of restricted stock vesting	(16)	(23)
Changes in operating assets and liabilities:		
Net (increase) decrease in accrued interest receivable	(111)	331
Net decrease (increase) in other assets	263	(142)
Net increase in deferred taxes	(3,371)	—
Net increase in income taxes receivable	(2)	(58)
Net decrease in accrued interest payable	(75)	(39)
Net decrease in other liabilities	(1,334)	(667)
Net cash provided by discontinued operations	—	—
Net cash provided by operating activities	695	204
Cash Flows From Investing Activities:		
Net decrease in interest-bearing time deposits with financial institutions	748	—
Maturities of and principal payments received on securities available for sale and other stock	3,914	4,130
Purchase of securities available for sale and other stock	—	(33)
Purchase of other investments	(87)	—
Principal payments received on other investments	—	2,087
Proceeds from sale of other real estate owned	757	—
Net (increase) decrease in loans	(31,430)	2,976
Purchases of premises and equipment	(180)	(329)
Proceeds from sale of premises and equipment	—	27
Net cash (used in) provided by investing activities	(26,278)	8,858
Cash Flows From Financing Activities:		
Net increase (decrease) in deposits	42,829	(44,359)
Payments of borrowings	—	(9,500)
Proceeds from exercise of common stock options	365	1,241
Net cash provided by (used in) financing activities	43,194	(52,618)
Net increase (decrease) in cash and cash equivalents	17,611	(43,556)
Cash and Cash Equivalents, beginning of period	113,921	177,135
Cash and Cash Equivalents, end of period	$131,532	$133,579

Supplementary Cash Flow Information:		
Cash paid for interest on deposits and other borrowings	$2,682	$2,686
Cash paid for income taxes	$2	$58
Non-Cash Investing Activities:		
Transfer of loans into other real estate owned	$—	$280
Non-Cash Financing Activities:		
Series C Preferred Stock issued in connection with dividends on Series B Preferred Stock	$—	$593

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

Table of Contents

1. Nature of Business

Organization

Pacific Mercantile Bancorp ("PMBC") is a bank holding company which, through its wholly owned subsidiary, Pacific Mercantile Bank (the "Bank"), is engaged in the commercial banking business in Southern California. PMBC is registered as a one bank holding company under the United States Bank Holding Company Act of 1956, as amended, and, as such, is regulated by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and the Federal Reserve Bank of San Francisco ("FRBSF") under delegated authority from the Federal Reserve Board. Substantially all of our operations are conducted and substantially all of our assets are owned by the Bank, which accounts for substantially all of our consolidated revenues, expenses, and income. The Bank provides a full range of banking services to small and medium-size businesses and professionals in Orange, Los Angeles, San Bernardino and San Diego counties in Southern California and is subject to competition from other banks and financial institutions and from financial services organizations conducting operations in those same markets. The Bank is chartered by the California Department of Business Oversight under the Division of Financial Institutions and is a member of the FRBSF. In addition, the deposit accounts of the Bank's customers are insured by the Federal Deposit Insurance Corporation ("FDIC") up to the maximum amount allowed by law. PM Asset Resolution, Inc. ("PMAR") is a wholly owned subsidiary of PMBC which exists for the purpose of purchasing certain non-performing loans and other real estate from the Bank and thereafter collecting on or disposing of those assets.

PMBC, the Bank and PMAR are sometimes referred to, together, on a consolidated basis, in this report as the "Company" or as "we", "us" or "our".

2. Significant Accounting Policies

Except as discussed below, our accounting policies are described in Note 2, Significant Accounting Policies of our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2015 ("Form 10-K").

Interim Consolidated Financial Statements Basis of Presentation

Our interim consolidated financial statements are prepared in accordance with generally accepted accounting principles in effect in the United States ("GAAP") for interim financial information pursuant to rules and regulations of the U.S. Securities and Exchange Commission (the "SEC"), including instructions to Form 10-Q and Article 10 of Regulation S-X, on a basis consistent with prior periods. Our financial statements reflect all adjustments that are, in the opinion of management, necessary to present a fair statement of the results for the interim periods presented. The interim results are not necessarily indicative of operating results for the full year. The interim information should be read in conjunction with our audited consolidated financial statements in our Form 10-K.

Use of Estimates

The preparation of the financial statements in conformity with GAAP requires us to make certain estimates and assumptions that could affect the reported amounts of certain of our assets, liabilities, and contingencies at the date of the financial statements and the reported amounts of our revenues and expenses during the reporting periods. For the fiscal periods covered by this report, those estimates related primarily to our determinations of the allowance for loan and lease losses ("ALLL"), other real estate owned ("OREO"), the fair values of securities available for sale, repurchase reserves, and the determination of the valuation allowance pertaining to deferred tax assets. If circumstances or financial trends on which those estimates were based were to change in the future or there were to occur any currently unanticipated events affecting the amounts of those estimates, our future financial position or results of operations could differ, possibly materially, from those expected at the current time.

Principles of Consolidation

Our consolidated financial statements for the three and six months ended June 30, 2016 and 2015 include the accounts of PMBC, the Bank and PMAR. All significant intercompany balances and transactions were eliminated in consolidation.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, “Revenue from Contracts with Customers (Topic 606),” which amended its guidance on revenue recognition to conform with international accounting guidance under the International Accounting Standards Board. The ASU provides a framework for addressing revenue recognition and replaces most existing revenue recognition guidance, as well as requires increased disclosure requirements. In August 2015, the FASB issued ASU 2015-14 to defer the effective date of ASU 2014-09 by one year. Accordingly,

Table of Contents

this guidance is effective for interim and annual periods beginning after December 15, 2017 with early adoption permitted for interim and annual periods beginning after December 15, 2016. We will adopt this guidance on January 1, 2018. We are currently evaluating the expected impact on our consolidated financial statements.
In June 2014, the FASB issued ASU 2014-11, “Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period,” which amended its guidance on how to account for certain performance related share-based compensation plans. The amendments clarify the guidance on how to account for performance based awards when the requisite service period is met prior to potential performance targets being achieved. This guidance is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted. We adopted this guidance on January 1, 2016 and it did not have a material effect on our consolidated financial statements.
In August 2014, the FASB issued ASU 2014-15, “Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern,” which defines management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and clarifies when to provide related footnote disclosure. This guidance is effective for interim and annual periods beginning after December 15, 2016. Early adoption is permitted. We will adopt this guidance on January 1, 2017 and do not expect it to have a material effect on our consolidated financial statements.
In February 2015, the FASB issued ASU 2015-02, “Consolidation (Topic 810): Amendments to the Consolidation Analysis,” amends the guidance for assessing how relationships of related parties affect the consolidation analysis, eliminates the presumption that a general partner should consolidate a limited partnership, eliminates the consolidation model specific to limited partnerships, clarifies when fees paid to a decision maker should be a factor in consolidation of a variable interest entity, and reduces the number of variable interest entity consolidation models. This guidance is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted. We adopted this guidance on January 1, 2016 and it did not have an impact on our consolidated financial statements.
In April 2015, the FASB issued ASU 2015-03, “Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs,” which requires that the debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. This simplifies the presentation of debt issuance costs and makes the presentation consistent with the presentation of debt discounts. This guidance is effective for interim and annual periods beginning after December 15, 2015. Early adoption is permitted. We adopted this guidance on January 1, 2016 and it did not have a material impact on our consolidated financial statements.
In August 2015, the FASB issued ASU 2015-15, Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements — Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting,” which clarifies the accounting for debt issuance costs for line-of-credit arrangements. We adopted this guidance on January 1, 2016 and it did not have a material impact on our consolidated financial statements.
In January 2016, the FASB issued ASU 2016-01,“Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,” which enhances the reporting model for financial instruments to provide users of financial statements with more useful information. Some of the provisions include: requiring equity investments to be measured at fair value with changes in fair value recognized in net income, simplifying the impairment assessment of equity investments without readily determinable fair values, eliminating the requirement to disclose the method and significant assumptions used to estimate fair value on financial instruments measured at amortized cost on the balance sheet, requiring public business entities to use the exit price notion when measuring the fair value of financial instruments, requiring the reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option, requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or notes to the financial statements, and clarifying that the reporting organization should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the organization's other deferred tax assets. This guidance is effective for interim and

annual periods beginning after December 15, 2017. Early adoption is not permitted for public companies. We will adopt this guidance on January 1, 2018 and do not expect it to have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842),” which requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: a lease liability measured on a discounted basis and a right-of-use asset a specified asset for the lease term. Under the new guidance, lessor account is largely unchanged and the accounting for sale and leaseback transactions were simplified. This guidance is effective for interim and annual periods beginning

Table of Contents

after December 15, 2018. Early adoption is permitted. We will adopt this guidance on January 1, 2019 and do not expect it to have a material impact on our consolidated financial statements and our disclosures related to leases.

In March 2016, the FASB issued ASU 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting," which simplifies several aspects of the accounting for share-based payment award transactions. Under the new guidance, some of the aspects that are simplified include: income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This guidance is effective for interim and annual periods beginning after December 15, 2016. Early adoption is permitted. We are currently evaluating the expected impact on our consolidated financial statements and whether we will early adopt this ASU.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments," which requires the measurement of all expected credit losses for financial assets held at the reporting date, based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions will now use forward-looking information to better inform their credit loss estimates. Additionally, the ASU amends the accounting guidance for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This guidance is effective for interim and annual periods beginning after December 15, 2019. Early adoption is permitted for interim and annual periods beginning after December 15, 2018. We will adopt this guidance on January 1, 2020 and expect that it will have a material impact on the determination of our ALLL.

3. Fair Value Measurements

Under FASB Accounting Standards Codification ("ASC") 820-10, we group assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1	Valuation is based upon quoted prices for identical instruments traded in active markets.
Level 2	Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
Level 3	Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Risks with Fair Value Measurements

Fair value estimates are made at a discrete point in time based on relevant market information and other information about the financial instruments. Because no active market exists for a significant portion of our financial instruments, fair value estimates are based in large part on judgments we make primarily regarding current economic conditions, risk characteristics of various financial instruments, prepayment rates, and future expected loss experience. These estimates are subjective in nature and invariably involve some inherent uncertainties. Additionally, the occurrence of unexpected events or changes in circumstances can occur that could require us to make changes to our assumptions and which, in turn, could significantly affect and require us to make changes to our previous estimates of fair value. In addition, the fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of existing and anticipated future customer relationships and the value of assets and liabilities that are not considered financial instruments, such as premises and equipment and OREO.

Measurement Methodology

Cash and Cash Equivalents. The fair value of cash and cash equivalents approximates its carrying value.

Interest-Bearing Deposits with Financial Institutions. The fair values of interest-bearing deposits maturing within one year approximate their carrying values.

FHLB and FRBSF Stock. The Bank is a member of the Federal Home Loan Bank of San Francisco (“FHLB”) and the FRBSF. As members, we are required to own stock of the FHLB and the FRBSF, the amount of which is based primarily on the level of our borrowings from those institutions. We also have the right to acquire additional shares of stock in either or both of the FHLB and the FRBSF. During the three and six months ended June 30, 2016, we purchased no shares of FHLB stock and no shares of FRBSF stock. The fair values of the FHLB and FRBSF stock are equal to their respective carrying amounts, are classified as restricted securities and are periodically evaluated for impairment based on our assessment of the ultimate recoverability of our investments in that stock. Any cash or stock dividends paid to us on such stock are reported as income.

Table of Contents

Investment Securities Available for Sale. Fair value measurement for our investment securities available for sale is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 investment securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the- counter markets and money market funds. Level 2 investment securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Other Investments. Other investments accounted for under the cost method of accounting are carried at their respective carrying amounts and are periodically evaluated for impairment based on our assessment of the ultimate recoverability of our investment. In the event that there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment and it is not practicable to estimate the fair value of the investment, then the fair value of such investment is not estimated. Any cash or stock dividends paid to us on such investments are reported as noninterest income.

Impaired Loans. Loans measured for impairment are measured at an observable market price (if available), or the fair value of the loan's collateral (if the loan is collateral dependent). The fair value of an impaired loan may be estimated using one of several methods, including collateral value, market value of similar debt, liquidation value and discounted cash flows. Those impaired loans not requiring a specific loan loss reserve represent loans for which the fair value of the expected repayments or collateral exceeds the recorded investments in such loans. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan at Level 2. When an appraised value is not available or we determine that the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the impaired loan at Level 3.

Loans. The fair value for loans with variable interest rates less a credit discount is the carrying amount. The fair value of fixed rate loans is derived by calculating the discounted value of future cash flows expected to be received by the various homogeneous categories of loans. All loans have been adjusted to reflect changes in credit risk. Changes are not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve.

Other Real Estate Owned. OREO is reported at its net realizable value (fair value less estimated costs to sell), at the time any real estate collateral is acquired by the Bank in satisfaction of a loan. Subsequently, OREO is carried at the lower of carrying value or fair value less estimated costs to sell. Fair value is determined based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the foreclosed asset at Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the foreclosed asset at Level 3.

Deposits. Deposits are carried at historical cost. The carrying amounts of deposits from savings and money market accounts are deemed to approximate fair value as they either have no stated maturities or short-term maturities. Certificates of deposit are estimated utilizing discounted cash flow techniques. The interest rates applied are rates currently being offered for similar certificates of deposit.

Borrowings. The fair value of borrowings is the carrying amount for those borrowings that mature on a daily basis. The fair value of term borrowings is derived by calculating the discounted value of future cash flows expected to be paid out by the Company.

Junior Subordinated Debentures. The fair value of the junior subordinated debentures is based on quoted market prices of the underlying securities. These securities are variable rate in nature and repriced quarterly.

Commitments to Extend Credit and Standby Letters of Credit. The fair value of commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Interest Receivable and Interest Payable. The carrying amounts of our accrued interest receivable and accrued interest payable are deemed to approximate fair value.
Assets Recorded at Fair Value on a Recurring Basis
The following tables show the recorded amounts of assets and liabilities measured at fair value on a recurring basis at June 30, 2016 and December 31, 2015:

(Dollars in thousands)	At June 30, 2016 Total	Level 1	Level 2	Level 3
Assets and Liabilities at Fair Value:				
Investment securities available for sale				
Residential mortgage backed securities issued by U.S. agencies	$42,313	$—	$42,313	$—
Residential collateralized mortgage obligations issued by non-agency	536	—	536	—
Asset-backed security	1,329	—	—	1,329
Mutual funds	5,085	5,085	—	—
Total securities available for sale at fair value	$49,263	$5,085	$42,849	$1,329

(Dollars in thousands)	At December 31, 2015 Total	Level 1	Level 2	Level 3
Assets and Liabilities at Fair Value:				
Investment securities available for sale				
Residential mortgage backed securities issued by U.S. agencies	$45,154	$—	$45,154	$—
Residential collateralized mortgage obligations issued by non-agency	632	—	632	—
Asset-backed security	1,480	—	—	1,480
Mutual funds	4,983	4,983	—	—
Total securities available for sale at fair value	$52,249	$4,983	$45,786	$1,480

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows for the six months ended June 30, 2016:

	Asset Backed Securities (Dollars in thousands)
Balance of recurring Level 3 instruments at December 31, 2015	$ 1,480
Total gains or losses (realized/unrealized):	
Included in other comprehensive income	(151)
Settlements	—
Balance of recurring Level 3 instruments at June 30, 2016	$ 1,329

Assets Recorded at Fair Value on a Nonrecurring Basis

We may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Information regarding assets measured at fair value on a nonrecurring basis is set forth in the table below.

	At June 30, 2016				At December 31, 2015			
(Dollars in thousands)	Total	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3
Assets at Fair Value:								
Impaired loans	$26,503	$ —	$ —	$26,503	$25,857	$ —	$—	$25,857
Other real estate owned[(1)]	—	—	—	—	650	—	650	—
Total	$26,503	$ —	$ —	$26,503	$26,507	$ —	$650	$25,857

(1) No remaining OREO as of June 30, 2016.

Significant Unobservable Inputs and Valuation Techniques of Level 3 Fair Value Measurements

For our fair value measurements classified in Level 3 of the fair value hierarchy as of June 30, 2016, a summary of the significant unobservable inputs and valuation techniques is as follows:

	Fair Value Measurement as of June 30, 2016 (Dollars in thousands)	Valuation Techniques(3)	Unobservable Inputs(3)	Range	Weighted Average
Assets					
Asset-backed security	$ 1,329	Third-Party Pricing	Marketability discount	N/A (1)	N/A (1)
			Illiquidity discount	N/A (1)	N/A (1)
Impaired loans	26,503	Third-Party Pricing	Appraisals	N/A (2)	N/A (2)
	$ 27,832				

(1) Information is unavailable as valuation was obtained from third-party pricing services.

(2) We obtain appraisals for our various properties included within impaired loans which primarily rely upon market comparisons. These market comparisons support our assumption that the carrying value of the respective loans either requires or does not require additional impairment.

(3) As of June 30, 2016, there has been no change to our valuation techniques or the types of unobservable inputs used in the calculation of fair value from December 31, 2015.

Fair Value Measurements for Other Financial Instruments

The table below provides estimated fair values and related carrying amounts of our financial instruments as of June 30, 2016 and December 31, 2015, excluding financial assets and liabilities which are recorded at fair value on a recurring basis.

