

NORTHRIM BANCORP INC  
Form 10-Q  
November 07, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-Q  
(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2018

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-33501

NORTHRIM BANCORP, INC.

(Exact name of registrant as specified in its charter)

Alaska

92-0175752

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

3111 C Street

Anchorage, Alaska 99503

(Address of principal executive offices) (Zip Code)

(907) 562-0062

(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  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  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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

Smaller Reporting Company  Emerging Growth Company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares of the issuer's Common Stock, par value \$1 per share, outstanding at November 7, 2018 was 6,884,386.



## TABLE OF CONTENTS

|          |  |           |
|----------|--|-----------|
| Part I   | FINANCIAL INFORMATION  |           |
| Item 1.  | Financial Statements (unaudited)   |           |
|          | <u>Consolidated Balance Sheets</u>   | <u>3</u>  |
|          | <u>Consolidated Statements of Income</u>   | <u>4</u>  |
|          | <u>Consolidated Statements of Comprehensive Income</u>                                       | <u>5</u>  |
|          | <u>Consolidated Statements of Changes in Shareholders' Equity</u>                            | <u>6</u>  |
|          | <u>Consolidated Statements of Cash Flows</u>   | <u>7</u>  |
|          | <u>Notes to the Consolidated Financial Statements</u>  | <u>9</u>  |
| Item 2.  | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>42</u> |
| Item 3.  | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | <u>57</u> |
| Item 4.  | <u>Controls and Procedures</u>   | <u>57</u> |
| Part II  | OTHER INFORMATION  |           |
| Item 1.  | <u>Legal Proceedings</u>   | <u>57</u> |
| Item 1A. | <u>Risk Factors</u>  | <u>57</u> |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | <u>57</u> |
| Item 3.  | <u>Defaults Upon Senior Securities</u>   | <u>57</u> |
| Item 4.  | <u>Mine Safety Disclosures</u>   | <u>57</u> |
| Item 5.  | <u>Other Information</u>   | <u>58</u> |
| Item 6.  | <u>Exhibits</u>  | <u>58</u> |
|          | <u>SIGNATURES</u>  | <u>59</u> |

**PART I. FINANCIAL INFORMATION**

These consolidated financial statements should be read in conjunction with the financial statements, accompanying notes and other relevant information included in Northrim BanCorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2017.

**ITEM 1. FINANCIAL STATEMENTS**

2

---

## CONSOLIDATED FINANCIAL STATEMENTS

## NORTHRIM BANCORP, INC.

## Consolidated Balance Sheets

(Unaudited)

| (In Thousands, Except Share Data)   | September 30,<br>2018 | December 31,<br>2017 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and due from banks   | \$37,651              | \$25,016             |
| Interest bearing deposits in other banks  | 32,528                | 52,825               |
| Investment securities available for sale, at fair value   | 264,193               | 307,019              |
| Marketable equity securities  | 6,035                 | 5,731                |
| Investment in Federal Home Loan Bank stock  | 2,103                 | 2,115                |
| Loans held for sale   | 56,636                | 43,979               |
| Loans   | 982,007               | 954,953              |
| Allowance for loan losses   | (20,160               | ) (21,461            |
| Net loans   | 961,847               | 933,492              |
| Purchased receivables, net  | 12,706                | 22,231               |
| Mortgage servicing rights, at fair value  | 9,695                 | 7,305                |
| Other real estate owned, net  | 8,707                 | 8,651                |
| Premises and equipment, net   | 38,637                | 37,867               |
| Goodwill  | 15,017                | 15,017               |
| Other intangible assets, net  | 1,154                 | 1,207                |
| Other assets  | 55,764                | 56,141               |
| Total assets  | \$1,502,673           | \$1,518,596          |
| <b>LIABILITIES</b>  |                       |                      |
| Deposits:   |                       |                      |
| Demand  | \$450,409             | \$414,686            |
| Interest-bearing demand   | 240,974               | 252,009              |
| Savings   | 233,611               | 247,458              |
| Money market  | 208,614               | 243,603              |
| Certificates of deposit less than \$250,000   | 66,831                | 69,283               |
| Certificates of deposit \$250,000 and greater   | 32,829                | 31,244               |
| Total deposits  | 1,233,268             | 1,258,283            |
| Securities sold under repurchase agreements   | 32,429                | 27,746               |
| Borrowings  | 7,282                 | 7,362                |
| Junior subordinated debentures  | 10,310                | 10,310               |
| Other liabilities   | 16,142                | 22,093               |
| Total liabilities   | 1,299,431             | 1,325,794            |
| <b>SHAREHOLDERS' EQUITY</b>   |                       |                      |
| Preferred stock, \$1 par value, 2,500,000 shares authorized, none issued or outstanding   | —                     | —                    |
| Common stock, \$1 par value, 10,000,000 shares authorized, 6,884,386 and 6,871,963 issued and outstanding at September 30, 2018 and December 31, 2017, respectively | 6,884                 | 6,872                |
| Additional paid-in capital  | 62,512                | 61,793               |
| Retained earnings   | 134,487               | 124,407              |
| Accumulated other comprehensive loss, net of tax  | (641                  | ) (270               |
| Total shareholders' equity  | 203,242               | 192,802              |
| Total liabilities and shareholders' equity  | \$1,502,673           | \$1,518,596          |
| See notes to consolidated financial statements  |                       |                      |



NORTHRIM BANCORP, INC.  
Consolidated Statements of Income  
(Unaudited)

| (In Thousands, Except Per Share Data)                              | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Interest Income  |                    |                    |                    |                    |
| Interest and fees on loans and loans held for sale                 | \$14,992           | \$14,341           | \$42,291           | \$41,180           |
| Interest on investment securities available for sale               | 1,314              | 956                | 3,870              | 3,158              |
| Dividends on marketable equity securities                          | 86                 | 87                 | 252                | 259                |
| Interest on investment securities held to maturity                 | —                  | 11                 | —                  | 31                 |
| Dividends on Federal Home Loan Bank stock                          | 19                 | 6                  | 45                 | 18                 |
| Interest on deposits in other banks                                | 169                | 118                | 512                | 230                |
| Total Interest Income  | 16,580             | 15,519             | 46,970             | 44,876             |
| Interest Expense   |                    |                    |                    |                    |
| Interest expense on deposits                                       | 595                | 429                | 1,413              | 1,325              |
| Interest expense on securities sold under agreements to repurchase | 9                  | 9                  | 26                 | 25                 |
| Interest expense on borrowings                                     | 59                 | 54                 | 174                | 130                |
| Interest expense on junior subordinated debentures                 | 98                 | 110                | 286                | 402                |
| Total Interest Expense   | 761                | 602                | 1,899              | 1,882              |
| Net Interest Income  | 15,819             | 14,917             | 45,071             | 42,994             |
| (Benefit) provision for loan losses                                | —                  | 2,500              | (300)              | 3,200              |
| Net Interest Income After Provision for Loan Losses                | 15,819             | 12,417             | 45,371             | 39,794             |
| Other Operating Income   |                    |                    |                    |                    |
| Mortgage banking income  | 5,903              | 6,219              | 16,325             | 18,020             |
| Purchased receivable income  | 767                | 752                | 2,474              | 2,217              |
| Bankcard fees  | 724                | 664                | 2,056              | 1,903              |
| Service charges on deposit accounts                                | 407                | 406                | 1,137              | 1,254              |
| Gain on sale of Northrim Benefits Group                            | —                  | 4,443              | —                  | 4,443              |
| Employee benefit plan income                                       | —                  | 609                | —                  | 2,506              |
| Gain (loss) on sale of securities, net                             | —                  | (3)                | —                  | 11                 |
| Other income   | 872                | 765                | 2,457              | 2,168              |
| Total Other Operating Income                                       | 8,673              | 13,855             | 24,449             | 32,522             |
| Other Operating Expense  |                    |                    |                    |                    |
| Salaries and other personnel expense                               | 11,261             | 11,115             | 33,208             | 33,750             |
| Occupancy expense  | 1,687              | 1,706              | 4,407              | 4,991              |
| Data processing expense  | 1,503              | 1,509              | 4,374              | 4,209              |
| Impairment of equity method investment                             | 804                | —                  | 804                | —                  |
| Professional and outside services                                  | 727                | 674                | 1,780              | 1,908              |
| Marketing expense  | 367                | 332                | 1,461              | 1,733              |
| Insurance expense  | 171                | 475                | 645                | 922                |
| OREO expense, net rental income and gains on sale                  | 43                 | (44)               | 157                | 216                |
| Intangible asset amortization expense                              | 18                 | 26                 | 53                 | 79                 |
| Compensation expense - RML acquisition payments                    | —                  | 149                | —                  | 323                |
| Other operating expense  | 1,518              | 1,749              | 4,611              | 4,685              |
| Total Other Operating Expense                                      | 18,099             | 17,691             | 51,500             | 52,816             |
| Income Before Provision for Income Taxes                           | 6,393              | 8,581              | 18,320             | 19,500             |
| Provision for income taxes   | 1,129              | 2,980              | 3,164              | 6,236              |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Net Income   | 5,264     | 5,601     | 15,156    | 13,264    |
| Less: Net income attributable to the noncontrolling interest | —         | 78        | —         | 327       |
| Net Income Attributable to Northrim BanCorp, Inc.            | \$5,264   | \$5,523   | \$15,156  | \$12,937  |
| Earnings Per Share, Basic                                    | \$0.77    | \$0.80    | \$2.21    | \$1.88    |
| Earnings Per Share, Diluted                                  | \$0.75    | \$0.79    | \$2.17    | \$1.85    |
| Weighted Average Shares Outstanding, Basic                   | 6,877,194 | 6,872,273 | 6,873,843 | 6,897,577 |
| Weighted Average Shares Outstanding, Diluted                 | 6,990,633 | 6,959,035 | 6,978,679 | 6,983,778 |
| See notes to consolidated financial statements               |           |           |           |           |

4

---



NORTHRIM BANCORP, INC.  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)  
 2010

|  | Three Months<br>Ended<br>September 30,<br>2018 |         | Nine Months<br>Ended September<br>30,<br>2017 |          |
|--|--|---------|---|----------|
| (In Thousands)   |  |         |   |          |
| Net income   | \$5,264  | \$5,601 | \$15,156                                      | \$13,264 |
| Other comprehensive income (loss), net of tax:   |  |         |   |          |
| Securities available for sale:   |  |         |   |          |
| Unrealized (losses) gains arising during the period  | (\$218 )                                       | \$197   | (\$1,325 )                                    | \$884    |
| Reclassification of net (gains) losses included in net income (net of tax (benefit) expense) of \$0 and (\$1) for the third quarter of 2018 and 2017, respectively, and \$0 and \$5 for the nine months ended September 30, 2018 and 2017, respectively) | —  | 2       | —   | (6 )     |
| Derivatives and hedging activities:  |  |         |   |          |
| Unrealized gains arising during the period   | 234  | 127     | 855   | 127      |
| Income tax benefit (expense) related to unrealized gains and losses  | 44   | (80 )   | 290   | (334 )   |
| Other comprehensive income (loss), net of tax  | 60   | 246     | (180 )  | 671      |
| Comprehensive income   | 5,324  | 5,847   | 14,976  | 13,935   |
| Less: comprehensive income attributable to the noncontrolling interest   | —  | 78      | —   | 327      |
| Comprehensive income attributable to Northrim BanCorp, Inc.  | \$5,324  | \$5,769 | \$14,976                                      | \$13,608 |

See notes to consolidated financial statements

## NORTHRIM BANCORP, INC.

Consolidated Statements of Changes in Shareholders' Equity  
(Unaudited)

| (In Thousands)   | Common Stock<br>Number<br>of<br>Shares | Par<br>Value | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Non-controlling<br>Interest | Total     |
|--|--|--------------|----------------------------------|----------------------|---|-----------------------------|-----------|
| Balance as of January 1, 2017  | 6,898                                  | \$6,898      | \$62,952                         | \$117,141            | (\$397 )                                      | \$118                       | \$186,712 |
| Cash dividend declared   | —                                      | —            | —                                | (5,970 )             | —   | —                           | (5,970 )  |
| Stock-based compensation expense   | —                                      | —            | 665                              | —                    | —   | —                           | 665       |
| Exercise of stock options and vesting of restricted stock units, net   | 32                                     | 32           | (275 )                           | —                    | —   | —                           | (243 )    |
| Treasury stock buy-back  | (58 )                                  | (58 )        | (1,549 )                         | —                    | —   | —                           | (1,607 )  |
| Distributions to noncontrolling interest   | —                                      | —            | —                                | —                    | —   | (445 )                      | (445 )    |
| Other comprehensive income, net of tax   | —                                      | —            | —                                | —                    | 212   | —                           | 212       |
| Reclassification for remeasuring of deferred tax assets related to investment securities   | —                                      | —            | —                                | 85                   | (85 )   | —                           | —         |
| Net income attributable to the noncontrolling interest   | —                                      | —            | —                                | —                    | —   | 327                         | 327       |
| Net income attributable to Northrim BanCorp, Inc.  | —                                      | —            | —                                | 13,151               | —   | —                           | 13,151    |
| Balance as of December 31, 2017  | 6,872                                  | \$6,872      | \$61,793                         | \$124,407            | (\$270 )                                      | \$—                         | \$192,802 |
| Cash dividend declared   | —                                      | —            | —                                | (5,205 )             | —   | —                           | (5,205 )  |
| Stock-based compensation expense   | —                                      | —            | 571                              | —                    | —   | —                           | 571       |
| Exercise of stock options and vesting of restricted stock units, net   | 12                                     | 12           | 148                              | —                    | —   | —                           | 160       |
| Other comprehensive loss, net of tax   | —                                      | —            | —                                | —                    | (180 )  | —                           | (180 )    |
| Cumulative effect of adoption of accounting principles related to premium-amortization of investment securities                    | —                                      | —            | —                                | (62 )                | —   | —                           | (62 )     |
| Reclassification for cumulative effect of adoption of accounting principles related to fair value measurement of equity securities | —                                      | —            | —                                | 191                  | (191 )  | —                           | —         |
| Net income attributable to Northrim BanCorp, Inc.  | —                                      | —            | —                                | 15,156               | —   | —                           | 15,156    |
| Balance as of September 30, 2018   | 6,884                                  | \$6,884      | \$62,512                         | \$134,487            | (\$641 )                                      | \$—                         | \$203,242 |

See notes to consolidated financial statements

NORTHRIM BANCORP, INC.  
Consolidated Statements of Cash Flows  
(Unaudited)

| (In Thousands)  | Nine Months<br>Ended September<br>30, |            |
|---|---------------------------------------|------------|
|   | 2018                                  | 2017       |
| Operating Activities:   |                                       |            |
| Net income  | \$15,156                              | \$13,264   |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: |                                       |            |
| Gain on sale of securities, net   | —                                     | (11 )      |
| Gain on sale of Northrim Benefits Group   | —                                     | (4,443 )   |
| Loss on disposal of premises and equipment  | 3                                     | 3          |
| Depreciation and amortization of premises and equipment                           | 1,504                                 | 2,042      |
| Amortization of software  | 670                                   | 184        |
| Intangible asset amortization   | 53                                    | 79         |
| Amortization of investment security premium, net of discount accretion            | 156                                   | 172        |
| Change in fair value of marketable equity securities                              | 143                                   | —          |
| (Increase) decrease deferred tax asset, net                                       | (207 )                                | 617        |
| Stock-based compensation  | 571                                   | 435        |
| Deferral of loan fees and (costs), net  | 199                                   | (459 )     |
| (Benefit) provision for loan losses   | (300 )                                | 3,200      |
| (Benefit) reserve for purchased receivables                                       | (4 )                                  | 29         |
| Additions to mortgage servicing rights carried at fair value                      | (2,662 )                              | (2,086 )   |
| Change in fair value of mortgage servicing rights carried at fair value           | 272                                   | 62         |
| Gain on sale of loans   | (11,666 )                             | (13,929 )  |
| Proceeds from the sale of loans held for sale                                     | 412,562                               | 419,783    |
| Origination of loans held for sale  | (413,553 )                            | (421,472 ) |
| Gain on sale of other real estate owned   | (133 )                                | (369 )     |
| Impairment on other real estate owned   | —                                     | 340        |
| Impairment on equity method investment  | 804                                   | —          |
| Net changes in assets and liabilities:  |                                       |            |
| Increase in accrued interest receivable   | (402 )                                | (396 )     |
| Decrease (increase) in other assets   | 683                                   | (1,459 )   |
| Decrease in other liabilities   | (6,061 )                              | (40 )      |
| Net Cash Used by Operating Activities   | (2,212 )                              | (4,454 )   |
| Investing Activities:   |                                       |            |
| Investment in securities:   |                                       |            |
| Purchases of investment securities available for sale                             | (48,570 )                             | (16,283 )  |
| Purchases of marketable equity securities   | (998 )                                | —          |
| Purchases of FHLB stock   | —                                     | (3,665 )   |
| Proceeds from sales/calls/maturities of securities available for sale             | 89,903                                | 77,865     |
| Proceeds from calls/sales of marketable equity securities                         | 500                                   | —          |
| Proceeds from redemption of FHLB stock  | 12                                    | 3,514      |
| Decrease in purchased receivables, net  | 9,529                                 | 7,532      |
| Increase in loans, net  | (28,789 )                             | (15,379 )  |
| Proceeds from sale of other real estate owned                                     | 612                                   | 3,265      |
| Proceeds from the sale of Northrim Benefits Group                                 | —                                     | 4,625      |
| Proceeds from sale of premises and equipment                                      | 3                                     | 116        |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|   |           |          |
|---|-----------|----------|
| Purchases of premises and equipment                     | (2,280 )  | (2,889 ) |
| Net Cash Provided by Investing Activities               | 19,922    | 58,701   |
| Financing Activities:                                   |           |          |
| Decrease in deposits                                    | (25,015 ) | (9,337 ) |
| Increase in securities sold under repurchase agreements | 4,683     | 3,477    |
| (Decrease) increase in borrowings                       | (80 )     | 3,049    |
| Distributions to noncontrolling interest                | —         | (445 )   |

7

---

|  |           |           |
|--|-----------|-----------|
| Repayment of junior subordinated debentures      | —         | (8,248 )  |
| Repurchase of common stock                       | —         | (1,608 )  |
| Proceeds from the issuance of common stock       | 194       | —         |
| Cash dividends paid                              | (5,154 )  | (4,417 )  |
| Net Cash Used by Financing Activities            | (25,372 ) | (17,529 ) |
| Net Change in Cash and Cash Equivalents          | (7,662 )  | 36,718    |
| Cash and Cash Equivalents at Beginning of Period | 77,841    | 50,551    |
| Cash and Cash Equivalents at End of Period       | \$70,179  | \$87,269  |

Supplemental Information:

|  |         |         |
|--|---------|---------|
| Income taxes paid                            | \$324   | \$7,764 |
| Interest paid                                | \$1,798 | \$1,821 |
| Transfer of loans to other real estate owned | \$535   | \$167   |
| Cash dividends declared but not paid         | \$51    | \$41    |

See notes to consolidated financial statements

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

### 1. Basis of Presentation and Significant Accounting Policies

The accompanying unaudited consolidated financial statements and corresponding footnotes have been prepared by Northrim BanCorp, Inc. (the "Company") in accordance with accounting principles generally accepted in the United States of America ("GAAP") and with instructions to Form 10-Q under the Securities Exchange Act of 1934, as amended. The year-end Consolidated Balance Sheet data was derived from the Company's audited financial statements. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The Company owns a 100% interest in Residential Mortgage Holding Company, LLC, the parent company of Residential Mortgage, LLC (collectively "RML") and consolidates their balance sheets and income statement into its financial statements. The Company owned a 50.1% interest in Northrim Benefits Group, LLC ("NBG") through August 14, 2017, and consolidated NBG's balance sheets and income statements into its financial statements through the date of the sale on August 14, 2017. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain immaterial reclassifications have been made to prior year amounts to maintain consistency with the current year with no impact on net income or total shareholders' equity. The Company determined that it operates in two primary operating segments: Community Banking and Home Mortgage Lending. The Company has evaluated subsequent events and transactions for potential recognition or disclosure. Operating results for the interim period ended September 30, 2018, are not necessarily indicative of the results anticipated for the year ending December 31, 2018. These consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017. The Company's significant accounting policies are discussed in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

#### Reclassification of Prior Year Presentation

Certain prior year amounts have been reclassified for consistency with the current period presentation. These reclassifications had no effect on the reported results of operations.

