Redwood Capital Bancorp

Audited Financial Statements

December 31, 2018

Redwood Capital Bancorp

April 15, 2019

Dear Shareholders,

2018 was another milestone year for Redwood Capital Bancorp (the "Company") and Redwood Capital Bank (the "Bank"). As we celebrate the Bank's thirteenth consecutive year of profitability, the Board of Directors and management team remain encouraged by the continued success of the Bank. With shareholder value and community service as core values, the Company's strong performance and financial position continue to increase our ability to serve all our stakeholders.

Last year, the Bank again garnered three prestigious awards for its financial performance and customer service. We received the distinction of being one of California's *Super Premier Performing Banks* by *The Findley Reports* and the *5-Star* designation from *Bauer Financial, Inc.* These are the highest ratings available from both well-known and respected bank rating firms. On a local level, readers of the *Times-Standard* voted the Bank as the "Best Bank" in their 2018 *Best of the North Coast Reader's Choice Awards*.

In 2018, the Company's net income after taxes was $4.14 million, or $2.12 per common share, fully diluted. The Company's earnings were driven by growing the earning assets of the Bank while controlling credit-related expenses as well as a reduced federal tax rate. With the impact of tax changes, earnings are up 60% year-over-year. Without the impact of tax changes and extraordinary items, earnings are up 17.34%. Loans grew by $23.3 million in 2018, while deposits grew by $23 million. The Bank's balance sheet is supported by a Leverage Capital Ratio of 8.66% at year-end 2018 compared to 7.98% at year-end 2017. The Leverage Capital Ratio exceeds the regulatory benchmark for well-capitalized institutions of 5.00%. Overall, the balance sheet remains very strong and is well positioned.

Maximizing shareholder wealth continues to be a top priority for the Company's Board of Directors and management team. In June of 2012, the Company paid its first quarterly cash dividend of $0.05 per share which was increased to $0.055 per share in May, 2013, to $0.06 per share in May, 2014, to $0.065 per share in August, 2017 and to $0.07 per share in May, 2018. As of March 31, 2019, RWCB stock was trading at $17.00 compared to $16.60 in March of 2018. During this same time period, the book value of RWCB stock increased from $12.86 per share to $14.75 per share. The increase in book value combined with the cash dividends of $0.28 resulted in a total return of 16.87%.

I would like to recognize Directors Craig Perrone, Jack Selvage and Larry DeBeni for their years of service to the Bank and its shareholders. These three founding directors were very active in the establishment of the Bank. I am very pleased to welcome Jeff Nelson and Michele Rieke to the Company's and the Bank's Boards of Directors. Their expansive expertise and leadership are just two of the many qualities that they will bring to the Boards of Directors.

There is a great deal of positive momentum as we move further into 2019. In January, 2019, the Bank received the Large Business of the Year award at the Greater Eureka Chamber of Commerce Annual Dinner. Our fourth branch location in Henderson Center, Eureka opened on Valentine's Day and March, 2019 marked the Bank's 15-year anniversary.

On behalf of our staff, senior management team and Board of Directors, thank you for the trust you have placed in us and the relationships we have developed over the past 15 years. Taking care of our shareholders and customers is paramount to how we do business every day. We look forward to seeing you at our annual shareholder meeting on Wednesday, May 15, 2019, at 6:00 p.m. at the Sequoia Conference Center, located at 901 Myrtle Avenue in Eureka.

Sincerely,

REDWOOD CAPITAL BANCORP

John E. Dalby
President & CEO

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INDEPENDENT AUDITOR'S REPORT

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary
Eureka, California

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Redwood Capital Bancorp and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

The Shareholders and
Board of Directors
Redwood Capital Bancorp and Subsidiary

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Redwood Capital Bancorp and Subsidiary, as of December 31, 2018 and 2017, and the results of their operations, comprehensive income, and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Richardson & Company, LLP

March 25, 2019

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2018 and 2017

	2018	2017
ASSETS		
Cash and due from banks	$ 10,575,709	$ 10,356,922
Federal funds sold	19,612,000	3,139,000
Interest-bearing deposits in other financial institutions	9,187,810	25,669,044
Cash and cash equivalents	39,375,519	39,164,966
Investment securities available-for-sale, at fair value	33,172,889	34,488,848
Mortgages held for sale	629,331	642,901
Loans, net of allowance of $4,043,836 and $3,655,651 as of December 31, 2018 and 2017, respectively	274,244,497	250,910,583
Premises and equipment, net	6,688,971	4,592,169
Cash surrender value of life insurance	8,072,796	6,620,332
Mortgage servicing rights, at fair value	1,001,757	785,432
Accrued interest receivable and other assets	5,549,962	5,384,824
TOTAL ASSETS	$ 368,735,722	$ 342,590,055
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Deposits		
Non interest-bearing	$ 95,624,755	$ 93,603,793
Interest-bearing	239,113,579	218,129,024
Total deposits	334,738,334	311,732,817
Borrowings	4,221,875	4,825,000
Accrued interest payable and other liabilities	2,200,241	2,019,101
TOTAL LIABILITIES	341,160,450	318,576,918
Commitments and contingencies (see accompanying notes)		
SHAREHOLDERS' EQUITY		
Common stock, no par value; 30,000,000 shares authorized; 1,945,337 and 1,924,157 shares issued and outstanding in 2018 and 2017	13,512,173	13,350,563
Additional paid-in capital	179,386	208,084
Retained earnings	14,224,468	10,616,449
Accumulated other comprehensive loss	(340,755)	(161,959)
TOTAL SHAREHOLDERS' EQUITY	27,575,272	24,013,137
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 368,735,722	$ 342,590,055

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2018 and 2017

	2018	2017
INTEREST INCOME		
Interest and fees on loans	$ 13,061,575	$ 12,080,268
Interest on taxable investment securities	695,671	610,216
Dividend income	155,584	126,736
Interest on federal funds sold	341,345	230,588
Interest on deposits in banks	195,709	115,471
Total interest income	14,449,884	13,163,279
INTEREST EXPENSE		
Interest on deposits	581,429	510,174
Interest on other borrowings	282,336	244,161
Total interest expense	863,765	754,335
NET INTEREST INCOME	13,586,119	12,408,944
Provision for loan losses	321,000	140,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	13,265,119	12,268,944
OTHER INCOME		
Service charges and fees	957,055	842,344
Mortgage banking revenue, net	691,240	623,777
Other income	747,704	423,192
Total other income	2,395,999	1,889,313
OTHER EXPENSES		
Salaries and employee benefits	5,554,722	4,995,008
Occupancy and equipment	952,548	939,174
Other	3,470,359	3,193,056
Total other expenses	9,977,629	9,127,238
INCOME BEFORE PROVISION FOR INCOME TAXES	5,683,489	5,031,019
Provision for income taxes	1,543,392	2,465,877
NET INCOME	$ 4,140,097	$ 2,565,142
NET INCOME PER SHARE	$ 2.14	$ 1.34
NET INCOME PER SHARE – ASSUMING DILUTION	$ 2.12	$ 1.32