	Estimated Fair Value									
	At June 30, 2016					At December 31, 2015				
	Carrying Value	Total	Level 1	Level 2	Level 3	Carrying Value	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)									
Financial assets:										
Cash and cash equivalents	$131,532	$131,532	$131,532	$ —	$ —	$113,921	$113,921	113,921	—	—
Interest-bearing deposits with financial institutions	3,917	3,917	3,917	—	—	4,665	4,665	4,665	—	—
Federal Reserve Bank of San Francisco and Federal Home Loan Bank stock	8,170	8,170	8,170	—	—	8,170	8,170	8,170	—	—
Loans, net	872,198	874,006	—	—	874,006	849,733	846,690	—	—	846,690
Accrued interest receivable	2,377	2,377	2,377	—	—	2,266	2,266	2,266	—	—
Financial liabilities:										
Noninterest bearing deposits	294,153	294,153	294,153	—	—	249,676	249,676	249,676	—	—
Interest-bearing deposits	642,516	642,667	—	642,667	—	644,164	643,935	—	643,935	—
Borrowings	10,000	10,024	—	10,024	—	10,000	9,999	—	9,999	—
Junior subordinated debentures	17,527	17,527	—	17,527	—	17,527	17,527	—	17,527	—
Accrued interest payable	180	180	180	—	—	255	255	255	—	—

4. Investments

Securities Available For Sale, at Fair Value

The following table sets forth the major components of securities available for sale and compares the amortized costs and estimated fair market values of, and the gross unrealized gains and losses on, these securities at June 30, 2016 and December 31, 2015:

(Dollars in thousands)	June 30, 2016				December 31, 2015			
	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
Securities Available for Sale								
Residential mortgage backed securities issued by U.S. Agencies[1]	$42,164	$ 204	$ (55)	$ 42,313	$46,126	$ 4	$ (976)	$ 45,154
Residential collateralized mortgage obligations issued by non-agencies[1]	551	—	(15)	536	646	—	(14)	632
Asset backed security[2]	2,027	—	(698)	1,329	2,027	—	(547)	1,480
Mutual funds[3]	5,000	92	(7)	5,085	5,000	33	(50)	4,983
Total	$49,742	$ 296	$ (775)	$ 49,263	$53,799	$ 37	$ (1,587)	$ 52,249

13

Table of Contents

(1) Secured by closed-end first liens on 1-4 family residential mortgages.
(2) Comprised of a security that represents an interest in a pool of trust preferred securities issued by U.S.-based banks and insurance companies.
(3) Consists primarily of mutual fund investments in closed-end first liens on 1-4 family residential mortgages.

At June 30, 2016 and December 31, 2015, U.S. agency mortgage backed securities with an aggregate fair market value of $16.6 million and $2.9 million, respectively, were pledged to secure repurchase agreements, local agency deposits and treasury, tax and loan accounts.

The amortized cost and estimated fair values of securities available for sale at June 30, 2016 and December 31, 2015 are shown in the tables below by contractual maturities taking into consideration historical prepayments based on the prior twelve months of principal payments. Expected maturities will differ from contractual maturities and historical prepayments, particularly with respect to collateralized mortgage obligations, primarily because prepayment rates are affected by changes in conditions in the interest rate market and, therefore, future prepayment rates may differ from historical prepayment rates.

	At June 30, 2016 Maturing in				
(Dollars in thousands)	One year or less	Over one year through five years	Over five years through ten years	Over ten Years	Total
Securities available for sale, amortized cost	$7,974	$ 25,514	$ 11,956	$4,298	$49,742
Securities available for sale, estimated fair value	7,966	25,740	11,956	3,601	49,263
Weighted average yield	1.59 %	1.56 %	1.57 %	2.29 %	1.63 %

	At December 31, 2015 Maturing in				
(Dollars in thousands)	One year or less	Over one year through five years	Over five years through ten years	Over ten Years	Total
Securities available for sale, amortized cost	$7,761	$ 26,178	$ 14,164	$5,696	$53,799
Securities available for sale, estimated fair value	7,599	25,716	13,857	5,077	52,249
Weighted average yield	1.63 %	1.60 %	1.60 %	2.05 %	1.65 %

We had no sales of securities available for sale during the three and six months ended June 30, 2016 and 2015.

The tables below indicate, as of June 30, 2016 and December 31, 2015, the gross unrealized losses and fair values of our investments, aggregated by investment category, and length of time that the individual securities have been in a continuous unrealized loss position.

	Securities with Unrealized Loss at June 30, 2016					
	Less than 12 months		12 months or more		Total	
(Dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Residential mortgage backed securities issued by U.S. Agencies	$351	$ (1)	$22,663	$ (54)	$23,014	$ (55)
Residential collateralized mortgage obligations issued by non-agencies	—	—	536	(15)	536	(15)
Asset backed security	—	—	1,329	(698)	1,329	(698)
Mutual funds	—	—	993	(7)	993	(7)
Total	$351	$ (1)	$25,521	$ (774)	$25,872	$ (775)

	Securities With Unrealized Loss as of December 31, 2015					
	Less than 12 months		12 months or more		Total	

(Dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Residential mortgage backed securities issued by U.S. Agencies	$20,597	$ (197)	$23,865	$ (779)	$44,462	$ (976)
Residential collateralized mortgage obligations issued by non-agencies	—	—	631	(14)	631	(14)
Asset-backed security	—	—	1,480	(547)	1,480	(547)
Mutual funds	1,728	(23)	973	(27)	2,701	(50)
Total	$22,325	$ (220)	$26,949	$ (1,367)	$49,274	$ (1,587)

Table of Contents

We regularly monitor investments for significant declines in fair value. We have determined that declines in the fair values of these investments below their respective amortized costs, as set forth in the tables above, are temporary because (i) those declines were due to interest rate changes and not to a deterioration in the creditworthiness of the issuers of those investment securities, and (ii) we have the ability to hold those securities until there is a recovery in their values or until their maturity.

We recognize other-than-temporary impairments ("OTTI") to our available-for-sale debt securities in accordance with FASB ASC 320-10. When there are credit losses associated with, but we have no intention to sell, an impaired debt security, and it is more likely than not that we will not have to sell the security before recovery of its cost basis, we will separate the amount of impairment, or OTTI, between the amount that is credit related and the amount that is related to non-credit factors. Credit-related impairments are recognized in our consolidated statements of operations. Any non-credit-related impairments are recognized and reflected in other comprehensive income in our consolidated statements of financial condition.

Through the impairment assessment process, we determined that the available-for-sale securities discussed below were other-than-temporarily impaired at June 30, 2016. We recorded no impairment credit losses on available-for-sale securities in our consolidated statements of operations for the three and six months ended June 30, 2016 and 2015. The OTTI related to factors other than credit losses, in the aggregate amount of $698 thousand, and was recognized as other comprehensive loss in our accompanying consolidated statement of financial condition as of June 30, 2016.

The table below presents, for the six months ended June 30, 2016, a roll-forward of OTTI in those instances when a portion of the OTTI was attributable to non-credit related factors and, therefore, was recognized in other comprehensive loss:

(Dollars in thousands)	Gross Other-Than-Temporary Impairments	Other-Than-Temporary Impairments Included in Other Comprehensive Loss	Net Other-Than-Temporary Impairments Included in Retained Earnings (Deficit)
Balance – December 31, 2015	$ (1,100)	$ (547)	$ (553)
Change in market value on a security for which an OTTI was previously recognized	(151)	(151)	—
Principal received on OTTI security	—	—	—
Balance – June 30, 2016	$ (1,251)	$ (698)	$ (553)

In determining the component of OTTI related to credit losses, we compare the amortized cost basis of each OTTI security to the present value of its expected cash flows, discounted using the effective interest rate implicit in the security at the date of acquisition.

As a part of our OTTI assessment process with respect to securities available for sale with unrealized losses, we consider available information about (i) the performance of the collateral underlying each such security, including any credit enhancements, (ii) historical prepayment speeds, (iii) delinquency and default rates, (iv) loss severities, (v) the age or "vintage" of the security, and (vi) any rating agency reports on the security. Significant judgments are required with respect to these and other factors in order to make a determination of the future cash flows that can be expected to be generated by the security.

Based on our OTTI assessment process, we determined that there is one asset-backed security in our portfolio of securities available for sale that was impaired as of June 30, 2016. This security is a multi-class, cash flow collateralized bond obligation backed by a pool of trust preferred securities issued by a diversified pool of 56 issuers that consisted of 45 U.S. depository institutions and 11 insurance companies at the time of the security's issuance in November 2007. We purchased $3.0 million face amount of this security in November 2007 at a price of 95.21% for a total purchase price of $2.9 million, out of a total of $363 million of this security sold at the time of issuance. The security that we own (CUSIP 74042CAE8) is the mezzanine class B piece security with a variable interest rate of 3 month LIBOR plus 60 basis points, which had a rating of Aa2 and AA by Moody's and Fitch, respectively, at the time of issuance in 2007.

As of June 30, 2016, the amortized cost of this security was $2.0 million with a fair value of $1.3 million, for an unrealized loss of approximately $698 thousand. As of June 30, 2016, the security had a Baa3 rating from Moody's and a B rating from Fitch and had experienced $42.5 million in defaults (12.5% of total current collateral) and $7.0 million in deferring securities (2.1% of total current collateral) from issuance to June 30, 2016. As of June 30, 2016, the mezzanine class B tranche had $59.5 million in excess subordination.

We have made a determination that the remainder of our securities with respect to which there were unrealized losses as of June 30, 2016 are not other-than-temporarily impaired, because we have concluded that we have the ability to continue to hold those securities until their respective fair market values increase above their respective amortized costs or, if necessary, until their

Table of Contents

respective maturities. In reaching that conclusion we considered a number of factors and other information, which included: (i) the significance of each such security, (ii) the amount of the unrealized losses attributable to each such security, (iii) our liquidity position, (iv) the impact that retention of those securities could have on our capital position and (v) our evaluation of the expected future performance of these securities (based on the criteria discussed above).

Other Investments

As of June 30, 2016 and December 31, 2015, we had one investment in a limited partnership which was accounted for under the cost method of accounting and included within other assets on the consolidated statements of financial condition. During the three and six months ended June 30, 2016, we contributed $12 thousand and $87 thousand, respectively, to the investment. We had no contributions to this investment during the three and six months ended June 30, 2015. As of June 30, 2016 and December 31, 2015, our other investment was as follows:

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
Investments accounted for under the cost method [(1)]	368	281

(1) Represents the aggregate carrying amount of our investments that were not evaluated for impairment.

5. Loans and Allowance for Loan and Lease Losses

The loan portfolio consisted of the following at:

	June 30, 2016		December 31, 2015	
(Dollars in thousands)	Amount	Percent	Amount	Percent
Commercial loans	$342,579	38.7 %	$347,300	40.3 %
Commercial real estate loans – owner occupied	216,845	24.5 %	195,554	22.7 %
Commercial real estate loans – all other	141,883	16.0 %	146,641	17.0 %
Residential mortgage loans – multi-family	92,101	10.4 %	81,487	9.5 %
Residential mortgage loans – single family	39,823	4.5 %	52,072	6.0 %
Land development loans	12,562	1.4 %	10,001	1.2 %
Consumer loans	38,634	4.4 %	28,663	3.3 %
Total loans	884,427	100.0%	861,718	100.0%
Deferred loan origination costs, net	1,200		731	
Allowance for loan and lease losses	(13,429)		(12,716)	
Loans, net	$872,198		$849,733	

At June 30, 2016 and December 31, 2015, loans of approximately $510 million and $523 million, respectively, were pledged to secure borrowings obtained from the FHLB and to support our unfunded borrowing capacity. During the three and six months ended June 30, 2016, we purchased $29.9 million of performing residential multi-family mortgage loans. No loans were purchased during the three and six months ended June 30, 2015.

Allowance for Loan and Lease Losses

The ALLL represents our estimate of credit losses in our loan and lease portfolio that are probable and estimable at the balance sheet date. We employ economic models that are based on bank regulatory guidelines, industry standards and our own historical loan loss experience, as well as a number of more subjective qualitative factors, to determine both the sufficiency of the ALLL and the amount of the provisions that are required to increase or replenish the ALLL.

The ALLL is first determined by (i) analyzing all classified loans (graded as “Substandard” or “Doubtful” under our internal asset quality grading parameters) on non-accrual status for loss exposure and (ii) establishing specific reserves as needed. ASC 310-10 defines loan impairment as the existence of uncertainty concerning collection of all principal and interest in accordance with the contractual terms of a loan. For collateral dependent loans, impairment is typically measured by comparing the loan amount to the fair value of collateral, less estimated costs to sell, with any "shortfall" amount charged off. Other methods can be used in estimating impairment, including market price and the present value of expected future cash flows discounted at the loan's original interest rate. We are an active lender with the U.S. Small Business Administration and collection of a percentage of the loan balance of many of the loans originated is guaranteed. The ALLL reserves are calculated against the non-guaranteed loan balances.

Table of Contents

On a quarterly basis, we utilize a classification based loan loss migration model as well as review individual loans in determining the adequacy of the ALLL for homogenous pools of loans that are not subject to specific reserve allocations. Our loss migration analysis tracks 16 quarters of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain consumer loans (automobile, mortgage and credit cards). We then apply these calculated loss factors, together with qualitative factors based on external economic conditions and trends and internal assessments, to the outstanding loan balances in each homogenous group of loans, and then, using our internal asset quality grading parameters, we grade the loans as “Pass,” “Special Mention,” “Substandard” or “Doubtful”. We analyze impaired loans individually. This grading is based on the credit classifications of assets as prescribed by government regulations and industry standards and is separated into the following groups:

- Pass: Loans classified as pass include current loans performing in accordance with contractual terms, installment/consumer loans that are not individually risk rated, and loans which exhibit certain risk factors that require greater than usual monitoring by management.
- Special Mention: Loans classified as special mention, while generally not delinquent, have potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank’s credit position at some future date.
- Substandard: Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
- Doubtful: Loans classified as doubtful have all the weaknesses inherent in a substandard loan, and may also be at delinquency status and have defined weaknesses based on currently existing facts, conditions and values making collection or liquidation in full highly questionable and improbable.

Table of Contents

Set forth below is a summary of the activity in the ALLL during the three and six months ended June 30, 2016 and 2015:

(Dollars in thousands)	Commercial	Real Estate	Land Development	Consumer and Single Family Mortgages	Total
ALLL in the three months ended June 30, 2016:					
Balance at beginning of period	$ 8,059	$4,069	$ 203	$ 698	$13,029
Charge offs	(8,509)	—	—	(540)	(9,049)
Recoveries	724	—	—	5	729
Provision	8,429	(241)	23	509	8,720
Balance at end of period	$ 8,703	$3,828	$ 226	$ 672	$13,429
ALLL in the six months ended June 30, 2016:					
Balance at beginning of period	$ 6,639	$5,109	$ 282	$ 686	$12,716
Charge offs	(8,672)	—	—	(540)	(9,212)
Recoveries	777	1	—	7	785
Provision	9,959	(1,282)	(56)	519	9,140
Balance at end of period	$ 8,703	$3,828	$ 226	$ 672	$13,429
ALLL in the three months ended June 30, 2015:					
Balance at beginning of period	$ 7,353	$4,287	$ 120	$ 879	$12,639
Charge offs	(730)	—	—	(151)	(881)
Recoveries	582	1	—	2	585
Provision	(724)	601	(76)	199	—
Balance at end of period	$ 6,481	$4,889	$ 44	$ 929	$12,343
ALLL in the six months ended June 30, 2015:					
Balance at beginning of period	$ 7,670	$5,133	$ 296	$ 734	$13,833
Charge offs	$ (2,117)	$—	$ (85)	$ (151)	$(2,353)
Recoveries	857	2	—	4	863
Provision	71	(246)	(167)	342	—
Balance at end of period	$ 6,481	$4,889	$ 44	$ 929	$12,343

Set forth below is information regarding loan balances and the related ALLL, by portfolio type, as of June 30, 2016 and December 31, 2015.

(Dollars in thousands)	Commercial	Real Estate	Land Development	Consumer and Single Family Mortgages	Total
ALLL balance at June 30, 2016 related to:					
Loans individually evaluated for impairment	$ —	$485	$ —	$ —	$485
Loans collectively evaluated for impairment	8,703	3,343	226	672	12,944
Total	$ 8,703	$3,828	$ 226	$ 672	$13,429
Loans balance at June 30, 2016 related to:					
Loans individually evaluated for impairment	$ 14,908	$10,151	$ 1,140	$ 304	$26,503
Loans collectively evaluated for impairment	327,671	440,678	11,422	78,153	857,924
Total	$ 342,579	$450,829	$ 12,562	$ 78,457	$884,427
ALLL balance at December 31, 2015 related to:					
Loans individually evaluated for impairment	$ —	$484	$ —	$ —	$484
Loans collectively evaluated for impairment	6,639	4,625	282	686	12,232
Total	$ 6,639	$5,109	$ 282	$ 686	$12,716
Loans balance at December 31, 2015 related to:					
Loans individually evaluated for impairment	$ 12,431	$11,107	$ 1,618	$ 701	$25,857
Loans collectively evaluated for impairment	334,869	412,575	8,383	80,034	835,861

Total	$ 347,300	$423,682	$ 10,001	$ 80,735	$861,718

Table of Contents

Credit Quality

The amounts of nonperforming assets and delinquencies that occur within our loan portfolio factor into our evaluation of the adequacy of the ALLL.