#### Recent Accounting Pronouncements

##### Accounting pronouncements implemented in 2018

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers ("ASU 2014-09"). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, this new guidance requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company has reviewed all revenue sources to determine the sources that are in scope for this guidance. As a bank, key revenue sources, including interest income and mortgage banking income have been identified as out of scope of this new guidance. The Company's overall assessment of material in-scope revenue sources include service charges on deposits, bankcard fees, and other miscellaneous revenue sources. The Company adopted the guidance on January 1, 2018, utilizing the modified retrospective approach, which did not have a material impact on how the Company recognizes revenue or on our consolidated financial statements and disclosures. See Note 2 of the Notes to Consolidated Financial Statements included in Item 1 of this report for disclosures related to revenue generated from contracts with customers.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”). The new guidance is intended to improve the recognition and measurement of financial instruments. ASU 2016-01 requires that equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) be measured at fair value with changes in fair value recognized in net income. In addition, the amendment requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial

statements. ASU 2016-01 also eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The amendment also requires a 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 (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The Company adopted the guidance on January 1, 2018 and reclassified \$191,000 in unrealized gains on its investments in preferred stock from other comprehensive income to retained earnings. Adoption of the guidance does not have a material or significant impact on the Company's consolidated financial statements. As of January 1, 2018, unrealized gains and losses on marketable equity securities are included in other operating income in the Consolidated Statement of Income.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 provides guidance on eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. The Company adopted the guidance on January 1, 2018 and made an accounting policy election to classify distributions from equity method investees using the cumulative earnings approach. Accordingly, these distributions are recorded as cash inflows in the operating activity section of the Statement of Cash Flows. Adoption of the guidance does not have a material or significant impact on the Company's consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation-Stock Compensation ("ASU 2017-09"). ASU 2017-09 provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. The Company adopted the guidance on January 1, 2018 and it did not have a material impact on the Company's consolidated financial position or results of operations.

In March 2017, the FASB issued ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs ("ASU 2017-08"). ASU 2017-08 amends the amortization period for certain purchased callable debt securities held at a premium by shortening the amortization period for the premium to the earliest call date. Under the current guidance, entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument. ASU 2017-08 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2018, and should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings. The Company early adopted this standard in the first quarter of 2018, which resulted in a \$62,000 decrease in beginning retained earnings through a cumulative-effect adjustment.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging ("ASU 2017-12"). ASU 2017-12 improves the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. In addition to that main objective, the amendments in this ASU make certain targeted improvements to simplify the application of the hedge accounting guidance in current GAAP based on the feedback received from preparers, auditors, users, and other stakeholders. ASU 2017-12 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2018, and all transition requirements and elections must be applied to hedging relationships existing (that is, hedging relationships in which the hedging instrument has not expired, been sold, terminated, or exercised or the entity has not removed the designation of the hedging relationship) on the date of adoption. The Company early adopted this standard in the first quarter of 2018, and it did not have a significant impact on the Company's consolidated financial position or results of operations.

Accounting pronouncements to be implemented in future periods

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"). ASU 2016-02 requires lessees, among other things, to recognize lease assets and lease liabilities on the balance sheet for those leases



classified as operating leases under previous authoritative guidance. This update also introduces new disclosure requirements for leasing arrangements. ASU 2016-02 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2018. All entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. As the Company expects to elect the transition option provided in ASU No. 2018-11 (see below), the modified retrospective approach will be applied on January 1, 2019 (as opposed to January 1, 2017). The Company also expects to elect certain relief options offered in ASU 2016-02 including the package of practical expedients, the option not to separate lease and non-lease components and instead to account for them as a single lease component, and the option not to recognize right-of-use assets and lease liabilities that arise from short-term leases (i.e., leases with terms of

twelve months or less). The Company will likely not elect the hindsight practical expedient, which allows entities to use hindsight when determining lease term and impairment of right-of-use assets. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore, not recognized on the Company's consolidated statements of condition. The Company expects the new accounting standard will require these lease agreements to be recognized on the consolidated statements of condition as a right-of-use asset and a corresponding lease liability. Therefore, the Company's preliminary evaluation indicates the provisions of ASU 2016-02 are expected to impact the Company's consolidated statements of condition, along with the Company's regulatory capital ratios. However, the Company does not expect the new guidance to have a material impact on the Company's consolidated statements of income. The Company has an implementation team working through the provisions of ASU 2016-02 and ASU 2018-11 to assess the impact on its accounting, disclosures, processes, internal control over financial reporting, regulatory capital, and risk-weighted assets. The Company is substantially complete with the evaluation of its lease population. It is expected that the Company will recognize right-of-use assets and lease liabilities (estimated between \$15 and \$25 million) upon adoption on January 1, 2019. The estimates will change due to changes in the lease portfolio prior to the adoption date.

In July 2018, the FASB issued ASU 2018-11, Leases - Targeted Improvements ("ASU 2018-11") to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Company). The Company expects to elect both transition options. ASU 2018-11 is not expected to have a material impact on the Company's Consolidated Financial Statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses ("ASU 2016-13"). ASU 2016-13 is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The standard requires the measurement of all expected credit losses for certain financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates, but will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. ASU 2016-13 requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2019. Early application will be permitted for specified periods. ASU 2016-13 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2019, and must be applied prospectively. The Company has formed a cross-functional team to begin implementation efforts of this new guidance. The team is evaluating the data elements and modeling options that are expected to be critical to the new process and has engaged external consulting services related to this effort. An estimate of the impact of this standard on the Company's consolidated financial position and results of operations has not yet been determined; however, the impact on the Company's process for calculating the allowance for loan losses ("Allowance") is expected to be significant.

In January 2017, the FASB issued ASU 2017-04, Intangibles-Goodwill and Other ("ASU 2017-04"). ASU 2017-04 simplifies how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. ASU 2017-04 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2019, and must be applied on a prospective basis. The Company does not believe that the adoption of this standard will have a material impact on the Company's consolidated financial position or results of operations.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820) ("ASU 2018-13"). ASU 2018-13 modifies the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, based on the

concepts in the Concepts Statement, including the consideration of costs and benefits. ASU 2018-13 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2019. The Company does not believe that the adoption of this standard will have a material impact on the Company's consolidated financial position or results of operations.

## 2. Revenue

The Company's revenue is included in net interest income and other operating income on its Consolidated Statements of Income. ASU 2014-09, which amends Topic 606 in the Accounting Standards Codification ("ASC"), establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts

to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of our ongoing revenue-generating transactions are not subject to ASC 606, including revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, purchased receivable income, financial guarantees, and derivatives are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as deposit related fees, interchange fees, merchant services income, and commissions from the sales of mutual funds and other investments. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company's non-interest revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

#### Bankcard fees

Bankcard fees are primarily comprised of debit card income and ATM fees. Debit card income is primarily comprised of interchange fees earned whenever the Company's debit cards are processed through card payment networks such as Visa or MasterCard. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. The Company's performance obligation for bankcard fees are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payments are typically received immediately or in the following month.

#### Service charges on deposit accounts

Service charges on deposit accounts consist of general service fees for monthly account maintenance, activity- or transaction-based fees, and account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), and other deposit account related fees and consist of transaction-based revenue, time-based revenue (service period), item-based revenue or some other individual attribute-based revenue. Revenue is recognized when our performance obligation is completed which is generally monthly for account maintenance services or when a transaction has been completed. Payments for service charges on deposit accounts are primarily received immediately or in the following month through a direct charge to customers' accounts.

#### Other

Other operating income consists of other recurring revenue streams such as merchant services income, commissions from sales of mutual funds and other investments, safety deposit box rental fees, bank check and other check fees, unrealized gains and losses on marketable securities, and other miscellaneous revenue streams. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. The Company's performance obligation for merchant services income is largely satisfied, and related revenue recognized, when the transactions have been completed. Payment is typically received immediately or in the following month. The Company earns commissions from the sale of mutual funds as periodic service fees (i.e., trailers) from Elliott Cove Capital Management typically based on a percentage of net asset value. Trailer revenue is recorded over time, quarterly, as net asset value is determined. The Company also earns commission income from the sale of annuity products. The Company acts as an intermediary between the Company's customer and Elliott Cove Investment Advisors for these transactions, and Commissions from annuity product sales are recorded when the Company's performance obligation is satisfied, which is generally upon the issuance of the annuity policy. The Company does not earn trailer fees on annuity sales. Payment for commissions from sales of mutual funds and other investments and annuity sales is typically received in the following quarter. Other service charges include revenue from safety deposit box rental fees, processing wire transfers, bank check and other check fees, and other services. The Company's performance obligations for these other revenue streams are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payments are typically received immediately or in the following month.

The following presents other operating income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three and nine-month periods ended September 30, 2018 and 2017:

| (In Thousands)                                     | Three Months  |               | Nine Months   |               |
|--|---------------|---------------|---------------|---------------|
|  | Ended         | Ended         | Ended         | Ended         |
|  | September 30, | September 30, | September 30, | September 30, |
|  | 2018          | 2017          | 2018          | 2017          |
| Other operating income                             |               |               |               |               |
| In-scope of Topic 606:                             |               |               |               |               |
| Bankcard fees                                      | \$724         | \$664         | \$2,056       | \$1,903       |
| Service charges on deposit accounts                | 407           | 406           | 1,137         | 1,254         |
| Other  | 405           | 371           | 1,204         | 1,094         |
| Other operating income (in-scope of Topic 606)     | \$1,536       | \$1,441       | \$4,397       | \$4,251       |
| Other operating income (out-of-scope of Topic 606) | 7,137         | 12,414        | 20,052        | 28,271        |
| Total other operating income                       | \$8,673       | \$13,855      | \$24,449      | \$32,522      |

#### Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's other operating revenue streams are largely based on transactional activity, or standard month-end revenue accruals. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.

#### Contract Acquisition Costs

In connection with the adoption of Topic 606, an entity is required to capitalize, and subsequently amortize into expense, certain incremental costs of obtaining a contract with a customer if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition costs.

### 3. Cash and Cash Equivalents

The Company is required to maintain a \$557,000 minimum average daily balance with the Federal Reserve Bank of San Francisco ("Federal Reserve Bank") for purposes of settling financial transactions and charges for Federal Reserve Bank services. The Company is also required to maintain cash balances or deposits with the Federal Reserve Bank sufficient to meet its statutory reserve requirements.

The Company is required to maintain a \$500,000 balance with a correspondent bank for outsourced servicing of ATMs.

The Company is required to maintain a \$100,000 and \$300,000 balance with a correspondent bank to collateralize the initial margin and the fair value exposure of its interest rate swap, respectively.

## 4. Investment Securities

The carrying values and estimated fair values of investment securities at the periods indicated are presented below:

| (In Thousands)                                  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2018                              |                   |                              |                               |               |
| Securities available for sale                   |                   |                              |                               |               |
| U.S. Treasury and government sponsored entities | \$208,321         | \$—                          | \$2,489                       | \$205,832     |
| Municipal securities                            | 11,879            | 8                            | 44                            | 11,843        |
| Corporate bonds                                 | 40,142            | 374                          | —                             | 40,516        |
| Collateralized loan obligations                 | 6,000             | 5                            | 3                             | 6,002         |
| Total securities available for sale             | \$266,342         | \$387                        | \$2,536                       | \$264,193     |
| December 31, 2017                               |                   |                              |                               |               |
| Securities available for sale                   |                   |                              |                               |               |
| U.S. Treasury and government sponsored entities | \$250,794         | \$3                          | \$1,336                       | \$249,461     |
| Municipal securities                            | 14,395            | 72                           | 46                            | 14,421        |
| Corporate bonds                                 | 36,654            | 478                          | —                             | 37,132        |
| Collateralized loan obligations                 | 6,000             | 5                            | —                             | 6,005         |
| Total securities available for sale             | \$307,843         | \$558                        | \$1,382                       | \$307,019     |

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2018 and December 31, 2017 were as follows:

| (In Thousands)                                  | Less Than 12<br>Months |                      | More Than 12<br>Months |                      | Total         |                      |
|---|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|   | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| September 30, 2018:                             |                        |                      |                        |                      |               |                      |
| Securities Available for Sale                   |                        |                      |                        |                      |               |                      |
| U.S. Treasury and government sponsored entities | \$111,942              | \$1,645              | \$93,890               | \$844                | \$205,832     | \$2,489              |
| Collateralized loan obligations                 | 2,997                  | 3                    | —                      | —                    | 2,997         | 3                    |
| Municipal securities                            | 6,365                  | 18                   | 1,566                  | 26                   | 7,931         | 44                   |
| Total   | \$121,304              | \$1,666              | \$95,456               | \$870                | \$216,760     | \$2,536              |
| December 31, 2017:                              |                        |                      |                        |                      |               |                      |
| Securities Available for Sale                   |                        |                      |                        |                      |               |                      |
| U.S. Treasury and government sponsored entities | \$116,331              | \$496                | \$122,605              | \$840                | \$238,936     | \$1,336              |
| Municipal securities                            | 3,994                  | 17                   | 2,298                  | 29                   | 6,292         | 46                   |
| Total   | \$120,325              | \$513                | \$124,903              | \$869                | \$245,228     | \$1,382              |

The unrealized losses on investments in U.S. treasury and government sponsored entities, collateralized loan obligations, and municipal securities in both periods were caused by changes in interest rates. At September 30, 2018 and December 31, 2017, there were 24 available-for-sale securities with unrealized losses that have been in a loss position for less than twelve months. There were 16 and 17 securities as of September 30, 2018 and December 31, 2017 that have been in an unrealized loss position for more than twelve months, respectively. The contractual terms of the investments in a loss position do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because it is more likely than not that the Company will hold these investments until a market

price recovery or maturity, these investments are not considered other-than-temporarily impaired.

At September 30, 2018 and December 31, 2017, \$53.5 million and \$51.6 million in securities were pledged for deposits and borrowings, respectively.

The amortized cost and estimated fair values of debt securities at September 30, 2018, are distributed by contractual maturity as shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands)                                | Amortized<br>Cost | Fair<br>Value | Weighted<br>Average<br>Yield |   |
|---|-------------------|---------------|------------------------------|---|
| US Treasury and government sponsored entities |                   |               |                              |   |
| Within 1 year                                 | \$30,005          | \$29,969      | 1.15                         | % |
| 1-5 years                                     | 174,986           | 172,576       | 1.87                         | % |
| 5-10 years                                    | 3,330             | 3,287         | 3.00                         | % |
| Total   | \$208,321         | \$205,832     | 1.79                         | % |
| Corporate bonds                               |                   |               |                              |   |
| 1-5 years                                     | \$21,702          | \$21,897      | 3.17                         | % |
| 5-10 years                                    | 18,440            | 18,619        | 3.37                         | % |
| Total   | \$40,142          | \$40,516      | 3.26                         | % |
| Collateralized loan obligations               |                   |               |                              |   |
| 5-10 years                                    | \$3,000           | \$2,997       | 3.77                         | % |
| Over 10 years                                 | 3,000             | 3,005         | 4.07                         | % |
| Total   | \$6,000           | \$6,002       | 3.92                         | % |
| Municipal securities                          |                   |               |                              |   |
| Within 1 year                                 | \$2,592           | \$2,591       | 2.05                         | % |
| 1-5 years                                     | 9,287             | 9,252         | 2.41                         | % |
| Total   | \$11,879          | \$11,843      | 2.34                         | % |

The proceeds and resulting gains and losses, computed using specific identification, from sales of investment securities for the three and nine-month periods ending September 30, 2018 and 2017, are as follows:

| (In Thousands)                        | Proceeds | Gross<br>Gains | Gross<br>Losses |
|---------------------------------------|----------|----------------|-----------------|
| Three Months Ended September 30, 2018 |          |                |                 |
| Available for sale securities         | \$—      | \$—            | \$—             |
| Three Months Ended September 30, 2017 |          |                |                 |
| Available for sale securities         | \$14,996 | \$—            | \$3             |
| Nine Months Ended September 30, 2018  |          |                |                 |
| Available for sale securities         | \$—      | \$—            | \$—             |
| Nine Months Ended September 30, 2017  |          |                |                 |
| Available for sale securities         | \$25,006 | \$14           | \$3             |



A summary of interest and dividend income for the three and nine-month periods ending September 30, 2018 and 2017, on available for sale investment securities and marketable equity securities are as follows:

| (In Thousands)                                | Three Months Ended September 30, |         | Nine Months Ended September 30, |         |
|---|----------------------------------|---------|---------------------------------|---------|
|   | 2018                             | 2017    | 2018                            | 2017    |
| US Treasury and government sponsored entities | \$868                            | \$653   | \$2,653                         | \$2,255 |
| Other   | 468                              | 298     | 1,255                           | 881     |
| Total taxable interest income                 | \$1,336                          | \$951   | \$3,908                         | \$3,136 |
| Municipal securities                          | \$64                             | \$92    | \$214                           | \$281   |
| Total tax-exempt interest income              | \$64                             | \$92    | \$214                           | \$281   |
| Total   | \$1,400                          | \$1,043 | \$4,122                         | \$3,417 |

#### 5. Loans and Credit Quality

The following table presents total portfolio loans by portfolio segment and class of financing receivable, based on the Company's asset quality rating ("AQR") criteria:

| (In Thousands)  | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Total     |
|---|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|--|----------------|-----------|
| September 30, 2018  |            |   |                                |                                 |                                     |                        |  |                |           |
| AQR Pass  | \$301,757  | \$36,119                                    | \$61,857                       | \$120,902                       | \$322,051                           | \$40,889               | \$19,525                               | \$22,495       | \$925,595 |
| AQR Special Mention                                       | 6,279      | —   | —                              | 4,484                           | 18,300                              | —                      | 199                                    | 16             | 29,278    |
| AQR Substandard   | 25,096     | —   | —                              | 4,780                           | 469                                 | 577                    | 478                                    | 62             | 31,462    |
| AQR Doubtful  | —          | —   | —                              | —                               | —                                   | 27                     | —                                      | —              | 27        |
| Subtotal  | \$333,132  | \$36,119                                    | \$61,857                       | \$130,166                       | \$340,820                           | \$41,493               | \$20,202                               | \$22,573       | \$986,362 |
| Less: Unearned origination fees, net of origination costs |            |   |                                |                                 |                                     |                        |  |                | (4,355 )  |
| Total loans   |            |   |                                |                                 |                                     |                        |  |                | \$982,007 |
| December 31, 2017   |            |   |                                |                                 |                                     |                        |  |                |           |
| AQR Pass  | \$277,371  | \$31,201                                    | \$80,093                       | \$127,059                       | \$307,780                           | \$39,777               | \$21,846                               | \$19,895       | \$905,022 |
| AQR Special Mention                                       | 4,921      | —   | —                              | 2,095                           | 11,051                              | 634                    | 3                                      | 22             | 18,726    |
| AQR Substandard   | 31,222     | —   | —                              | 2,888                           | 482                                 | —                      | 767                                    | 2              | 35,361    |
| Subtotal  | \$313,514  | \$31,201                                    | \$80,093                       | \$132,042                       | \$319,313                           | \$40,411               | \$22,616                               | \$19,919       | \$959,109 |
| Less: Unearned origination fees, net of origination costs |            |   |                                |                                 |                                     |                        |  |                | (4,156 )  |
| Total loans   |            |   |                                |                                 |                                     |                        |  |                | \$954,953 |

Loans are carried at their principal amount outstanding, net of charge-offs, unamortized fees and direct loan origination costs. Loan balances are charged-off to the Allowance when management believes that collection of principal is unlikely. Interest income on loans is accrued and recognized on the principal amount outstanding except for loans in a nonaccrual status. All classes of loans are placed on nonaccrual and considered impaired when management believes doubt exists as to the collectability of the interest or principal. Cash payments received on nonaccrual loans are directly applied to the principal balance. Generally, a loan may be returned to accrual status when the delinquent principal and interest is brought current in accordance with the terms of the loan agreement. Additionally, certain ongoing performance criteria, which generally includes a performance period of six months, must be met in order for a loan to be returned to accrual status. Loans are reported as past due when

installment payments, interest payments, or maturity payments are past due based on contractual terms.