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31, 2018 and 2017

	2018	2017
NET INCOME	$ 4,140,097	$ 2,565,142
Other comprehensive income (loss), net of tax		
Available for sale securities		
Unrealized gains (losses) arising during the year, net of tax expense (benefit) of $75,032 and $28,086 as of 2018 and 2017, respectively	(178,796)	(40,167)
Effect of new tax rates		(26,649)
Total other comprehensive income	(178,796)	(66,816)
COMPREHENSIVE INCOME	$ 3,961,301	$ 2,498,326

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the Years Ended December 31, 2018 and 2017

	Common Stock		Additional		Accumulated Other	Total
	Shares	Amount	Paid-In Capital	Retained Earnings	Comprehensive Income (Loss)	Shareholders' Equity
Balance at January 1, 2017	1,903,575	$ 13,209,339	$ 236,038	$ 8,503,237	$ (95,143)	$ 21,853,471
Cash dividends on common stock ($0.25 per share)				(478,579)		(478,579)
Dividends on preferred stock						
Redemption and retirement of stock	(5,950)	(118,799)				(118,799)
Restricted stock expense			232,069			232,069
Restricted stock vested	26,532	260,023	(260,023)			
Net income				2,565,142		2,565,142
Other comprehensive loss, net of taxes					(40,167)	(40,167)
Effect of new tax rates from Tax Cuts and Jobs Act of 2017				26,649	(26,649)	
Balance at December 31, 2017	1,924,157	13,350,563	208,084	10,616,449	(161,959)	24,013,137
Cash dividends on common stock ($0.275 per share)				(532,078)		(532,078)
Redemption and retirement of stock	(6,336)	(116,034)				(116,034)
Restricted stock expense			248,946			248,946
Restricted stock vested	27,516	277,644	(277,644)			
Net income				4,140,097		4,140,097
Other comprehensive loss, net of taxes					(178,796)	(178,796)
Balance at December 31, 2018	1,945,337	$ 13,512,173	$ 179,386	$ 14,224,468	$ (340,755)	$ 27,575,272

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

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2018 and 2017

	2018	2017
OPERATING ACTIVITIES		
Net income	$ 4,140,097	$ 2,565,142
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	321,000	140,000
Deferred loan origination fees and costs, net	25,594	(30,098)
Realized loss on premises and equipment disposals	24,815	
Depreciation and amortization	604,232	639,882
Change in mortgage servicing rights carried at fair value	(216,325)	
Stock-based compensation expense	248,946	232,069
Net change in loans held for sale	13,570	(65,767)
Earnings on cash surrender value of life insurance	47,536	(178,888)
Net change in accrued interest receivable and other assets	(21,306)	457,481
Net change in accrued interest payable and other liabilities	181,140	202,185
NET CASH PROVIDED BY OPERATING ACTIVITIES	5,369,299	3,962,006
INVESTING ACTIVITIES		
Purchase of available-for-sale investment securities	(6,855,766)	(5,261,246)
Proceeds from maturity of available-for-sale investment securities	2,000,000	345,000
Proceeds from paydowns on mortgage-backed securities	5,575,446	3,527,249
Purchase of Federal Home Loan Bank stock	(68,800)	(220,700)
Purchases of life insurance	(1,500,000)	
Loan originations and payments, net	(23,680,508)	(10,483,383)
Purchases of premises and equipment	(2,383,398)	(79,985)
NET CASH USED BY INVESTING ACTIVITIES	(26,913,026)	(12,173,065)
FINANCING ACTIVITIES		
Net increase in deposits	23,005,517	7,885,657
Repurchase of restricted stock	(116,034)	(118,799)
Repayments of borrowings	(603,125)	(603,125)
Dividends paid on common stock	(532,078)	(478,579)
NET CASH PROVIDED BY FINANCING ACTIVITIES	21,754,280	6,685,154
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	210,553	(1,525,905)
Cash and cash equivalents at beginning of year	39,164,966	40,690,871
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 39,375,519	$ 39,164,966

REDWOOD CAPITAL BANCORP
AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

For the Years Ended December 31, 2018 and 2017

	2018	2017
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$ 859,507	$ 774,448
Income taxes	1,695,500	2,015,000
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES		
Net change in unrealized gains/losses on available-for-sale investment securities	$ (253,828)	$ (68,253)
Net change in deferred income taxes on unrealized gains and losses on securities available-for-sale	75,032	28,086
Effect of tax rate changes on unrealized investment gains and losses		(26,649)

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

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business: Redwood Capital Bancorp (the Company), formed in 2007, is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, Redwood Capital Bank (the Bank). The Bank was incorporated on November 3, 2003 and commenced operations on March 24, 2004. The Bank is subject to regulation, supervision, and regular examination by the California Department of Business Oversight (CDBO) and the Federal Deposit Insurance Corporation (FDIC). The regulations of these agencies govern most aspects of the Bank's business. The financial statements of the Company are prepared in conformity with generally accepted accounting principles and general practices within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing these financial statements.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and the Bank. All material intercompany accounts and transactions have been eliminated.

Nature of Operations: The Bank provides commercial, industrial, agricultural, residential and personal credit and other banking services through its branches located in Eureka, Fortuna, and Arcata, California.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral. The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions. While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Investment Securities: Securities are classified as held-to-maturity if the Company has both the intent and ability to hold those debt securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for amortization of premium and accretion of discount, computed by the interest method over their contractual lives.

Securities are classified as available-for-sale if the Company intends to hold those debt securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities held as available-for-sale are carried at fair value. Unrealized holding gains or losses are reported as increases or decreases in other comprehensive income as a separate component of shareholders' equity, net of the related deferred tax effect. Realized gains or losses, determined on the basis of the cost of specific securities sold, are included in earnings.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Mortgages Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost of fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Mortgage loans held for sale are generally sold with servicing rights retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

Loans: Loans are stated at the amount of unpaid principal, including unamortized premiums, reduced by net deferred loan fees. Premiums are recognized over the estimated life of the loan as yield adjustments. Loan origination fees, net of direct origination costs, are deferred and recognized as an adjustment of the yield on the related loan. Amortization of net deferred loan fees is discontinued when the loan is placed on nonaccrual status. Interest on loans is accrued and credited to income based on the principal amount outstanding.

Allowance for Loan Losses: The allowance is maintained at a level which, in the opinion of management, is adequate to absorb probable losses inherent in the loan portfolio. Credit losses related to off-balance-sheet instruments are included in other liabilities. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. The allowance is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed monthly and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance.

All loans, except those to individuals, are considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Allowances on impaired loans are established based on the present value of expected future cash flows discounted at the loan's historical effective interest rate or, for collateral-dependent loans, on the fair value of the collateral. Cash receipts on impaired loans are used to reduce principal.

Income Recognition on Impaired and Nonaccrual Loans: Loans, including those considered impaired, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful or is partially charged off, the loan is classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

While a loan is classified as nonaccrual and the future collectability of the recorded balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability of the recorded balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation and amortization is computed principally by the straight-line method over estimated useful lives of the related assets.