The following table provides a summary of the delinquency status of loans by portfolio type at June 30, 2016 and December 31, 2015:

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater	Total Past Due	Current	Total Loans Outstanding	Loans >90 Days and Accruing
At June 30, 2016							
Commercial loans	$3,145	$ 70	$ 6,910	$10,125	$332,454	$ 342,579	$ —
Commercial real estate loans – owner-occupied	—	—	1,016	1,016	215,829	216,845	—
Commercial real estate loans – all other	—	—	5,060	5,060	136,823	141,883	—
Residential mortgage loans – multi-family	2,364	—	—	2,364	89,737	92,101	—
Residential mortgage loans – single family	—	—	—	—	39,823	39,823	—
Land development loans	—	—	1,140	1,140	11,422	12,562	—
Consumer loans	115	—	—	115	38,519	38,634	—
Total	$5,624	$ 70	$ 14,126	$19,820	$864,607	$ 884,427	$ —
At December 31, 2015							
Commercial loans	$2,010	$ 1,008	$ 8,766	$11,784	$335,516	$ 347,300	$ —
Commercial real estate loans – owner-occupied	—	—	797	797	194,757	195,554	—
Commercial real estate loans – all other	316	—	5,207	5,523	141,118	146,641	—
Residential mortgage loans – multi-family	—	—	—	—	81,487	81,487	—
Residential mortgage loans – single family	—	—	535	535	51,537	52,072	—
Land development loans	—	—	1,618	1,618	8,383	10,001	—
Consumer loans	—	—	—	—	28,663	28,663	—
Total(1)	$2,326	$ 1,008	$ 16,923	$20,257	$841,461	$ 861,718	$ —

(1) Loans 90 days or more past due included one consumer mortgage loan collateralized by residential real estate with a recorded investment of $535 thousand which was in the process of foreclosure at December 31, 2015.

Generally, the accrual of interest on a loan is discontinued when principal or interest payments become more than 90 days past due, unless we believe that the loan is adequately collateralized and it is in the process of collection. There were no loans 90 days or more past due and still accruing interest at June 30, 2016 or December 31, 2015. In certain instances, when a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of cash are applied as principal reductions when received (referred to as full nonaccrual basis of accounting), except when the ultimate collectability of principal is probable, in which case such payments are applied to accrued and unpaid interest, which is credited to income (referred to as nonaccrual cash basis of accounting). Non-accrual loans may be restored to accrual status when principal and interest become current and full repayment becomes expected.

Table of Contents

The following table provides information with respect to loans on nonaccrual status, by portfolio type, as of June 30, 2016 and December 31, 2015:

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
Nonaccrual loans:		
Commercial loans	$14,840	$ 12,284
Commercial real estate loans – owner occupied	3,940	3,815
Commercial real estate loans – all other	5,777	6,268
Residential mortgage loans – multi-family	434	447
Residential mortgage loans – single family	—	701
Land development loans	1,140	1,618
Consumer	189	—
Total[(1)]	$26,320	$ 25,133

(1) Nonaccrual loans may include loans that are currently considered performing loans.

20

Table of Contents

We classify our loan portfolio using internal asset quality ratings. The following table provides a summary of loans by portfolio type and our internal asset quality ratings as of June 30, 2016 and December 31, 2015:

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
Pass:		
Commercial loans	$318,015	$ 329,192
Commercial real estate loans – owner occupied	210,907	189,944
Commercial real estate loans – all other	127,491	127,702
Residential mortgage loans – multi family	91,667	81,040
Residential mortgage loans – single family	39,823	51,371
Land development loans	11,422	8,383
Consumer loans	38,331	28,663
Total pass loans	$837,656	$ 816,295
Special Mention:		
Commercial loans	$9,656	$ 5,626
Commercial real estate loans – owner occupied	649	177
Commercial real estate loans – all other	8,615	9,452
Total special mention loans	$18,920	$ 15,255
Substandard:		
Commercial loans	$13,348	$ 12,482
Commercial real estate loans – owner occupied	5,289	5,433
Commercial real estate loans – all other	5,777	9,487
Residential mortgage loans – multi family	434	447
Residential mortgage loans – single family	—	701
Land development loans	1,140	1,618
Consumer loans	303	—
Total substandard loans	$26,291	$ 30,168
Doubtful:		
Commercial loans	$1,560	$ —
Total doubtful loans	$1,560	$ —
Total Loans:	$884,427	$ 861,718

Impaired Loans

A loan generally is classified as impaired when, in our opinion, principal or interest is not likely to be collected in accordance with the contractual terms of the loan agreement. We measure for impairments on a loan-by-loan basis, using either the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent.

The following table sets forth information regarding impaired loans, at June 30, 2016 and December 31, 2015:

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
Impaired loans:		
Nonaccruing loans	$10,901	$ 5,063
Nonaccruing restructured loans	15,419	20,070
Accruing restructured loans [(1)]	183	724
Accruing impaired loans	—	—
Total impaired loans	$26,503	$ 25,857
Impaired loans less than 90 days delinquent and included in total impaired loans	$—	$ 6,584

(1) See "Troubled Debt Restructurings" below for a description of accruing restructured loans at June 30, 2016 and December 31, 2015.

Table of Contents

The table below contains additional information with respect to impaired loans, by portfolio type, as of June 30, 2016 and December 31, 2015:

	June 30, 2016			December 31, 2015		
	Recorded Investment	Unpaid Principal Balance	Related Allowance (1)	Recorded Investment	Unpaid Principal Balance	Related Allowance (1)
	(Dollars in thousands)					
No allowance recorded:						
Commercial loans	$ 14,908	$ 23,520	$ —	$ 12,431	$ 14,137	$ —
Commercial real estate loans – owner occupied	2,350	2,573	—	2,371	2,515	—
Commercial real estate loans – all other	5,778	6,061	—	6,668	6,806	—
Residential mortgage loans – multi-family	434	446	—	447	450	—
Residential mortgage loans – single family	—	—	—	701	1,037	—
Land development loans	1,140	1,362	—	1,618	1,732	—
Consumer loans	304	304	—	—	—	—
Total	24,914	34,266	—	24,236	26,677	—
With allowance recorded:						
Commercial real estate loans – owner occupied	1,589	1,872	485	1,621	1,872	484
Total	1,589	1,872	485	1,621	1,872	484
Total						
Commercial loans	$ 14,908	$ 23,520	$ —	$ 12,431	$ 14,137	$ —
Commercial real estate loans – owner occupied	3,939	4,445	485	3,992	4,387	484
Commercial real estate loans – all other	5,778	6,061	—	6,668	6,806	—
Residential mortgage loans – multi-family	434	446	—	447	450	—
Residential mortgage loans – single family	—	—	—	701	1,037	—
Land development loans	1,140	1,362	—	1,618	1,732	—
Consumer loans	304	304	—	—	—	—
Total	26,503	36,138	485	25,857	28,549	484

(1) When the discounted cash flows, collateral value or market price equals or exceeds the recorded investment in the loan, then specific reserves are not required to be set aside for the loan within the ALLL. This typically occurs when the impaired loans have been partially charged-off and/or there have been interest payments received and applied to the balance of the principal outstanding.

At June 30, 2016 and December 31, 2015, there were $24.9 million and $24.2 million, respectively, of impaired loans for which no specific reserves had been allocated because these loans, in our judgment, were sufficiently collateralized. Of the impaired loans at June 30, 2016 for which no specific reserves were allocated, $19.5 million had been deemed impaired in the prior year.

Average balances and interest income recognized on impaired loans, by portfolio type, for the three and six months ended June 30, 2016 and 2015 were as follows:

Table of Contents

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016		2015		2016		2015	
	Average Balance	Interest Income Recognized	Average Balance	Interest Income Recognized	Average Balance	Interest Income Recognized	Average Balance	Interest Income Recognized
	(Dollars in thousands)							
No allowance recorded:								
Commercial loans	$12,388	$ 51	$14,533	$ 25	$12,402	$ 247	$15,876	$ 99
Commercial real estate loans – owner occupied	2,249	3	3,492	81	2,290	3	3,051	81
Commercial real estate loans – all other	5,977	—	5,812	201	6,208	—	5,663	201
Residential mortgage loans – multi-family	438	—	454	4	441	—	303	9
Residential mortgage loans – single family	267	—	4,143	29	412	—	4,220	58
Land development loans	1,368	—	1,701	7	1,451	—	1,838	7
Consumer loans	433	11	—	—	288	19	—	—
Total	23,120	65	30,135	347	23,492	269	30,951	455
With allowance recorded:								
Commercial loans	6,280	—	1,057	6	4,186	—	1,556	6
Commercial real estate loans – owner occupied	1,595	—	—	—	1,604	—	—	—
Total	7,875	—	1,057	6	5,790	—	1,556	6
Total								
Commercial loans	18,668	51	15,590	31	16,588	247	17,432	105
Commercial real estate loans – owner occupied	3,844	3	3,492	81	3,894	3	3,051	81
Commercial real estate loans – all other	5,977	—	5,812	201	6,208	—	5,663	201
Residential mortgage loans – multi-family	438	—	454	4	441	—	303	9
Residential mortgage loans – single family	267	—	4,143	29	412	—	4,220	58
Land development loans	1,368	—	1,701	7	1,451	—	1,838	7
Consumer loans	433	11	—	—	288	19	—	—
Total	$30,995	$ 65	$31,192	$ 353	$29,282	$ 269	$32,507	$ 461

The interest that would have been earned had the impaired loans remained current in accordance with their original terms was $393 thousand and $304 thousand during the three months ended June 30, 2016 and 2015, respectively. The interest that would have been earned had the impaired loans remained current in accordance with their original terms was $775 thousand and $508 thousand during the six months ended June 30, 2016 and 2015, respectively.

Troubled Debt Restructurings (“TDRs”)

Pursuant to the FASB's ASU No. 2011-2, A Creditor's Determination of whether a Restructuring is a Troubled Debt Restructuring, the Bank's TDRs totaled $15.6 million and $20.8 million at June 30, 2016 and December 31, 2015, respectively. TDRs consist of loans to which modifications have been made for the purpose of alleviating temporary impairments of the borrower's financial condition and cash flows. Those modifications have come in the forms of changes in amortization terms, reductions in interest rates, interest only payments and, in limited cases, concessions to outstanding loan balances. The modifications are made as part of workout plans we enter into with the borrower that are designed to provide a bridge for the borrower's cash flow shortfalls in the near term. If a borrower works through

the near term issues, then in most cases, the original contractual terms of the borrower's loan will be reinstated.
Of the $15.6 million of TDRs outstanding at June 30, 2016, $183 thousand were performing in accordance with their terms and accruing interest, and $15.4 million were not. Our impairment analysis determined $485 thousand of specific reserves were required on the TDR balances outstanding at June 30, 2016.
The following table presents loans restructured as TDRs during the three and six months ended June 30, 2016 and 2015:

Table of Contents

(Dollars in thousands)	Three Months Ended June 30, 2016 Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	June 30, 2015 Number of loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Performing						
Commercial loans	—	$ —	$ —	1	$ 94	$ 94
Commercial real estate – owner occupied	—	—	—	1	2,741	2,741
Commercial real estate – all other	—	—	—	1	4,158	4,158
	—	—	—	3	6,993	6,993
Nonperforming						
Commercial loans	—	—	—	1	250	250
	—	—	—	1	250	250
Total Troubled Debt Restructurings[1]	—	$ —	$ —	4	$ 7,243	$ 7,243

(Dollars in thousands)	Six Months Ended June 30, 2016 Number of loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	June 30, 2015 Number of loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Performing						
Commercial loans	—	$ —	$ —	1	$ 94	$ 94
Commercial real estate – owner occupied	—	—	—	1	2,741	2,741
Commercial real estate – all other	—	—	—	1	4,158	4,158
Consumer loans	1	562	115	—	—	—
	1	562	115	3	6,993	6,993
Nonperforming						
Commercial loans	—	—	—	1	250	250
	—	—	—	1	250	250
Total Troubled Debt Restructurings	1	$ 562	$ 115	4	$ 7,243	$ 7,243

(1) No loans were restructured during the three months ended June 30, 2016.

During the three and six months ended June 30, 2016 and 2015, TDRs that were modified within the preceding 12-month period which subsequently defaulted were as follows:

	Three Months Ended June 30, 2016 Number of loans	Recorded Investment	June 30, 2015 Number of loans	Recorded Investment	Six Months Ended June 30, 2016 Number of loans	Recorded Investment	June 30, 2015 Number of loans	Recorded Investment
	(Dollars in thousands)							
Commercial loans	—	$ —	—	$ —	1	$ 60	—	$ —
Commercial real estate - owner occupied	1	$ 770	—	$ —	1	$ 770	—	$ —
Total[1]	1	$ 770	—	$ —	2	$ 830	—	$ —

(1) During the three and six months ended June 30, 2015, there were no TDRs that were modified within the preceding 12-month period which subsequently defaulted.

24

Table of Contents

6. Income Taxes
For the three and six months ended June 30, 2016, we had an income tax benefit of $3.6 million and $3.4 million, respectively, as a result of our net loss during both the first and second quarters of fiscal 2016. During the second quarter of 2016, management evaluated the positive and negative evidence and determined that no valuation allowance was needed as of June 30, 2016. Management's determination regarding no requirement for a valuation allowance at June 30, 2016 represents a significant estimate, which is susceptible to change in the near term if the Company experiences net losses in subsequent periods. For the three and six months ended June 30, 2015, we recorded no income tax provision or benefit. We recorded no income tax provision for the three and six months ended June 30, 2015 as a result of positive and negative evidence that management evaluated. Based on the analysis performed, management chose not to release any portion of the $11.4 million valuation allowance as of June 30, 2015. We file income tax returns with the U.S. federal government and the state of California. As of June 30, 2016, we were subject to examination by the Internal Revenue Service with respect to our U.S. federal tax returns for the 2012 to 2014 tax years and Franchise Tax Board for California state income tax returns for the 2011 to 2014 tax years. Net operating losses on our U.S. federal and California state income tax returns may be carried forward twenty years. As of June 30, 2016, we do not believe there will be any material adverse changes in our unrecognized tax benefits over the next 12 months.
Our policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of tax expense. We did not have any accrued interest or penalties associated with any unrecognized tax benefits, and no interest expense was recognized during the three and six months ended June 30, 2016 and 2015.
7. Stock-Based Employee Compensation Plans
In May 2010, our shareholders approved the adoption of our 2010 Equity Incentive Plan (the “2010 Incentive Plan”), which authorized and set aside a total of 400,000 shares of our common stock for issuance on the exercise of stock options or the grant of restricted stock or other equity incentives to our officers, and other key employees and directors. An additional 158,211 shares of common stock were also set aside which was equal to the total of the shares that were available for the grant of equity incentives under our shareholder-approved 2008 and 2004 Equity Incentive Plans (the "Previously Approved Plans") at the time of the adoption of the 2010 Incentive Plan. Options to purchase a total of 361,654 shares of our common stock granted under the Previously Approved Plans were outstanding at June 30, 2016. The 2010 Incentive Plan provides that if any of these outstanding options under the Previously Approved Plans expire or are terminated for any reason, then the number of shares that would become available for grants or awards of equity incentives under the 2010 Incentive Plan would be increased by an equivalent number of shares. At the Annual Shareholders meeting held in May 2013, our shareholders approved an additional 800,000 share increase in the maximum number of shares of our common stock that may be issued pursuant to grants or exercises of options or restricted shares or other equity incentives under the 2010 Incentive Plan, of which 154,834 shares of restricted stock, net of shares withheld for taxes, have vested as of June 30, 2016 thereby decreasing the maximum number of shares authorized under the 2010 Incentive Plan. As a result, as of June 30, 2016, the maximum number of shares that were authorized for the grant of options or other equity incentives under the 2010 Incentive Plan totaled 1,565,031 (assuming that all 361,654 shares of our common stock subject to options under the Previously Approved Plans expire or are terminated), or approximately 7% of the shares of our common stock then outstanding.
A stock option entitles the recipient to purchase shares of our common stock at a price per share that may not be less than 100% of the fair market value of the Company’s shares on the date the option is granted. Restricted shares may be granted at such purchase prices and on such other terms, including restrictions and Company repurchase or reacquisition rights, as are fixed by the Compensation Committee at the time rights to purchase such restricted shares are granted. Stock Appreciation Rights ("SARs") entitle the recipient to receive a cash payment in an amount equal to the difference between the fair market value of the Company’s shares on the date of vesting and a “base price” (which, in most cases, will be equal to the fair market value of the Company’s shares on the date the SAR is granted), subject to the right of the Company to make such payment in shares of its common stock at their then fair market value. Options, restricted shares and SARs may vest immediately or in installments over various periods generally ranging up to five years, subject to the recipient’s continued employment or service or the achievement of specified performance goals, as determined by the Compensation Committee at the time it grants or awards the options, the restricted shares or the

SARs. Stock options and SARs may be granted for terms of up to 10 years after the date of grant, but will terminate sooner upon or shortly after a termination of service occurring prior to the expiration of the term of the option or SAR. The Company will become entitled to repurchase any unvested restricted shares, at the same price that was paid for the shares by the recipient, or to cancel those shares in the event of a termination of employment or service of the holder of such shares or if any performance goals specified in the award are not satisfied. To date, the Company has not granted any SARs.