16

---

Nonaccrual loans: Nonaccrual loans net of government guarantees totaled \$16.4 million and \$21.2 million at September 30, 2018 and December 31, 2017, respectively. Nonaccrual loans at the periods indicated are presented below by segment:

| (In Thousands)                            | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater                           | Current  | Total    |
|---|------------------------------|------------------------------|-----------------------------------|----------|----------|
|   |                              |                              | Than<br>90<br>Days<br>Past<br>Due |          |          |
| September 30, 2018                        |                              |                              |                                   |          |          |
| Commercial                                | \$121                        | \$600                        | \$2,742                           | \$11,271 | \$14,734 |
| Real estate term owner occupied           | —                            | —                            | 1,694                             | —        | 1,694    |
| Real estate term other                    | —                            | —                            | 26                                | —        | 26       |
| Consumer secured by 1st deeds of trust    | —                            | —                            | 226                               | —        | 226      |
| Consumer other                            | —                            | —                            | 40                                | 8        | 48       |
| Total nonperforming loans                 | 121                          | 600                          | 4,728                             | 11,279   | 16,728   |
| Government guarantees on nonaccrual loans | —                            | —                            | (62 )                             | (217 )   | (279 )   |
| Net nonaccrual loans                      | \$121                        | \$600                        | \$4,666                           | \$11,062 | \$16,449 |
| December 31, 2017                         |                              |                              |                                   |          |          |
| Commercial                                | \$810                        | \$—                          | \$2,652                           | \$16,455 | \$19,917 |
| Real estate term owner occupied           | —                            | —                            | —                                 | 1,331    | 1,331    |
| Consumer secured by 1st deeds of trust    | —                            | —                            | 378                               | —        | 378      |
| Total nonperforming loans                 | 810                          | —                            | 3,030                             | 17,786   | 21,626   |
| Government guarantees on nonaccrual loans | —                            | —                            | (94 )                             | (373 )   | (467 )   |
| Net nonaccrual loans                      | \$810                        | \$—                          | \$2,936                           | \$17,413 | \$21,159 |

Past Due Loans: Past due loans and nonaccrual loans at the periods indicated are presented below by segment:

| (In Thousands)  | 30-59    | 60-89    | Greater  | Total   | Nonaccrual | Current   | Total     |
|---|----------|----------|----------|---------|------------|-----------|-----------|
|   | Days     | Days     | Than     |         |            |           |           |
|   | Past Due | Past Due | 90 Days  | Past    |            |           |           |
|   | Still    | Still    | Still    | Due     |            |           |           |
|   | Accruing | Accruing | Accruing |         |            |           |           |
| September 30, 2018  |          |          |          |         |            |           |           |
| Commercial  | \$1,098  | \$—      | \$—      | \$1,098 | \$14,734   | \$317,300 | \$333,132 |
| Real estate construction one-to-four family               | —        | —        | —        | —       | —          | 36,119    | 36,119    |
| Real estate construction other                            | —        | —        | —        | —       | —          | 61,857    | 61,857    |
| Real estate term owner occupied                           | 211      | 738      | —        | 949     | 1,694      | 127,523   | 130,166   |
| Real estate term non-owner occupied                       | —        | —        | —        | —       | —          | 340,820   | 340,820   |
| Real estate term other                                    | —        | 577      | —        | 577     | 26         | 40,890    | 41,493    |
| Consumer secured by 1st deed of trust                     | —        | —        | 152      | 152     | 226        | 19,824    | 20,202    |
| Consumer other  | 22       | 10       | —        | 32      | 48         | 22,493    | 22,573    |
| Subtotal  | \$1,331  | \$1,325  | \$152    | \$2,808 | \$16,728   | \$966,826 | \$986,362 |
| Less: Unearned origination fees, net of origination costs |          |          |          |         |            |           | (4,355 )  |
| Total   |          |          |          |         |            |           | \$982,007 |
| December 31, 2017   |          |          |          |         |            |           |           |
| Commercial  | \$503    | \$—      | \$240    | \$743   | \$19,917   | \$292,854 | \$313,514 |
| Real estate construction one-to-four family               | —        | —        | —        | —       | —          | 31,201    | 31,201    |
| Real estate construction other                            | 90       | —        | —        | 90      | —          | 80,003    | 80,093    |
| Real estate term owner occupied                           | 966      | —        | —        | 966     | 1,331      | 129,745   | 132,042   |
| Real estate term non-owner occupied                       | —        | —        | —        | —       | —          | 319,313   | 319,313   |
| Real estate term other                                    | —        | —        | —        | —       | —          | 40,411    | 40,411    |
| Consumer secured by 1st deed of trust                     | 363      | —        | —        | 363     | 378        | 21,875    | 22,616    |
| Consumer other  | 161      | 53       | 12       | 226     | —          | 19,693    | 19,919    |
| Subtotal  | \$2,083  | \$53     | \$252    | \$2,388 | \$21,626   | \$935,095 | \$959,109 |
| Less: Unearned origination fees, net of origination costs |          |          |          |         |            |           | (4,156 )  |
| Total   |          |          |          |         |            |           | \$954,953 |

Impaired Loans: The Company considers a loan to be impaired when it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement. Once a loan is determined to be impaired, the impairment is measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate, except that if the loan is collateral dependent, the impairment is measured by using the fair value of the loan's collateral. Nonperforming loans with an outstanding balance of \$50,000 or greater are individually evaluated for impairment based upon the borrower's overall financial condition, resources, and payment record, and the prospects for support from any financially responsible guarantors.

At September 30, 2018 and December 31, 2017, the recorded investment in loans that are considered to be impaired was \$35.4 million and \$32.0 million, respectively. The following table presents information about impaired loans by class as of the periods indicated:

| (In Thousands)   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|--|---------------------|--------------------------|-------------------|
| September 30, 2018                                       |                     |                          |                   |
| With no related allowance recorded                       |                     |                          |                   |
| Commercial - AQR special mention                         | \$2,105             | \$2,105                  | \$—               |
| Commercial - AQR substandard                             | 23,608              | 25,148                   | —                 |
| Real estate term owner occupied- AQR special mention     | 1,008               | 1,008                    | —                 |
| Real estate term owner occupied- AQR substandard         | 4,781               | 4,781                    | —                 |
| Real estate term non-owner occupied- AQR pass            | 319                 | 319                      | —                 |
| Real estate term non-owner occupied- AQR substandard     | 469                 | 469                      | —                 |
| Real estate term other - AQR pass                        | 504                 | 504                      | —                 |
| Real estate term other - AQR substandard                 | 577                 | 577                      | —                 |
| Consumer secured by 1st deeds of trust - AQR pass        | 131                 | 131                      | —                 |
| Consumer secured by 1st deeds of trust - AQR substandard | 252                 | 252                      | —                 |
| Subtotal   | \$33,754            | \$35,294                 | \$—               |
| With an allowance recorded                               |                     |                          |                   |
| Commercial - AQR substandard                             | \$1,454             | \$1,958                  | \$323             |
| Consumer secured by 1st deeds of trust - AQR substandard | 226                 | 226                      | 49                |
| Subtotal   | \$1,680             | \$2,184                  | \$372             |
| Total  |                     |                          |                   |
| Commercial - AQR special mention                         | \$2,105             | \$2,105                  | \$—               |
| Commercial - AQR substandard                             | 25,062              | 27,106                   | 323               |
| Real estate term owner-occupied - AQR special mention    | 1,008               | 1,008                    | —                 |
| Real estate term owner-occupied - AQR substandard        | 4,781               | 4,781                    | —                 |
| Real estate term non-owner occupied - AQR pass           | 319                 | 319                      | —                 |
| Real estate term non-owner occupied - AQR substandard    | 469                 | 469                      | —                 |
| Real estate term other - AQR pass                        | 504                 | 504                      | —                 |
| Real estate term other - AQR substandard                 | 577                 | 577                      | —                 |
| Consumer secured by 1st deeds of trust - AQR pass        | 131                 | 131                      | —                 |
| Consumer secured by 1st deeds of trust - AQR substandard | 478                 | 478                      | 49                |
| Total  | \$35,434            | \$37,478                 | \$372             |

| (In Thousands)  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|---|------------------------|--------------------------------|----------------------|
| December 31, 2017   |                        |                                |                      |
| With no related allowance recorded                        |                        |                                |                      |
| Commercial - AQR special mention                          | \$2,153                | \$2,153                        | \$—                  |
| Commercial - AQR substandard                              | 16,671                 | 17,742                         | —                    |
| Real estate term owner occupied - AQR substandard         | 2,862                  | 2,862                          | —                    |
| Real estate term non-owner occupied - AQR pass            | 303                    | 303                            | —                    |
| Real estate term non-owner occupied - AQR special mention | 89                     | 89                             | —                    |
| Real estate term non-owner occupied - AQR substandard     | 482                    | 482                            | —                    |
| Real estate term other - AQR pass                         | 559                    | 559                            | —                    |
| Consumer secured by 1st deeds of trust - AQR pass         | 136                    | 136                            | —                    |
| Consumer secured by 1st deeds of trust - AQR substandard  | 724                    | 809                            | —                    |
| Subtotal  | \$23,979               | \$25,135                       | \$—                  |
| With an allowance recorded                                |                        |                                |                      |
| Commercial - AQR substandard                              | \$7,988                | \$7,988                        | \$966                |
| Subtotal  | \$7,988                | \$7,988                        | \$966                |
| Total   |                        |                                |                      |
| Commercial - AQR special mention                          | \$2,153                | \$2,153                        | \$—                  |
| Commercial - AQR substandard                              | 24,659                 | 25,730                         | 966                  |
| Real estate term owner occupied - AQR substandard         | 2,862                  | 2,862                          | —                    |
| Real estate term non-owner occupied - AQR pass            | 303                    | 303                            | —                    |
| Real estate term non-owner occupied - AQR special mention | 89                     | 89                             | —                    |
| Real estate term non-owner occupied - AQR substandard     | 482                    | 482                            | —                    |
| Real estate term other - AQR pass                         | 559                    | 559                            | —                    |
| Consumer secured by 1st deeds of trust - AQR pass         | 136                    | 136                            | —                    |
| Consumer secured by 1st deeds of trust - AQR substandard  | 724                    | 809                            | —                    |
| Total   | \$31,967               | \$33,123                       | \$966                |

The unpaid principal balance included in the tables above represents the recorded investment at the dates indicated, plus amounts charged off for book purposes.

The following tables summarize our average recorded investment and interest income recognized on impaired loans for the three and nine-month periods ended September 30, 2018 and 2017:

| Three Months Ended September 30,<br><br>(In Thousands)       | 2018                              |                                  | 2017                              |                                  |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|  | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>                    |                                   |                                  |                                   |                                  |
| Commercial - AQR special mention                             | \$2,113                           | \$31                             | \$97                              | \$—                              |
| Commercial - AQR substandard                                 | 26,518                            | 43                               | 18,125                            | 72                               |
| Real estate term owner occupied- AQR special mention         | 617                               | —                                | —                                 | —                                |
| Real estate term owner occupied- AQR substandard             | 2,908                             | 52                               | 7,345                             | 114                              |
| Real estate term non-owner occupied- AQR pass                | 206                               | 7                                | 346                               | 6                                |
| Real estate term non-owner occupied- AQR substandard         | 287                               | 8                                | 580                               | 9                                |
| Real estate term other - AQR pass                            | 310                               | 11                               | 585                               | 10                               |
| Real estate term other - AQR substandard                     | 353                               | —                                | 641                               | 11                               |
| Consumer secured by 1st deeds of trust - AQR pass            | 132                               | 2                                | —                                 | —                                |
| Consumer secured by 1st deeds of trust - AQR special mention | —                                 | —                                | 139                               | 3                                |
| Consumer secured by 1st deeds of trust - AQR substandard     | 154                               | 2                                | 771                               | 5                                |
| Subtotal   | \$33,598                          | \$156                            | \$28,629                          | \$230                            |
| <b>With an allowance recorded</b>                            |                                   |                                  |                                   |                                  |
| Commercial - AQR special mention                             | \$—                               | \$—                              | \$2,083                           | \$3                              |
| Commercial - AQR substandard                                 | 1,081                             | 10                               | 10,056                            | 4                                |
| Consumer secured by 1st deeds of trust - AQR substandard     | 136                               | —                                | —                                 | —                                |
| Subtotal   | \$1,217                           | \$10                             | \$12,139                          | \$7                              |
| <b>Total</b>   |                                   |                                  |                                   |                                  |
| Commercial - AQR special mention                             | \$2,113                           | \$31                             | \$2,180                           | \$3                              |
| Commercial - AQR substandard                                 | 27,599                            | 53                               | 28,181                            | 76                               |
| Real estate term owner-occupied - AQR special mention        | 617                               | —                                | —                                 | —                                |
| Real estate term owner-occupied - AQR substandard            | 2,908                             | 52                               | 7,345                             | 114                              |
| Real estate term non-owner occupied - AQR pass               | 206                               | 7                                | 346                               | 6                                |
| Real estate term non-owner occupied - AQR substandard        | 287                               | 8                                | 580                               | 9                                |
| Real estate term other - AQR pass                            | 310                               | 11                               | 585                               | 10                               |
| Real estate term other - AQR substandard                     | 353                               | —                                | 641                               | 11                               |
| Consumer secured by 1st deeds of trust - AQR pass            | 132                               | 2                                | —                                 | —                                |
| Consumer secured by 1st deeds of trust - AQR special mention | —                                 | —                                | 139                               | 3                                |
| Consumer secured by 1st deeds of trust - AQR substandard     | 290                               | 2                                | 771                               | 5                                |
| Total Impaired Loans   | \$34,815                          | \$166                            | \$40,768                          | \$237                            |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

| Nine Months Ended September 30,<br>(In Thousands)            | 2018                              |                                  | 2017                              |                                  |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|  | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>                    |                                   |                                  |                                   |                                  |
| Commercial - AQR special mention                             | \$2,192                           | \$96                             | \$49                              | \$1                              |
| Commercial - AQR substandard                                 | 25,271                            | 300                              | 20,363                            | 405                              |
| Real estate term owner occupied- AQR pass                    | —                                 | —                                | 82                                | 5                                |
| Real estate term owner occupied- AQR special mention         | 208                               | —                                | —                                 | —                                |
| Real estate term owner occupied- AQR substandard             | 4,019                             | 129                              | 6,257                             | 260                              |
| Real estate term non-owner occupied- AQR pass                | 294                               | 18                               | 367                               | 38                               |
| Real estate term non-owner occupied- AQR special mention     | 29                                | 2                                | —                                 | —                                |
| Real estate term non-owner occupied- AQR substandard         | 413                               | 22                               | 654                               | 38                               |
| Real estate term other - AQR pass                            | 462                               | 28                               | 604                               | 32                               |
| Real estate term other - AQR substandard                     | 119                               | —                                | 652                               | 34                               |
| Consumer secured by 1st deeds of trust - AQR pass            | 136                               | 10                               | —                                 | —                                |
| Consumer secured by 1st deeds of trust - AQR special mention | —                                 | —                                | 141                               | 10                               |
| Consumer secured by 1st deeds of trust - AQR substandard     | 168                               | 8                                | 506                               | 13                               |
| Consumer other - AQR substandard                             | —                                 | —                                | 17                                | 1                                |
| Subtotal   | \$33,311                          | \$613                            | \$29,692                          | \$837                            |
| <b>With an allowance recorded</b>                            |                                   |                                  |                                   |                                  |
| Commercial - AQR special mention                             | \$—                               | \$—                              | \$702                             | \$3                              |
| Commercial - AQR substandard                                 | 2,866                             | 17                               | 7,979                             | 4                                |
| Commercial - AQR doubtful                                    | 18                                | —                                | —                                 | —                                |
| Consumer secured by 1st deeds of trust - AQR substandard     | 126                               | —                                | —                                 | —                                |
| Subtotal   | \$3,010                           | \$17                             | \$8,681                           | \$7                              |
| <b>Total</b>   |                                   |                                  |                                   |                                  |
| Commercial - AQR special mention                             | \$2,192                           | \$96                             | \$751                             | \$4                              |
| Commercial - AQR substandard                                 | 28,137                            | 317                              | 28,342                            | 409                              |
| Commercial - AQR doubtful                                    | 18                                | —                                | —                                 | —                                |
| Real estate term owner-occupied - AQR pass                   | —                                 | —                                | 82                                | 5                                |
| Real estate term owner-occupied - AQR special mention        | 208                               | —                                | —                                 | —                                |
| Real estate term owner-occupied - AQR substandard            | 4,019                             | 129                              | 6,257                             | 260                              |
| Real estate term non-owner occupied - AQR pass               | 294                               | 18                               | 367                               | 38                               |
| Real estate term non-owner occupied - AQR special mention    | 29                                | 2                                | —                                 | —                                |
| Real estate term non-owner occupied - AQR substandard        | 413                               | 22                               | 654                               | 38                               |
| Real estate term other - AQR pass                            | 462                               | 28                               | 604                               | 32                               |
| Real estate term other - AQR substandard                     | 119                               | —                                | 652                               | 34                               |
| Consumer secured by 1st deeds of trust - AQR pass            | 136                               | 10                               | —                                 | —                                |
| Consumer secured by 1st deeds of trust - AQR special mention | —                                 | —                                | 141                               | 10                               |
| Consumer secured by 1st deeds of trust - AQR substandard     | 294                               | 8                                | 506                               | 13                               |
| Consumer other - AQR substandard                             | —                                 | —                                | 17                                | 1                                |
| Total Impaired Loans   | \$36,321                          | \$630                            | \$38,373                          | \$844                            |

Purchased Credit Impaired Loans: The Company acquired 18 purchased credit impaired loans in connection with its acquisition of Alaska Pacific Bancshares, Inc. on April 1, 2014 subject to the requirements of FASB ASC 310-30 Loans and Debt Securities





Acquired with Deteriorated Credit Quality. This group of loans consists primarily of commercial and commercial real estate loans, and unlike a pool of consumer mortgages, it is not practicable for the Company to analyze the accretable yield of these loans. As such, the Company has elected the cost recovery method of income recognition for these loans, and thus no accretable yield has been identified for these loans. At the acquisition date, April 1, 2014, the fair value of this group of loans was \$3.9 million. The carrying value of these loans as of September 30, 2018 was \$792,000.

Troubled Debt Restructurings: Loans classified as troubled debt restructurings (“TDR”) totaled \$17.9 million and \$23.8 million at September 30, 2018 and December 31, 2017, respectively. A TDR is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession that it would not grant otherwise. The Company has granted a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

Rate Modification: A modification in which the interest rate is changed.

Term Modification: A modification in which the maturity date, timing of payments, or frequency of payments is changed.

Payment Modification: A modification in which the dollar amount of the payment is changed, or in which a loan is converted to interest only payments for a period of time is included in this category.

Combination Modification: Any other type of modification, including the use of multiple categories above.

AQR pass graded loans included above in the impaired loan data are loans classified as TDRs. By definition, TDRs are considered impaired loans. All of the Company's TDRs are included in impaired loans.

The following table presents the breakout between newly restructured loans that occurred during the nine months ended September 30, 2018 and restructured loans that occurred prior to 2018 that are still included in portfolio loans:

| (In Thousands)                                   | Accrual Nonaccrual Total |          |               |
|--|--------------------------|----------|---------------|
|  | Status                   | Status   | Modifications |
| New Troubled Debt Restructurings                 |                          |          |               |
| Commercial - AQR substandard                     | \$—                      | \$1,738  | \$1,738       |
| Real estate term owner occupied- AQR substandard | —                        | 1,694    | 1,694         |
| Subtotal   | \$—                      | \$3,432  | \$3,432       |
| Existing Troubled Debt Restructurings            | \$3,252                  | \$11,178 | \$14,430      |
| Total  | \$3,252                  | \$14,610 | \$17,862      |

The following tables present newly restructured loans that occurred during the nine months ended September 30, 2018 and 2017, by concession (terms modified):

| (In Thousands)                                     | Number of Contracts | September 30, 2018 |                   |                      |                          |                     |
|--|---------------------|--------------------|-------------------|----------------------|--------------------------|---------------------|
|  |                     | Rate Modification  | Term Modification | Payment Modification | Combination Modification | Total Modifications |
| Pre-Modification Outstanding Recorded Investment:  |                     |                    |                   |                      |                          |                     |
| Commercial - AQR substandard                       | 4                   | \$—                | \$—               | \$2,704              | \$—                      | \$2,704             |
| Real estate term owner occupied- AQR substandard   | 2                   | —                  | —                 | 1,694                | —                        | 1,694               |
| Total  | 6                   | \$—                | \$—               | \$4,398              | \$—                      | \$4,398             |
| Post-Modification Outstanding Recorded Investment: |                     |                    |                   |                      |                          |                     |
| Commercial - AQR substandard                       | 4                   | \$—                | \$—               | \$1,738              | \$—                      | \$1,738             |
| Real estate term owner occupied- AQR substandard   | 2                   | —                  | —                 | 1,694                | —                        | 1,694               |
| Total  | 6                   | \$—                | \$—               | \$3,432              | \$—                      | \$3,432             |
| September 30, 2017                                 |                     |                    |                   |                      |                          |                     |
| (In Thousands)                                     | Number of Contracts | Rate Modification  | Term Modification | Payment Modification | Combination Modification | Total Modifications |
| Pre-Modification Outstanding Recorded Investment:  |                     |                    |                   |                      |                          |                     |
| Commercial - AQR special mention                   | 1                   | \$—                | \$2,078           | \$—                  | \$—                      | \$2,078             |
| Commercial - AQR substandard                       | 2                   | —                  | 10,665            | 210                  | —                        | 10,875              |
| Total  | 3                   | \$—                | \$12,743          | \$210                | \$—                      | \$12,953            |
| Post-Modification Outstanding Recorded Investment: |                     |                    |                   |                      |                          |                     |
| Commercial - AQR special mention                   | 1                   | \$—                | \$2,078           | \$—                  | \$—                      | \$2,078             |
| Commercial - AQR substandard                       | 2                   | —                  | 9,099             | 205                  | —                        | 9,304               |
| Total  | 3                   | \$—                | \$11,177          | \$205                | \$—                      | \$11,382            |

The Company had no commitments to extend additional credit to borrowers whose terms have been modified in TDRs. There were \$965,000 of charge-offs in the nine months ended September 30, 2018 on loans that were newly classified as TDRs during the same period.