Foreclosed Real Estate: Foreclosed real estate includes both formally foreclosed property and in-substance foreclosed property. In-substance foreclosed properties are those properties for which the Company has taken physical possession, regardless of whether formal foreclosure proceedings have taken place. At the time of foreclosure, foreclosed real estate is recorded at fair value less cost to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of their new cost basis or fair value minus estimated costs to sell. Revenue and expenses from operations and subsequent adjustments to the carrying amount are included in other non-interest expenses.

Investment in Federal Home Loan Bank Stock: As a member of the Federal Home Loan Bank (FHLB) System, the Bank is required to maintain an investment in capital stock of the FHLB. The investment exceeds the minimum requirement at December 31, 2018 and 2017. The investment is stated at cost in the accompanying balance sheets and is reported as part of other assets.

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

Mortgage Servicing Rights: When mortgage loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in mortgage banking revenue. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income.

Under the fair value measurement method, the Company measure servicing rights at fair value at each reporting date and reports changes in fair value of servicing assets in earnings in he period in which the changes occur, and are included with mortgage banking revenue, net on the income statement. The fair values of servicing rights are subjected to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses. Servicing fee income, which is reported on the income statement as mortgage banking revenue, net, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned.

Retirement Plans: Retirement plan expense is the net of service and interest cost and amortization of gains and losses not immediately recognized. Employee 401(k) expense is the amount of matching contributions. Retirement plan expense allocates the benefits over years of service.

Income Taxes: Provisions for income taxes are based on amounts reported in the statements of operations (after exclusion of non-taxable income such as interest on state and municipal securities) and include deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred taxes are computed using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are recognized for deductible temporary differences and tax credit carryforwards, and then a valuation allowance is established to reduce that deferred tax asset if it is "more likely than not" that the related tax benefits may not be realized.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Net Income Per Share of Common Stock: Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year, after giving retroactive effect to stock dividends and splits. Net income per share assuming dilution is computed similar to net income per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. Included in the denominator is the dilutive effect of stock options computed under the treasury method.

Advertising: Advertising costs are charged to operations in the year incurred.

Off-Balance-Sheet Financial Instruments: In the ordinary course of business the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

Stock-Based Compensation Accounting: Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards.

Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. The Company's accounting policy is to recognize forfeitures as they occur.

Operating Segments: Reportable segments are based on products and services, geography, legal structure, management structure and any other manner in which management desegregates a company for making operating decisions and assessing performance. The Company has determined that its business is comprised of a single operating segment.

Cash and Cash Equivalents: For the purpose of presentation in the Statement of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and due from banks," "Federal funds sold" and "interest-bearing deposits in other financial institutions."

Subsequent events: The Company has evaluated subsequent events for recognition and disclosure through March 25, 2019, which is the date the financial statements were available to be issued.

New Pronouncements: In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)* intended to improve financial reporting regarding leasing transactions. The new standard affects all companies and organizations that lease assets. The standard will require organizations to recognize on the statement of financial condition the assets and liabilities for the rights and obligations created by those leases if the lease terms are more than 12 months. The guidance also will require qualitative and quantitative disclosures providing additional information about the amounts recorded in the financial statements. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is evaluating the potential impact of the amendment on the Company's financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326) providing guidance to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables and held to maturity debt securities. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in certain eases recognized by a lessor. In addition, the amendments in this Update require credit losses be presented as an allowance rather than as a write-down on available-for-sale debt securities.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The amendments in this update are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach). The Company believes the amendments in this update will have an impact on the Company's financial statements and is working to evaluate the significance of that impact.

In March 2017, the FASB issued ASU No. 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities* that shortens the amortization period for premiums on certain callable debt securities to the earliest call date rather than the maturity date of the security. The amendments in this update do not require an accounting change for securities held at a discount. The discount continues to be amortized to maturity. The amendments in this update are applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is evaluating the potential impact of the new standard on the Bank's financial statements.

NOTE B – INVESTMENT SECURITIES

The amortized cost and approximate fair value of investment securities are summarized as follows:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2018				
Securities Available-for-Sale				
U.S. Treasury Notes	$ 1,982,581		$ (1,019)	$ 1,981,562
U.S. government agency securities	1,786,792	$ 16,362		1,803,154
Small Business Adminstration Securities	10,418,976		(165,295)	10,253,681
Mortgage-backed securities	5,295,384	4,106	(82,810)	5,216,680
Municipal securities	4,819,044	23,648	(3,030)	4,839,662
Collateralized mortgage obligations	9,353,865	16,469	(292,184)	9,078,150
Total	$ 33,656,642	$ 60,585	$ (544,338)	$ 33,172,889
December 31, 2017				
Securities Available-for-Sale				
U.S. Treasury Notes	$ 2,002,141		$ (3,000)	$ 1,999,141
U.S. government agency securities	1,822,963	$ 53,448		1,876,411
Small Business Adminstration Securities	13,934,546	1,659	(84,822)	13,851,383
Mortgage-backed securities	3,261,253	370	(77,375)	3,184,248
Municipal securities	3,978,943	57,925	(592)	4,036,276
Collateralized mortgage obligations	9,718,926	22,538	(200,075)	9,541,389
Total	$ 34,718,772	$ 135,940	$ (365,864)	$ 34,488,848

NOTE B – INVESTMENT SECURITIES (Continued)

The maturities of investment securities at December 31, 2018 were as follows:

	Available-for-Sale	
	Amortized Cost	Fair Value
Due within one year	$ 2,311,220	$ 2,310,201
Due from one year to five years	4,980,368	4,979,252
Due from five years to ten years	2,095,818	2,080,518
Due after ten years	24,269,236	23,802,918
	$ 33,656,642	$ 33,172,889

The amortized cost and fair value of mortgage-backed securities and collateralized mortgage obligations are presented by contractual maturity in the preceding table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations without call or prepayment penalties.

There were no sales of investment securities available-for-sale during 2018 and 2017.

Investment securities with an amortized cost of $26,353,191 and a fair value of $26,601,647 at December 31, 2018 were pledged to secure public deposits. Investment securities with an amortized cost of $25,571,022 and a fair value of $26,261,294 at December 31, 2017 were pledged to secure public deposits.

The following table shows the investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2018 and 2017.