Under FASB ASC 718-10, we are required to recognize, in our financial statements, the fair value of the options or any restricted shares that we grant as compensation cost over their respective service periods. The fair values of the options that were outstanding at June 30, 2016 under the 2010 Incentive Plan were estimated as of their respective dates of grant using the Black-

Table of Contents

Scholes option-pricing model. The Company, under the 2010 Incentive Plan, granted restricted stock for the benefit of its employees and directors. These restricted shares vest over a period of three years for employees and one year for directors. The recipients of restricted shares have the right to vote all shares subject to such grant and receive all dividends with respect to such shares whether or not the shares have vested. The recipients do not pay any cash consideration for the shares.

Stock Options

The table below summarizes the weighted average assumptions used to determine the fair values of the options granted during the following periods:

	Three Months Ended June 30,		Six Months Ended June 30,	
Assumptions with respect to:	2016	2015[(1)]	2016	2015
Expected volatility	37 %	— %	38 %	44 %
Risk-free interest rate	1.34 %	— %	1.60 %	1.82 %
Expected dividends	— %	— %	— %	— %
Expected term (years)	6.2	—	6.3	6.0
Weighted average fair value of options granted during period	$2.67	$ —	$2.81	$3.13

(1) No stock options were granted during the three months ended June 30, 2015.

The following table summarizes the stock option activity under the Company’s equity incentive plans during the six months ended June 30, 2016 and 2015, respectively.

	Number of Shares	Weighted-Average Exercise Price Per Share	Number of Shares	Weighted-Average Exercise Price Per Share
	2016		2015	
Outstanding – January 1,	838,696	$ 6.20	1,257,390	$ 6.51
Granted	379,551	6.92	112,828	7.09
Exercised	(83,158)	4.37	(226,564)	5.54
Forfeited/Canceled	(57,737)	8.88	(134,553)	11.56
Outstanding – June 30,	1,077,352	6.45	1,009,101	6.12
Options Exercisable – June 30,	576,670	$ 6.13	529,284	$ 5.80
Options Vested – June 30,	576,670	$ 6.07	529,284	$ 5.80

Options to purchase 41,780 and 22,252 shares of our common stock were exercised during the three months ended June 30, 2016 and 2015, respectively. Options to purchase 83,158 and 226,564 shares of our common stock were exercised during the six months ended June 30, 2016 and 2015, respectively. The aggregate intrinsic value of options exercised during the three months ended June 30, 2016 and 2015 was $110 thousand and $21 thousand, respectively. The aggregate intrinsic value of options exercised during the six months ended June 30, 2016 and 2015 was $239 thousand and $343 thousand, respectively. The fair values of options that vested during the three months ended June 30, 2016 and 2015 was $40 thousand and $96 thousand, respectively. The fair values of options that vested during the six months ended June 30, 2016 and 2015 was $154 thousand and $170 thousand, respectively.

Table of Contents

The following table provides additional information regarding the vested and unvested options that were outstanding at June 30, 2016.

	Options Outstanding as of June 30, 2016				Options Exercisable as of June 30, 2016[1]	
	Vested	Unvested	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Shares	Weighted Average Exercise Price
\$2.97 – \$4.99	95,503	1,000	\$ 3.62	4.31	95,503	\$ 3.61
\$5.00 – \$6.99	442,794	338,855	6.48	7.86	442,794	6.32
\$7.00– \$10.00	24,573	160,827	7.10	9.23	24,573	7.10
\$10.01-\$17.31	13,800	—	15.91	0.38	13,800	15.91
	576,670	500,682	\$ 6.45	7.68	576,670	\$ 6.13

(1) The weighted average remaining contractual life of the options that were exercisable as of June 30, 2016 was 6.39 years.

The aggregate intrinsic value of options that were outstanding and exercisable under the 2010 Incentive Plan at June 30, 2016 and December 31, 2015 was \$680 thousand and \$904 thousand, respectively.

A summary of the status of the unvested options outstanding as of June 30, 2016, and changes in the weighted average grant date fair values of the unvested options during the six months ended June 30, 2016, are set forth in the following table.

	For the six months ended June 30, 2016		2015	
	Number of Shares Subject to Options	Weighted Average Grant Date Fair Value	Number of Shares Subject to Options	Weighted Average Grant Date Fair Value
Unvested at the beginning of the period	215,926	\$ 2.93	468,504	\$ 2.68
Granted	379,551	2.76	112,828	3.13
Vested	(52,738)	2.93	(74,301)	2.57
Forfeited/Canceled	(42,057)	2.90	(27,214)	2.26
Unvested at the end of the period	500,682	2.80	479,817	2.86

At June 30, 2016, the weighted average period over which nonvested awards were expected to be recognized was 2.73 years.

Restricted Stock

The following table summarizes the activity related to restricted stock granted, vested and forfeited under our equity incentive plans during the six months ended June 30, 2016 and 2015.

	For the six months ended June 30, 2016		2015	
	Number of Shares	Average Grant Date Fair Value	Number of Shares	Average Grant Date Fair Value
Outstanding at the beginning of the period	129,283	\$ 6.75	141,254	\$ 6.29
Granted	113,975	6.82	98,829	7.10
Vested	(47,764)	6.83	(15,848)	6.43

Forfeited	(30,585)	6.63	(3,638)	6.18
Outstanding at the end of the period	164,909	$ 6.80	220,597	$ 6.63

27

Table of Contents

Compensation Expense

We expect that the compensation expense that will be recognized during the periods presented below in respect of stock options and restricted stock outstanding at June 30, 2016, will be as follows:

(Dollars in thousands)	Estimated Stock Based Compensation Expense Stock Options	Estimated Stock Based Compensation Expense Restricted Stock	Estimated Stock Based Compensation Expense Total
For the years ending December 31,			
Remainder of 2016	$ 235	$ 258	$ 493
2017	391	292	683
2018	306	147	453
2019	63	34	97
2020 and beyond	28	16	44
	$ 1,023	$ 747	$ 1,770

The aggregate amounts of stock based compensation expense recognized in our consolidated statements of operations for the three months ended June 30, 2016 and 2015 were $276 thousand and $367 thousand, respectively, in each case net of taxes. The aggregate amounts of stock based compensation expense recognized in our consolidated statements of operations for the six months ended June 30, 2016 and 2015 were $553 thousand and $683 thousand, respectively, in each case net of taxes.

8. Earnings Per Share ("EPS")

Basic EPS excludes dilution and is computed by dividing net income or loss available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if stock options or other contracts to issue common stock were exercised or converted into common stock that would then share in our earnings.

The following table shows how we computed basic and diluted EPS for the three and six months ended June 30, 2016 and 2015.

(In thousands, except per share data)	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Numerator:				
Net (loss) income	$ (4,710)	$ 138	$ (4,426)	$ 54
Accumulated undeclared dividends on preferred stock	—	(309)	—	(618)
Numerator for basic and diluted net (loss) income available to common shareholders	$ (4,710)	$ (171)	$ (4,426)	$ (564)
Denominator:				
Basic weighted average outstanding shares of common stock	22,962	19,774	22,918	19,696
Dilutive effect of employee stock options and contingently issuable shares	—	—	—	—
Diluted weighted average common stock and common stock equivalents	22,962	19,774	22,918	19,696
Basic (loss) income per common share:				
Net (loss) income available to common shareholders	$ (0.21)	$ (0.01)	$ (0.19)	$ (0.03)
Diluted (loss) income per common share:				
Net (loss) income available to common shareholders	$ (0.21)	$ (0.01)	$ (0.19)	$ (0.03)

28

Table of Contents

The weighted average shares that have an antidilutive effect in the calculation of diluted net loss per share and have been excluded from the computations above were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Stock options(1)	1,038,920	1,023,375	1,016,521	1,079,309
Convertible securities(2)	—	2,767,385	—	2,750,794
Shares subject to stock purchase warrants(3)	—	761,278	—	761,278

(1) Stock options were excluded from the computation of diluted earnings per common share for the three and six months ended June 30, 2016 and 2015 as we reported a net loss available to common shareholders.

(2) Convertible securities were excluded from the computation of diluted earnings per common share for the three and six months ended June 30, 2015 as we reported a net loss available to common shareholders.

(3) Stock purchase warrants were excluded from the computation of diluted earnings per common share for the three and six months ended June 30, 2015 because the exercisability of those warrants was conditioned on the happening of certain future events.

9. Shareholders' Equity

Accumulated Other Comprehensive Income (Loss), net

Accumulated other comprehensive income (loss), net as of June 30, 2016 and December 31, 2015 was as follows:

	Unrealized Gain (Loss) on Securities Available-for-Sale, net of tax	Accumulated Other Comprehensive Income, Net
	(Dollars in thousands)	
Ending balance as of December 31, 2014	$ (692)	$ (692)
Other comprehensive income before reclassifications, net of tax provision of $81 thousand (1)	(118)	(118)
Amounts reclassified from accumulated other comprehensive loss, net of tax	—	—
Other comprehensive income, net of tax provision of $81 thousand	(118)	(118)
Ending balance as of December 31, 2015	$ (810)	$ (810)
Other comprehensive loss before reclassifications, net of tax provision of $440 thousand (1)	630	630
Amounts reclassified from accumulated other comprehensive income, net of tax	—	—
Other comprehensive loss, net of tax provision of $440 thousand	630	630
Ending balance as of June 30, 2016	$ (180)	$ (180)

(1) Tax impact included in Deferred tax assets.

10. Commitments and Contingencies

Repurchase Reserves

We have historically maintained reserves for possible repurchases that we may have been required to make of certain of the mortgage loans which we sold as a result of deficiencies or defects that may be found to exist in such loans. Our repurchase reserve also covered returns of any premiums earned and administrative fees pertaining to the repurchase of mortgage loans that did not meet investor guidelines, including potential loss of advances on Veterans Affairs or

Federal Housing Authority Ginnie Mae loans. As a result of our exit from the mortgage banking business and no longer being subject to potential loss for anything other than mortgage fraud, we have undertaken an analysis of our accrual. Our analysis assumes that the repurchase liability exposure will decrease over time as mortgage loans are paid off and as we are no longer originating new mortgage loans. No loans were repurchased during the three and six months ended June 30, 2016 or during the three months ended June 30, 2015. We repurchased $619 thousand of loans during the six months ended June 30, 2015. The following table sets forth information at June 30, 2016 and December 31, 2015, with respect to our repurchase reserves:

Table of Contents

	At and For the Six Months Ended June 30, 2016	At and For the Year Ended December 31, 2015
	(Dollars in thousands)	
Beginning balance	$314	$ 381
Recovery of repurchases	(27)	(1)
Settlements	—	(66)
Total repurchases reserve	$287	$ 314

Commitments

To meet the financing needs of our customers in the normal course of business, we are a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. At June 30, 2016 and December 31, 2015, we were committed to fund certain loans including letters of credit amounting to approximately $248 million and $193 million, respectively. The contractual amounts of a credit-related financial instrument, such as a commitment to extend credit, a credit-card arrangement or a letter of credit, represent the amount of potential accounting loss should the commitment be fully drawn upon, the customer were to default, and the value of any existing collateral securing the customer’s payment obligation becomes worthless. The loss reserve for unfunded loan commitments was $275 thousand at each of June 30, 2016 and December 31, 2015.

As a result, we use the same credit policies in making commitments to extend credit and conditional obligations as we do for on-balance sheet instruments. Commitments generally have fixed expiration dates; however, since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer’s creditworthiness on a case-by-case basis, using the same credit underwriting standards that are employed in making commercial loans. The amount of collateral obtained, if any, upon an extension of credit is based on our evaluation of the creditworthiness of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, residential real estate and income-producing commercial properties.

Litigation, Claims and Assessments

We are a defendant in or a party to a number of legal actions or proceedings that arise in the ordinary course of business. In some of these actions and proceedings, claims for monetary damages are asserted against us.

In accordance with applicable accounting guidance, we assess the likelihood of any loss or exposure with respect to lawsuits and other proceedings that are pending against us. We establish an accrued liability for lawsuits or other legal proceedings when they present loss contingencies that are both probable and estimable. Where a loss is not probable but it is reasonably possible or where a loss in excess of an amount accrued is reasonably possible, we disclose an estimate of the amount of the loss or range of possible losses for the claim if a reasonable estimate can be made, unless the amount of reasonably possible losses with respect to the matter is not material to our financial condition, results of operations or cash flows. We estimate any potential loss based upon currently available information and significant judgments and a variety of assumptions, and known and unknown uncertainties. Moreover, the facts and circumstances on which such estimates are based will change over time. Therefore, the amount of any losses we might incur in any lawsuits or other legal proceedings may exceed amounts which we had accrued based on our estimates and those estimates do not represent the maximum loss exposure that we may have in connection with any lawsuits or other legal proceedings.

Based on our evaluation of the lawsuits and other proceedings that were pending against us as of June 30, 2016, the outcomes in those suits or other proceedings are not expected to have, either individually or in the aggregate, a material adverse effect on our consolidated financial position, results of operations or cash flows. However, in light of the inherent uncertainties involved, some of which are beyond our control, and the very large or indeterminate damages often sought in such legal actions or proceedings, an adverse outcome in one or more of these suits or proceedings could be material to our financial position, results of operations or cash flows for any particular reporting period.

11. Business Segment Information

We have one reportable business segment, commercial banking. The commercial banking segment provides small and medium-size businesses, professional firms and individuals with a diversified range of products and services such as various types of deposit accounts, various types of commercial and consumer loans, cash management services, and online banking services.

Table of Contents

Since our operating segment derives all of its revenues from interest and noninterest income and interest expense constitutes its most significant expense, this segment is reported below using net interest income (interest income less interest expense) and noninterest income (primarily net gains on sales of small business administration loans and fee income). We do not allocate general and administrative expenses or income taxes to our operating segment.
The following table sets forth information regarding the net interest income and noninterest income for our commercial banking segment for the three and six months ended June 30, 2016 and 2015.

(Dollars in thousands)	Commercial	Other[(1)]	Total
Net interest income for the three months ended June 30,			
2016	$8,623	$(143)	$8,480
2015	$8,562	$(73)	$8,489
Noninterest income for the three months ended June 30,			
2016	$859	$5	$864
2015	$613	$3	$616
Net interest income for the six months ended June 30,			
2016	$17,465	$(282)	$17,183
2015	$16,805	$(167)	$16,638
Noninterest income for the six months ended June 30,			
2016	$1,600	$18	$1,618
2015	$1,492	$6	$1,498
Segment Assets at:			
June 30, 2016	$1,084,682	$16,233	$1,100,915
December 31, 2015	$1,051,501	$10,888	$1,062,389

(1) Represents net interest income and noninterest income for PMAR and PMBC.

Table of Contents

12. Regulatory Capital

Under federal banking regulations that apply to all United States based bank holding companies and federally insured banks, the Company (on a consolidated basis) and the Bank (on a stand-alone basis) must meet specific capital adequacy requirements that, for the most part, involve quantitative measures, primarily in terms of the ratios of their capital to their assets, liabilities, and certain off-balance sheet items, calculated under regulatory accounting practices. Under those regulations, each bank holding company must meet a minimum capital ratio and each federally insured bank is determined by its primary federal bank regulatory agency to come within one of the following capital adequacy categories on the basis of its capital ratios:

- well capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized; or
- critically undercapitalized

Certain qualitative assessments also are made by a banking institution's primary federal regulatory agency that could lead the agency to determine that the banking institution should be assigned to a lower capital category than the one indicated by the quantitative measures used to assess the institution's capital adequacy. At each successive lower capital category, a banking institution is subject to greater operating restrictions and increased regulatory supervision by its federal bank regulatory agency.

The following table sets forth the capital and capital ratios of the Company (on a consolidated basis) and the Bank (on a stand-alone basis) at June 30, 2016, as compared to the respective regulatory requirements applicable to them.

			Applicable Federal Regulatory Requirement			
			For Capital Adequacy Purposes		To be Categorized As Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
Total Capital to Risk Weighted Assets:						
Company	$148,592	15.0%	$79,034	At least 8.0	N/A	N/A
Bank	130,121	13.5%	77,180	At least 8.0	$96,475	At least 10.0
Common Equity Tier 1 Capital to Risk Weighted Assets:						
Company	$123,818	12.5%	$44,457	At least 4.5	N/A	N/A
Bank	117,942	12.2%	43,414	At least 4.5	$62,709	At least 6.5
Tier 1 Capital to Risk Weighted Assets:						
Company	$136,126	13.8%	$59,275	At least 6.0	N/A	N/A
Bank	117,942	12.2%	57,885	At least 6.0	$77,180	At least 8.0
Tier 1 Capital to Average Assets:						
Company	$136,126	12.4%	$43,970	At least 4.0	N/A	N/A
Bank	117,942	10.9%	43,369	At least 4.0	$54,211	At least 5.0

In early July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt correct action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier 1 capital ratio, increase the minimum Tier 1 capital ratio requirement, and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The final rules took effect for community banks on January 1, 2015, subject to a transition period for certain parts of the rules. At June 30, 2016, the Bank (on a stand-alone basis) continued to qualify as a well-capitalized institution, and the Company continued to exceed the minimum required capital ratios applicable to it, under the capital adequacy guidelines described above.

ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward Looking Statements

32

Table of Contents

Statements contained in this Quarterly Report on Form 10-Q (this “Report”) that are not historical facts or that discuss our expectations, beliefs or views regarding our future operations or future financial performance, or financial or other trends in our business or in the markets in which we operate, constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include words such as “believe,” “expect,” “anticipate,” “intend,” “plan,” “estimate,” “project,” "forecast," or words of similar meaning, or future or conditional verbs suc as “will,” “would,” “should,” “could,” or “may.” The information contained in such forward-looking statements is based on current information available to us and on assumptions that we make about future economic and market conditions and other events over which we do not have control. In addition, our business and the markets in which we operate are subject to a number of risks and uncertainties. Such risks and uncertainties, and the occurrence of events in the future or changes in circumstances that had not been anticipated, could cause our financial condition or actual operating results in the future to differ materially from our expected financial condition or operating results that are set forth in the forward-looking statements contained in this Report and could, therefore, also affect the price performance of our shares.