All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the Allowance. There were two TDRs with specific impairment at September 30, 2018 and December 31, 2017.

The Company had no TDRs that subsequently defaulted within the first twelve months of restructure, during the year ending December 31, 2017. The following table presents TDRs that occurred during the twelve-month period ending September 30, 2018 that subsequently defaulted during the nine months ended September 30, 2018:

| (In Thousands)  | Number of Contracts | September 30,<br>2018<br>Recorded<br>Investment |
|---|---------------------|---|
| Troubled Debt Restructurings that Subsequently Defaulted: |                     |   |
| Commercial - AQR substandard                              | 2                   | \$559   |
| Real estate term owner occupied - AQR substandard         | 1                   | 1,331   |
| Total   | 3                   | \$1,890   |

## 6. Allowance for Loan Losses

The following tables detail activity in the Allowance for the periods indicated:

| Three Months Ended<br>September 30,   | Commercial | Real<br>estate<br>construction<br>one-to-four<br>family | Real<br>estate<br>construction<br>other | Real<br>estate<br>term<br>owner<br>occupied | Real<br>estate<br>term<br>non-owner<br>occupied | Real<br>estate<br>term<br>other | Consumer<br>secured<br>by 1st<br>deed of<br>trust | Consumer<br>other | Unallocated | Total    |
|---------------------------------------|------------|---|---|---|---|---------------------------------|---|-------------------|-------------|----------|
| 2018                                  |            |   |   |   |   |                                 |   |                   |             |          |
| Balance, beginning of period          | \$5,626    | \$596   | \$1,086                                 | \$2,170                                     | \$6,219   | \$1,001                         | \$352   | \$396             | \$2,662     | \$20,108 |
| Charge-Offs                           | —          | —   | —                                       | —   | —   | —                               | —   | (9)               | —           | (9)      |
| Recoveries                            | 57         | —   | —                                       | —   | —   | 1                               | 1   | 2                 | —           | 61       |
| Provision (benefit)                   | 254        | 79  | 34                                      | (43)  | (11)  | (291)                           | 21  | 27                | (70)        | —        |
| Balance, end of period                | \$5,937    | \$675   | \$1,120                                 | \$2,127                                     | \$6,208   | \$711                           | \$374   | \$416             | \$2,592     | \$20,160 |
| Balance, end of period:               |            |   |   |   |   |                                 |   |                   |             |          |
| Individually evaluated for impairment | \$323      | \$—   | \$—                                     | \$—   | \$—   | \$—                             | \$49  | \$—               | \$—         | \$372    |
| Balance, end of period:               |            |   |   |   |   |                                 |   |                   |             |          |
| Collectively evaluated for impairment | \$5,614    | \$675   | \$1,120                                 | \$2,127                                     | \$6,208   | \$711                           | \$325   | \$416             | \$2,592     | \$19,788 |
| 2017                                  |            |   |   |   |   |                                 |   |                   |             |          |
| Balance, beginning of period          | \$5,822    | \$521   | \$1,517                                 | \$2,354                                     | \$7,075   | \$774                           | \$327   | \$362             | \$1,309     | \$20,061 |
| Charge-Offs                           | (1,118)    | —   | —                                       | —   | —   | —                               | (85)  | —                 | —           | (1,203)  |
| Recoveries                            | 102        | —   | —                                       | —   | —   | —                               | —   | 4                 | —           | 106      |
| Provision (benefit)                   | 2,210      | 79  | 261                                     | (10)  | (60)  | 10                              | 93  | (2)               | (81)        | 2,500    |
| Balance, end of period                | \$7,016    | \$600   | \$1,778                                 | \$2,344                                     | \$7,015   | \$784                           | \$335   | \$364             | \$1,228     | \$21,464 |
| Balance, end of period:               |            |   |   |   |   |                                 |   |                   |             |          |
| Individually evaluated for impairment | \$1,514    | \$—   | \$—                                     | \$—   | \$—   | \$—                             | \$—   | \$—               | \$—         | \$1,514  |
| Balance, end of period:               |            |   |   |   |   |                                 |   |                   |             |          |
| Collectively evaluated for impairment | \$5,502    | \$600   | \$1,778                                 | \$2,344                                     | \$7,015   | \$784                           | \$335   | \$364             | \$1,228     | \$19,950 |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

| Nine Months Ended<br>September 30,                                  | Commercial | Real estate<br>one-to-four<br>family | Real estate<br>construction<br>other | Real estate<br>term<br>owner<br>occupied | Real estate<br>term<br>non-owner<br>occupied | Real estate<br>term<br>other | Consumer<br>secured<br>by 1st<br>deed of<br>trust | Consumer<br>other | Unallocated | Total    |
|---|------------|--------------------------------------|--------------------------------------|--|--|------------------------------|---|-------------------|-------------|----------|
| 2018  |            |                                      |                                      |  |  |                              |   |                   |             |          |
| Balance, beginning of period  | \$6,172    | \$629                                | \$1,566                              | \$2,194                                  | \$6,043                                      | \$725                        | \$315   | \$307             | \$3,510     | \$21,461 |
| Charge-Offs   | (1,042)    | —                                    | —                                    | —  | —  | —                            | (91)  | (80)              | —           | (1,213)  |
| Recoveries  | 200        | —                                    | —                                    | —  | —  | 3                            | 2   | 7                 | —           | 212      |
| Provision (benefit)   | 607        | 46                                   | (446)                                | (67)                                     | 165  | (17)                         | 148   | 182               | (918)       | (300)    |
| Balance, end of period  | \$5,937    | \$675                                | \$1,120                              | \$2,127                                  | \$6,208                                      | \$711                        | \$374   | \$416             | \$2,592     | \$20,160 |
| Balance, end of period:<br>Individually evaluated<br>for impairment | \$323      | \$—                                  | \$—                                  | \$—                                      | \$—  | \$—                          | \$49  | \$—               | \$—         | \$372    |
| Balance, end of period:<br>Collectively evaluated<br>for impairment | \$5,614    | \$675                                | \$1,120                              | \$2,127                                  | \$6,208                                      | \$711                        | \$325   | \$416             | \$2,592     | \$19,788 |
| 2017  |            |                                      |                                      |  |  |                              |   |                   |             |          |
| Balance, beginning of period  | \$5,535    | \$550                                | \$1,465                              | \$2,358                                  | \$6,853                                      | \$819                        | \$313   | \$408             | \$1,396     | \$19,697 |
| Charge-Offs   | (1,582)    | —                                    | —                                    | —  | —  | (5)                          | (85)  | (17)              | —           | (1,689)  |
| Recoveries  | 246        | —                                    | —                                    | —  | —  | —                            | 2   | 8                 | —           | 256      |
| Provision (benefit)   | 2,817      | 50                                   | 313                                  | (14)                                     | 162  | (30)                         | 105   | (35)              | (168)       | 3,200    |
| Balance, end of period  | \$7,016    | \$600                                | \$1,778                              | \$2,344                                  | \$7,015                                      | \$784                        | \$335   | \$364             | \$1,228     | \$21,464 |
| Balance, end of period:<br>Individually evaluated<br>for impairment | \$1,514    | \$—                                  | \$—                                  | \$—                                      | \$—  | \$—                          | \$—   | \$—               | \$—         | \$1,514  |
| Balance, end of period:<br>Collectively evaluated<br>for impairment | \$5,502    | \$600                                | \$1,778                              | \$2,344                                  | \$7,015                                      | \$784                        | \$335   | \$364             | \$1,228     | \$19,950 |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

The following is a detail of the recorded investment in the loan portfolio, segregated by amounts evaluated individually or collectively in the Allowance at the periods indicated:

| (In Thousands)                        | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deed of trust | Consumer other | Total     |
|---------------------------------------|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|---------------------------------------|----------------|-----------|
| September 30, 2018                    |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Balance, end of period                | \$333,132  | \$36,119                                    | \$61,857                       | \$130,166                       | \$340,820                           | \$41,493               | \$20,202                              | \$22,573       | \$986,362 |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Individually evaluated for impairment | \$27,167   | \$—   | \$—                            | \$5,789                         | \$788                               | \$1,081                | \$609                                 | \$—            | \$35,434  |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Collectively evaluated for impairment | \$305,965  | \$36,119                                    | \$61,857                       | \$124,377                       | \$340,032                           | \$40,412               | \$19,593                              | \$22,573       | \$950,928 |
| December 31, 2017                     |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Balance, end of period                | \$313,514  | \$31,201                                    | \$80,093                       | \$132,042                       | \$319,313                           | \$40,411               | \$22,616                              | \$19,919       | \$959,109 |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Individually evaluated for impairment | \$26,812   | \$—   | \$—                            | \$2,862                         | \$874                               | \$559                  | \$860                                 | \$—            | \$31,967  |
| Balance, end of period:               |            |   |                                |                                 |                                     |                        |                                       |                |           |
| Collectively evaluated for impairment | \$286,702  | \$31,201                                    | \$80,093                       | \$129,180                       | \$318,439                           | \$39,852               | \$21,756                              | \$19,919       | \$927,142 |

The following represents the balance of the Allowance for the periods indicated segregated by segment and class:

| (In Thousands)                         | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Unallocated | Total    |
|--|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|--|----------------|-------------|----------|
| September 30, 2018                     |            |   |                                |                                 |                                     |                        |  |                |             |          |
| Individually evaluated for impairment: |            |   |                                |                                 |                                     |                        |  |                |             |          |
| AQR Substandard                        | \$323      | \$—   | \$—                            | \$—                             | \$—                                 | \$—                    | \$49                                   | \$—            | \$—         | \$372    |
| Collectively evaluated for impairment: |            |   |                                |                                 |                                     |                        |  |                |             |          |
| AQR Pass                               | 5,435      | 675   | 1,120                          | 2,065                           | 5,631                               | 711                    | 320                                    | 397            | —           | 16,354   |
| AQR Special Mention                    | 179        | —   | —                              | 62                              | 577                                 | —                      | 5                                      | —              | —           | 823      |
| AQR Substandard                        | —          | —   | —                              | —                               | —                                   | —                      | —                                      | 19             | —           | 19       |
| Unallocated                            | —          | —   | —                              | —                               | —                                   | —                      | —                                      | —              | 2,592       | 2,592    |
|  | \$5,937    | \$675                                       | \$1,120                        | \$2,127                         | \$6,208                             | \$711                  | \$374                                  | \$416          | \$2,592     | \$20,160 |
| December 31, 2017                      |            |   |                                |                                 |                                     |                        |  |                |             |          |
| Individually evaluated for impairment: |            |   |                                |                                 |                                     |                        |  |                |             |          |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|  |         |       |         |         |         |       |       |       |         |          |
|--|---------|-------|---------|---------|---------|-------|-------|-------|---------|----------|
| AQR Substandard                        | \$966   | \$—   | \$—     | \$—     | \$—     | \$—   | \$—   | \$—   | \$—     | \$966    |
| Collectively evaluated for impairment: |         |       |         |         |         |       |       |       |         |          |
| AQR Pass                               | 5,079   | 629   | 1,566   | 2,154   | 5,680   | 725   | 315   | 305   | —       | 16,453   |
| AQR Special Mention                    | 120     | —     | —       | 40      | 363     | —     | —     | 1     | —       | 524      |
| AQR Substandard Unallocated            | 7       | —     | —       | —       | —       | —     | —     | 1     | —       | 8        |
|  | —       | —     | —       | —       | —       | —     | —     | —     | 3,510   | 3,510    |
|  | \$6,172 | \$629 | \$1,566 | \$2,194 | \$6,043 | \$725 | \$315 | \$307 | \$3,510 | \$21,461 |



## 7. Purchased Receivables

Purchased receivables are carried at their principal amount outstanding, net of a reserve for anticipated losses that have not yet been identified, and have a maturity of less than one year. Purchased receivable balances are charged against this reserve when management believes that collection of principal is unlikely. Management evaluates the adequacy of the reserve for purchased receivable losses based on historical loss experience by class of receivable and its assessment of current economic conditions. As of September 30, 2018, the Company has one class of purchased receivables. There were no purchased receivables past due at September 30, 2018 or December 31, 2017, and there were no restructured purchased receivables at September 30, 2018 or December 31, 2017.

Income on purchased receivables is accrued and recognized on the principal amount outstanding using an effective interest method except when management believes doubt exists as to the collectability of the income or principal. As of September 30, 2018, the Company is accruing income on all purchased receivable balances outstanding.

The following table summarizes the components of net purchased receivables for the periods indicated:

| (In Thousands)                          | September 30, December 31, |          |
|---|----------------------------|----------|
|   | 2018                       | 2017     |
| Purchased receivables                   | \$12,902                   | \$22,431 |
| Reserve for purchased receivable losses | (196 )                     | (200 )   |
| Total                                   | \$12,706                   | \$22,231 |

The following table sets forth information regarding changes in the purchased receivable reserve for the three and nine-month periods ending September 30, 2018 and 2017, respectively:

| (In Thousands)                              | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Balance, beginning of period                | \$201              | \$194              | \$200              | \$171              |
| Charge-offs                                 | —                  | —                  | —                  | —                  |
| Recoveries                                  | —                  | —                  | —                  | —                  |
| Charge-offs net of recoveries               | —                  | —                  | —                  | —                  |
| (Benefit) reserve for purchased receivables | (5 )               | 6                  | (4 )               | 29                 |
| Balance, end of period                      | \$196              | \$200              | \$196              | \$200              |

## 8. Mortgage Servicing Rights

The following table details the activity in the Company's mortgage servicing rights ("MSR") for the three and nine months ended September 30, 2018 and 2017:

| (In Thousands)   | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Balance, beginning of period                                 | \$8,733            | \$5,828            | \$7,305            | \$4,157            |
| Additions for new MSR capitalized                            | 1,090              | 649                | 2,662              | 2,086              |
| Changes in fair value:                                       |                    |                    |                    |                    |
| Due to changes in model inputs of assumptions <sup>(1)</sup> | 125                | (188 )             | 490                | 332                |
| Other <sup>(2)</sup>   | (253 )             | (108 )             | (762 )             | (394 )             |
| Balance, end of period                                       | \$9,695            | \$6,181            | \$9,695            | \$6,181            |



(1) Principally reflects changes in discount rates and prepayment speed assumptions, which are primarily affected by changes in interest rates.

(2) Represents changes due to collection/realization of expected cash flows over time.

The following table details information related to our serviced mortgage loan portfolio as of September 30, 2018 and December 31, 2017:

| (In Thousands)                                | September 30,<br>2018 | December 31,<br>2017 |
|---|-----------------------|----------------------|
| Balance of mortgage loans serviced for others | \$516,008             | \$406,291            |
| MSR as a percentage of serviced loans         | 1.88                  | % 1.80               |

The Company recognized servicing fees of \$1.6 million and \$997,000 during the three-month periods ending September 30, 2018 and 2017, respectively, and \$4.0 million and \$3.0 million during the nine-month periods ending September 30, 2018 and 2017, respectively, which includes revenues recognized at origination of new MSR, late fees, and ancillary fees as a component of other noninterest income in the Company's Consolidated Statements of Income.

The following table outlines the key assumptions used in measuring the fair value of MSR as of September 30, 2018 and December 31, 2017:

|                          | 2018  | 2017  |
|--------------------------|-------|-------|
| Constant prepayment rate | 8.28% | 9.00% |
| Discount rate            | 9.89% | 9.45% |

Key economic assumptions and the sensitivity of the current fair value for MSR to immediate adverse changes in those assumptions at September 30, 2018 and December 31, 2017 were as follows:

| (In Thousands)                        | September 30,<br>2018 | December 31,<br>2017 |
|---------------------------------------|-----------------------|----------------------|
| Aggregate portfolio principal balance | \$516,008             | \$406,291            |
| Weighted average rate of note         | 3.86                  | % 3.77               |

| September 30, 2018          | Base    | 1.0% Adverse<br>Rate Change | 2.0%<br>Adverse Rate<br>Change |   |
|-----------------------------|---------|-----------------------------|--------------------------------|---|
| Conditional prepayment rate | 8.28    | % 21.26                     | % 23.04                        | % |
| Discount rate               | 9.89    | % 8.89                      | % 7.89                         | % |
| Fair value MSR              | \$9,695 | \$6,163                     | \$5,896                        |   |
| Percentage of MSR           | 1.88    | % 1.19                      | % 1.14                         | % |

| December 31, 2017           | Base    | 1.0% Adverse<br>Rate Change | 2.0%<br>Adverse Rate<br>Change |   |
|-----------------------------|---------|-----------------------------|--------------------------------|---|
| Conditional prepayment rate | 9.00    | % 23.33                     | % 25.25                        | % |
| Discount rate               | 9.45    | % 8.45                      | % 7.45                         | % |
| Fair value MSR              | \$7,305 | \$4,343                     | \$4,109                        |   |
| Percentage of MSR           | 1.80    | % 1.07                      | % 1.01                         | % |

The above tables show the sensitivity to market rate changes for the par rate coupon for a conventional one-to-four family Alaska Housing Finance Corporation/FNMA/FHLMC serviced home loan. The above tables reference a 100 basis point and 200 basis point decrease in note rates.

These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company's methodology for estimating the fair value of MSR is highly sensitive to changes in key assumptions. For example, actual prepayment

experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of the MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance; however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of MSR fair value is limited by the conditions existing and assumptions made at a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

## 9. Derivatives

### Interest rates swaps related to community banking activities

The Company enters into commercial loan interest rate swap agreements with commercial banking customers which are offset with a corresponding swap agreement with a third party financial institution ("counterparty"). The Company has agreements with its counterparties that contain provisions that provide that if the Company fails to maintain its status as a well-capitalized institution, then the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements. These agreements also require that the Company and the counterparty collateralize any fair value shortfalls that exceed \$250,000 with eligible collateral, which includes cash and securities backed with the full faith and credit of the federal government. Similarly, the Company could be required to settle its obligations under the agreement if specific regulatory events occur, such as if the Company were issued a prompt corrective action directive or a cease and desist order, or if certain regulatory ratios fall below specified levels. The Company pledged \$300,000 in available for sale securities to collateralize fair value shortfalls on interest rate swap agreements as of both September 30, 2018 and December 31, 2017.

The Company had interest rate swaps related to commercial loans with an aggregate notional amount of \$15.2 million and \$12.5 million at September 30, 2018 and December 31, 2017, respectively. At September 30, 2018, the notional amount of interest rate swaps is made up of two variable to fixed rate swaps to a commercial loan customer totaling \$7.6 million, and two fixed to variable rate swaps with a counterparty totaling \$7.6 million. Changes in fair value from these four interest rate swaps offset each other in the first nine months of 2018. The Company recognized \$70,000 in fee income related to interest rate swaps in the three and nine-month periods ending September 30, 2018 and recognized \$10,000 and \$26,000 in fee income in the three and nine-month periods ending September 30, 2017, respectively. Interest rate swap income is recorded in other income on the Consolidated Statements of Income. None of these interest rate swaps are designated as hedging instruments.

The Company entered into an interest rate swap in the third quarter of 2017 to hedge the variability in cash flows arising out of its junior subordinated debentures, which is floating rate debt, by swapping the cash flows with an interest rate swap which receives floating and pays fixed. The Company has designated this interest rate swap as a hedging instrument. The interest rate swap effectively fixes the Company's interest payments on the \$10.0 million of junior subordinated debentures held under Northrim Statutory Trust 2 at 3.72% through its maturity date. The floating rate that the dealer pays is equal to the three month LIBOR plus 1.37% which reprices quarterly on the payment date. This rate was 3.70% as of September 30, 2018. The Company pledged \$400,000 in cash to collateralize initial margin and fair value exposure of our counterparty on this interest rate swap as of September 30, 2018. Changes in the fair value of this interest rate swap are reported in other comprehensive income. The unrealized gain on this interest rate swap was \$1.0 million as of September 30, 2018.