	2018			
	Less than 12 months		More than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury	$ 1,981,562	$ (1,019)		
Small Business Administration securities	1,436,403	(25,057)	$ 8,488,640	$ (140,238)
Mortgage-backed securities	1,000,737	(2,580)	2,288,465	(80,230)
Municipal securities	1,316,557	(3,030)		
Collateralized mortgage obligations			7,863,495	(292,184)
	$ 5,735,259	$ (31,686)	$ 18,640,600	$ (512,652)

	2017			
	Less than 12 months		More than 12 Months	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury			$ 999,141	$ (3,000)
Small Business Administration securities	$ 5,878,817	$ (22,765)	6,669,891	(62,057)
Mortgage-backed securities	190,845	(1,822)	2,776,532	(75,553)
Municipal securities	742,084	(592)		
Collateralized mortgage obligations	3,966,222	(58,923)	5,055,236	(141,152)
	$ 10,777,968	$ (84,102)	$ 15,500,800	$ (281,762)

NOTE B – INVESTMENT SECURITIES (Continued)

There were two U.S. Treasury securities, two Small Business Administration securities, one mortgage-backed security and two municipal securities that were in a continuous loss position for less than 12 months as of December 31, 2018. There were fourteen Small Business Administration securities, six mortgage-backed securities and ten collateralized mortgage obligation that were in a continuous loss position for 12 months or more as of December 31, 2018.

There were six Small Business Administration securities, two mortgage-backed securities, one municipal security, and four collateralized mortgage obligations that were in a continuous loss position for less than 12 months as of December 31, 2017. There were one U.S. Treasury security, nine Small Business Administration securities, four mortgage-backed securities, and six collateralized mortgage obligations that were in a continuous loss position for 12 months or more as of December 31, 2017.

The unrealized losses on these securities were caused by interest rate increases. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2018 and 2017.

NOTE C – LOANS, NET

Major classifications of loans at December 31 are summarized as follows:

	2018	2017
Commercial real estate	$ 177,465,586	$ 151,092,597
Commercial loans, including unamortized purchase premiums of $819,516 in 2018 and $1,023,347 in 2017	44,746,848	46,895,288
Construction and land loans	6,471,955	6,544,208
Residential real estate	16,762,481	15,437,112
Loans to individuals	24,452,092	25,585,732
Agricultural	8,186,487	8,782,819
	278,085,449	254,337,756
Net deferred loan fees and costs	202,884	228,478
Allowance for loan losses	(4,043,836)	(3,655,651)
	$ 274,244,497	$ 250,910,583

The Company receives fees for servicing retained on loans sold. Loans being serviced by the Company for others totaled approximately $112,208,432 and $113,860,974 for the years ended December 31, 2018 and 2017, respectively.

NOTE C – LOANS, NET (Continued)

The maturity and repricing of the loan portfolio is as follows at December 31:

	2018	2017
Fixed rate loan maturities		
Three months or less	$ 379,194	$ 1,091,006
Over three months to twelve months	1,817,764	4,513,265
Over one year to five years	12,358,562	9,393,490
Over five years to fifteen years	7,204,980	8,779,123
Over fifteen years	3,184,193	2,236,054
Floating rate loans repricing		
Quarterly or more frequently	59,508,762	61,781,383
Quarterly to annual frequency	17,857,806	20,052,854
One to five years frequency	145,049,770	118,713,519
Five to fifteen years frequency	30,103,293	27,187,771
Non-accrual loans	621,125	589,291
	$ 278,085,449	$ 254,337,756

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The Company's methodology for assessing the appropriateness of the allowance consists of three key elements, which include the general allowance, the specific allowance and an allowance for changing environmental factors. These various components are factored into a single allowance analysis.

General Allowance: The determination of the general allowance is based on estimates made by management, including but not limited to, consideration of historical losses by portfolio segment, peer bank losses, analysis of the economy, market rate environment, underwriting standards and other criteria as identified by the credit administrator. The portfolio segments include commercial real estate, construction, single family residential, home equity lines of credit, agricultural land, commercial, agricultural loans/lines and consumer. In addition, the Company segregates each of these segments into local and out-of-area loans. Local refers to properties located in Humboldt, Del Norte and Trinity counties, and out-of-area refers to properties located outside of the tri-county area. Peer bank loss information is used for loans that are out-of-area, unless the Company's loss history is higher. The general allowance consists of reserve factors that are based on charge-off history and management's assessment of each portfolio segment. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate—These loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

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

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

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

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

Installment and other loans to individuals—The installment loan portfolio is comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for purchase of heavy equipment or industrial vehicles may also be included.

Agriculture—Loans secured by agricultural land and production are especially vulnerable to two risk factors that are largely outside the control of the Company and borrowers, commodity prices and weather conditions.

Specific Allowance: Regular credit reviews of the portfolio also identify loans that are considered potentially impaired. A loan is considered impaired when, based on current information and events, the Company determines that they will probably not be able to collect all amounts due according to the loan contract, including scheduled interest payments. When the Company identifies a loan as impaired, the Company measures the impairment using discounted cash flows, except when the sole remaining source of repayment for the loans is the liquidation of the collateral. In these cases, the Company uses the current fair value of the collateral, less selling costs. If the Company determines that the value of the impaired loan is less than the recorded investment in the loan, the Company either recognizes an impairment reserve as a specific allowance to be provided for in the allowance or charges-off the impaired balance on collateral dependent loans if it is determined that such amount represents a confirmed loss. Loans determined to be impaired with a specific allowance are excluded from the general allowance so as not to double-count the loss exposure.

Qualitative factors: This component of the allowance is management's best estimate of the probable impact that various qualitative factors may have on the loan portfolio. It is not allocated to specific loans or groups of loans, but rather is intended to absorb losses caused by several factors, including changes in the nature and volume of the portfolio, changes in the terms of loans, changes in lending policies and procedures, underwriting collection practices, changes in international, national, regional, and local economic and business conditions, changes in the experience and ability of lending management and staff, changes in the volume and severity of past due loans, changes in the volume of non-accrual loans, changes in the volume and severity of adversely classified or graded loans, changes in the quality of the Company's loan review system, changes in the value of underlying collateral, the existence and effect of any concentrations of credit, changes in the level of concentrations of credit and the effect of other external factors such as competition and legal and regulatory requirements.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. The Board of Directors review the adequacy of the allowance quarterly, including consideration of current economic conditions, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, or past loan experience and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulators, the FDIC and the CDBO, review the adequacy of the allowance as an integral part of their examination process. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

The following table summarizes activity related to the allowance for loan losses by loan portfolio segment and the allocation of the allowance for loan losses by loan portfolio segment and by impairment methodology for the years ended December 31, 2018 and 2017:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Unallocated and Qualitative Factors	Total
2018								
Allowance for credit losses:								
Beginning balance	$ 1,801,457	$ 703,775	$ 77,707	$ 191,101	$ 356,786	$ 100,377	$ 424,448	$ 3,655,651
Charge-offs				(1,191)	(3,716)			(4,907)
Recoveries	53,199	12,054			6,839			72,092
Provision	533,758	(104,331)	3,851	21,457	(700)	14,784	(147,819)	321,000
Ending balance	$ 2,388,414	$ 611,498	$ 81,558	$ 211,367	$ 359,209	$ 115,161	$ 276,629	$ 4,043,836
Ending balance:								
Individually evaluated for impairment	$ 144,100	$ 47,611			$ 50,000			$ 241,711
Collectively evaluated for impairment	2,244,314	563,887	$ 81,558	$ 211,367	309,209	$ 115,161	$ 276,629	3,802,125
Total allowance	$ 2,388,414	$ 611,498	$ 81,558	$ 211,367	$ 359,209	$ 115,161	$ 276,629	$ 4,043,836
Ending balance:								
Individually evaluated for impairment	$ 342,519	$ 203,882			$ 278,606			$ 825,007
Collectively evaluated for impairment	177,123,067	44,542,966	$ 6,471,955	$ 16,762,481	24,173,486	$ 8,186,487		277,260,442
Total loans	$ 177,465,586	$ 44,746,848	$ 6,471,955	$ 16,762,481	$ 24,452,092	$ 8,186,487	$ -	$ 278,085,449