In addition to the risk of incurring loan losses, which is an inherent risk of the banking business, these risks and uncertainties include, but are not limited to, the following: the risk that the economic recovery in the United States, which is improving but still relatively fragile, will be adversely affected by domestic or international economic conditions, which could cause us to incur additional loan losses and adversely affect our results of operations in the future; the risk that our interest margins and, therefore, our net interest income will be adversely affected by changes in prevailing interest rates; the risk that we will not succeed in further reducing our remaining nonperforming assets, in which event we would face the prospect of further loan charge-offs and write-downs of assets; the risk that we will not be able to manage our interest rate risks effectively, in which event our operating results could be harmed; the prospect that government regulation of banking and other financial services organizations will increase, causing our costs of doing business to increase and restricting our ability to take advantage of business and growth opportunities; the risk that our efforts to develop a robust commercial banking platform may not succeed; and the risk that we may be unable to realize our expected level of increasing deposit inflows. Additional information regarding these and other risks and uncertainties to which our business is subject is contained in our Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Form 10-K”) that we filed with the Securities and Exchange Commission (“SEC”) on March 14, 2016, and readers of this Report are urged to review the additional information contained in that report, and in any subsequent Quarterly Report on Form 10-Q that we file with the SEC. We urge you to read those risk factors in conjunction with your review of the following discussion and analysis of our results of operations for the three and six months ended, and our financial condition at, June 30, 2016.

Due to the risks and uncertainties we face, readers are cautioned not to place undue reliance on the forward-looking statements contained in this Report, which speak only as of the date of this Report, or to make predictions about future performance based solely on historical financial performance. We also disclaim any obligation to update forward-looking statements contained in this Report as a result of new information, future events or otherwise, except as may otherwise be required by law.

Overview

The following discussion presents information about our consolidated results of operations, financial condition, liquidity and capital resources and should be read in conjunction with our consolidated financial statements and the notes thereto included in Item 1 above of this Report.

Our principal operating subsidiary is Pacific Mercantile Bank (the “Bank”), which is a California state chartered bank. The Bank accounts for substantially all of our consolidated revenues, expenses and income and our consolidated assets and liabilities. Accordingly, the following discussion focuses primarily on the Bank’s results of operations and financial condition.

As of June 30, 2016, our total assets, net loans and total deposits were $1.1 billion, $872 million and $937 million, respectively.

The Bank, which is headquartered in Orange County, California, approximately 40 miles south of Los Angeles, conducts a commercial banking business in Orange, Los Angeles, San Bernardino and San Diego counties in Southern California. The Bank is also a member of the Federal Reserve System and its deposits are insured, to the maximum extent permitted by law, by the Federal Deposit Insurance Corporation (the "FDIC"). For the three and six months ended June 30, 2016 and 2015, we operated as one reportable segment, Commercial Banking.

Unless the context otherwise requires, the "Company," "we," "our," "ours," and "us" refer to Pacific Mercantile Bancorp and it consolidated subsidiaries.

Table of Contents

Results of Operations

Operating Results for the Three and Six Months Ended June 30, 2016 and 2015

Our operating results for the three and six months ended June 30, 2016, compared to the same period in June 30, 2015, was as follows:

	Three Months Ended June 30,		2016 vs. 2015	Six Months Ended June 30,		2016 vs. 2015
	2016	2015	% Change	2016	2015	% Change
	(Dollars in thousands)					
Interest income	$9,835	$9,813	0.2 %	$19,790	$19,285	2.6 %
Interest expense	1,355	1,324	2.3 %	2,607	2,647	(1.5)%
Provision for loan and lease losses	8,720	—	100.0 %	9,140	—	100.0 %
Non-interest income	864	616	40.3 %	1,618	1,498	8.0 %
Non-interest expense	8,893	8,967	(0.8)%	17,448	18,082	(3.5)%
Income tax expense	(3,559)	—	(100.0)%	(3,361)	—	(100.0)%
Net (loss) income	(4,710)	138	(3,513.0)%	(4,426)	54	(8,296.3)%

Interest Income

Three Months Ended June 30, 2016 and 2015

Total interest income remained flat for the three months ended June 30, 2016 as compared to the three months ended June 30, 2015. This was primarily due to an increase in interest income on loans during the three months ended June 30, 2016 compared to the same prior year period, offset by a decrease in the interest income earned on investments. During the three months ended June 30, 2016 and 2015, interest income on loans was $9.3 million and $9.2 million, respectively, yielding 4.41% and 4.46% on average loan balances of $843.4 million and $824.7 million, respectively. The increase in the average loan balances is attributable to an increase in loan demand and the purchase of $29.9 million of performing residential multi-family mortgage loans during the three months ended June 30, 2016. During the three months ended June 30, 2016 and 2015, interest income from our securities available-for-sale and stock was $369 thousand and $558 thousand, respectively, yielding 2.54% and 3.38% on average balances of $58.4 million and $66.1 million, respectively. The investment yield decrease is primarily due to our receipt of a cash dividend paid on our FHLB stock during the three months ended June 30, 2015. The average securities balances decreased as a result of maturities of, and payments on, securities which we did not fully replace. Interest income from our short-term investments, including our federal funds sold and interest-bearing deposits, was $212 thousand and $80 thousand for the three months ended June 30, 2016 and 2015, respectively, yielding 0.50% and 0.25% on average balances of $169.6 million and $126.3 million, respectively. The increase in interest income from our short-term investments was primarily attributable to a higher average balance and an increase in the average yield during the three months ended June 30, 2016 as compared to the three months ended June 30, 2015. The increase in the average yield is attributable to the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) raising interest rates by 25 basis points in the fourth quarter of 2015. As a result, total interest income on investments decreased for the three months ended June 30, 2016 as compared to the three months ended June 30, 2015.

Six Months Ended June 30, 2016 and 2015

Total interest income increased 2.6% to $19.8 million for the six months ended June 30, 2016 from $19.3 million for the six months ended June 30, 2015. This was primarily due to an increase in interest income on loans during the six months ended June 30, 2016 compared to the same prior year period, which was primarily attributable to an increase in the average loan balance and an increase in both average yield on loans and the average balance on short-term investments over the same period. During the six months ended June 30, 2016 and 2015, interest income on loans was $18.7 million and $18.2 million, respectively, yielding 4.46% and 4.44% on average loan balances of $842.8 million and $826.1 million, respectively. The increase in the average loan balances is attributable to an increase in loan demand. The increase in average loan yield is primarily attributable to the actions of the Federal Reserve Board to raise short-term interest rates by 25 basis points in the fourth quarter of 2015.

During the six months ended June 30, 2016 and 2015, interest income from our securities available-for-sale and stock was $719 thousand and $931 thousand, respectively, yielding 2.44% and 2.79% on average balances of $59.2 million and $67.2 million, respectively. The investment yield decrease is primarily due to our receipt of a cash dividend paid on our FHLB stock during the six months ended June 30, 2015. The average securities balances decreased as a result of maturities of, and payments on, securities which we did not fully replace. Interest income from our short-term investments, including our federal funds sold and interest-bearing deposits, was $369 thousand and $160 thousand for the six months ended June 30, 2016 and 2015, respectively, yielding 0.51% and 0.26% on average balances of $145.9 million and $125.9 million, respectively. The increase in the average

Table of Contents

yield is attributable to the Federal Reserve Board raising interest rates by 25 basis points in the fourth quarter of 2015. As a result, total interest income on investments remained flat for the six months ended June 30, 2016 and 2015.

Interest Expense

Three Months Ended June 30, 2016 and 2015

Total interest expense increased 2.3% for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. The increase was primarily due to an increase in our cost of funds from 0.77% at June 30, 2015 to 0.80% at June 30, 2016, partially offset by a decline in the average interest-bearing liabilities from $692.6 million at June 30, 2015 to $678.2 million at June 30, 2016, which consisted of deposits, borrowings and junior subordinated debentures. Our cost of funds increased as a result of the actions of the Federal Reserve Board to raise short-term interest rates by 25 basis points in the fourth quarter of 2015. The decrease in our average interest-bearing liabilities is primarily attributable to the decrease in the average balance of our borrowings as a result of our decision to decrease our FHLB borrowings. Interest expense on our certificates of deposit for the three months ended June 30, 2016 and 2015 was $636 thousand and $700 thousand, respectively, with a cost of funds of 0.97% and 0.88% on average balances of $262.5 million and $317.4 million, respectively.

Six Months Ended June 30, 2016 and 2015

Total interest expense remained flat for the six months ended June 30, 2016 as compared to the six months ended June 30, 2015. This was primarily due to a decrease in average interest-bearing liabilities from $697.2 million at June 30, 2015 to $667.1 million at June 30, 2016, partially offset by an increase in our cost of funds from 0.77% and 0.79%, respectively, which consisted of deposits, borrowings and junior subordinated debentures. The decrease in our average interest-bearing liabilities is primarily attributable to the decrease in average balance of our borrowings as a result of our decision to decrease our FHLB borrowings.

Net Interest Margin

One of the principal determinants of a bank’s income is its net interest income, which is the difference between (i) the interest that a bank earns on loans, investment securities and other interest earning assets, on the one hand, and (ii) its interest expense, which consists primarily of the interest it must pay to attract and retain deposits and the interest that it pays on borrowings and other interest-bearing liabilities, on the other hand. As a general rule, all other things being equal, the greater the difference or "spread" between the amount of our interest income and the amount of our interest expense, the greater will be our net income; whereas, a decline in that difference or "spread" will generally result in a decline in our net income.

A bank’s interest income and interest expense are affected by a number of factors, some of which are outside of its control, including national and local economic conditions and the monetary policies of the Federal Reserve Board which affect interest rates, competition in the market place for loans and deposits, the demand for loans and the ability of borrowers to meet their loan payment obligations. Net interest income, when expressed as a percentage of total average interest earning assets, is a banking organization’s “net interest margin.”

The following table sets forth information regarding our average balance sheet, yields on interest earning assets, interest expense on interest-bearing liabilities, the interest rate spread and the interest rate margin for the three and six months ended June 30, 2016 and 2015. Average balances are calculated based on average daily balances.

Table of Contents

	Three Months Ended June 30,			2015		
	2016					
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)					
Interest-earning assets						
Short-term investments[1]	$169,633	$212	0.50 %	$126,287	$80	0.25 %
Securities available for sale and stock[2]	58,365	369	2.54 %	66,132	558	3.38 %
Loans[3]	843,406	9,254	4.41 %	824,712	9,175	4.46 %
Total interest-earning assets	1,071,404	9,835	3.69 %	1,017,131	9,813	3.87 %
Noninterest-earning assets						
Cash and due from banks	16,611			18,710		
All other assets	18,632			9,863		
Total assets	$1,106,647			$1,045,704		
Interest-bearing liabilities:						
Interest-bearing checking accounts	$55,768	45	0.32 %	$35,852	25	0.28 %
Money market and savings accounts	332,304	505	0.61 %	291,758	419	0.58 %
Certificates of deposit	262,491	636	0.97 %	317,443	700	0.88 %
Other borrowings	10,066	25	1.00 %	30,022	55	0.73 %
Junior subordinated debentures	17,527	144	3.30 %	17,527	125	2.86 %
Total interest bearing liabilities	678,156	1,355	0.80 %	692,602	1,324	0.77 %
Noninterest bearing liabilities						
Demand deposits	286,966			224,954		
Accrued expenses and other liabilities	5,836			6,510		
Shareholders' equity	135,689			121,638		
Total liabilities and shareholders' equity	$1,106,647			$1,045,704		
Net interest income		$8,480			$8,489	
Net interest income/spread			2.89 %			3.10 %
Net interest margin			3.18 %			3.35 %

(1) Short-term investments consist of federal funds sold and interest bearing deposits that we maintain at other financial institutions.

(2) Stock consists of Federal Home Loan Bank of San Francisco ("FHLB") stock and Federal Reserve Bank of San Francisco (“FRBSF”) stock.

(3) Loans include the average balance of nonaccrual loans.

Table of Contents

	Six Months Ended June 30,					
	2016			2015		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)					
Interest-earning assets						
Short-term investments[1]	$145,871	$369	0.51 %	$125,895	$160	0.26 %
Securities available for sale and stock[2]	59,220	719	2.44 %	67,216	931	2.79 %
Loans[3]	842,803	18,702	4.46 %	826,084	18,194	4.44 %
Total interest-earning assets	1,047,894	19,790	3.80 %	1,019,195	19,285	3.82 %
Noninterest-earning assets						
Cash and due from banks	16,190			16,761		
All other assets	19,186			10,120		
Total assets	$1,083,270			$1,046,076		
Interest-bearing liabilities:						
Interest-bearing checking accounts	$53,667	67	0.25 %	$37,541	48	0.26 %
Money market and savings accounts	322,987	961	0.60 %	290,625	824	0.57 %
Certificates of deposit	262,873	1,245	0.95 %	316,968	1,397	0.89 %
Other borrowings	10,033	50	1.00 %	34,530	127	0.74 %
Junior subordinated debentures	17,527	284	3.26 %	17,527	251	2.89 %
Total interest bearing liabilities	667,087	2,607	0.79 %	697,191	2,647	0.77 %
Noninterest bearing liabilities						
Demand deposits	274,686			221,300		
Accrued expenses and other liabilities	9,098			6,642		
Shareholders' equity	135,399			120,943		
Total liabilities and shareholders' equity	$1,086,270			$1,046,076		
Net interest income		$17,183			$16,638	
Net interest income/spread			3.01 %			3.05 %
Net interest margin			3.30 %			3.29 %

(1) Short-term investments consist of federal funds sold and interest bearing deposits that we maintain at other financial institutions.
(2) Stock consists of FHLB stock and FRBSF stock.
(3) Loans include the average balance of nonaccrual loans.

The following table sets forth changes in interest income, including loan fees, and interest paid in the three and six months ended June 30, 2016 and 2015 and the extent to which those changes were attributable to changes in (i) the volumes of or the rates of interest earned on interest-earning assets and (ii) the volumes of or the rates of interest paid on our interest-bearing liabilities.

Table of Contents

	Three Months Ended June 30, 2016 Compared to Three Months Ended June 30, 2015 Increase (Decrease) due to Changes in			Six Months Ended June 30, 2016 Compared to Six Months Ended June 30, 2015 Increase (Decrease) due to Changes in		
	Volume	Rates	Total Increase (Decrease)	Volume	Rates	Total Increase (Decrease)
	(Dollars in thousands)					
Interest income						
Short-term investments[1]	$34	$98	$ 132	$ 29	$ 180	$ 209
Securities available for sale and stock[2]	(61)	(128)	(189)	(103)	(109)	(212)
Loans	189	(110)	79	412	96	508
Total earning assets	162	(140)	22	338	167	505
Interest expense						
Interest-bearing checking accounts	16	4	20	20	(1)	19
Money market and savings accounts	60	26	86	97	40	137
Certificates of deposit	(130)	66	(64)	(248)	96	(152)
Borrowings	(45)	15	(30)	(111)	34	(77)
Junior subordinated debentures	—	19	19	—	33	33
Total interest-bearing liabilities	(99)	130	31	(242)	202	(40)
Net interest income	$261	$(270)	$ (9)	$ 580	$ (35)	$ 545

(1) Short-term investments consist of federal funds sold and interest bearing deposits that we maintain at financial institutions.
(2) Stock consists of FHLB stock and FRBSF stock.

Provision for Loan and Lease Losses

We maintain reserves to provide for loan losses that occur in the ordinary course of the banking business. When it is determined that the payment in full of a loan has become unlikely, the carrying value of the loan is reduced ("written down") to what management believes is its realizable value or, if it is determined that a loan no longer has any realizable value, the carrying value of the loan is written off in its entirety (a loan "charge-off"). Loan charge-offs and write-downs are charged against our allowance for loan and lease losses (“ALLL”). The amount of the ALLL is increased periodically to replenish the ALLL after it has been reduced due to loan write-downs or charge-offs. The ALLL also is increased or decreased periodically to reflect increases or decreases in the volume of outstanding loans and to take account of changes in the risk of probable loan losses due to financial performance of borrowers, the value of collateral securing non-performing loans or changing economic conditions. Increases in the ALLL are made through a "provision for loan and lease losses" that is recorded as an expense in the statement of operations. Increases in the ALLL are also recognized through the recovery of charged-off loans which are added back to the ALLL. As such, recoveries are a direct offset for a provision for loan and lease losses that would otherwise be needed to replenish or increase the ALLL.