### Interest rates swaps related to home mortgage banking activities

The Company also uses derivatives to hedge the risk of changes in the fair values of interest rate lock commitments. The Company enters into commitments to originate residential mortgage loans at specific rates; the value of these commitments are detailed in the table below as "interest rate lock commitments". The Company also hedges the interest rate risk associated with its residential mortgage loan commitments, which are referred to as "retail interest rate contracts" in the table below. Market risk with respect to commitments to originate loans arises from changes in the value of contractual positions due to changes in interest rates. RML had commitments to originate mortgage loans

held for sale totaling \$69.0 million and \$43.6 million at September 30, 2018 and December 31, 2017, respectively. Changes in the value of RML's interest rate derivatives are recorded in mortgage banking income on the Consolidated Statements of Income. None of these derivatives are designated as hedging instruments.

The following table presents the fair value of derivatives not designated as hedging instruments at September 30, 2018 and December 31, 2017:

| (In Thousands)                 |              | Asset Derivatives      |            | September 30, December 31, |      |      |
|--------------------------------|--------------|------------------------|------------|----------------------------|------|------|
|                                |              |                        |            | 2018                       | 2017 | 2018 |
|                                |              | Balance Sheet Location | Fair Value | Fair Value                 |      |      |
| Interest rate swaps            | Other assets |                        | \$122      | \$77                       |      |      |
| Interest rate lock commitments | Other assets |                        | 1,117      | 873                        |      |      |
| Total                          |              |                        | \$1,239    | \$950                      |      |      |

| (In Thousands)      |                   | Liability Derivatives  |            | September 30, December 31, |      |      |
|---------------------|-------------------|------------------------|------------|----------------------------|------|------|
|                     |                   |                        |            | 2018                       | 2017 | 2018 |
|                     |                   | Balance Sheet Location | Fair Value | Fair Value                 |      |      |
| Interest rate swaps | Other liabilities |                        | \$122      | \$77                       |      |      |
| Total               |                   |                        | \$122      | \$77                       |      |      |

The following table presents the net gains (losses) of derivatives not designated as hedging instruments for the three and nine-month periods ending September 30, 2018 and 2017:

| (In Thousands)                 |                         | Income Statement Location |         | Three Months Ended |                    | Nine Months Ended  |                    |
|--------------------------------|-------------------------|---------------------------|---------|--------------------|--------------------|--------------------|--------------------|
|                                |                         |                           |         | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Interest rate contracts        | Mortgage banking income | \$138                     | (\$370) | \$511              | (\$482)            |                    |                    |
| Interest rate lock commitments | Mortgage banking income | (281)                     | 193     | 203                | 364                |                    |                    |
| Total                          |                         | (\$143)                   | (\$177) | \$714              | (\$118)            |                    |                    |

Our derivative transactions with counterparties under International Swaps and Derivative Association master agreements include "right of set-off" provisions. "Right of set-off" provisions are legally enforceable rights to offset recognized amounts and there may be an intention to settle such amounts on a net basis. We do not offset such financial instruments for financial reporting purposes.

The following table summarizes the derivatives that have a right of offset as of September 30, 2018 and December 31, 2017:

|                           |  |   |  | Gross amounts not offset in the Statement of Financial Position |            |
|---------------------------|--|---|--|---|------------|
|                           |  | Gross amounts offset in the Statement of Financial Position | Net amounts of assets and liabilities presented in the Statement of Financial Position | Financial Instruments   | Net Amount |
| <b>September 30, 2018</b> |  |   |  |   |            |
| (In Thousands)            | Gross amounts of recognized assets and liabilities |   |  |   |            |
| Asset Derivatives         |  |   |  |   |            |
| Interest rate swaps       | \$122  | \$—   | \$122  | \$—   | \$122      |
| Liability Derivatives     |  |   |  |   |            |
| Interest rate swaps       | \$122  | \$—   | \$122  | \$-122  | \$—        |
| <b>December 31, 2017</b>  |  |   |  |   |            |
| (In Thousands)            | Gross amounts of recognized assets and liabilities |   |  |   |            |
| Asset Derivatives         |  |   |  |   |            |
| Interest rate swaps       | \$77   | \$—   | \$77   | \$—   | \$77       |
| Liability Derivatives     |  |   |  |   |            |
| Interest rate swaps       | \$77   | \$—   | \$77   | \$-77   | \$—        |

10. Stock Incentive Plan



The Company adopted the 2017 Stock Option Plan (“2017 Plan”) following shareholder approval of the 2017 Plan at the 2017 Annual Meeting. Subsequent to the adoption of the 2017 Plan, no additional grants may be issued under the prior plans. The 2017 Plan provides for grants of up to 350,000 shares of common stock.

**Stock Options:** Under the 2017 Plan and previous plans, certain key employees have been granted the option to purchase set amounts of common stock at the market price on the day the option was granted. Optionees, at their own discretion, may cover the cost of exercise through the exchange at the then fair value of already owned shares of the Company’s stock. Options are granted for a 10-year period and vest on a pro-rata basis over the initial three years from grant.

The Company measures the fair value of each stock option at the date of grant using the Black-Scholes option pricing model. For the three-month periods ended September 30, 2018 and 2017, the Company recognized \$31,000 and \$34,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense. For the nine months ended September 30, 2018 and 2017, the Company recognized \$139,000 and \$100,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense.

The Company allows stock options to be exercised through cash or cashless transactions. Cashless stock option exercises require a portion of the options exercised to be net settled in satisfaction of the exercise price and applicable tax withholding requirements. The Company issued 11,427 and 12,423 shares from the exercise of stock options for the three and nine-month periods ended September 30, 2018, respectively. The Company received \$195,000 cash for the stock option exercises in the three

and nine months ended September 30, 2018. In the three months ended September 30, 2018, the Company net settled \$74,000 for cashless stock option exercises. In the nine-month periods ended September 30, 2018, the Company net settled \$130,000 for cashless stock option exercises. The Company withheld \$154,000 and \$227,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the three and nine-month periods ended September 30, 2018, respectively.

The Company issued zero and 12,789 shares, respectively, from the exercise of stock options in the three and nine-month periods ended September 30, 2017. The Company received zero cash for stock option exercises in the three and nine months ended September 30, 2017. In the three months ended September 30, 2017 the Company net settled \$0 for cashless stock option exercises. In the nine months ended September 30, 2017 the Company net settled \$862,000 for cashless stock option exercises. The Company withheld \$0 and \$1.0 million to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the three and nine months ended September 30, 2017.

There were no stock options granted in the three and nine months ended September 30, 2018.

There were 3,775 stock options granted in the three and nine months ended September 30, 2017.

**Restricted Stock Units:** The Company grants restricted stock units to certain key employees periodically. Recipients of restricted stock units do not pay any cash consideration to the Company for the shares and receive all dividends with respect to such shares when the shares vest. Restricted stock units cliff vest at the end of a three-year time period. For the three months ended September 30, 2018 and 2017, the Company recognized \$128,000 and \$121,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense. For the nine months ended September 30, 2018 and 2017, the Company recognized \$432,000 and \$335,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense.

There were no restricted stock units granted in the three and nine-month periods ended September 30, 2018.

There were 2,337 restricted stock units granted in the three and nine-month periods ended September 30, 2017.

## 11. Fair Value of Assets and Liabilities

### Fair Value Hierarchy

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction between market participants at the measurement date. GAAP established a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following three levels:

**Level 1:** Valuation is based upon quoted prices for identical instruments traded in active markets. A quoted market price in an active market provides the most reliable evidence of fair value and is used to measure fair value whenever available. A contractually binding sales price also provides reliable evidence of fair value.

**Level 2:** Valuation is based upon quoted market 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 significant assumptions not observable in the market, or inputs that require significant management judgment or estimation, some of which may be internally developed.

### Assets and Liabilities Measured at Fair Value on a Recurring Basis

**Investment securities available for sale and marketable securities:** Fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

**Loans held for sale:** Due to the short term nature of these instruments, the carrying amounts reported in the consolidated balance sheets represent their fair values.

**Mortgage servicing rights:** MSR do not trade in an active market with readily observable market data and as a result, the Company classifies the fair value of these assets as Level 3 measurement. In order to determine the fair value of MSRs, the present value of net expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds,



escrow calculations, delinquency rates, and ancillary fee income net of servicing costs. The model assumptions are also compared to publicly filed information from several large MSR holders, as available.

Derivative instruments: The fair value of the interest rate lock commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. The pull-through rate assumptions are considered Level 3 valuation inputs and are significant to the interest rate lock commitment valuation; as such, the interest rate lock commitment derivatives are classified as Level 3. Interest rate contracts are valued in a model, which uses as its basis a discounted cash flow technique incorporating credit valuation adjustments to reflect nonperformance risk in the measurement of fair value. Although the Company has determined that the majority of inputs used to value its interest rate derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of September 30, 2018, the Company has assessed the significance of the impact of these adjustments on the overall valuation of its interest rate positions and has determined that they are not significant to the overall valuation of its interest rate derivatives. As a result, the Company has classified its interest rate derivative valuations in Level 2 of the fair value hierarchy.

Assets Subject to Nonrecurring Adjustment to Fair Value:

The Company is also required to measure certain assets such as equity method investments, goodwill, intangible assets, impaired loans, and other real estate owned (“OREO”) at fair value on a nonrecurring basis in accordance with GAAP. Any nonrecurring adjustments to fair value usually result from the writedown of individual assets.

The Company uses either in-house evaluations or external appraisals to estimate the fair value of OREO and impaired loans as of each reporting date. In-house appraisals are considered Level 3 inputs and external appraisals are considered Level 2 inputs. The Company’s determination of which method to use is based upon several factors. The Company takes into account compliance with legal and regulatory guidelines, the amount of the loan, the size of the assets, the location and type of property to be valued and how critical the timing of completion of the analysis is to the assessment of value. Those factors are balanced with the level of internal expertise, internal experience and market information available, versus external expertise available such as qualified appraisers, brokers, auctioneers and equipment specialists.

The Company uses external sources to estimate fair value for projects that are not fully constructed as of the date of valuation. These projects are generally valued as if complete, with an appropriate allowance for cost of completion, including contingencies developed from external sources such as vendors, engineers and contractors. The Company believes that recording other real estate owned that is not fully constructed based on as if complete values is more appropriate than recording other real estate owned that is not fully constructed using as is values. We concluded that as-is-complete values are appropriate for these types of projects based on the accounting guidance for capitalization of project costs and subsequent measurement of the value of real estate. GAAP specifically states that estimates and cost allocations must be reviewed at the end of each reporting period and reallocated based on revised estimates. The Company adjusts the carrying value of other real estate owned in accordance with this guidance for increases in estimated cost to complete that exceed the fair value of the real estate at the end of each reporting period.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company’s entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Estimated fair values as of the periods indicated are as follows:

| (In Thousands)                                   | September 30, 2018 |             | December 31, 2017 |             |
|--|--------------------|-------------|-------------------|-------------|
|  | Carrying Amount    | Fair Value  | Carrying Amount   | Fair Value  |
| <b>Financial assets:</b>                         |                    |             |                   |             |
| <b>Level 1 inputs:</b>                           |                    |             |                   |             |
| Cash, due from banks and deposits in other banks | \$70,179           | \$70,179    | \$77,841          | \$77,841    |
| Investment securities available for sale         | 75,165             | 75,165      | 59,117            | 59,117      |
| Marketable equity securities                     | 6,035              | 6,035       | —                 | —           |
| <b>Level 2 inputs:</b>                           |                    |             |                   |             |
| Investment securities available for sale         | 189,028            | 189,028     | 253,633           | 253,633     |
| Investment in Federal Home Loan Bank stock       | 2,103              | 2,103       | 2,115             | 2,115       |
| Accrued interest receivable                      | 4,787              | 4,787       | 4,385             | 4,385       |
| Interest rate swaps                              | 1,161              | 1,161       | 261               | 261         |
| <b>Level 3 inputs:</b>                           |                    |             |                   |             |
| Loans and loans held for sale <sup>1</sup>       | 1,038,643          | \$1,006,152 | 999,445           | 1,001,346   |
| Purchased receivables, net                       | 12,706             | 12,706      | 22,231            | 22,231      |
| Interest rate lock commitments                   | 1,117              | 1,117       | 873               | 873         |
| Mortgage servicing rights                        | 9,695              | 9,695       | 7,305             | 7,305       |
| <b>Financial liabilities:</b>                    |                    |             |                   |             |
| <b>Level 2 inputs:</b>                           |                    |             |                   |             |
| Deposits   | \$1,233,268        | \$1,231,850 | \$1,258,283       | \$1,257,670 |
| Securities sold under repurchase agreements      | 32,429             | 32,429      | 27,746            | 27,746      |
| Borrowings                                       | 7,282              | 6,901       | 7,362             | 7,308       |
| Accrued interest payable                         | 125                | 125         | 24                | 24          |
| Interest rate swaps                              | 122                | 122         | 77                | 77          |
| Retail interest rate contracts                   | —                  | —           | —                 | —           |
| <b>Level 3 inputs:</b>                           |                    |             |                   |             |
| Junior subordinated debentures                   | 10,310             | 10,001      | 10,310            | 9,856       |

<sup>1</sup>Carrying amount is net of unearned income. In accordance with the prospective adoption of ASU 2016-01, the fair value of loans and loans held for sale as of September 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

The following table sets forth the balances as of the periods indicated of assets measured at fair value on a recurring basis:

| (In Thousands)                                  | Total     | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
|---|-----------|---|---|--|
| <b>September 30, 2018</b>                       |           |   |   |  |
| <b>Assets:</b>                                  |           |   |   |  |
| Available for sale securities                   |           |   |   |  |
| U.S. Treasury and government sponsored entities | \$205,832 | \$54,452  | \$151,380   | \$—  |
| Municipal securities                            | 11,843    | —   | 11,843  | —  |
| Corporate bonds                                 | 40,516    | 20,713  | 19,803  | —  |
| Collateralized loan obligations                 | 6,002     | —   | 6,002   | —  |
| Total available for sale securities             | \$264,193 | \$75,165  | \$189,028   | \$—  |
| Marketable equity securities                    | \$6,035   | \$6,035   | \$—   | \$—  |
| Total marketable equity securities              | \$6,035   | \$6,035   | \$—   | \$—  |
| Interest rate swaps                             | \$1,161   | \$—   | \$1,161   | \$—  |
| Interest rate lock commitments                  | 1,117     | —   | —   | 1,117  |
| Mortgage servicing rights                       | 9,695     | —   | —   | 9,695  |
| Total other assets                              | \$11,973  | \$—   | \$1,161   | \$10,812   |
| <b>Liabilities:</b>                             |           |   |   |  |
| Interest rate swaps                             | \$122     | \$—   | \$122   | \$—  |
| Total other liabilities                         | \$122     | \$—   | \$122   | \$—  |
| <b>December 31, 2017</b>                        |           |   |   |  |
| <b>Assets:</b>                                  |           |   |   |  |
| Available for sale securities                   |           |   |   |  |
| U.S. Treasury and government sponsored entities | \$249,461 | \$49,878  | \$199,583   | \$—  |
| Municipal securities                            | 14,421    | —   | 14,421  | —  |
| Corporate bonds                                 | 37,132    | 3,508   | 33,624  | —  |
| Collateralized loan obligations                 | 6,005     | —   | 6,005   | —  |
| Total available for sale securities             | \$307,019 | \$53,386  | \$253,633   | \$—  |
| Marketable equity securities                    | \$5,731   | \$5,731   | \$—   | \$—  |
| Total marketable securities                     | \$5,731   | \$5,731   | \$—   | \$—  |
| Interest rate swaps                             | \$261     | \$—   | \$261   | \$—  |
| Interest rate lock commitments                  | 873       | —   | —   | 873  |
| Mortgage servicing rights                       | 7,305     | —   | —   | 7,305  |
| Total other assets                              | \$8,439   | \$—   | \$261   | \$8,178  |
| <b>Liabilities:</b>                             |           |   |   |  |
| Interest rate swaps                             | \$77      | \$—   | \$77  | \$—  |
| Total other liabilities                         | \$77      | \$—   | \$77  | \$—  |



The following table provides a reconciliation of the assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine-month periods ended September 30, 2018 and 2017:

| (In Thousands)   | Beginning balance | Change included in earnings | Purchases and issuances | Sales and settlements | Ending balance | Net change in unrealized gains (losses) relating to items held at end of period |
|--|-------------------|-----------------------------|-------------------------|-----------------------|----------------|---|
| <b>Three Months Ended September 30, 2018</b>   |                   |                             |                         |                       |                |   |
| Interest rate lock commitments   | \$1,417           | (\$560 )                    | \$4,641                 | (\$4,381 )            | \$1,117        | \$1,117   |
| Mortgage servicing rights  | 8,733             | (128 )                      | 1,090                   | —                     | 9,695          | —   |
| Total  | \$10,150          | (\$688 )                    | \$5,731                 | (\$4,381 )            | \$10,812       | \$1,117   |
| <b>Three Months Ended September 30, 2017</b>   |                   |                             |                         |                       |                |   |
| Interest rate lock commitments   | \$1,337           | (\$455 )                    | \$4,443                 | (\$3,817 )            | \$1,508        | \$1,508   |
| Mortgage servicing rights  | 5,828             | (296 )                      | 649                     | —                     | 6,181          | —   |
| Total  | \$7,165           | (\$751 )                    | \$5,092                 | (\$3,817 )            | \$7,689        | \$1,508   |
| <b>Net change in unrealized gains (losses) relating to items held at end of period</b> |                   |                             |                         |                       |                |   |
| (In Thousands)   | Beginning balance | Change included in earnings | Purchases and issuances | Sales and settlements | Ending balance | Net change in unrealized gains (losses) relating to items held at end of period |
| <b>Nine Months Ended September 30, 2018</b>  |                   |                             |                         |                       |                |   |
| Interest rate lock commitments   | \$873             | (\$1,562 )                  | \$14,125                | (\$12,319 )           | \$1,117        | \$1,117   |
| Mortgage servicing rights  | 7,305             | (272 )                      | 2,662                   | —                     | 9,695          | —   |
| Total  | \$8,178           | (\$1,834 )                  | \$16,787                | (\$12,319 )           | \$10,812       | \$1,117   |
| <b>Nine Months Ended September 30, 2017</b>  |                   |                             |                         |                       |                |   |
| Interest rate lock commitments   | \$1,137           | (\$873 )                    | \$11,944                | (\$10,700 )           | \$1,508        | \$1,508   |
| Mortgage servicing rights  | 4,157             | (62 )                       | 2,086                   | —                     | 6,181          | —   |
| Total  | \$5,294           | (\$935 )                    | \$14,030                | (\$10,700 )           | \$7,689        | \$1,508   |





As of and for the periods ending September 30, 2018 and December 31, 2017, except for certain assets as shown in the following table, no impairment or valuation adjustment was recognized for assets recognized at fair value on a nonrecurring basis. For loans measured for impairment, the Company classifies fair value measurements using observable inputs, such as external appraisals, as Level 2 valuations in the fair value hierarchy, and unobservable inputs, such as in-house evaluations, as Level 3 valuations in the fair value hierarchy.

| (In Thousands)                          | Total           | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
|---|-----------------|---|---|--|
| <b>September 30, 2018</b>               |                 |   |   |  |
| Loans measured for impairment           | \$1,680         | \$—   | \$226   | \$1,454  |
| Other assets - equity method investment | 743             | —   | —   | 743  |
| <b>Total</b>                            | <b>\$2,423</b>  | <b>\$—</b>  | <b>\$226</b>  | <b>\$2,197</b>                                     |
| <b>December 31, 2017</b>                |                 |   |   |  |
| Loans measured for impairment           | \$7,988         | \$—   | \$—   | \$7,988  |
| Other real estate owned                 | 3,927           | —   | —   | 3,927  |
| Other assets - equity method investment | 2,292           | —   | —   | 2,292  |
| <b>Total</b>                            | <b>\$14,207</b> | <b>\$—</b>  | <b>\$—</b>  | <b>\$14,207</b>                                    |

The following table presents the gains and (losses) resulting from nonrecurring fair value adjustments for the three and nine-month periods ended September 30, 2018 and 2017:

| (In Thousands)   | Three Months<br>Ended<br>September 30,<br>2018 |                | Nine Months<br>Ended<br>September 30,<br>2017 |                |
|--|--|----------------|---|----------------|
| Loans measured for impairment                                    | \$299  | \$1,120        | (\$594)                                       | \$900          |
| Other real estate owned  | —  | 74             | —   | 340            |
| Other operating expense - impairment of equity method investment | 804  | —              | 804   | —              |
| <b>Total loss from nonrecurring measurements</b>                 | <b>\$1,103</b>                                 | <b>\$1,194</b> | <b>\$210</b>                                  | <b>\$1,240</b> |

## Assets and Liabilities Measured at Fair Value Using Significant Unobservable Inputs (Level 3)

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring and nonrecurring basis at September 30, 2018 and December 31, 2017:

| Financial Instrument          | Valuation Technique              | Unobservable Input                               | Weighted Average Rate Range |   |
|-------------------------------|----------------------------------|--|-----------------------------|---|
| September 30, 2018            |                                  |  |                             |   |
| Loans measured for impairment | In-house valuation of collateral | Discount rate                                    | 25% - 65%                   |   |
| Interest rate lock commitment | External pricing model           | Pull through rate                                | 93.53                       | % |
| Mortgage servicing rights     | Discounted cash flow             | Constant prepayment rate                         | 8.20% - 10.34%              |   |
|                               |                                  | Discount rate                                    | 9.87% - 11.00%              |   |
| December 31, 2017             |                                  |  |                             |   |
| Loans measured for impairment | In-house valuation of collateral | Discount rate                                    | 32% - 40%                   |   |
|                               | Discounted cash flow             | Discount rate                                    | 14                          | % |
| Other real estate owned       | Fair value of collateral         | Estimated capital costs to complete improvements | 25% - 32%                   |   |
| Interest rate lock commitment | External pricing model           | Pull through rate                                | 93.05                       | % |
| Mortgage servicing rights     | Discounted cash flow             | Constant prepayment rate                         | 8.94% - 11.34%              |   |
|                               |                                  | Discount rate                                    | 9.42% - 10.05%              |   |

## 12. Segment Information

The Company's operations are managed along two operating segments: Community Banking and Home Mortgage Lending. The Community Banking segment's principal business focus is the offering of loan and deposit products to business and consumer customers in its primary market areas. As of September 30, 2018, the Community Banking segment operated 14 branches throughout Alaska. The Home Mortgage Lending segment's principal business focus is the origination and sale of mortgage loans for 1-4 family residential properties.