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Unallocated and Qualitative Factors	Total
2017								
Allowance for credit losses:								
Beginning balance	$ 1,857,629	$ 428,219	$ 89,690	$ 223,580	$ 380,943	$ 129,457	$ 369,689	$ 3,479,207
Charge-offs					(6,238)			(6,238)
Recoveries	11,665	18,265			12,752			42,682
Provision	(67,837)	257,291	(11,983)	(32,479)	(30,671)	(29,080)	54,759	140,000
Ending balance	$ 1,801,457	$ 703,775	$ 77,707	$ 191,101	$ 356,786	$ 100,377	$ 424,448	$ 3,655,651
Ending balance:								
Individually evaluated for impairment		$ 127,529			$ 50,000			$ 177,529
Collectively evaluated for impairment	$ 1,801,457	576,246	$ 77,707	$ 191,101	306,786	$ 100,377	$ 424,448	3,478,122
Total allowance	$ 1,801,457	$ 703,775	$ 77,707	$ 191,101	$ 356,786	$ 100,377	$ 424,448	$ 3,655,651
Ending balance:								
Individually evaluated for impairment		$ 322,793	$ 203,466		$ 307,282			$ 833,541
Collectively evaluated for impairment	$ 151,092,597	46,572,495	6,340,742	$ 15,437,112	25,278,450	$ 8,782,819		253,504,215
Total loans	$ 151,092,597	$ 46,895,288	$ 6,544,208	$ 15,437,112	$ 25,585,732	$ 8,782,819	$ -	$ 254,337,756

Credit Quality of Loans

The Company assigns a risk rating to loans over a certain threshold and periodically performs detailed reviews of all such loans to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. These risk ratings can be grouped into the following major categories, defined as follows:

Pass: A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Watch List: A watch list loan has significant weaknesses resulting from performance trends or management concerns.

Special Mention: A special mention loan is currently protected, but is weak due to negative trends in the financial statements of the borrower and current cash flow problems, among other criteria. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard: A substandard loan has well-defined weaknesses where a payment default and/or a loss is possible, but not yet probable. Cash flow is insufficient to service the debt, with prospects that the condition is permanent. Loans classified as substandard are inadequately protected by the current net worth and repayment capacity of the borrower and there is a likelihood that collateral will have to be liquidated and/or guarantor called upon to repay the debt.

Doubtful: Loans classified as doubtful have characteristics of those classified as substandard but available information suggests it is unlikely that the loan will be repaid in its entirety. Cash flow is insufficient to service the debt. If the current material adverse trends continue, it is unlikely the borrower will have the ability to meet the terms of the loan agreement. It may be difficult to project the exact amount of loss, but the probability of some loss is greater than 50%.

Loss: Loans classified as loss have characteristics those classified as of doubtful but the loan will not be repaid in full. Debt service coverage clearly reflects the borrower's inability to service the debt. The borrower cannot generate sufficient cash flow to cover fixed charges. All near-term and long-term trends concerning cash flow and earnings are negative. Collateral and guarantees provide no support.

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2018 and 2017:

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
2018							
Grade:							
Pass	$ 172,492,270	$ 38,046,913	$ 6,471,955	$ 16,544,862	$ 23,803,609	$ 8,186,487	$ 265,546,096
Watch	1,826,515	4,422,807		77,704	369,877		6,696,903
Special Mention		1,213,388					1,213,388
Substandard	3,146,801	1,063,740		139,915	278,606		4,629,062
Total	$ 177,465,586	$ 44,746,848	$ 6,471,955	$ 16,762,481	$ 24,452,092	$ 8,186,487	$ 278,085,449

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

	Commercial Real Estate	Commercial	Construction and Land	Residential	Individual	Agriculture	Total
2017							
Grade:							
Pass	$ 144,900,248	$ 40,552,805	$ 5,714,974	$ 14,990,269	$ 24,726,110	$ 8,782,819	$ 239,667,225
Watch	2,718,484	4,739,752	625,768	221,275	427,411		8,732,690
Special Mention	313,119	659,111			124,929		1,097,159
Substandard	3,160,746	943,620	203,466	225,568	307,282		4,840,682
Total	$ 151,092,597	$ 46,895,288	$ 6,544,208	$ 15,437,112	$ 25,585,732	$ 8,782,819	$ 254,337,756

The following table summarizes the Company's past due loans and non-accrual loans by loan portfolio segment as of December 31, 2018 and 2017:

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2018							
Commercial real estate					$ 342,519	$ 177,123,067	$ 177,465,586
Commercial						44,746,848	44,746,848
Construction and land						6,471,955	6,471,955
Residential	$ 266,013			$ 266,013		16,496,468	16,762,481
Individual	86,083			86,083	278,606	24,087,403	24,452,092
Agriculture						8,186,487	8,186,487
Total	$ 352,096	$ -	$ -	$ 352,096	$ 621,125	$ 277,112,228	$ 278,085,449

	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2017							
Commercial real estate						$ 151,092,597	$ 151,092,597
Commercial	$ 1,086,400			$ 1,086,400		45,808,888	46,895,288
Construction and land	52,859			52,859	$ 203,466	6,287,883	6,544,208
Residential	1,026,164			1,026,164	194,007	14,216,941	15,437,112
Individual	76,631			76,631	191,819	25,317,282	25,585,732
Agriculture						8,782,819	8,782,819
Total	$ 2,242,054	$ -	$ -	$ 2,242,054	$ 589,292	$ 251,506,410	$ 254,337,756

There were no accruing loans past due 90 days or more at December 31, 2018 and 2017.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

The following table shows information related to impaired loans by loan portfolio segment as of December 31, 2018 and 2017:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2018					
With no related allowance recorded:					
Commercial				$ 43,201	$ 5,191
Construction and land	$ 6,124			107,857	
Individual	105,905	101,858		112,708	
With an allowance recorded:					
Commercial real estate	344,483	342,519	$ 144,100	162,756	
Commercial	205,921	203,882	47,611	212,763	14,390
Individual	180,968	176,748	50,000	188,503	
Total:					
Commercial real estate	344,483	342,519	144,100	162,756	
Commercial	205,921	203,882	47,611	255,964	19,581
Construction and land	6,124			107,857	
Individual	286,873	278,606	50,000	301,211	
Total	$ 843,401	$ 825,007	$ 241,711	$ 827,788	$ 19,581

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
2017					
With no related allowance recorded:					
Commercial	$ 107,992	$ 107,870		$ 132,683	$ 8,377
Construction and land	209,590	203,466		263,996	
Individual	119,511	115,463		128,131	
With an allowance recorded:					
Commercial	215,318	214,923	$ 127,529	149,377	14,490
Individual	196,039	191,819	50,000	201,779	
Total:					
Commercial	323,310	322,793	127,529	282,060	22,867
Construction and land	209,590	203,466		263,996	
Individual	315,550	307,282	50,000	329,910	
Total	$ 848,450	$ 833,541	$ 177,529	$ 875,966	$ 22,867

The Company had no commitments to loan additional funds to borrowers of impaired or nonaccrual loans at December 31, 2018 and 2017.