We employ economic models and data that conform to bank regulatory guidelines and reflect sound industry practices as well as our own historical loan loss experience to determine the sufficiency of the ALLL and any provisions needed to increase or replenish the ALLL. Those determinations involve judgments and assumptions about current economic conditions and external events that can impact the ability of borrowers to meet their loan obligations. However, the duration and impact of these factors cannot be determined with any certainty. As such, unanticipated changes in economic or market conditions, bank regulatory guidelines or the sound practices that are used to determine the sufficiency of the ALLL, could require us to record additional, and possibly significant, provisions to increase the ALLL. This would have the effect of reducing reportable income or, in the most extreme circumstance, creating a reportable loss. In addition, the Federal Reserve Bank and the California Department of Business Oversight (“CDBO”),

as an integral part of their regulatory oversight, periodically review the adequacy of our ALLL. These agencies may require us to make additional provisions for perceived potential loan losses, over and above the provisions that we have already made, the effect of which would be to reduce our income or increase any losses we might incur.
We recorded a $8.7 million provision for loan and lease losses during the three months ended June 30, 2016 as compared to no provision for loan and lease losses recorded for the three months ended June 30, 2015. We recorded a provision of $8.7 million for the second quarter of 2016 due to new loan growth and charge offs on several loans previously placed on nonaccrual status, which exceeded recoveries during the second quarter. Of the $9.0 million in gross charge-offs, $7.5 million was attributable to one large commercial loan that the Company wrote down to the estimated net realizable value of the underlying collateral. There was no provision in the second quarter of 2015 as our loan portfolio decreased by $7.0 million during the three months ended June 30, 2015.

Table of Contents

We recorded a $9.1 million provision for loan and lease losses during the six months ended June 30, 2016 as compared to no provision for loan and lease losses recorded for the six months ended June 30, 2015. We recorded a provision for loan and lease losses of $9.1 million for the six months ended June 30, 2016 primarily as a result of new loan growth and charge offs on several loans previously placed on nonaccrual status, which exceeded recoveries during the six months ended June 30, 2016.

See "—Financial Condition—Nonperforming Assets and Allowance for Loan and Lease Losses" below in this Item 2 for additional information regarding the ALLL.

Noninterest Income

The following table identifies the components of and the percentage changes in noninterest income during the three and six months ended June 30, 2016 and 2015:

	Three Months Ended June 30,				Six Months Ended June 30,			
	Amount	Amount	Percentage Change		Amount	Amount	Percentage Change	
	2016	2015	2016 vs. 2015		2016	2015	2016 vs. 2015	
	(Dollars in thousands)							
Service fees on deposits and other banking services	$267	$ 234	14.1	%	$522	$446	17.0	%
Net gain on sale of small business administration loans	—	—	—	%	40	—	100.0	%
Other noninterest income	597	382	56.3	%	1,056	1,052	0.4	%
Total noninterest income	$864	$ 616	40.3	%	$1,618	$1,498	8.0	%

Three Months Ended June 30, 2016 and 2015

Noninterest income increased by $248 thousand, or 40.3%, for the three months ended June 30, 2016 as compared to the three months ended June 30, 2015, primarily as a result of a $255 thousand recovery during the second quarter of 2016.

Six Months Ended June 30, 2016 and 2015

Noninterest income increased $120 thousand, or 8.0%, for the six months ended June 30, 2016 as compared to the six months ended June 30, 2015, primarily as a result of:

- An increase of $40 thousand in net gain on sale of small business administration (“SBA”) loans for the six months ended June 30, 2016 as compared to the same period in 2015; and
- An increase in loan servicing and referral fees during the six months ended June 30, 2016 as compared to the same period in 2015.

Noninterest Expense

The following table sets forth the principal components and the amounts of, and the percentage changes in, noninterest expense during the three and six months ended June 30, 2016 and 2015.

	Three Months Ended June 30,				Six Months Ended June 30,				
	2016	2015	2016 vs. 2015		2016		2015	2016 vs. 2015	
	Amount	Amount	Percent Change		Amount		Amount	Percent Change	
	(Dollars in thousands)								
Salaries and employee benefits	$5,506	$ 5,423	1.5	%	$11,193		$11,330	(1.2	)%
Occupancy	793	752	5.5	%	1,538		1,412	8.9	%
Equipment and depreciation	450	430	4.7	%	873		823	6.1	%
Data processing	287	255	12.5	%	602		491	22.6	%
FDIC expense	251	339	(26.0	)%	446		692	(35.5	)%
Other real estate owned expense, net	—	59	(100.0	)%	(70	)	161	(143.5	)%
Professional fees	774	744	4.0	%	1,325		1,372	(3.4	)%
Business development	201	198	1.5	%	344		392	(12.2	)%
Loan related expense	73	170	(57.1	)%	113		239	(52.7	)%
Insurance	76	88	(13.6	)%	152		175	(13.1	)%
Other operating expenses [1]	482	509	(5.3	)%	932		995	(6.3	)%

Total noninterest expense	$8,893	$8,967	(0.8)%	$17,448	$18,082	(3.5)%

Table of Contents

(1) Other operating expenses primarily consist of telephone, advertising, director fees, regulatory expenses, and correspondent bank fees.

Three Months Ended June 30, 2016 and 2015

Noninterest expense decreased $74 thousand, or 0.8%, for the three months ended June 30, 2016 as compared to the three months ended June 30, 2015, primarily as a result of:

- A decrease of $88 thousand in our FDIC insurance expense as a result of a decrease in our insurance premium rate;
- A decrease of $97 thousand in loan related expenses; partially offset by
- An increase of $83 thousand in salaries and employee benefits primarily related to hiring-related expenses for our new chief credit officer; and
- An increase in our professional fees primarily related to a legal settlement reached during the second quarter of 2016.

Six Months Ended June 30, 2016 and 2015

Noninterest expense decreased $634 thousand, or 3.5%, for the six months ended June 30, 2016 as compared to the six months ended June 30, 2015, primarily as a result of:

- A decrease of $137 thousand in salaries and employee benefits primarily related to a decrease in our personnel expense as a result of severance paid to the SBA Group in 2015;
- A decrease of $246 thousand in our FDIC insurance expense as a result of a decrease in our insurance premium rate;
- A decrease of $231 thousand in OREO as a result of lower carrying costs and other expenses related to OREO during the six months ended June 30, 2016 as compared to the same period in 2015; and
- A decrease of $126 thousand in loan related expenses; partially offset by
- An increase in various expense accounts related to the normal course of operating, including expenses related to the conversion of some of our branches to loan production offices and our data processing expense.

Provision for Income Tax

For the three and six months ended June 30, 2016, we had an income tax benefit of $3.6 million and $3.4 million, respectively, as a result of our net loss during both periods. For the three and six months ended June 30, 2015, we recorded no income tax provision or benefit. As a result of the positive and negative evidence that management evaluated with respect to the Company's deferred tax asset, we determined that no valuation allowance was required at June 30, 2016. Management’s determination regarding no requirement for a valuation allowance on our deferred tax asset at June 30, 2016 relies on our conclusion that positive evidence outweighs negative evidence, which is dependent upon current conditions and expectations going forward. In the future, if we conclude that negative evidence, including net losses, outweighed positive evidence based upon conditions and expectations at that time we would need to establish a valuation allowance. We recorded no income tax provision for the three and six months ended June 30, 2015 as a result of positive and negative evidence that management evaluated. Based on the analysis performed, management chose not to release any portion of the $11.4 million valuation allowance as of June 30, 2015.

Financial Condition

Assets

Our total assets increased by $39 million to $1.1 billion at June 30, 2016 from $1.1 billion at December 31, 2015. The following table sets forth the composition of our interest earning assets at:

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
Interest-bearing deposits with financial institutions (1)	$119,986	$103,276
Interest-bearing time deposits with financial institutions	3,917	4,665
Federal Reserve Bank of San Francisco and Federal Home Loan Bank Stock, at cost	8,170	8,170
Securities available for sale, at fair value	49,263	52,249
Loans (net of allowances of $13,429 and $12,716, respectively)	872,198	849,733

(1) Includes interest-earning balances maintained at the FRBSF.

Investment Portfolio

Table of Contents

Securities Available for Sale. Securities that we intend to hold for an indefinite period of time, but which may be sold in response to changes in liquidity needs, in interest rates, or in prepayment risks or other similar factors, are classified as "securities available for sale". Such securities are recorded on our balance sheet at their respective fair values and increases or decreases in those values are recorded as unrealized gains or losses, respectively, and are reported as other comprehensive income (loss) on our accompanying consolidated statements of financial condition, rather than included in or deducted from our earnings.

The following is a summary of the major components of securities available for sale and a comparison of the amortized cost, estimated fair values and the gross unrealized gains and losses attributable to those securities, as of June 30, 2016 and December 31, 2015:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
Securities available for sale at June 30, 2016:				
Residential mortgage backed securities issued by U.S. Agencies	$ 42,164	$ 204	$ (55)	$ 42,313
Residential collateralized mortgage obligations issued by non agencies	551	—	(15)	536
Asset backed security	2,027	—	(698)	1,329
Mutual funds	5,000	92	(7)	5,085
Total securities available for sale	$ 49,742	$ 296	$ (775)	$ 49,263
Securities available for sale at December 31, 2015:				
Residential mortgage backed securities issued by U.S. Agencies	$ 46,126	$ 4	$ (976)	$ 45,154
Residential collateralized mortgage obligations issued by non agencies	646	—	(14)	632
Asset backed security	2,027	—	(547)	1,480
Mutual funds	5,000	33	(50)	4,983
Total securities available for sale	$ 53,799	$ 37	$ (1,587)	$ 52,249

The amortized cost of securities available for sale at June 30, 2016 is shown in the table below by contractual maturities taking into consideration historical prepayments based on the prior twelve months of principal payments. Expected maturities will differ from contractual maturities and historical prepayments, particularly with respect to collateralized mortgage obligations, primarily because prepayment rates are affected by changes in conditions in the interest rate market and, therefore, future prepayment rates may differ from historical prepayment rates.

	June 30, 2016 Maturing in									
	One year or less		Over one year through five years		Over five years through ten years		Over ten years		Total	
(Dollars in thousands)	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
Securities available for sale:										
Residential mortgage-backed securities issued by U.S. Agencies	$7,423	1.47 %	$20,514	1.49 %	$11,956	1.57 %	$2,271	1.69 %	$42,164	1.52 %
Non-agency collateralized mortgage obligations	551	3.21 %	—	—	—	—	—	—	551	3.21 %
Asset backed securities	—	—	—	—	—	—	2,027	2.96 %	2,027	2.96 %
Mutual funds	—	—	5,000	1.84 %	—	—	—	—	5,000	1.84 %
	$7,974	1.59 %	$25,514	1.56 %	$11,956	1.57 %	$4,298	2.29 %	$49,742	1.63 %

Total Securities Available
for sale

41

Table of Contents

Loans

The following table sets forth the composition, by loan category, of our loan portfolio at June 30, 2016 and December 31, 2015:

	June 30, 2016		December 31, 2015	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Commercial loans	$342,579	38.7 %	$347,300	40.3 %
Commercial real estate loans – owner occupied	216,845	24.5 %	195,554	22.7 %
Commercial real estate loans – all other	141,883	16.0 %	146,641	17.0 %
Residential mortgage loans – multi-family	92,101	10.4 %	81,487	9.5 %
Residential mortgage loans – single family	39,823	4.5 %	52,072	6.0 %
Land development loans	12,562	1.4 %	10,001	1.2 %
Consumer loans	38,634	4.4 %	28,663	3.3 %
Total loans	884,427	100.0%	861,718	100.0%
Deferred loan origination costs, net	1,200		731	
Allowance for loan and lease losses	(13,429)		(12,716)	
Loans, net	$872,198		$849,733	

Commercial loans are loans to businesses to finance capital purchases or improvements, or to provide cash flow for operations. Commercial real estate and residential mortgage loans are loans secured by trust deeds on real properties, including commercial properties and single family and multi-family residences. Land development loans are loans secured by non-arable bare land. Consumer loans include installment loans to consumers.

The following table sets forth the maturity distribution of our loan portfolio (excluding single and multi-family residential mortgage loans and consumer loans) at June 30, 2016:

	June 30, 2016			
	One Year or Less	Over One Year Through Five Years	Over Five Years	Total
	(Dollars in thousands)			
Real estate loans[(1)]				
Floating rate	$16,937	$ 33,971	$164,467	$215,375
Fixed rate	14,329	59,547	82,039	155,915
Commercial loans				
Floating rate	92,886	80,227	29,065	202,178
Fixed rate	63,718	70,856	5,827	140,401
Total	$187,870	$ 244,601	$281,398	$713,869

(1) Does not include mortgage loans on single or multi-family residences or consumer loans, which totaled $131.9 million and $38.6 million, respectively, at June 30, 2016.

Nonperforming Assets and Allowance for Loan and Lease Losses

Nonperforming Assets. Non-performing loans consist of (i) loans on non-accrual status which are loans on which the accrual of interest has been discontinued and include restructured loans when there has not been a history of past performance on debt service in accordance with the contractual terms of the restructured loans, and (ii) loans 90 days or more past due and still accruing interest. Non-performing assets are comprised of non-performing loans and OREO, which consists of real properties which we have acquired by or in lieu of foreclosure and which we intend to offer for sale.

Loans are placed on non-accrual status when, in our opinion, the full timely collection of principal or interest is in doubt. Generally, the accrual of interest is discontinued when principal or interest payments become more than 90 days past due, unless we believe the loan is adequately collateralized and the loan is in the process of collection. However, in certain instances, we may place a particular loan on non-accrual status earlier, depending upon the individual circumstances involved in that loan's delinquency. When a loan is placed on non-accrual status, previously accrued but unpaid interest is reversed against current income. Subsequent collections of unpaid amounts on such a loan are applied to reduce principal when received, except when the ultimate collectability of principal is probable, in which case such payments are applied to interest and are credited to income. Non-accrual loans may be restored to accrual status if and when principal and interest become current and full repayment is expected. Interest income is recognized on the accrual basis for impaired loans which, based on our non-accrual policy, do not require non-accrual treatment.

The following table sets forth information regarding our nonperforming assets, as well as information regarding restructured loans, at June 30, 2016 and December 31, 2015:

	At June 30, 2016	At December 31, 2015
	(Dollars in thousands)	
Nonaccrual loans:		
Commercial loans	$14,840	$ 12,284
Commercial real estate	9,717	10,083
Residential real estate	434	1,148
Land development	1,140	1,618
Consumer	189	—
Total nonaccrual loans	$26,320	$ 25,133
Loans past due 90 days and still accruing interest:		
Total loans past due 90 days and still accruing interest	$—	$ —
Other real estate owned (OREO):		
Residential real estate	—	650
Total other real estate owned	$—	$ 650
Total nonperforming assets	$26,320	$ 25,783
Restructured loans:		
Accruing loans	$183	$ 724
Nonaccruing loans (included in nonaccrual loans above)	15,419	20,070
Total restructured loans	$15,602	$ 20,794

As the above table indicates, total nonperforming assets increased by approximately $537 thousand, or 2.1%, to $26.3 million as of June 30, 2016 from $25.8 million as of December 31, 2015. The increase in our non-performing loans resulted primarily from $14.9 million moving to nonaccrual status during the six months ended June 30, 2016 partially offset by $4.5 million in pay offs and $9.2 million charged-off during the same period. Of these amounts, $12.5 million related to one commercial loan relationship moving to nonaccrual status during the first quarter of 2016, of which $7.5 million was charged-off during the second quarter of 2016. The borrower experienced a rapid deterioration in financial condition and the Company has written down the loan to the estimated net realizable value of the underlying collateral. The two legacy loans that were placed on nonaccrual status in the fourth quarter of 2015 remain well collateralized. These loans were renegotiated and have been operating under forbearance agreements with terms requiring full repayment of principal and interest. Subsequent to June 30, 2016, the outstanding principal and interest of $4.3 million on one of these loans and the remaining loan is in process of refinance with full repayment expected in 2016. The decrease in our OREO balance from December 31, 2015 related to the sale of the remaining portion of our OREO property during the first quarter of 2016, which resulted in a gain of $107 thousand during the six months ended June 30, 2016.

Information Regarding Impaired Loans. At June 30, 2016, loans deemed impaired totaled $26.5 million as compared to $25.9 million at December 31, 2015. We had an average investment in impaired loans of $31.0 million and $29.3 million, respectively, for the three and six months ended June 30, 2016 as compared to $31.2 million and $32.5 million, respectively, for the three and six months ended June 30, 2015. The interest that would have been earned during the three and six months ended June 30, 2016 had the nonaccruing impaired loans remained current in accordance with their original terms was approximately $393 thousand and $775 thousand, respectively.

Table of Contents

The following table sets forth the amount of impaired loans to which a portion of the ALLL has been specifically allocated, and the aggregate amount so allocated, in accordance with Accounting Standards Codification ("ASC") 310-10, and the amount of the ALLL and the amount of impaired loans for which no such allocations were made, in each case at June 30, 2016 and December 31, 2015:

	June 30, 2016			December 31, 2015		
	Loans	Reserves for Loan Losses	% of Reserves to Loans	Loans	Reserves for Loan Losses	% of Reserves to Loans
	(Dollars in thousands)					
Impaired loans with specific reserves	$1,589	$ 485	30.5 %	$1,621	$ 484	29.9 %
Impaired loans without specific reserves	24,914	—	—	24,236	—	—
Total impaired loans	$26,503	$ 485	1.8 %	$25,857	$ 484	1.9 %

The $646 thousand increase in impaired loans to $26.5 million at June 30, 2016 from $25.9 million at December 31, 2015 was primarily attributable to additions of $16.0 million to impaired loans during the six months ended June 30, 2016 partially offset by $6.1 million in pay offs and $9.2 million charged-off during the same period. Of these amounts, $12.5 million related to one commercial loan relationship moving to impaired loans during the first quarter of 2016, of which $7.5 million was charged-off during the second quarter of 2016. The borrower experienced a rapid deterioration in financial condition and the Company has written down the loan to the estimated net realizable value of the underlying collateral. Accruing restructured loans were comprised of a number of loans performing in accordance with modified terms, which included lowering of interest rates, deferral of payments, or modifications to payment terms. Based on an internal analysis, using the current estimated fair values of the collateral or the discounted present values of the future estimated cash flows of the impaired loans, we concluded that, at June 30, 2016, $485 thousand of specific reserves were required on one impaired loan and that all remaining impaired loans were well secured and adequately collateralized with no specific reserves required.