Summarized financial information for the Company's reportable segments and the reconciliation to the consolidated financial results is shown in the following tables:

| (In Thousands)          | Three Months Ended September 30, 2018 |                       |              |
|-------------------------|---------------------------------------|-----------------------|--------------|
|                         | Community Banking                     | Home Mortgage Lending | Consolidated |
| Interest income         | \$15,923                              | \$657                 | \$16,580     |
| Interest expense        | 565                                   | 196                   | 761          |
| Net interest income     | 15,358                                | 461                   | 15,819       |
| Benefit for loan losses | —                                     | —                     | —            |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|   |         |       |         |
|---|---------|-------|---------|
| Other operating income                            | 2,770   | 5,903 | 8,673   |
| Other operating expense                           | 12,204  | 5,895 | 18,099  |
| Income before provision for income taxes          | 5,924   | 469   | 6,393   |
| Provision for income taxes                        | 996     | 133   | 1,129   |
| Net income attributable to Northrim BanCorp, Inc. | \$4,928 | \$336 | \$5,264 |

| (In Thousands)   | Three Months Ended September 30, 2017 |                       |              |
|--|---------------------------------------|-----------------------|--------------|
|  | Community Banking                     | Home Mortgage Lending | Consolidated |
| Interest income  | \$14,953                              | \$566                 | \$15,519     |
| Interest expense   | 388                                   | 214                   | 602          |
| Net interest income  | 14,565                                | 352                   | 14,917       |
| Provision for loan losses                                    | 2,500                                 | —                     | 2,500        |
| Other operating income                                       | 7,636                                 | 6,219                 | 13,855       |
| Compensation expense - RML acquisition payments              | 149                                   | —                     | 149          |
| Other operating expense                                      | 12,252                                | 5,290                 | 17,542       |
| Income before provision for income taxes                     | 7,300                                 | 1,281                 | 8,581        |
| Provision for income taxes                                   | 2,452                                 | 528                   | 2,980        |
| Net income   | 4,848                                 | 753                   | 5,601        |
| Less: net income attributable to the noncontrolling interest | 78                                    | —                     | 78           |
| Net income attributable to Northrim BanCorp, Inc.            | \$4,770                               | \$753                 | \$5,523      |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

Nine Months Ended September  
30, 2018

| (In Thousands)                                    | Community<br>Banking | Home<br>Mortgage<br>Lending | Consolidated |
|---|----------------------|-----------------------------|--------------|
| Interest income                                   | \$45,443             | \$1,527                     | \$46,970     |
| Interest expense                                  | 1,435                | 464                         | 1,899        |
| Net interest income                               | 44,008               | 1,063                       | 45,071       |
| Benefit for loan losses                           | (300 )               | —                           | (300 )       |
| Other operating income                            | 8,124                | 16,325                      | 24,449       |
| Other operating expense                           | 36,319               | 15,181                      | 51,500       |
| Income before provision for income taxes          | 16,113               | 2,207                       | 18,320       |
| Provision for income taxes                        | 2,537                | 627                         | 3,164        |
| Net income attributable to Northrim BanCorp, Inc. | \$13,576             | \$1,580                     | \$15,156     |

Nine Months Ended September  
30, 2017

| (In Thousands)   | Community<br>Banking | Home<br>Mortgage<br>Lending | Consolidated |
|--|----------------------|-----------------------------|--------------|
| Interest income  | \$43,550             | \$1,326                     | \$44,876     |
| Interest expense   | 1,483                | 399                         | 1,882        |
| Net interest income  | 42,067               | 927                         | 42,994       |
| Provision for loan losses                                    | 3,200                | —                           | 3,200        |
| Other operating income                                       | 14,502               | 18,020                      | 32,522       |
| Compensation expense - RML acquisition payments              | 323                  | —                           | 323          |
| Other operating expense                                      | 37,158               | 15,335                      | 52,493       |
| Income before provision for income taxes                     | 15,888               | 3,612                       | 19,500       |
| Provision for income taxes                                   | 4,745                | 1,491                       | 6,236        |
| Net income   | 11,143               | 2,121                       | 13,264       |
| Less: net income attributable to the noncontrolling interest | 327                  | —                           | 327          |
| Net income attributable to Northrim BanCorp, Inc.            | \$10,816             | \$2,121                     | \$12,937     |

September 30, 2018

| (In Thousands)      | Community<br>Banking | Home<br>Mortgage<br>Lending | Consolidated |
|---------------------|----------------------|-----------------------------|--------------|
| Total assets        | \$1,421,407          | \$81,266                    | \$1,502,673  |
| Loans held for sale | \$—                  | \$56,636                    | \$56,636     |

December 31, 2017

| (In Thousands) | Community<br>Banking | Home<br>Mortgage<br>Lending | Consolidated |
|----------------|----------------------|-----------------------------|--------------|
|----------------|----------------------|-----------------------------|--------------|

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

|                     |             |          |             |
|---------------------|-------------|----------|-------------|
| Total assets        | \$1,452,602 | \$65,994 | \$1,518,596 |
| Loans held for sale | \$—         | \$43,979 | \$43,979    |

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

This discussion should be read in conjunction with the unaudited consolidated financial statements of Northrim BanCorp, Inc. (the "Company") and the notes thereto presented elsewhere in this report and with the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Except as otherwise noted, references to "we", "our", "us" or "the Company" refer to Northrim BanCorp, Inc. and its subsidiaries that are consolidated for financial reporting purposes.

### Note Regarding Forward Looking-Statements

This quarterly report on Form 10-Q includes "forward-looking statements," as that term is defined for purposes of Section 21E of the Securities Exchange Act of 1934, as amended, which are not historical facts. These forward-looking statements describe management's expectations about future events and developments such as future operating results, growth in loans and deposits, continued success of the Company's style of banking, and the strength of the local economy. All statements other than statements of historical fact, including statements regarding industry prospects and future results of operations or financial position, made in this report are forward-looking. We use words such as "anticipate," "believe," "expect," "intend" and similar expressions in part to help identify forward-looking statements. Forward-looking statements reflect management's current plans and expectations and are inherently uncertain. Our actual results may differ significantly from management's expectations, and those variations may be both material and adverse. Forward-looking statements are subject to various risks and uncertainties that may cause our actual results to differ materially and adversely from our expectations as indicated in the forward-looking statements. These risks and uncertainties include: the general condition of, and changes in, the Alaska economy; our ability to maintain or expand our market share or net interest margin; our ability to maintain asset quality; our ability to implement our marketing and growth strategies; and our ability to execute our business plan. Further, actual results may be affected by competition on price and other factors with other financial institutions; customer acceptance of new products and services; the regulatory environment in which we operate; and general trends in the local, regional and national banking industry and economy. Many of these risks, as well as other risks that may have a material adverse impact on our operations and business, are identified in Part II. Item 1A Risk Factors of this report and Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as well as in our other filings with the Securities and Exchange Commission. However, you should be aware that these factors are not an exhaustive list, and you should not assume these are the only factors that may cause our actual results to differ from our expectations. In addition, you should note that forward looking statements are made only as of the date of this report and that we do not intend to update any of the forward-looking statements or the uncertainties that may adversely impact those statements, other than as required by law.

### Critical Accounting Policies

The preparation of the consolidated financial statements requires us to make a number of estimates and assumptions that affect the reported amounts and disclosures in the consolidated financial statements. On an ongoing basis, we evaluate our estimates and assumptions based upon historical experience and various other factors and circumstances. We believe that our estimates and assumptions are reasonable; however, actual results may differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and on our results of operations for the reporting periods.

The accounting policies that involve significant estimates and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities, are considered critical accounting policies. The Company's critical accounting policies include those that address the accounting for the allowance for loan losses ("Allowance"), valuation of goodwill and other intangible assets, the valuation of other real estate owned, and the valuation of mortgage servicing rights. These critical accounting policies are further described in Item 7, Management's Discussion and Analysis, and in Note 1, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Management has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.





### Update on Economic Conditions

According to the Alaska Department of Labor and Workforce Development, Alaska is still losing ground on wages, but the losses are getting smaller. In the fourth quarter of 2017, wages contracted by 0.5%. In addition, the State of Alaska Department of Labor estimates that employment decreased by 0.6% in August of this year compared to August of 2017.

As was widely anticipated, the Federal Open Market Committee ("FOMC") increased the target federal funds rate in September of 2018 from 2.00% to 2.25%. This is the eighth increase since the Fed began normalizing policy in December 2015. Along with the rate increase, the FOMC continued to project one more hike before the end of 2018 and three in 2019.

### Highlights and Summary of Performance - Three and Nine Month Periods ending September 30, 2018

The Company reported net income attributable to the Company and diluted earnings per share of \$5.3 million and \$0.75, respectively, for the third quarter of 2018 compared to net income attributable to the Company and diluted earnings per share of \$5.5 million and \$0.79, respectively, for the third quarter of 2017. This decrease in net income is primarily due to the \$4.4 million gain on the sale of the Company's interest in Northrim Benefits Group, LLC ("NBG") that occurred in the third quarter of 2017. This decrease in revenue was partially offset by an increase in net interest income mostly due to increases in interest rates, a decrease in the provision for loan losses primarily due to improving qualitative factors in the Company's calculation of the Allowance, and a decrease in the provision for income taxes resulting from enacted federal tax legislation that lowered federal corporate tax rates effective January 1, 2018.

The Company reported net income attributable to the Company and diluted earnings per share of \$15.2 million and \$2.17, respectively, for the first nine months of 2018 compared to net income attributable to the Company and diluted earnings per share of \$12.9 million and \$1.85, respectively, for the same period in 2017. This increase in net income is primarily due to an increase in net interest income mostly due to increases in interest rates, a decrease in the provision for loan losses primarily due to improving qualitative factors in the Company's calculation of the Allowance, and a decrease in the provision for income taxes resulting from enacted federal tax legislation that lowered federal corporate tax rates effective January 1, 2018, and a decrease in other operating expense due to one-time costs associated with the core conversion that were incurred in 2017. These changes were only partially offset by the decrease in net income resulting from the sale of the Company's interest in NBG in 2017.

Other financial measures are shown in the table below:

|  | Three Months  |         | Nine Months   |         |
|--|---------------|---------|---------------|---------|
|  | Ended         |         | Ended         |         |
|  | September 30, |         | September 30, |         |
|  | 2018          | 2017    | 2018          | 2017    |
| Return on average assets               | 1.40 %        | 1.44 %  | 1.36 %        | 1.15 %  |
| Return on average shareholders' equity | 10.27 %       | 11.25 % | 10.18 %       | 9.02 %  |
| Dividend payout ratio                  | 35.60 %       | 27.88 % | 34.35 %       | 34.51 % |

### Credit Quality

Nonperforming assets: Nonperforming assets, net of government guarantees at September 30, 2018 decreased \$4.7 million, or 17% to \$24.0 million as compared to \$28.7 million at December 31, 2017. Other real estate owned ("OREO"), net of government guarantees, increased \$110,000 to \$7.4 million at September 30, 2018 as compared to \$7.3 million at December 31, 2017 as additions to OREO, which were comprised of four single-family mortgage properties, were only partially offset by sales of OREO during the period. Nonperforming loans, net of government guarantees decreased \$4.8 million during the first nine months of 2018 as compared to December 31, 2017, primarily due to paydowns. Nonperforming purchased receivables were zero at both September 30, 2018 and December 31, 2017.

The following table summarizes OREO activity for the three and nine-month periods ending September 30, 2018 and 2017:

|  | Three Months<br>Ended<br>September 30,<br>2018 |         | Nine Months<br>Ended<br>September 30,<br>2017 |          |
|--|--|---------|---|----------|
|  | 2018   | 2017    | 2018  | 2017     |
|  | (In Thousands)                                 |         |   |          |
| Balance, beginning of the period                       | \$8,959  | \$4,315 | \$8,651                                       | \$6,574  |
| Transfers from loans                                   | —  | —       | 535   | 167      |
| Proceeds from the sale of other real estate owned      | (336 )   | (950 )  | (612 )  | (3,265 ) |
| Gain on sale of other real estate owned, net           | 84   | 214     | 133   | 369      |
| Impairment on other real estate owned                  | —  | (74 )   | —   | (340 )   |
| Balance at end of period                               | 8,707  | 3,505   | 8,707   | 3,505    |
| Government guarantees                                  | (1,279 )                                       | —       | (1,279 )                                      | —        |
| Balance at end of period, net of government guarantees | \$7,428  | \$3,505 | \$7,428                                       | \$3,505  |

Potential problem loans: Potential problem loans are loans which are currently performing in accordance with contractual terms but that have developed negative indications that the borrower may not be able to comply with present payment terms and which may later be included in nonaccrual, past due, or impaired loans. These loans are closely monitored and their performance is reviewed by management on a regular basis. At September 30, 2018, management had identified potential problem loans of \$15.2 million as compared to potential problem loans of \$9.5 million at December 31, 2017. The increase in potential problem loans from December 31, 2017 to September 30, 2018 is primarily the result of the addition of nine commercial relationships totaling \$9.6 million, net of pay downs of \$3.9 million.

Troubled debt restructurings (“TDRs”): TDRs are those loans for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower, have been granted due to the borrower’s weakened financial condition. Interest on TDRs will be accrued at the restructured rates when it is anticipated that no loss of original principal will occur, and the interest can be collected, which is generally after a period of six months. The Company had \$3.3 million in loans classified as TDRs that were performing and \$14.6 million in TDRs included in nonaccrual loans at September 30, 2018 for a total of approximately \$17.9 million. At December 31, 2017 there were \$7.6 million in loans classified as TDRs that were performing and \$16.2 million in TDRs included in nonaccrual loans for a total of \$23.8 million. The decrease in performing TDRs at September 30, 2018 is primarily the result of the payoff of two loans in the first nine months of 2018. The decrease in TDRs included in nonaccrual loans at September 30, 2018 is the result of pay downs in the first nine months of 2018, which were only partially offset by the restructuring of six loans within two relationships during the same period. See Note 5 of the Notes to Consolidated Financial Statements included in Item 1 of this report for further discussion of TDRs.

## RESULTS OF OPERATIONS

### Income Statement

#### Net Income

Net income attributable to the Company for the third quarter of 2018 decreased \$259,000, or 5%, to \$5.3 million as compared to \$5.5 million for the same period in 2017. Net income attributable to the Company for the first nine months of 2018 increased \$2.2 million, or 17%, to \$15.2 million compared to \$12.9 million in the first nine months of 2017. Both periods included increases in net interest income and decreases in other operating income, the provision for loan losses, and the provision for income taxes.

## Net Interest Income/Net Interest Margin

Net interest income for the third quarter of 2018 increased \$902,000, or 6%, to \$15.8 million as compared to \$14.9 million for the third quarter in 2017. Net interest margin increased 41 basis points to 4.69% in the third quarter of 2018 as compared to 4.28% in the third quarter of 2017. Net interest income for the first nine months of 2018 increased \$2.1 million, or 5%, to \$45.1 million as compared to \$43.0 million for the first nine months of 2017. Net interest margin increased 28 basis points to 4.49% in the first nine months of 2018 as compared to 4.21% in the same period in 2017. The increases in net interest income in both of these periods were primarily the result of higher interest income on loans and both long and short term investments compared to the same periods in 2017. Changes in net interest margin in both the quarter and nine months ended September 30, 2018 as compared to the same period in the prior year are detailed below:

|   | Three<br>Months<br>Ended<br>September<br>30, 2018 | vs.<br>September<br>30, 2017 |
|---|---|------------------------------|
| Nonaccrual interest adjustments           | —   | %                            |
| Interest rates and loan fees              | 0.44  | %                            |
| Volume and mix of interest-earning assets | (0.03)  | %                            |
| Change in NIM                             | 0.41  | %                            |

|   | Nine<br>Months<br>Ended<br>September<br>30, 2018 | vs.<br>September<br>30, 2017 |
|---|--|------------------------------|
| Nonaccrual interest adjustments           | (0.01)   | %                            |
| Interest rates and loan fees              | 0.28   | %                            |
| Volume and mix of interest-earning assets | 0.01   | %                            |
| Change in NIM                             | 0.28   | %                            |

## Components of Net Interest Margin

The following table compares average balances and rates as well as net tax equivalent margins on earning assets for the three-month periods ended September 30, 2018 and 2017:

(Dollars in  
Thousands)

|  | Three Months Ended September 30, |             |            |       | Interest income/<br>expense |          |       |     | Average<br>Yields/Costs<br>Tax Equivalent |        |        |
|--|----------------------------------|-------------|------------|-------|-----------------------------|----------|-------|-----|---|--------|--------|
|  | Average Balances                 |             | Change     |       | 2018                        |          | 2017  |     | Change                                    |        |        |
|  | 2018                             | 2017        | \$         | %     | 2018                        | 2017     | \$    | %   | 2018                                      | 2017   | Change |
| Loans <sup>1,2</sup>   | \$984,914                        | \$1,003,751 | (\$18,837) | (2 )% | \$14,352                    | \$13,800 | \$552 | 4   | % 5.81                                    | % 5.49 | % 0.32 |
| Loans held for sale  | 54,792                           | 57,346      | (2,554)    | (4 )% | 640                         | 541      | 99    | 18  | % 4.64                                    | % 3.74 | % 0.90 |
| Short-term<br>investments <sup>3</sup>                             | 34,136                           | 37,349      | (3,213)    | (9 )% | 169                         | 118      | 51    | 43  | % 1.94                                    | % 1.24 | % 0.70 |
| Long-term<br>investments <sup>4</sup>                              | 264,377                          | 284,806     | (20,429)   | (7 )% | 1,419                       | 1,060    | 359   | 34  | % 2.29                                    | % 1.63 | % 0.66 |
| Total investments  | 298,513                          | 322,155     | (23,642)   | (7 )% | 1,588                       | 1,178    | 410   | 35  | % 2.24                                    | % 1.58 | % 0.66 |
| Interest-earning<br>assets   | 1,338,219                        | 1,383,252   | (45,033)   | (3 )% | 16,580                      | 15,519   | 1,061 | 7   | % 4.97                                    | % 4.51 | % 0.46 |
| Nonearning assets  | 150,808                          | 142,226     | 8,582      | 6     | %                           |          |       |     |   |        |        |
| Total  | \$1,489,027                      | \$1,525,478 | (\$36,451) | (2 )% |                             |          |       |     |   |        |        |
| Interest-bearing<br>demand   | \$242,025                        | \$235,515   | \$6,510    | 3     | % \$51                      | \$19     | \$32  | 168 | % 0.08                                    | % 0.03 | % 0.05 |
| Savings deposits   | 237,838                          | 251,921     | (14,083)   | (6 )% | 156                         | 130      | 26    | 20  | % 0.26                                    | % 0.10 | % 0.16 |
| Money market<br>deposits   | 217,593                          | 234,618     | (17,025)   | (7 )% | 215                         | 105      | 110   | 105 | % 0.39                                    | % 0.09 | % 0.30 |
| Time deposits  | 97,800                           | 117,689     | (19,889)   | (17)% | 173                         | 175      | (2)   | (1) | % 0.70                                    | % 0.58 | % 0.12 |
| Total<br>interest-bearing<br>deposits                              | 795,256                          | 839,743     | (44,487)   | (5 )% | 595                         | 429      | 166   | 39  | % 0.30                                    | % 0.20 | % 0.10 |
| Borrowings   | 46,663                           | 49,223      | (2,560)    | (5 )% | 166                         | 173      | (7)   | (4) | % 1.39                                    | % 1.36 | % 0.03 |
| Total<br>interest-bearing<br>liabilities                           | 841,919                          | 888,966     | (47,047)   | (5 )% | 761                         | 602      | 159   | 26  | % 0.36                                    | % 0.27 | % 0.09 |
| Demand deposits and<br>other<br>noninterest-bearing<br>liabilities | 443,780                          | 441,809     | 1,971      | —     | %                           |          |       |     |   |        |        |
| Equity   | 203,328                          | 194,703     | 8,625      | 4     | %                           |          |       |     |   |        |        |
| Total  | \$1,489,027                      | \$1,525,478 | (\$36,451) | (2 )% |                             |          |       |     |   |        |        |
| Net interest income  |                                  |             |            |       | \$15,819                    | \$14,917 | \$902 | 6   | %   |        |        |
| Net interest margin  |                                  |             |            |       |                             |          |       |     | 4.69%                                     | 4.28%  | 0.41%  |
| Average loans to<br>average<br>interest-earning assets             | 73.60                            | % 72.56     | %          |       |                             |          |       |     |   |        |        |
| Average loans to<br>average total deposits                         | 80.47                            | % 79.49     | %          |       |                             |          |       |     |   |        |        |
|  | 35.03                            | % 33.50     | %          |       |                             |          |       |     |   |        |        |

Average non-interest  
deposits to average  
total deposits  
Average  
interest-earning assets  
to average 158.95 % 155.60 %  
interest-bearing  
liabilities

<sup>1</sup>Interest income includes loan fees. Loan fees recognized during the period and included in the yield calculation totaled \$808,000 and \$856,000 in the third quarter of 2018 and 2017, respectively.