NOTE D – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (Continued)

Troubled Debt Restructurings

The terms of certain loans have been modified in troubled debt restructurings. The modification of the terms of such loans included one or more of a combination of the following: a reduction of the stated interest rate of the loan at a stated rate of interest lower than the current market rate for new debt with similar risk; and extension of the maturity date; or a permanent reduction of the recorded investment in the loan. At December 31, 2018 and 2017, the Company had $345,123 and $249,871, respectively, of loans to borrowers whose loan terms were modified in troubled debt restructurings. The Company allocated $144,100 and $3,324 of specific reserves to these troubled debt restructurings as of December 31, 2018 and 2017, respectively. The Company has not committed to lend additional amounts as of December 31, 2018 and 2017 to borrowers with outstanding loans that are classified as troubled debt restructurings.

There were no loans modified as troubled debt restructurings or restructurings for which there was a default (defined as 90 or more days past due based on restructured terms) within twelve months of the modification date during the years ended December 31, 2018 and 2017.

The troubled debt restructurings increased the amount of specific reserves under ASC 310 described above. There were no defaults of troubled debt restructurings modified in the past twelve months during 2018 and 2017.

NOTE E – PREMISES AND EQUIPMENT

Premises and equipment consisted of the following at December 31:

	2018	2017
Land	$ 894,920	$ 894,920
Building and improvements	5,496,788	5,496,788
Furniture, fixtures and equipment	2,121,852	2,062,281
Construction in progress	2,270,379	
	10,783,939	8,453,989
Less: Accumulated depreciation	(4,094,968)	(3,861,820)
	$ 6,688,971	$ 4,592,169

Depreciation and amortization included in occupancy expense totaled $261,781 and $317,160 in 2018 and 2017, respectively.

NOTE F – MORTGAGE SERVICING RIGHTS

The following table presents the changes in the Bank's mortgage servicing rights for the years ended December 31:

	2018	2017
Fair value, beginning of year	$ 785,432	$ 785,432
Additions for new mortgage servicing rights capitalized	201,721	37,715
Change in fair value due to changes in model inputs and assumptions	14,604	(37,715)
Fair value, end of year	$ 1,001,757	$ 785,432
Balance of mortgage loans serviced for others	$ 112,208,432	$ 110,663,495
Mortgage servicing rights as a percentage of serviced loans	0.89%	0.71%

NOTE F – MORTGAGE SERVICING RIGHTS (Continued)

The amounts of contractually specified servicing fees, late fees and ancillary fees earned, recorded in mortgage banking revenue on the consolidated statements of operations, were $277,521 and $271,063 for the years ended December 31, 2018 and 2017, respectively. Changes in fair value are also included in mortgage banking revenue on the consolidated statements of operations.

The fair value of mortgage servicing rights is determined using a discounted cash flow model. In order to determine the fair value of the mortgage servicing rights, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. Key assumptions used in measuring the fair value of mortgage servicing rights as of December 31, 2018 and 2017 include a discount rate of 10% and 11%, respectively. A proprietary market implied prepayment model is used by the independent valuation group.

The expected life of the loans can vary from management's estimates due to prepayments by borrowers, especially when rates fall. Prepayments in excess of management's estimates would negatively impact the recorded value of the mortgage servicing rights. The value of the mortgage servicing rights is also dependent upon the discount rate used in the model, which is based on current market rates. A significant increase in the discount rate would reduce the value of mortgage servicing rights. The sensitivities surrounding mortgage servicing rights are expected to have an immaterial impact on fair value.

NOTE G – INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following at December 31:

	2018	2017
Negotiable order of withdrawal (NOW)	$ 91,586,010	$ 84,905,446
Savings and money markets	121,178,087	106,751,879
Time	26,349,482	26,471,699
	$ 239,113,579	$ 218,129,024

Interest expense on these deposits for the years ended December 31 is as follows:

	2018	2017
Negotiable order of withdrawal (NOW)	$ 90,682	$ 81,461
Savings and money markets	270,735	213,462
Time	220,012	215,251
	$ 581,429	$ 510,174

The maturities of time deposits at December 31 are as follows:

	2018	2017
Three months or less	$ 5,128,119	$ 5,643,834
Over three months through twelve months	11,720,586	9,306,133
Over one year through three years	8,910,777	11,167,068
Over three years	590,000	354,664
	$ 26,349,482	$ 26,471,699

Time deposits that meet or exceed the FDIC insurance limit of $250,000 at December 31, 2018 and 2017 were $8,117,356 and $7,860,544, respectively.

NOTE H – LENDING AGREEMENTS

The Company has federal funds line of credit agreements with other banks. The maximum borrowings available under these lines amount to $16,000,000 at December 31, 2018 and 2017. The Company has an agreement to borrow up to $1,000,000 at December 31, 2018 and 2017, which is secured by an assignment of life insurance policies. There were no borrowings outstanding under these agreements at December 31, 2018 and 2017.

The Company has an agreement to borrow from the Federal Home Loan Bank to the extent of pledged assets, up to 25% of total assets as of December 31, 2018 and 2017. Assets pledged under the agreement at December 31, 2018 totaled $368,620,736, resulting in a limit on borrowings of $92,155,184. Assets pledged under the agreement at December 31, 2017 totaled $342,503,014, resulting in a limit on borrowings of $85,625,754. The Company also maintains a letter of credit with the Federal Home Loan Bank of $8,000,000, as of December 31, 2018 and 2017, which serves as collateral for public and other deposits and is collateralized by a portion of the loans discussed above. No amounts were outstanding under this agreement as of December 31, 2018 and 2017.

The Company has an agreement to borrow from the Federal Reserve Bank by obtaining advances or discounting eligible paper to the extent of pledged collateral. Promissory notes and deeds of trust on the Bank's loans totaling $5,266,297 and $5,561,341 for 2018 and 2017, respectively, were held by the Federal Reserve Bank as collateral. There were no borrowings outstanding under this agreement at December 31, 2018 and 2017.

In November 2015, the Company borrowed an additional $4,156,250 under a new agreement from an existing lender to finance the redemption of Series C Preferred Stock issued to the U.S. Treasury in December 2015. Effective on April 6, 2018, the loan was modified from a variable interest rate to a fixed rate of 5.5% and the outstanding balance is calculated at 5.5% until the loan matures on April 6, 2021. The interest rate at December 31, 2018 and 2017 was 5.5% and 4.70%, respectively. The loan is amortized over a 10 year period. Quarterly principal payments of $150,781 are due concluding with one final lump sum payment of $2,864,844 on April 6, 2021. The outstanding principal balance at December 31, 2018 and 2017 was $4,221,875 and $4,825,000, respectively.