Allowance for Loan and Lease Losses. The ALLL totaled $13.4 million, representing 1.52% of loans outstanding, at June 30, 2016, as compared to $12.7 million, or 1.48% of loans outstanding, at December 31, 2015.

The adequacy of the ALLL is determined through periodic evaluations of the loan portfolio and other factors that can reasonably be expected to affect the ability of borrowers to meet their loan obligations. Those factors are inherently subjective as the process for determining the adequacy of the ALLL involves some significant estimates and assumptions about such matters such as (i) economic conditions and trends and the amounts and timing of expected future cash flows of borrowers which can affect their ability to meet their loan obligations to us, (ii) the fair value of the collateral securing non-performing loans, (iii) estimates of losses that we may incur on non-performing loans, which are determined on the basis of historical loss experience and industry loss factors and bank regulatory guidelines, which are subject to change, and (iv) various qualitative factors. Since those factors are subject to changes in economic and other conditions and changes in regulatory guidelines or other circumstances over which we have no control, the amount of the ALLL may prove to be insufficient to cover all of the loan losses we might incur in the future. In such an event, it may become necessary for us to increase the ALLL from time to time to maintain its adequacy. Such increases are effectuated by means of a charge to income, referred to as the "provision for loan and lease losses", in our statements of our operations. See "—Results of Operations— Provision for Loan and Lease Losses, above in this Item 2.

The amount of the ALLL is first determined by assigning reserve ratios for all loans. All non-accrual loans and other loans classified as "Special Mention," "Substandard" or "Doubtful" ("classified loans" or "classification categories") and not fully collateralized are then assigned specific reserves within the ALLL, with greater reserve allocations made to loans deemed to be of a higher risk. These ratios are determined based on prior loss history and industry guidelines and loss factors, by type of loan, adjusted for current economic factors and current economic trends. Refer to Note 5, Loans and Allowance for Loan and Lease Losses, in Item 1 for definitions related to our internal asset quality indicators stated above.

On a quarterly basis, we utilize a classification based loan loss migration model as well as review individual loans in determining the adequacy of the ALLL. Our loss migration analysis tracks a certain number of quarters of loan loss history and industry loss factors to determine historical losses by classification category for each loan type, except certain consumer loans (automobile, mortgage and credit cards), which are analyzed as homogeneous loan pools. These calculated loss factors are then applied to outstanding loan balances. We analyze impaired loans individually.

In determining whether and the extent to which we will make adjustments to our loan loss migration model for purposes of determining the ALLL, we also consider a number of qualitative factors that can affect the performance and the collectability of the loans in our loan portfolio. Such qualitative factors include:

- The effects of changes that we may make in our loan policies or underwriting standards on the quality of the loans and the risks in our loan portfolios;

Table of Contents

- Trends and changes in local, regional and national economic conditions, as well as changes in industry specific conditions, and any other reasonably foreseeable events that could affect the performance or the collectability of the loans in our loan portfolios;
- Material changes that may occur in the mix or in the volume of the loans in our loan portfolios that could alter, whether positively or negatively, the risk profile of those portfolios;
- Changes in management or loan personnel or other circumstances that could, either positively or negatively, impact the application of our loan underwriting standards, the monitoring of nonperforming loans or our loan collection efforts; and
- External factors that, in addition to economic conditions, can affect the ability of borrowers to meet their loan obligations, such as fires, earthquakes and terrorist attacks.

Determining the effects that these qualitative factors may have on the performance of each category of loans in our loan portfolio requires numerous judgments, assumptions and estimates about conditions, trends and events which may subsequently prove to have been incorrect due to circumstances outside of our control. Moreover, the effects of qualitative factors such as these on the performance of our loan portfolios are often difficult to quantify. As a result, we may sustain loan losses in any particular period that are sizable in relation to the ALLL or that may even exceed the ALLL.

In response to the economic recession, we (i) implemented more stringent loan underwriting standards, (ii) strengthened loan underwriting and approval processes, and (iii) added personnel with experience in addressing problem assets.

Set forth below is information regarding loan balances and the related ALLL, by portfolio type, for the six months ended June 30, 2016 and 2015.

(Dollars in thousands)	Commercial	Real Estate	Land Development	Consumer and Single Family Mortgages	Total
ALLL for the six months ended June 30, 2016:					
Balance at beginning of year	$ 6,639	$5,109	$ 282	$ 686	$12,716
Charge offs	(8,672)	—	—	(540)	(9,212)
Recoveries	777	1	—	7	785
Provision	9,959	(1,282)	(56)	519	9,140
Balance at end of year	$ 8,703	$3,828	$ 226	$ 672	$13,429
Allowance for loan and lease losses as a percentage of average total loans					1.59 %
Allowance for loan and lease losses as a percentage of total outstanding loans					1.52 %
Ratio of net charge-offs to average loans outstanding (annualized)					2.01 %
ALLL for the six months ended June 30, 2015:					
Balance at beginning of year	$ 7,670	$5,133	$ 296	$ 734	$13,833
Charge offs	(2,117)	—	(85)	(151)	(2,353)
Recoveries	857	2	—	4	863
Provision	71	(246)	(167)	342	—
Balance at end of year	$ 6,481	$4,889	$ 44	$ 929	$12,343
Allowance for loan and lease losses as a percentage of average total loans					1.49 %
Allowance for loan and lease losses as a percentage of total outstanding loans					1.48 %
Ratio of net charge-offs to average loans outstanding (annualized)					0.36 %

The ALLL increased $1.1 million from June 30, 2015 to June 30, 2016 primarily as a result of new loan growth and charge offs exceeding recoveries during that same period.

We classify our loan portfolios using asset quality ratings. The credit quality table in Note 5, Loans and Allowance for Loan and Lease Losses above in Item 1, provides a summary of loans by portfolio type and asset quality ratings as of June 30, 2016 and December 31, 2015. Loans totaled approximately $884.4 million at June 30, 2016, an increase of $22.7 million from

Table of Contents

$861.7 million at December 31, 2015. The disaggregation of the loan portfolio by risk rating in the credit quality table located in Note 5 reflects the following changes that occurred between December 31, 2015 and June 30, 2016:

- Loans rated "Pass" totaled $837.7 million, an increase of $21.4 million from $816.3 million at December 31, 2015. The increase was primarily attributable to new loan growth partially offset by downgrades to "Special Mention", "Substandard" and "Doubtful" of $6.4 million, $13.1 million and $1.6 million, respectively, and paydowns of principal payments.
- Loans rated "Special Mention" totaled $18.9 million, an increase of $3.7 million from $15.3 million at December 31, 2015. The increase was primarily the result of $6.4 million downgraded from "Pass", partially offset by payoffs and principal payments.
- Loans rated "Substandard" totaled $26.3 million, a decrease of $3.9 million from $30.2 million at December 31, 2015. This decrease was primarily the result of principal payments of $1.1 million, payoffs of $6.7 million and $9.2 million of loans charged off partially offset by $13.1 million downgraded from "Pass".
- Loans rated "Doubtful" totaled $1.6 million, an increase of $1.6 million from $0 at December 31, 2015. This increase was the result of one commercial loan downgraded from "Pass."

Our loss migration analysis currently utilizes a series of twelve staggered 16-quarter migration periods, which was increased during the second quarter of 2015 from four staggered 16-quarter migration periods in order to broaden the loss experience incorporated into the analysis. As a result, for purposes of determining applicable loss factors at June 30, 2016, our migration analysis covered the period from December 1, 2010 to June 30, 2016. We believe this was consistent with and reasonably reflects current economic conditions, portfolio trends and the risks that were inherent in our loan portfolio at June 30, 2016.

The table below sets forth loan delinquencies, by quarter, for the five preceding quarters ended June 30, 2016.

	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015
Loans Delinquent:	(Dollars in thousands)				
90 days or more:					
Commercial loans	$6,910	$ 8,193	$ 8,766	$ 10,383	$12,132
Commercial real estate	6,076	6,229	6,004	2,579	—
Residential mortgages	—	535	535	535	763
Land development loans	1,140	1,595	1,618	1,640	1,685
	14,126	16,552	16,923	15,137	14,580
30-89 days:					
Commercial loans	3,215	28,781	3,018	5,346	527
Commercial real estate	—	247	316	1,255	4,847
Residential mortgages	2,364	—	—	—	—
Land development loans	—	—	—	—	—
Consumer loans	115	250	—	—	—
	5,694	29,278	3,334	6,601	5,374
Total Past Due(1):	$19,820	$ 45,830	$ 20,257	$ 21,738	$19,954

(1) Past due balances include nonaccrual loans.

As the above table indicates, total past due loans decreased by $437 thousand, to $19.8 million at June 30, 2016 from $20.3 million at December 31, 2015. Loans past due 90 days or more decreased by $2.8 million, to $14.1 million at June 30, 2016, from $16.9 million at December 31, 2015. Of the $14.1 million loans past due 90 days or more at June 30, 2016, $4.0 million was fully paid off subsequent to June 30, 2016.

Loans 30-89 days past due increased by $2.4 million to $5.7 million at June 30, 2016 from $3.3 million at December 31, 2015 primarily attributable to additions of $5.7 million in delinquent loans, partially offset by payoffs of $2.3 million and loans brought current of $1.0 million. The $5.7 million of new delinquent loans primarily relate to loans that have matured and are in process of renewal or being paid off.

46

Table of Contents

Deposits

Average Balances of and Average Interest Rates Paid on Deposits

Set forth below are the average amounts of, and the average rates paid on, deposits for the six months ended June 30, 2016 and year ended December 31, 2015:

	Six Months Ended June 30, 2016			Year Ended December 31, 2015		
	Average Balance	Average Rate		Average Balance	Average Rate	
	(Dollars in thousands)					
Noninterest bearing demand deposits	$274,686	—		$237,371	—	
Interest-bearing checking accounts	53,667	0.25	%	40,916	0.23	%
Money market and savings deposits	322,987	0.60	%	300,088	0.57	%
Time deposits[1]	262,873	0.95	%	308,529	0.90	%
Total deposits	$914,213	0.50	%	$886,904	0.51	%

(1) Comprised of time certificates of deposit in denominations of less than and more than $100,000.

Deposit Totals

Deposits totaled $936.7 million at June 30, 2016 as compared to $893.8 million at December 31, 2015. The following table provides information regarding the mix of our deposits at June 30, 2016 and December 31, 2015:

	At June 30, 2016			At December 31, 2015		
	Amounts	% of Total Deposits		Amounts	% of Total Deposits	
	(Dollars in thousands)					
Deposits						
Noninterest bearing demand deposits	$294,153	31.5	%	$249,676	27.9	%
Savings and other interest-bearing transaction deposits	373,997	39.9	%	363,838	40.7	%
Time deposits[1]	268,519	28.7	%	280,326	31.4	%
Total deposits	$936,669	100.0	%	$893,840	100.0	%

(1) Comprised of time certificates of deposit in denominations of less than and more than $100,000.

Certificates of deposit in denominations of $100,000 or more, on which we pay higher rates of interest than on other deposits, aggregated $236.9 million, or 25.3%, of total deposits at June 30, 2016, as compared to $245.2 million, or 27.4%, of total deposits at December 31, 2015. This decrease was due to our decision to decrease our reliance on certificates of deposit.

Set forth below is a maturity schedule of domestic time certificates of deposit outstanding at June 30, 2016 and December 31, 2015:

	June 30, 2016		December 31, 2015	
Maturities	Certificates of Deposit Under $ 100,000	Certificates of Deposit $100,000 or more	Certificates of Deposit Under $100,000	Certificates of Deposit $100,000 or more
	(Dollars in thousands)			
Three months or less	$7,164	$ 54,434	$13,419	$ 109,179
Over three and through six months	6,069	50,560	5,453	31,336

Over six and through twelve months	13,907	97,382	12,286	83,252
Over twelve months	4,471	34,532	3,957	21,444
Total	$31,611	$ 236,908	$35,115	$ 245,211

Liquidity

We actively manage our liquidity needs to ensure that sufficient funds are available to meet our needs for cash, including to fund new loans and deposit withdrawals by our customers. We project the future sources and uses of funds and maintain liquid funds for unanticipated events. Our primary sources of cash include cash we have on deposit at other financial institutions, payments from borrowers on their loans, proceeds from sales or maturities of securities held for sale, sales of residential mortgage loans, increases in deposits and increases in borrowings principally from the FHLB. The primary uses of cash include funding new loans and making advances on existing lines of credit, purchasing investments, including securities available for sale, funding new residential mortgage loans, funding deposit withdrawals and paying operating expenses. We maintain funds in overnight federal funds and other short-term investments to provide for short-term liquidity needs. We also have obtained credit lines from the FHLB and other financial institutions to meet any additional liquidity requirements we might have. See "—Contractual Obligations—Borrowings" below for additional information related to our borrowings from the FHLB.

Our liquid assets, which included cash and due from banks, federal funds sold, interest earning deposits that we maintain with financial institutions and unpledged securities available for sale (excluding FRBSF and FHLB stock) totaled $163.4 million, which represented 15% of total assets, at June 30, 2016. We believe that our cash and cash equivalent resources, together with available borrowings under our credit facilities, will be sufficient to meet normal operating requirements for at least the next twelve months, including to enable us to meet any increase in deposit withdrawals that might occur in the foreseeable future.

Cash Flow Provided by Operating Activities. During the six months ended June 30, 2016, operating activities provided net cash of $695 thousand, primarily attributable to the adjustments for depreciation and amortization and stock compensation expense to our net income before income tax benefit or provision of $1.4 million. During the six months ended June 30, 2015, operating activities provided net cash of $204 thousand, primarily attributable to a decrease in our accrued interest receivable and our net income of $54 thousand.

Cash Flow (Used in) Provided by Investing Activities. During the six months ended June 30, 2016, investing activities used net cash of $26.3 million, primarily attributable to $31.4 million used to fund an increase in loans, partially offset by $3.9 million of cash from maturities of and principal payments on securities available for sale and proceeds of $757 thousand from the sale of OREO. During the six months ended June 30, 2015, investing activities provided net cash of $8.9 million, primarily comprised of $4.1 million of cash from maturities and principal payments on securities available for sale, $2.1 million of cash from principal payments on other investments and $3.0 million provided by paydowns in loans.

Cash Flow Provided by (Used in) Financing Activities. During the six months ended June 30, 2016, financing activities provided net cash of $43.2 million, consisting of a $44.5 million increase in our demand deposits, which was the result of new client acquisition. During the six months ended June 30, 2015, financing activities used net cash of $52.6 million, consisting primarily of a $43.2 million net decrease in interest bearing deposits, which resulted primarily from a decision to decrease the rates of interest we pay on our certificates of deposit in order to increase our loan-to-deposit ratio and decrease our cost of funds, and a $9.5 million decrease in borrowings.

Ratio of Loans to Deposits. The relationship between gross loans and total deposits can provide a useful measure of a bank's liquidity. Since repayment of loans tends to be less predictable than the maturity of investments and other liquid resources, the higher the loan-to-deposit ratio the less liquid are our assets. On the other hand, since we realize greater yields on loans than we do on investments, a lower loan-to-deposit ratio can adversely affect interest income and earnings. As a result, our goal is to achieve a loan-to-deposit ratio that appropriately balances the requirements of liquidity and the need to generate a fair return on our assets. At June 30, 2016 and December 31, 2015, the loan-to-deposit ratio was 94% and 96%, respectively.

Capital Resources

Regulatory Capital Requirements Applicable to Banking Institutions

Under federal banking regulations that apply to all United States based bank holding companies and federally insured banks, the Company (on a consolidated basis) and the Bank (on a stand-alone basis) must meet specific capital adequacy requirements that, for the most part, involve quantitative measures, primarily in terms of the ratios of their capital to their assets, liabilities, and certain off-balance sheet items, calculated under regulatory accounting practices. Under those regulations, each bank holding company must meet a minimum capital ratio and each federally insured bank is determined by its primary federal bank regulatory agency to come within one of the following capital adequacy categories on the basis of its capital ratios:

- well capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized; or
- critically undercapitalized

Certain qualitative assessments also are made by a banking institution's primary federal regulatory agency that could lead the agency to determine that the banking institution should be assigned to a lower capital category than the one indicated by

Table of Contents

the quantitative measures used to assess the institution's capital adequacy. At each successive lower capital category, a banking institution is subject to greater operating restrictions and increased regulatory supervision by its federal bank regulatory agency.

The following table sets forth the capital and capital ratios of the Company (on a consolidated basis) and the Bank (on a stand-alone basis) at June 30, 2016, as compared to the respective regulatory requirements applicable to them.