<sup>2</sup>Nonaccrual loans are included with a zero effective yield. Average nonaccrual loans included in the computation of the average loan balances were \$16.3 million and \$21.4 million in the third quarter of 2018 and 2017, respectively.

<sup>3</sup>Consists of interest bearing deposits in other banks.

<sup>4</sup>Consists of investment debt securities available for sale, equity securities, investment securities held to maturity, and investment in Federal Home Loan Bank stock.

The following tables set forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the three-month periods ending September 30, 2018 and 2017. Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rates:

| (In Thousands)          | Three Months Ended               |         |         |
|-------------------------|----------------------------------|---------|---------|
|                         | September 30, 2018<br>vs. 2017   |         |         |
|                         | Increase<br>(decrease)<br>due to |         |         |
|                         | Volume                           | Rate    | Total   |
| <b>Interest Income:</b> |                                  |         |         |
| Loans                   | (\$210)                          | \$762   | \$552   |
| Loans held for sale     | (23 )                            | 122     | 99      |
| Short-term investments  | (9 )                             | 60      | 51      |
| Long-term investments   | (77 )                            | 436     | 359     |
| Total interest income   | (\$319)                          | \$1,380 | \$1,061 |

|                           |         |       |       |
|---------------------------|---------|-------|-------|
| <b>Interest Expense:</b>  |         |       |       |
| Interest-bearing deposits | (\$19 ) | \$185 | \$166 |
| Borrowings                | (12 )   | 5     | (7 )  |
| Total interest expense    | (\$31 ) | \$190 | \$159 |

Edgar Filing: NORTHRIM BANCORP INC - Form 10-Q

The following table compares average balances and rates as well as net tax equivalent margins on earning assets for the nine-month periods ended September 30, 2018 and 2017:

(Dollars in Thousands)

|   | Nine Months Ended September 30, |             |            |        |                             |          |         |      | Average Yields/Costs |         |         |   |
|---|---------------------------------|-------------|------------|--------|-----------------------------|----------|---------|------|----------------------|---------|---------|---|
|   | Average Balances                |             | Change     |        | Interest income/<br>expense |          | Change  |      | Tax Equivalent       |         |         |   |
|   | 2018                            | 2017        | \$         | %      | 2018                        | 2017     | \$      | %    | 2018                 | 2017    | Change  |   |
| Loans <sup>1,2</sup>                                      | \$968,225                       | \$981,220   | (\$12,995) | (1 )%  | \$40,810                    | \$39,908 | \$902   | 2    | % 5.66%              | % 5.48% | % 0.18  | % |
| Loans held for sale                                       | 46,042                          | 44,313      | 1,729      | 4      | % 1,481                     | 1,272    | 209     | 16   | % 4.30%              | % 3.84% | % 0.46  | % |
| Short-term investments <sup>3</sup>                       | 39,335                          | 28,827      | 10,508     | 36     | % 512                       | 230      | 282     | 123  | % 1.72%              | % 1.05% | % 0.67  | % |
| Long-term investments <sup>4</sup>                        | 288,311                         | 311,215     | (22,904)   | (7 )%  | 4,167                       | 3,466    | 701     | 20   | % 2.07%              | % 1.63% | % 0.44  | % |
| Total investments   | 327,646                         | 340,042     | (12,396)   | (4 )%  | 4,679                       | 3,696    | 983     | 27   | % 2.03%              | % 1.58% | % 0.45  | % |
| Interest-earning assets                                   | 1,341,913                       | 1,365,575   | (23,662)   | (2 )%  | 46,970                      | 44,876   | 2,094   | 5    | % 4.73%              | % 4.46% | % 0.27  | % |
| Nonearning assets   | 146,006                         | 142,507     | 3,499      | 2      | %                           |          |         |      |                      |         |         |   |
| Total   | \$1,487,919                     | \$1,508,082 | (\$20,163) | (1 )%  |                             |          |         |      |                      |         |         |   |
| Interest-bearing demand                                   | \$242,646                       | \$213,943   | \$28,703   | 13     | % \$108                     | \$52     | \$56    | 108  | % 0.06%              | % 0.03% | % 0.03  | % |
| Savings deposits  | 242,840                         | 249,695     | (6,855)    | (3 )%  | 405                         | 390      | 15      | 4    | % 0.22%              | % 0.10% | % 0.12  | % |
| Money market deposits                                     | 231,246                         | 239,111     | (7,865)    | (3 )%  | 476                         | 311      | 165     | 53   | % 0.28%              | % 0.09% | % 0.19  | % |
| Time deposits   | 97,607                          | 127,379     | (29,772)   | (23 )% | 424                         | 572      | (148)   | (26) | % 0.58%              | % 0.60% | (0.02)% | % |
| Total interest-bearing deposits                           | 814,339                         | 830,128     | (15,789)   | (2 )%  | 1,413                       | 1,325    | 88      | 7    | % 0.23%              | % 0.21% | % 0.02  | % |
| Borrowings  | 45,943                          | 51,247      | (5,304)    | (10 )% | 486                         | 557      | (71)    | (13) | % 1.39%              | % 1.42% | (0.03)% | % |
| Total interest-bearing liabilities                        | 860,282                         | 881,375     | (21,093)   | (2 )%  | 1,899                       | 1,882    | 17      | 1    | % 0.29%              | % 0.28% | % 0.01  | % |
| Demand deposits and other noninterest-bearing liabilities | 428,575                         | 434,905     | (6,330)    | (1 )%  |                             |          |         |      |                      |         |         |   |
| Equity  | 199,062                         | 191,802     | 7,260      | 4      | %                           |          |         |      |                      |         |         |   |
| Total   | \$1,487,919                     | \$1,508,082 | (\$20,163) | (1 )%  |                             |          |         |      |                      |         |         |   |
| Net interest income                                       |                                 |             |            |        | \$45,071                    | \$42,994 | \$2,077 | 5    | %                    |         |         |   |
| Net interest margin                                       |                                 |             |            |        |                             |          |         |      | 4.49%                | 4.21%   | 0.28    | % |
| Average loans to average interest-earning assets          | 72.15                           | % 71.85     | %          |        |                             |          |         |      |                      |         |         |   |
| Average loans to average total deposits                   | 79.03                           | % 78.73     | %          |        |                             |          |         |      |                      |         |         |   |
|   | 33.53                           | % 33.39     | %          |        |                             |          |         |      |                      |         |         |   |

Average  
 non-interest  
 deposits to average  
 total deposits  
 Average  
 interest-earning  
 assets to average 155.99 % 154.94 %  
 interest-bearing  
 liabilities

<sup>1</sup>Interest income includes loan fees. Loan fees recognized during the period and included in the yield calculation totaled \$2.1 million and \$2.4 million in the first nine months of 2018 and 2017, respectively.

<sup>2</sup>Nonaccrual loans are included with a zero effective yield. Average nonaccrual loans included in the computation of the average loan balances were \$18.1 million and \$16.8 million in the first nine months of 2018 and 2017, respectively.

<sup>3</sup>Consists of interest bearing deposits in other banks.

<sup>4</sup>Consists of investment debt securities available for sale, equity securities, investment securities held to maturity, and investment in Federal Home Loan Bank stock.



The following tables set forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the nine-month periods ending September 30, 2018 and 2017. Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rates:

| (In Thousands)          | Nine Months Ended                |         |         |
|-------------------------|----------------------------------|---------|---------|
|                         | September 30, 2018<br>vs. 2017   |         |         |
|                         | Increase<br>(decrease) due<br>to |         |         |
|                         | Volume                           | Rate    | Total   |
| <b>Interest Income:</b> |                                  |         |         |
| Loans                   | (\$282)                          | \$1,184 | \$902   |
| Loans held for sale     | 52                               | 157     | 209     |
| Short-term investments  | 103                              | 179     | 282     |
| Long-term investments   | (263)                            | 964     | 701     |
| Total interest income   | (\$390)                          | \$2,484 | \$2,094 |

|                           |        |       |      |
|---------------------------|--------|-------|------|
| <b>Interest Expense:</b>  |        |       |      |
| Interest-bearing deposits | (\$22) | \$110 | \$88 |
| Borrowings                | (56)   | (15)  | (71) |
| Total interest expense    | (\$78) | \$95  | \$17 |

#### Provision for Loan Losses

The provision for loan losses was zero for the third quarter of 2018 and was a benefit of \$300,000 for the nine-month period ending September 30, 2018. In the third quarter of 2018, the increase in portfolio loans that would normally result in an increase in the provision for loan losses was offset by an improvement in the qualitative factors that management utilizes in the calculation of the Allowance. Nonperforming loans, net of government guarantees were essentially flat during the third quarter of 2018 and adversely classified loans decreased \$3.5 million to \$29.7 million at September 30, 2018 from \$33.2 million at the end of the second quarter of 2018. The benefit of \$300,000 for the nine-month period ending September 30, 2018 is the result of the impact of improvement in the qualitative factors, which exceeded the impact of the increase in portfolio loans. The ratio of the Allowance to total nonperforming loans, net of government guarantees was 121% at September 30, 2018 as compared to 100% at December 31, 2017.

The provision for loan losses for the three and nine-month periods ending September 30, 2017 was \$2.5 million and \$3.2 million, respectively. While adversely classified loans and delinquencies improved slightly during these periods, the Company's assessment of the severity of credit issues for the largest relationships in this subset of the loan portfolio worsened, which led to higher net charge-offs and an increase in the specific reserve in our allowance for loan losses in the third quarter of 2017.

See "Analysis of the Allowance for Loan Losses" under the "Financial Condition-Balance Sheet Overview" and Note 6 of the Notes to Consolidated Financial Statements included in Item 1 of this report for more information on changes in the Company's Allowance.

### Other Operating Income

Other operating income for the three-month period ended September 30, 2018, decreased \$5.2 million, or 37%, to \$8.7 million as compared to the same period in 2017 primarily due to the \$4.4 million gain on the sale of the Company's interest in NBG that occurred in the third quarter of 2017, a \$609,000 decrease in employee benefit plan income and an \$316,000 decrease in mortgage banking income. Other operating income for the nine-month period ended September 30, 2018, decreased \$8.1 million, or 25%, to \$24.4 million as compared to the same period in 2017 primarily due to the \$4.4 million gain on the sale of the Company's interest in NBG noted above, as well as a \$2.5 million decrease in employee benefit plan income and a \$1.7 million decrease in mortgage banking income. The decrease in employee benefit plan income in both periods resulted from the sale of the Company's interest in NBG in the third quarter of 2017. Decreased mortgage banking income was primarily the result of decreased volume and yield on mortgage loans sold for both periods.

### Other Operating Expense

Other operating expense for the third quarter of 2018 increased \$408,000, or 2%, to \$18.1 million as compared to the same period in 2017 due to a \$605,000, or 11%, increase in the Home Mortgage Lending segment that resulted primarily from an \$804,000 writedown of the carrying value the Company's minority ownership interest in another mortgage origination business owned by RML. This increase was partially offset by a \$197,000 decrease in other operating expenses in the Community Banking segment, which included a \$149,000 decrease in compensation expense for earn out payments related to the acquisition of RML resulting from the decrease in net income from RML in 2018 as compared to 2017.

Other operating expense for the first nine months of 2018 decreased \$1.3 million, or 2%, to \$51.5 million as compared to the same period in 2017 due to a \$1.2 million, or 3%, decrease in the Community Banking segment and a \$154,000, or 1%, decrease in the Home Mortgage Lending segment. In the Community Banking segment, other operating expenses in 2017 included \$943,000 of one-time costs related to the conversion of the Company's core system which occurred in May 2017. Compensation expense for earn out payments related to the acquisition of RML decreased \$323,000 as a result of the decrease in net income from RML in 2018 as compared to 2017. Additionally, occupancy expense included a one-time technical correction that decreased depreciation expense by \$670,000. These decreases were partially offset by increases of \$296,000, \$281,000, and \$219,000, in data processing expense, employee group medical costs, and Company 401(k) match contributions to employees, respectively. The decrease in the expenses in the Home Mortgage Lending segment in the first nine months of 2018 compared to the same period in 2017 is primarily due to a reduction in salaries and benefit costs that resulted from a reduction of full time equivalent employees at RML, which was partially offset by the writedown of the carrying value of the Company's minority ownership interest in the mortgage origination business owned by RML noted above.

### Income Taxes

The provision for income taxes for the three and nine-month periods ending September 30, 2018, decreased \$1.9 million or 62%, and \$3.1 million, or 49%, as compared to the same periods in 2017, primarily due to a decrease in the enacted federal corporate tax rate that was partially offset by an increase in pre-tax income. The effective tax rate for the three-month period ending September 30, 2018 decreased to 18% from 35%, and the effective tax rate for the nine-month period ending June 30, 2018 decreased to 17% from 32% compared to the same periods in 2017.

## FINANCIAL CONDITION

### Balance Sheet Overview

#### Portfolio Investments

Portfolio investments at September 30, 2018 decreased 14%, or \$42.5 million, to \$270.2 million from \$312.8 million at December 31, 2017 as some proceeds from maturities and security calls were invested in portfolio loans in the first nine months of 2018. Additionally, deposits decreased during the same period.

The table below details portfolio investment balances by portfolio investment type:

| (In Thousands)                                  | September 30,<br>2018 |               | December 31,<br>2017 |               |
|---|-----------------------|---------------|----------------------|---------------|
|   | Dollar                | Percent       | Dollar               | Percent       |
|   | Amount                | of<br>Total   | Amount               | of<br>Total   |
|   | Balance               | % of<br>total | Balance              | % of<br>total |
| U.S. Treasury and government sponsored entities | \$205,832             | 76.2 %        | \$249,461            | 79.8 %        |
| Municipal securities                            | 11,843                | 4.4 %         | 14,421               | 4.6 %         |
| Corporate bonds                                 | 40,516                | 15.0 %        | 37,132               | 11.9 %        |
| Collateralized loan obligations                 | 6,002                 | 2.2 %         | 6,005                | 1.9 %         |
| Preferred stock                                 | 6,035                 | 2.2 %         | 5,731                | 1.8 %         |
| Total portfolio investments                     | \$270,228             |               | \$312,750            |               |

#### Loans and Lending Activities

Our loan products include short and medium-term commercial loans, commercial credit lines, construction and real estate loans, and consumer loans. From our inception, we have emphasized commercial, land development and home construction, and commercial real estate lending. This type of lending has generally provided us with market opportunities and higher net interest margins than other types of lending. However, it also involves greater risks, including greater exposure to changes in local economic conditions, than certain other types of lending.

Portfolio loans increased by \$27.1 million, or 3%, to \$982.0 million at September 30, 2018 from \$955.0 million at December 31, 2017, primarily as a result of increased commercial loans and real estate term loans relating to non-owner occupied properties. This increase was partially offset by decreased real estate construction loans in the first nine months of 2018 due to the term out of construction projects that were completed in the first nine months of 2018. Real estate construction one-to-four family loans, which are mostly residential housing construction loans remained consistent at 4% of portfolio loans at September 30, 2018 compared to 3% at December 31, 2017.

The following table details loan balances by loan type as of the dates indicated:

| (In Thousands)  | September 30,<br>2018 |             | December 31,<br>2017 |             |
|---|-----------------------|-------------|----------------------|-------------|
|   | Dollar                | Percent     | Dollar               | Percent     |
|   | Amount                | of<br>Total | Amount               | of<br>Total |
|   |                       |             |                      |             |
| Commercial  | \$333,132             | 33.9 %      | \$313,514            | 32.8 %      |
| Real estate construction one-to-four family                 | 36,119                | 3.7 %       | 31,201               | 3.3 %       |
| Real estate construction other                              | 61,857                | 6.3 %       | 80,093               | 8.4 %       |
| Real estate term owner occupied                             | 130,166               | 13.3 %      | 132,042              | 13.8 %      |
| Real estate term non-owner occupied                         | 340,820               | 34.6 %      | 319,313              | 33.4 %      |
| Real estate term other                                      | 41,493                | 4.2 %       | 40,411               | 4.2 %       |
| Consumer secured by 1st deeds of trust                      | 20,202                | 2.1 %       | 22,616               | 2.4 %       |
| Consumer other  | 22,573                | 2.3 %       | 19,919               | 2.1 %       |
| Subtotal  | \$986,362             |             | \$959,109            |             |
| Less: Unearned origination fee,<br>net of origination costs | (4,355 )              | (0.4 )%     | (4,156 )             | (0.4 )%     |
| Total loans   | \$982,007             |             | \$954,953            |             |

## Information about loans directly exposed to the oil and gas industry

The Company defines "direct exposure" to the oil and gas industry as companies that it has identified as significantly reliant upon activity related to the oil and gas industry, such as oilfield services, lodging, equipment rental, transportation, and other logistic services specific to the industry. The Company estimates that \$55.7 million, or approximately 6% of loans as of September 30, 2018 have direct exposure to the oil and gas industry as compared to \$70.8 million, or approximately 7% of loans as of December 31, 2017. The Company has no loans to oil producers or exploration companies as of September 30, 2018 or December 31, 2017, but the totals noted include a loan related to construction of an oil rig. The balance of this loan was \$8.0 million and \$9.2 million at September 30, 2018 and December 31, 2017, respectively, and is classified as an AQR pass loan in both periods. The Company's unfunded commitments to borrowers that have direct exposure to the oil and gas industry was \$38.5 million and \$53.5 million at September 30, 2018 and December 31, 2017, respectively. The portion of the Company's allowance for loan losses that related to the loans with direct exposure to the oil and gas industry was estimated at \$1.2 million and \$1.8 million as of September 30, 2018 and December 31, 2017, respectively.