NOTE I – OTHER EXPENSES

Other expenses consisted of the following for the years ended December 31:

	2018	2017
Data processing	$ 741,308	$ 690,393
Insurance expense	472,969	323,051
Marketing and promotion	494,606	475,562
Professional fees	377,941	372,745
Director and shareholder	362,887	405,901
Operating expense	278,267	233,982
Loan and collection expense	228,258	193,460
Miscellaneous employee expense	153,500	132,048
Stationery and forms	84,896	89,045
Telephone expense	84,540	88,449
Postage and delivery	83,544	80,438
Dues and memberships	60,150	60,448
Operational losses	26,694	30,030
Security expense	18,469	13,846
Subscriptions	2,080	1,839
Other non-interest expense	250	1,819
	$ 3,470,359	$ 3,193,056

NOTE J – RETIREMENT PLANS

The Company has a defined contribution retirement plan covering substantially all of the Company's employees. Employees may elect to have a portion of their compensation contributed to the plan in conformity with the requirements of Section 401(k) of the Internal Revenue Code. The Company will make contributions equal to 100% of the effective deferral made by the employees, up to a maximum of 4% of the employees' eligible earnings. Salaries and employee benefits expense includes the Company's contributions to the plan of $144,000 during both 2018 and 2017.

The Company has single premium life insurance policies in connection with the retirement plans for thirteen key officers. The policies provide protection against the adverse financial effects from the death of key officers and to provide income to offset expenses associated with the plan. The officers are insured under the policies, but the Company is the owner and beneficiary. At December 31, 2018 and 2017, the cash surrender value of these policies totaled $8,072,796 and $6,620,332, respectively.

The Company has a deferred compensation plan that is unfunded, which allows the Directors to defer a portion of current compensation in exchange for the Company's commitment to pay a deferred benefit at retirement. If death occurs prior to or during retirement, the Company will pay the Director's beneficiary or estate the benefits set forth in the plan. Deferred compensation is vested as to the amounts deferred. At December 31, 2018 and 2017, the liability recorded for the deferred compensation plan totaled $438,188 and $407,696, respectively.

The Company has unfunded noncontributory defined benefit retirement plans that cover certain officers. The plan provides defined benefits that are typically a fixed amount over a ten year period after retirement. The officers typically need to work ten years, or until the age of 65, from the plan date to be fully vested. The company uses December 31 as the measurement date for its pension plans.

The ending benefit obligation was $590,380 and $444,082 at December 31, 2018 and 2017, respectively. There were no employer contributions or benefits paid for 2018 and 2017. The plan is unfunded so there were no plan assets at December 31, 2018 and 2017.

The service cost for the years ended December 31, 2018 and 2017 was $289,590 and $93,461, respectively. The prior service credit for the year ended December 31, 2018 was $143,293, which is included in the line item "other income" in the Consolidated Statements of Operations.

The weighted average discount rate assumptions used to determine the retirement benefit obligations for the years ended December 31, 2018 and 2017 were 5.81% and 6.00%, respectively. The weighted average discount rate assumptions used to determine the net periodic retirement cost for the years ended December 31, 2018 and 2017 were 5.61% and 6.00%, respectively.

The Company expects to have no contribution to its retirement plan in 2019. Benefit payments, which reflect expected future service, are expected to be $15,068 in 2023 and $858,333 in the following five years.

NOTE K – INCOME TAXES

The provision for income taxes was comprised of the following at December 31:

	2018	2017
Current		
Federal	$ 1,232,796	$ 1,243,075
State	609,321	549,322
	1,842,117	1,792,397
Deferred		
Federal	(256,069)	708,550
State	(42,656)	(35,070)
	(298,725)	673,480
Provision for income taxes	$ 1,543,392	$ 2,465,877

The following is a reconciliation of income taxes computed at the Federal statutory rate of 21% in 2018 and 34% in 2017 to the effective rate used for the provision for income taxes for the years ended December 31:

	2018	2017
Income benefit at the Federal statutory rate	$ 1,193,533	$ 1,710,546
State franchise tax benefit, less Federal income tax effect	486,711	359,939
Revaluation of deferred tax assets due to the Tax Cuts and Jobs Act of 2017		546,527
Earnings on cash surrender value of life insurance	14,053	(73,620)
Tax exempt municipal securities	(21,170)	(33,708)
Vesting of restricted stock grants	(65,365)	
Nondeductible expenses and other	(64,370)	(43,807)
Net provision for income taxes	$ 1,543,392	$ 2,465,877

In December 2017, H.R. 1, known as the Tax Cuts and Jobs Act of 2017 (the Act), was signed into law. The Act makes changes to the U.S. Internal Revenue Code of 1986, including a decrease in the federal corporate tax rate to 21% from 34%, effective January 1, 2018. As a result of the enactment of this law, the Company revalued its deferred tax assets during the year ended December 31, 2017 from a combined federal and California tax rate of 41.15% to a combined rate of 29.56%. The amount totaling $546,527 described as "Revaluation of deferred taxes due to the Tax Cuts and Jobs Act of 2017" in the table above represents the effect of revaluing the Company's deferred taxes due to the enactment of the Act. In February 2018, to address stakeholder concerns about the accounting treatment of the effect of revaluing the deferred taxes on unrealized gains and losses on securities available-for-sale (the effect), FASB issued ASU 2018-02*, Income Statement – Reporting Comprehensive Income (Topic 220), Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. The effect was required to be adjusted through income tax expense, resulting in an amount in accumulated other comprehensive income (loss) not reflecting the appropriate tax rate (referred to as "stranded tax effects"). ASU 2018-02 allows a reclassification adjustment of the stranded tax effects from accumulated other comprehensive income (loss) to retained earnings so the amount in accumulated other comprehensive income (loss) reflects the appropriate tax rate. The $26,649 "Effect of new tax rates from Tax Cuts and Jobs Act of 2017" in the consolidated statement of changes in shareholders' equity represents the adjustment of the stranded tax effects.

NOTE K – INCOME TAXES (Continued)

The tax effects of temporary differences that give rise to the components of the net deferred tax assets as of December 31 were as follows:

	2018	2017
Deferred tax assets:		
Allowance for loan losses	$ 920,980	$ 826,081
Salary continuation accrual	174,537	131,287
Depreciation	166,152	164,866
State taxes	145,825	123,699
Available-for-sale securities	142,997	67,965
Deferred compensation	129,544	120,530
Non-qualified restricted stock	102,612	68,608
Accrued vacation	55,103	55,103
Allowance for loan commitments	26,607	23,651
Non-accrual interest	11,823	8,007
Other	7,121	2,597
Total deferred tax assets	1,883,301	1,592,394
Deferred tax liabilities:		
Mortgage servicing rights	(296,155)	(232,202)
Federal Home Loan Bank dividends	(17,916)	(17,916)
Total deferred tax liabilities	(314,071)	(250,118)
Net deferred tax assets	$ 1,569,230	$ 1,342,276

Amounts presented for the tax effects of temporary differences are based upon estimates and assumptions and could vary from amounts ultimately reflected on the Company's tax returns. Accordingly, the variances from amounts reported in prior years are primarily adjustments to conform to the tax returns as filed. As of December 31, 2018 and 2017, the Company had income tax receivable of $81,099 and $91,431, respectively.