			Applicable Federal Regulatory Requirement			
			For Capital Adequacy Purposes		To be Categorized As Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
Total Capital to Risk Weighted Assets:						
Company	$148,592	15.0%	$79,034	At least 8.0	N/A	N/A
Bank	130,121	13.5%	77,180	At least 8.0	$96,475	At least 10.0
Common Equity Tier 1 Capital to Risk Weighted Assets:						
Company	$123,818	12.5%	$44,457	At least 4.5	N/A	N/A
Bank	117,942	12.2%	43,414	At least 4.5	$62,709	At least 6.5
Tier 1 Capital to Risk Weighted Assets:						
Company	$136,126	13.8%	$59,275	At least 6.0	N/A	N/A
Bank	117,942	12.2%	57,885	At least 6.0	$77,180	At least 8.0
Tier 1 Capital to Average Assets:						
Company	$136,126	12.4%	$43,970	At least 4.0	N/A	N/A
Bank	117,942	10.9%	43,369	At least 4.0	$54,211	At least 5.0

In early July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt correct action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier 1 capital ratio, increase the minimum Tier 1 capital ratio requirement, and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The final rules took effect for community banks on January 1, 2015, subject to a transition period for certain parts of the rules. At June 30, 2016 the Bank (on a stand-alone basis) continued to qualify as a well-capitalized institution, and the Company continued to exceed the minimum required capital ratios applicable to it, under the capital adequacy guidelines described above.

The consolidated total capital and Tier 1 capital of the Company at June 30, 2016 includes an aggregate of $17.0 million principal amount of the $17.5 million of 30-year junior subordinated debentures that we issued in 2002 and 2004 (the "Debentures"). See "—Contractual Obligations—Junior Subordinated Debentures" below for additional information. We contributed the net proceeds from the sales of the Debentures to the Bank, thereby providing it with additional cash to fund the growth of its banking operations and, at the same time, to increase its total capital and Tier 1 capital. As of June 30, 2016, we were current on all interest payments.

Dividend Policy and Share Repurchase Programs.

It is, and since the beginning of 2009 it has been, the policy of the Boards of Directors of the Company and the Bank to preserve cash to enhance our capital positions and the Bank's liquidity. Accordingly, we do not expect to pay dividends or make share repurchases for the foreseeable future.

The principal source of cash available to a bank holding company consists of cash dividends from its bank subsidiaries. There are currently several restrictions on the Bank's ability to pay us cash dividends. Government regulations, including the laws of the State of California, as they pertain to the payment of cash dividends by California state chartered banks, limits the amount of funds that the Bank is permitted to dividend to us. Further, Section 23(a) of the Federal Reserve Act limits the amounts that a bank may loan to its bank holding company to an aggregate of no more than 10% of the bank subsidiary's capital surplus and retained earnings and requires that such loans be secured by specified assets of the bank holding company. While restrictions on the payment of dividends from the Bank to us exist, there are no restrictions on the dividends that PMAR may pay us. PMAR has approximately $15.7 million in assets and could provide us with additional cash if required. In addition, we currently have sufficient cash on hand to meet our cash obligations. As a result, we do not expect that these restrictions will impact our ability to meet our cash obligations.

Table of Contents

Off Balance Sheet Arrangements

Loan Commitments and Standby Letters of Credit. To meet the financing needs of our customers in the normal course of business, we are a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At June 30, 2016 and December 31, 2015, we were committed to fund certain loans including letters of credit amounting to approximately $248 million and $193 million, respectively.

Commitments to extend credit and standby letters of credit generally have fixed expiration dates or other termination clauses and the customer may be required to pay a fee and meet other conditions in order to draw on those commitments or standby letters of credit. We expect, based on historical experience, that many of the commitments will expire without being drawn upon and, therefore, the total commitment amounts do not necessarily represent future cash requirements.

To varying degrees, commitments to extend credit involve elements of credit and interest rate risk for us that are in excess of the amounts recognized in our balance sheets. Our maximum exposure to credit loss in the event of nonperformance by the customers to whom such commitments are made could potentially be equal to the amount of those commitments. As a result, before making such a commitment to a customer, we evaluate the customer’s creditworthiness using the same underwriting standards that we would apply if we were approving loans to the customer. In addition, we often require the customer to secure its payment obligations for amounts drawn on such commitments with collateral such as accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, residential properties and properties under construction. As a consequence, our exposure to credit and interest rate risk on such commitments is not different in character or amount than risks inherent in the outstanding loans in our loan portfolio.

Standby letters of credit are conditional commitments issued by the Bank to guarantee a payment obligation of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

Contractual Obligations

Borrowings. As of June 30, 2016, we had $10.0 million of outstanding short-term borrowings that we had obtained from the FHLB. The table below sets forth the amounts of, the interest rates we pay on and the maturity dates of these FHLB borrowings. These borrowings had a weighted-average annualized interest rate of 1.02% for the three months ended June 30, 2016.

Principal Amounts	Interest Rate	Maturity Dates
(Dollars in thousands)		
$5,000	1.08 %	September 19, 2016
5,000	0.96 %	September 30, 2016

At June 30, 2016, $510.1 million of loans were pledged to secure these FHLB borrowings and to support our unfunded borrowing capacity. At June 30, 2016, we had unused borrowing capacity of $239 million with the FHLB. The highest amount of borrowings outstanding at any month-end during the six months ended June 30, 2016 was $10 million, which consisted of borrowings from the FHLB. By comparison, the highest amount of borrowings outstanding at any month end in 2015 consisted of $39.5 million of borrowings from the FHLB.

Junior Subordinated Debentures. Pursuant to rulings of the Federal Reserve Board, bank holding companies were permitted to issue long term subordinated debt instruments that, subject to certain conditions, would qualify as and, therefore, augment capital for regulatory purposes. At June 30, 2016, we had outstanding approximately $17.5 million principal amount of Debentures, of which $17.0 million qualified as additional Tier 1 capital for regulatory purposes as of June 30, 2016.

Set forth below is certain information regarding the Debentures:

Original Issue Dates	Principal Amount	Interest Rates	Maturity Dates
September 2002	$ 7,217	LIBOR plus 3.40%	September 2032
October 2004	10,310	LIBOR plus 2.00%	October 2034

Total	$ 17,527

(1) Subject to the receipt of prior regulatory approval, we may redeem the Debentures, in whole or in part, without premium or penalty, at any time prior to maturity.

Table of Contents

These Debentures require quarterly interest payments, which are used to make quarterly distributions required to be paid on the corresponding trust preferred securities. Subject to certain conditions, we have the right, at our discretion, to defer those interest payments, and the corresponding distributions on the trust preferred securities, for up to five years. Exercise of this deferral right does not constitute a default of our obligations to pay the interest on the Debentures or the corresponding distributions that are payable on the trust preferred securities. As of June 30, 2016, we were current on all interest payments.

Credit Risk

Credit risk is the risk of loss arising from adverse changes in a client's or counterparty's ability to meet its financial obligations under agreed-upon terms. Credit risk primarily exists in our loan and investment portfolio. The degree of credit risk will vary based on many factors including the duration of the transaction, the financial capacity of the client, the contractual terms of the agreement and the availability and quality of collateral. We manage credit risk by limiting the total amount of credit extended to a single borrower relationship, by verification of its business operations and assets and with a thorough understanding of the nature and scope of the business activities in which they are engaged.

As appropriate, management and Board level committees evaluate and approve credit standards and oversee the credit risk management function related to loans and investments. These committees' primary responsibilities include ensuring the adequacy of our credit risk management infrastructure, overseeing credit risk management strategies and methodologies, monitoring economic and market conditions that may impact our credit-related activities, and finally, evaluating and monitoring overall portfolio credit risk.

We maintain a comprehensive credit policy that includes specific underwriting guidelines as well as standards for loan origination and reporting as well as portfolio management. The credit policy is developed by credit management and approved by the Board of Directors, which also reviews it at least annually. In addition, the credit policy sets forth requirements that ensure compliance with all applicable laws and regulatory guidance.

Our underwriting guidelines outline specific standards and risk management criteria for each lending product offered. Loan types are further segmented into subsections where the inherent credit risk warrants detailed transaction and monitoring parameters, as follows:

- Loan structures, which includes the lien priority, amortization terms and loan tenors;
- Collateral requirements, coverage margins and valuation methods;
- Underwriting considerations which include recommended due diligence and verification requirements; and
- Specific credit performance standards. Examples include minimum debt service coverage ratios, liquidity requirements as well as limits on financial leverage.

We measure and document each loan's compliance with our policy criteria at underwriting. If an exception to these criteria exists, an explanation of the factors that mitigate this additional risk is considered before an approval is granted. A report of loans with policy exceptions is reported to the Credit Policy Committee of the Board of Directors of the Bank on a monthly basis.

We continuously monitor a client's ability to perform under its obligations. Reporting requirements and loan covenants are set forth in each loan approval and compliance with these items are monitored on at least an annual basis or more frequently as conditions warrant. Loan covenant compliance is tracked and results are reported to credit management.

Under our credit risk management structure, each loan is assigned an internal asset quality rating that is based on defined credit standards. While the criteria may vary by product, each rating focuses on the borrower's inherent operating risks, the quality of management, historical financial performance, financial capacity, the stability of profits and cash flow, and the adequacy of the secondary repayment sources. Asset quality ratings for each loan are monitored and reassessed on an ongoing basis. If necessary, ratings are adjusted to reflect changes in the client's financial condition, cash flow or financial position. Regular reporting to management and the Board includes the aggregated portfolio exposure by asset quality rating as one measure of credit risk within the loan portfolio. Refer to "Financial Condition — Allowance for Loan and Lease Losses" above in this Item 2 for further detail regarding our internal asset quality ratings.

The Bank recognizes that substantial risks are posed by concentrations of credit assets. As such, it maintains a diversified loan portfolio by limiting exposures by loan structure, business type or purpose, collateral type, and perceived asset quality. Credit management defines areas of concentration, recommends appropriate thresholds to the Board of Directors and takes action if needed to manage potential risk where asset concentrations exist.

Market Risk

Market risk is the risk that values of assets and liabilities or revenues will be adversely affected by changes in market conditions such as interest rate fluctuations. This risk is inherent in the financial instruments associated with our operations and/or activities, including loans, securities and short-term borrowings.

Table of Contents

The primary market risk to which we are exposed is interest rate risk, which is inherent in the financial instruments associated with our operations, primarily including our loans, deposits and borrowings. Interest rate risk is the exposure of a company's financial condition, both earnings and the market value of assets and liabilities, to adverse movements in interest rates. Interest rate risk results from differences in the maturity or timing of interest earning assets and interest bearing liabilities, changes in the slope of the yield curve over time, imperfect correlation in the adjustment of rates earned and paid on different instruments with otherwise similar characteristics (e.g. three-month Treasury bill versus three-month LIBOR) and from interest-rate-related options embedded in bank products (e.g. loan prepayments, floors and caps, callable investment securities, customers redeploying non-interest bearing to interest bearing deposits, etc.).

The potential impact of interest rate risk is significant because of the liquidity and capital adequacy consequences that reduced earnings or net operating losses caused by a reduction in net interest income imply. We recognize and accept that interest rate risk is a routine part of bank operations and will from time to time impact our profits and capital position. The objective of interest rate risk management is to control exposure of net interest income to risks associated with interest rate movements in the market, to achieve consistent growth in net interest income and to profit from favorable market opportunities.

We measure interest rate risk and the effect of changes in market interest rates using a net interest income simulation analysis. The analysis incorporates our balance sheet as of June 30, 2016 and assumptions that reflect the current interest rate environment. The analysis estimates the interest rate impact of a parallel increase in interest rates over a twelve-month horizon.

The analysis below incorporates our assumptions for the market yield curve, pricing sensitivities on loans and deposits, reinvestment of asset and liability cash flows, and prepayments on loans and securities. The new loans, investment securities, borrowings and deposits are assumed to have interest rates that reflect our forecast of prevailing market terms. We also assumed that LIBOR and prime rates do not fall below 0% for loans and borrowings. FHLB borrowings are assumed to convert to cash as they run off. Actual results may differ from forecasted results due to changes in market conditions as well as changes in management strategies.

The estimated changes in net interest income for a twelve-month period based on changes in the interest rates applied as of June 30, 2016 were as follows:

Change in Market Interest Rates (basis points)	Amount ($) (in thousands)	Percent (%)
+200	$ 4,065	11.0 %
+100	2,044	5.5 %
-100	(3,022)	(8.2)%

In addition to NII simulation, we measure the impact of market interest rate changes on our economic value of equity ("EVE"). EVE is defined as the net present value of assets, less the net present value of liabilities, adjusted for any off-balance sheet items.

The estimated changes in EVE in the following table are based on a discounted cash flow analysis which incorporates the impacts of changes in market interest rates. The model simulations and calculations are highly assumption-dependent and will change regularly as our asset/liability structure changes, as interest rate environments evolve, and as we change our assumptions in response to relevant market or business circumstances. These calculations do not reflect the changes that we anticipate or may make to reduce our EVE exposure in response to a change in market interest rates as part of our overall interest rate risk management strategy. As with any method of measuring interest rate risk, certain limitations are inherent in the method of analysis presented in the preceding table. We are exposed to yield curve risk, prepayment risk and basis risk, which cannot be fully modeled and expressed using the above methodology. Accordingly, the results in the following table should not be relied upon as a precise indicator of actual results in the event of changing market interest rates. Additionally, the resulting changes in EVE and NII estimates are not intended to represent, and should not be construed to represent the underlying value.

The estimated changes in EVE based on interest rates applied as of June 30, 2016 were as follows:

Change in Market Interest Rates (basis points)	Amount ($) (in thousands)	Percent (%)
+200	$ 17,690	11.2 %
+100	8,997	5.7 %
-100	(14,854)	(9.4)%

Table of Contents

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) and general practices in the banking industry. Certain of those accounting policies are considered critical accounting policies, because they require us to make assumptions and judgments regarding circumstances or trends that could affect the carrying value of our material assets, such as, for example, assumptions regarding economic conditions or trends that could impact our ability to fully collect our loans or ultimately realize the carrying value of certain of our other assets, such as securities available for sale and our deferred tax asset. Those assumptions and judgments are based on current information available to us regarding those economic conditions or trends or other circumstances. If adverse changes were to occur in the conditions, trends or other events on which our assumptions or judgments had been based, then under GAAP it could become necessary for us to reduce the carrying values of any affected assets on our balance sheet. In addition, because reductions in the carrying value of assets are sometimes effectuated by or require charges to income, such reductions also may have the effect of reducing our income.

There have been no significant changes during the six months ended June 30, 2016 to the items that we disclosed as our critical accounting policies and estimates in Critical Accounting Policies within Management's Discussion and Analysis of Financial Condition and Results of Operations included in our 2015 Form 10-K.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to certain financial risks, which are discussed in detail in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Credit Risk and Market Risk sections.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

As required by SEC rules, an evaluation was performed under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer of the effectiveness, as of June 30, 2016, of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2016, the Company’s disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the three months ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to legal actions that arise from time to time in the ordinary course of our business. Currently, neither we nor any of our subsidiaries is a party to, and none of our or our subsidiaries' property is the subject of, any material legal proceeding.

ITEM 1A. RISK FACTORS

There have been no material changes in our assessment of our risk factors from those set forth in our 2015 Form 10-K.

ITEM 6. EXHIBITS

(a) Exhibits

The Index to Exhibits attached hereto is incorporated by reference.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on August 5, 2016.

PACIFIC MERCANTILE BANCORP

By: /S/ THOMAS M. VERTIN
Thomas M. Vertin
President and Chief Executive Officer
(Principal Executive Officer)

PACIFIC MERCANTILE BANCORP

By: /S/ CURT A. CHRISTIANSSEN
Curt A. Christianssen
Chief Financial Officer
(Principal Financial Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description of Exhibit
3.1	Articles of Incorporation of Pacific Mercantile Bancorp (Incorporated by reference to the same numbered exhibit to the Company's Registration Statement (No. 333-33452) on Form S-1 filed with the Commission on June 14, 2000.)
3.2	Certificate of Amendment of Articles of Incorporation of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q dated August 14, 2001.)
3.3	Certificate of Amendment of Articles of Incorporation of Pacific Mercantile Bancorp (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K dated January 26, 2012 and filed with the Commission on February 1, 2012.)
3.4	Certificate of Determination of Rights, Preferences, Privileges and Restrictions of Series A Convertible 10% Cumulative Preferred Stock of Pacific Mercantile Bancorp. (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K (No. 000-30777) dated October 6, 2010.)
3.5	Certificate of Amendment of Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series A Convertible 10% Cumulative Preferred Stock of Pacific Mercantile Bancorp. (Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K dated January 26, 2012 and filed with the Commission on February 1, 2012.)
3.6	Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series B Convertible 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp. (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K (No. 000-30777) dated August 22, 2011.)
3.7	Certificate of Determination of Rights, Preferences, Privileges and Restrictions of the Series C 8.4% Noncumulative Preferred Stock of Pacific Mercantile Bancorp. (Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K (No. 000-30777) dated August 22, 2011.)
3.8	Pacific Mercantile Bancorp Bylaws, Amended and Restated as of January 22, 2014. (Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K (No. 000-30777) dated January 22, 2014.)
10.1	Employment Agreement dated May 31, 2016 with Thomas J. Inserra (Incorporated by reference to Exhibit 10.1 to the Company’s Current Report on Form 8-K (No. 000-30777) dated May 27, 2016.)
10.2	Change in Control Severance Plan Participation Agreement dated May 27, 2016 (Incorporated by reference to Exhibit 10.1 to the Company’s Current Report on Form 8-K (No. 000-30777) dated May 27, 2016.)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1**	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 101.INS	XBRL Instance Document
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document
Exhibit 101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
Exhibit 101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
Exhibit 101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

** Furnished herewith.