The following table details loan balances by loan segment and class of financing receivable for loans with direct oil and gas exposure as of the dates indicated:

| (In Thousands)      | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Total    |
|---------------------|------------|---|--------------------------------|---------------------------------|-------------------------------------|------------------------|--|----------------|----------|
| September 30, 2018  |            |   |                                |                                 |                                     |                        |  |                |          |
| AQR Pass            | \$35,645   | \$—   | \$—                            | \$7,918                         | \$7,485                             | \$—                    | \$—                                    | \$408          | \$51,456 |
| AQR Special Mention | —          | —   | —                              | 2,325                           | —                                   | —                      | —                                      | —              | 2,325    |
| AQR Substandard     | 1,837      | —   | —                              | 50                              | —                                   | —                      | —                                      | —              | 1,887    |
| Total               | \$37,482   | \$—   | \$—                            | \$10,293                        | \$7,485                             | \$—                    | \$—                                    | \$408          | \$55,668 |
| December 31, 2017   |            |   |                                |                                 |                                     |                        |  |                |          |
| AQR Pass            | \$48,601   | \$—   | \$—                            | \$9,731                         | \$7,778                             | \$—                    | \$—                                    | \$435          | \$66,545 |
| AQR Substandard     | 4,234      | —   | —                              | —                               | —                                   | —                      | —                                      | —              | 4,234    |
| Total               | \$52,835   | \$—   | \$—                            | \$9,731                         | \$7,778                             | \$—                    | \$—                                    | \$435          | \$70,779 |

## Analysis of Allowance for Loan Losses

The Company maintains an Allowance to reflect management's assessment of probable, estimable losses inherent in the loan portfolio. The Allowance is increased by provisions for loan losses and loan recoveries and decreased by loan charge-offs. The size of the Allowance is determined through quarterly assessments of probable estimated losses in the loan portfolio. Our methodology for making such assessments and determining the adequacy of the Allowance includes the following key elements:

▲ specific allocation for impaired loans. Management determines the fair value of the majority of these loans based on the underlying collateral values. This analysis is based upon a specific analysis for each impaired loan, including external appraisals on loans secured by real property, management's assessment of the current market, recent payment history, and an evaluation of other sources of repayment. In-house evaluations of fair value are used in the impairment analysis in some situations. Inputs to the in-house evaluation process include information about sales of comparable properties in the appropriate markets and changes in tax assessed values. The Company obtains appraisals on real and personal property that secure its loans during the loan origination process in accordance with regulatory guidance and its loan policy. The Company obtains updated appraisals on loans secured by real or personal property based upon its

assessment of changes in the current market or particular projects or properties, information from other current appraisals, and other sources of information. Appraisals may be adjusted downward by the Company based on its evaluation of the facts and circumstances on a case by case basis. External appraisals may be discounted when management believes that the absorption period used in the appraisal is unrealistic, when expected liquidation costs exceed those included in the appraisal, or when management's evaluation of deteriorating market conditions warrants an adjustment. Additionally, the Company may also adjust appraisals in the above circumstances between appraisal dates. The Company uses the information provided in these updated appraisals along with its evaluation of all other information available on a particular property as it assesses the collateral coverage on its performing and nonperforming loans and the impact that may have on the adequacy of its Allowance. The specific allowance for impaired loans, as well as the overall Allowance, may increase based on the Company's assessment of updated appraisals. See Note 11 of the Notes to Consolidated Financial

Statements included in Item 1 of this report for further discussion of the Company's estimation of impaired loans measured at fair value.

When the Company determines that a loss has occurred on an impaired loan, a charge-off equal to the difference between carrying value and fair value is recorded. If a specific allowance is deemed necessary for a loan, and then that loan is partially charged off, the loan remains classified as a nonperforming loan after the charge-off is recognized.

A general allocation. The Company has identified segments and classes of loans not considered impaired for purposes of establishing the general allocation allowance. The Company disaggregates the loan portfolio into segments and classes based on its assessment of how different pools of loans with like characteristics in the portfolio behave over time. This determination is based on historical experience and management's assessment of how current facts and circumstances are expected to affect the loan portfolio.

The Company first disaggregates the loan portfolio into the following eight segments: commercial, real estate construction one-to-four family, real estate construction other, real estate term owner occupied, real estate term non-owner occupied, real estate term other, consumer secured by 1st deeds of trust, and other consumer loans. After division of the loan portfolio into segments, the Company then further disaggregates each of the segments into classes. The Company has a total of five classes, which are based off of the Company's loan risk grading system known as the Asset Quality Rating ("AQR") system. The risk ratings are discussed in Note 5 to the Consolidated Financial Statements included in Item 8 of the Company's Annual Report on Form 10-K for the year ending December 31, 2017. There are five loan classes: pass (pass AQR grades, which are grades 1 – 6), special mention, substandard, doubtful, and loss. There have been no changes to these loan classes in 2018.

After the portfolio has been disaggregated into segments and classes, the Company calculates a general reserve for each segment and class based on the average loss history for each segment and class. The Company uses a look-back period of five years in the calculation of average historical loss rates. After the Company calculates a general allocation using our loss history, the general reserve is then adjusted for qualitative factors by segment and class. Qualitative factors are based on management's assessment of current trends that may cause losses inherent in the current loan portfolio to differ significantly from historical losses. Some factors that management considers in determining the qualitative adjustment to the general reserve include our concentration of large borrowers; national and local economic trends; general business conditions; trends in local real estate markets; economic, political, and industry specific factors that affect resource development in Alaska; effects of various political activities; peer group data; and internal factors such as underwriting policies and expertise of the Company's employees.

An unallocated reserve. The unallocated portion of the Allowance provides for other credit losses inherent in our loan portfolio that may not have been contemplated in the specific and general components of the Allowance, and it acknowledges the inherent imprecision of all loss prediction models. The unallocated component is reviewed periodically based on trends in credit losses and overall economic conditions. At September 30, 2018 and December 31, 2017, the unallocated allowance as a percentage of the total Allowance was 13% and 16%, respectively.

The following table sets forth information regarding changes in the Allowance for the periods indicated:

| (In Thousands)                         | Three Months    |          | Nine Months     |          |
|--|-----------------|----------|-----------------|----------|
|  | Ended September |          | Ended September |          |
|  | 30,             | 30,      | 30,             | 30,      |
|  | 2018            | 2017     | 2018            | 2017     |
| Balance at beginning of period         | \$20,108        | \$20,061 | \$21,461        | \$19,697 |
| Charge-offs:                           |                 |          |                 |          |
| Commercial                             | —               | 1,118    | 1,042           | 1,582    |
| Real estate term other                 | —               | —        | —               | 5        |
| Consumer secured by 1st deeds of trust | —               | 85       | 91              | 85       |
| Consumer other                         | 9               | —        | 80              | 17       |
| Total charge-offs                      | 9               | 1,203    | 1,213           | 1,689    |
| Recoveries:                            |                 |          |                 |          |
| Commercial                             | 57              | 102      | 200             | 246      |
| Real estate term other                 | 1               | —        | 3               | —        |
| Consumer secured by 1st deeds of trust | 1               | —        | 2               | 2        |
| Consumer other                         | 2               | 4        | 7               | 8        |
| Total recoveries                       | 61              | 106      | 212             | 256      |
| Net, (recoveries) charge-offs          | (52 )           | 1,097    | 1,001           | 1,433    |
| (Benefit) provision for loan losses    | —               | 2,500    | (300 )          | 3,200    |
| Balance at end of period               | \$20,160        | \$21,464 | \$20,160        | \$21,464 |

While management believes that it uses the best information available to determine the Allowance, unforeseen market conditions and other events could result in adjustment to the Allowance, and net income could be significantly affected if circumstances differed substantially from the assumptions used in making the final determination of the Allowance. Moreover, bank regulators frequently monitor banks' loan loss allowances, and if regulators were to determine that the Company's Allowance is inadequate, they may require the Company to increase the Allowance, which may adversely impact the Company's net income and financial condition.

#### Deposits

Deposits are the Company's primary source of funds. Total deposits decreased \$25.0 million to \$1.233 billion at September 30, 2018 from \$1.258 billion at December 31, 2017. The following table summarizes the Company's composition of deposits as of the periods indicated:

| (In thousands)          | September 30, |            | December 31, |            |
|-------------------------|---------------|------------|--------------|------------|
|                         | 2018          | 2017       | 2018         | 2017       |
|                         | Balance       | % of total | Balance      | % of total |
| Demand deposits         | \$450,409     | 36 %       | \$414,686    | 33 %       |
| Interest-bearing demand | 240,974       | 20 %       | 252,009      | 20 %       |
| Savings deposits        | 233,611       | 19 %       | 247,458      | 20 %       |
| Money market deposits   | 208,614       | 17 %       | 243,603      | 19 %       |
| Time deposits           | 99,660        | 8 %        | 100,527      | 8 %        |
| Total deposits          | \$1,233,268   |            | \$1,258,283  |            |

The Company's mix of deposits continues to contribute to a low cost of funds with balances in transaction accounts representing 92% of total deposits at both September 30, 2018 and December 31, 2017.

The only deposit category with stated maturity dates is certificates of deposit. At September 30, 2018, the Company had \$99.7 million in certificates of deposit as compared to certificates of deposit of \$100.5 million at December 31, 2017. At September 30, 2018, \$55.6 million, or 56%, of the Company's certificates of deposits are scheduled to mature over the next 12 months as compared to \$66.0 million, or 66%, of total certificates of deposit at December 31, 2017. The aggregate amount of certificates of deposit in amounts of \$100,000 and greater at September 30, 2018 and December 31, 2017, was \$62.7 million and





\$61.4 million, respectively. The following table sets forth the amount outstanding of deposits in amounts of \$100,000 and greater by time remaining until maturity and percentage of total deposits as of September 30, 2018:

| (In Thousands)           | Time Certificates<br>of Deposit<br>of \$100,000 or<br>More |                                 |   |
|--------------------------|--|---------------------------------|---|
|                          | Amount   | Percent<br>of Total<br>Deposits |   |
| Amounts maturing in:     |  |                                 |   |
| Three months or less     | \$8,284  | 13                              | % |
| Over 3 through 6 months  | 7,811  | 12                              | % |
| Over 6 through 12 months | 17,152   | 27                              | % |
| Over 12 months           | 29,458   | 48                              | % |
| Total                    | \$62,705   | 100                             | % |

There were no depositors with deposits representing 10% or more of total deposits at September 30, 2018 or December 31, 2017.

#### Borrowings

FHLB: Northrim Bank (the "Bank") is a member of the Federal Home Loan Bank of Des Moines (the "FHLB"). As a member, the Bank is eligible to obtain advances from the FHLB. FHLB advances are dependent on the availability of acceptable collateral such as marketable securities or real estate loans, although all FHLB advances are secured by a blanket pledge of the Bank's assets. At September 30, 2018, our maximum borrowing line from the FHLB was \$669.3 million, approximately 45% of the Bank's assets, subject to the FHLB's collateral requirements. The Company has outstanding advances of \$7.3 million as of September 30, 2018 which were originated to match fund low income housing projects that qualify for long term fixed interest rates. The first advance is a \$2.0 million FHLB Community Investment Program advance which was originated on March 22, 2013. It has an eighteen year term with a 30 year amortization period, which mirrors the term of the term real estate loan made to the borrower, and a fixed rate of 3.12%. The second advance is a \$2.2 million FHLB Community Investment Cash Advance Program advance that was originated in the second quarter of 2016. This advance has a 20 year term with a 30 year amortization period, which mirrors the term of the term real estate loan made to the borrower, and a fixed interest rate of 2.61%. The last advance is a \$3.1 million FHLB Community Investment Cash Advance Program advance that was originated in the third quarter of 2017. This advance has a 20 year term with a 30 year amortization period and a fixed interest rate of 3.25%, which mirrors the term of the loan made to the borrower. All of these FHLB advances are included in borrowings.

Federal Reserve Bank: The Federal Reserve Bank of San Francisco (the "Federal Reserve Bank") is holding \$83.8 million of loans as collateral to secure advances made through the discount window on September 30, 2018. There were no discount window advances outstanding at September 30, 2018 or December 31, 2017.

Other Short-term Borrowings: Securities sold under agreements to repurchase were \$32.4 million and \$27.7 million, respectively, for September 30, 2018 and December 31, 2017. The average balance outstanding of securities sold under agreements to repurchase during the three-month periods ending September 30, 2018 and 2017 was \$29.1 million and \$28.9 million, respectively, and \$28.3 million and \$28.4 million, respectively, in the nine-month periods ending September 30, 2018 and 2017. The maximum outstanding at any month-end was \$32.4 million and \$31.1 million, respectively, during the same three-month periods ending September 30, 2018 and 2017 and \$32.4 and \$31.8 million, respectively, for the nine-month periods ending September 30, 2018 and 2017. The securities sold under agreements to repurchase are held by the FHLB under the Company's control.

The Company is subject to provisions under Alaska state law, which generally limit the amount of outstanding debt to 15% of total assets or \$225.4 million and \$225.8 million at September 30, 2018 and December 31, 2017, respectively.

At September 30, 2018 and December 31, 2017, the Company had no short-term (original maturity of one year or less) borrowings that exceeded 30% of shareholders' equity.

Long-term Borrowings. The Company had no long-term borrowing outstanding other than the FHLB advance noted above as of September 30, 2018 or December 31, 2017.

### Liquidity and Capital Resources

The Company is a single bank holding company and its primary ongoing source of liquidity is from dividends received from the Bank. Such dividends arise from the cash flow and earnings of the Bank. Banking regulations and regulatory authorities may limit the amount of, or require the Bank to obtain certain approvals before paying, dividends to the Company. Given that the Bank currently meets and the Bank anticipates that it will continue to meet, all applicable capital adequacy requirements for a “well-capitalized” institution by regulatory standards, the Company expects to continue to receive dividends from the Bank during the remainder of 2018.

The Company manages its liquidity through its Asset and Liability Committee. Our primary sources of funds are customer deposits and advances from the FHLB. These funds, together with loan repayments, loan sales, other borrowed funds, retained earnings, and equity are used to make loans, to acquire securities and other assets, and to fund deposit flows and continuing operations. The primary sources of demands on our liquidity are customer demands for withdrawal of deposits and borrowers' demands that we advance funds against unfunded lending commitments. Our total unfunded commitments to fund loans and letters of credit at September 30, 2018 were \$265.8 million. We do not expect that all of these loans are likely to be fully drawn upon at any one time. Additionally, as noted above, our total deposits at September 30, 2018 were \$1.233 billion.

As shown in the Consolidated Statements of Cash Flows included in Part I - Item 1 "Financial Statements" of this report, net cash used in operating activities was \$2.2 million for the first nine months of 2018 primarily due to a decrease in other liabilities as the Company funded prior commitments to invest in low income housing tax credit partnerships and cash used in connection with the origination of loans held for sale being only partially offset by proceeds from the sale of loans held for sale. Net cash provided by investing activities was \$19.9 million for the same period, primarily due to proceeds from maturities of investment securities, which were only partially offset by cash invested into portfolio loans and purchases of new investment securities. Net cash used in financing activities in the same period was \$25.4 million, primarily due to a decrease in deposits.

The sources by which we meet the liquidity needs of our customers are current assets and borrowings available through our correspondent banking relationships and our credit lines with the Federal Reserve Bank and the FHLB. At September 30, 2018, our funds available for borrowing under our existing lines of credit were \$744.4 million.

Given these sources of liquidity and our expectations for customer demands for cash and for our operating cash needs, we believe our sources of liquidity to be sufficient to fund our ongoing operating activities and our anticipated capital requirements for at least 12 months.

The Company issued 12,423 shares of its common stock in the first nine months of 2018 and did not repurchase any shares of its common stock under the Company's publicly announced repurchase program. At September 30, 2018, the Company had 6,884,386 shares of its common stock outstanding.

### Capital Requirements and Ratios

We are subject to minimum capital requirements. Federal banking agencies have adopted regulations establishing minimum requirements for the capital adequacy of banks and bank holding companies. The requirements address both risk-based capital and leverage capital. We believe as of September 30, 2018, that the Company and the Bank met all applicable capital adequacy requirements for a “well-capitalized” institution by regulatory standards.

The table below illustrates the capital requirements in effect in 2018 for the Company and the Bank and the actual capital ratios for each entity that exceed these requirements. Management intends to maintain capital ratios for the Bank in 2018, exceeding the FDIC's requirements for the “well-capitalized” classification. The capital ratios for the Company exceed those for the Bank primarily because the \$10 million trust preferred securities offering completed in the fourth quarter of 2005 is included in the Company's capital for regulatory purposes, although they are accounted for as a long-term debt in our financial statements. The trust preferred securities are not accounted for on the Bank's financial statements nor are they included in its capital. As a result, the Company has \$10 million more in regulatory capital than the Bank at both September 30, 2018 and December 31, 2017, which explains most of the difference in the capital ratios for the two entities.



|                              | Minimum Required<br>Capital | Well-Capitalized | Actual Ratio<br>Company | Actual Ratio Bank |
|------------------------------|-----------------------------|------------------|-------------------------|-------------------|
| September 30, 2018           |                             |                  |                         |                   |
| Total risk-based capital     | 8.00%                       | 10.00%           | 16.58%                  | 14.36%            |
| Tier 1 risk-based capital    | 6.00%                       | 8.00%            | 15.33%                  | 13.11%            |
| Common equity tier 1 capital | 4.50%                       | 6.50%            | 14.58%                  | 13.11%            |
| Leverage ratio               | 4.00%                       | 5.00%            | 13.41%                  | 11.48%            |
| December 31, 2017            |                             |                  |                         |                   |
| Total risk-based capital     | 8.00%                       | 10.00%           | 15.90%                  | 14.08%            |
| Tier 1 risk-based capital    | 6.00%                       | 8.00%            | 14.65%                  | 12.83%            |
| Common equity tier 1 capital | 4.50%                       | 6.50%            | 13.89%                  | 12.83%            |
| Leverage ratio               | 4.00%                       | 5.00%            | 12.41%                  | 10.87%            |

See Note 21 of the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for a detailed discussion of the capital ratios. The requirements for "well-capitalized" come from the Prompt Correction Action rules. See Item 1 - Business - Supervision and Regulation in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. These rules apply to the Bank but not to the Company. Under the rules of the Federal Reserve Bank, a bank holding company such as the Company is generally defined to be "well capitalized" if its Tier 1 risk-based capital ratio is 8.0% or more and its total risk-based capital ratio is 10.0% or more.

#### Off-Balance Sheet Items

The Company is a party to financial instruments with off-balance sheet risk. Among the off-balance sheet items entered into in the ordinary course of business are commitments to extend credit, commitments to originate loans held for sale and the issuance of letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized on the balance sheet. Certain commitments are collateralized. We apply the same credit standards to these commitments as in all of our lending activities and include these commitments in our lending risk evaluations. As of September 30, 2018 and December 31, 2017, the Company's commitments to extend credit and to provide letters of credit which are not reflected on its balance sheet amounted to \$265.8 million and \$291.5 million, respectively. Additionally, the Company had commitments to originate loans held for sale of \$69.0 million and \$43.6 million, as of September 30, 2018 and December 31, 2017, respectively. Since many of the commitments are expected to expire without being drawn upon, these total commitment amounts do not necessarily represent future cash requirements. The Company has established reserves of \$131,000 and \$152,000 at September 30, 2018 and December 31, 2017 respectively, for losses related to these commitments that are recorded in other liabilities on the consolidated balance sheet.

#### Capital Expenditures and Commitments

The Company has capital commitments related to planned improvements to the Company's corporate office building, a new branch, and other branch improvements. At September 30, 2018 the Company considers these commitments to be immaterial.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our assessment of market risk as of September 30, 2018 indicates that there are no material changes in the quantitative and qualitative disclosures from those in our Annual Report on Form 10-K for the year ended December 31, 2017.

### ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934). Our principal executive and financial officers supervised and participated in this evaluation. Based on this evaluation, our principal executive and financial officers each concluded that as of September 30, 2018, the disclosure controls and procedures are effective in timely alerting them to material information required to be included in the periodic reports to the Securities and Exchange Commission. The design of any system of controls is based in part upon various assumptions about the likelihood of future events, and there can be no assurance that any of our plans, products, services or procedures will succeed in achieving their intended goals under future conditions.

#### Changes in Internal Control over Disclosure and Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15-d-15(f) of the Securities Exchange Act of 1934) that occurred during the quarterly period ended September 30, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

During the normal course of its business, the Company is a party to various debtor-creditor legal actions, disputes, claims, and litigation related to the conduct of its banking business. These include cases filed as a plaintiff in collection and foreclosure cases, and the enforcement of creditors' rights in bankruptcy proceedings. Management does not expect that the resolution of these matters will have a material effect on the Company's business, financial position, results of operations, or cash flows.

#### ITEM 1A. RISK FACTORS

For information regarding risk factors, please refer to Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. These risk factors have not materially changed as of September 30, 2018.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a)-(b) Not applicable

(c) There were no stock repurchases by the Company during the nine-month period ending September 30, 2018.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

(a) Not applicable

(b) There have been no material changes to the procedures by which shareholders may nominate directors to the Company's board of directors.

ITEM 6. EXHIBITS

31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a)

31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)

32.1 Certification of Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

32.2 Certification of Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

101.INS XBRL Instance Document

101.SCH XBRL Schema Document

101.CALXBRL Calculation Linkbase Document

101.LABXBRL Labels Linkbase Document

101.PRE XBRL Presentation Linkbase Document

101.DEF XBRL Definition Linkbase Document

Notes to Exhibits List:

---

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheet, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income and Changes in Shareholders' Equity, (iv) Consolidated Statements of Cash Flows, and (v) Notes to the Consolidated Financial Statements. In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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.

NORTHRIM BANCORP, INC.

November 7, 2018 By/s/ Joseph M. Schierhorn

Joseph M. Schierhorn  
Chairman, President, Chief Executive Officer  
and Chief Operating Officer  
(Principal Executive Officer)

November 7, 2018 By/s/ Jed W. Ballard

Jed W. Ballard  
Executive Vice President, Chief Financial Officer  
(Principal Financial and Accounting Officer)