The Company and its subsidiary file an income tax return in the U.S. federal jurisdiction and a franchise tax return in the State of California jurisdiction. The Company is no longer subject to U.S. federal income tax examinations and State franchise tax examinations by taxing authorities for years prior to 2015 and 2014, respectively.

There have been no adjustments identified for unrecognized tax benefits requiring an adjustment to the income statement. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. The Company has recognized no interest or penalties since this pronouncement was implemented.

The California Franchise Tax Board (FTB) audited the Company's 2011 and 2012 franchise tax returns related to the enterprise zone loan interest deductions. The Company accrued approximately $50,000 as a potential settlement at December 31, 2017. The Company paid $50,000 to settle this claim in 2018.

NOTE L– EARNINGS PER SHARE

The following is a computation of basic and diluted earnings per share for the years ended December 31, 2018 and 2017.

	2018	2017
Basic:		
Net income	$ 4,140,097	$ 2,565,142
Weighted-average common shares outstanding	1,936,478	1,915,724
Earnings per share	$ 2.14	$ 1.34
Diluted:		
Net income	$ 4,140,907	$ 2,565,142
Weighted-average common shares outstanding	1,936,478	1,915,724
Net effect of dilutive securities - based on the Treasury stock method using average market price		
Unvested restricted stock	16,573	34,322
Weighted-average common shares outstanding and common stock equivalents	1,953,051	1,950,046
Earnings per share - assuming dilution	$ 2.12	$ 1.32

NOTE M – STOCK OPTION PLAN

The Company has a stock option plan established in 2004 under which incentive and nonstatutory stock options and restricted stock may be granted. The Company's Stock Option Plan provides for the granting of a maximum of 495,000 shares of the Company's common stock to directors, key employees and consultants at an exercise price not less than the fair market value of the shares on the date of grant and for a term of no more than 10 years. Options granted vest equally each year over the life of the option from the date the option is granted. Generally, if an optionee's continuous status as a director, employee or consultant is terminated for various reasons, the nonvested options expire. The Bank estimates the number of awards that are expected to vest when determining the compensation costs. There were no stock options outstanding at December 31, 2018 and 2017.

A summary of restricted stock activity follows for the years ended December 31:

	Restricted Stock					
	2018			2017		
	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value	Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested at beginning of year	53,036	$ 10.24		79,606	$ 9.80	
Granted				2,300	19.99	
Shares vested and issued	(27,516)	10.23		(26,532)	9.80	
Forfeited	(4,200)	9.80		(2,338)	9.80	
Nonvested at end of year	21,320	10.01	$ 330,673	53,036	10.24	$ 948,284

NOTE M – STOCK OPTION PLAN (Continued)

As of December 31, 2018 and 2017, there was $84,536 and $371,044 of total unrecognized compensation cost related to nonvested restricted stock. That cost is expected to be recognized over a weighted-average period of 0.37 and 1.37 years, respectively.

Total compensation cost for all share-based payments recognized in net income for 2018 and 2017 totaled $248,945 and $232,069, respectively. A tax benefit of $75,597 and $95,496 was recognized during 2018 and 2017, respectively, related to this compensation cost.

NOTE N – RELATED PARTY TRANSACTIONS

During the normal course of business, the Company has entered into transactions with its directors, executive officers, significant shareholders and their affiliates (related parties). The aggregate amount of loans to such related parties totaled $11,569,980 and $6,870,251 at December 31, 2018 and 2017, respectively. At December 31, 2018 and 2017, commitments to related parties of $3,877,516 and $2,880,645, respectively, were undisbursed. The Company has received deposits from directors and officers and their related interests totaling $6,458,464 and $7,341,146 at December 31, 2018 and 2017, respectively.

NOTE O – CONTINGENT LIABILITIES AND COMMITMENTS

Financial Instruments with Off-Balance-Sheet Risk: The Company's financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit, standby letters of credit and credit card arrangements. A summary of the Company's commitments and contingent liabilities at December 31, 2018 and 2017 are as follows:

	Contractual Amounts	
	2018	2017
Commitments to extend credit	$ 61,909,300	$ 58,080,699
Standby letters of credit	564,642	242,101
Credit card arrangements	1,660,911	1,208,625

Commitments to extend credit, standby letters of credit and credit card arrangements include exposure to some credit loss in the event of nonperformance of the customer. The Company's credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the balance sheet. Because most of these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Company. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, deeds of trust on residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending facilities to customers.

The Company did not incur any losses on its commitments in 2018 and 2017.

NOTE O – CONTINGENT LIABILITIES AND COMMITMENTS (Continued)

Lease arrangement: On February 1, 2014, the Company entered into an agreement with Humboldt State University (University) for the transfer of a Company-owned building to the University in exchange for a reduced lease rate on a building owned by the University that the Company is leasing from the University. The initial term of the lease will be five years with an option to extend the lease for seven periods of five years. The lease will be extended automatically the first five periods unless the Bank elects to decline the lease option. The monthly rental rate is $5,840 per month, but the rent is reduced by $3,327 per month for the first twenty years of the lease as consideration for the transfer of the Bank building valued at $505,000 and the Bank paying for $95,000 of renovation costs at the Bank-owned building. The $600,000 is recorded as prepaid rent and is being amortized into rent expense on a straight-line basis over 20 years. The net rent will be increased every five years by the change in the consumer price index. Rental expense was $60,156 in 2018 and 2017. The following table summarizes future minimum commitments under the non-cancellable operating lease:

	Gross rent	Rent Reduction	Net Rent
Years ended December 31:			
2019	$ 70,080	$ (39,924)	$ 30,156
2020	70,080	(39,924)	30,156
2021	70,080	(39,924)	30,156
2022	70,080	(39,924)	30,156
2023	70,080	(39,924)	30,156
2024	5,840	(3,327)	2,513
	$ 356,240	$ (202,947)	$ 153,293

NOTE P – CONCENTRATIONS OF CREDIT RISK

Most of the Company's business activity is with customers located within the State of California, primarily in and around the counties of Humboldt, Del Norte, and Trinity. Most of the Company's loans have been granted to customers in the Company's market area. General economic conditions or natural disasters affecting the primary market area could affect the ability of customers to repay loans and the value of real property used as collateral. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. The Company requires that all loans have adequate collateral to secure the loan or that the borrower has evidence of sufficient cash flows to repay loans when the loans are made. All collateral must have an appraisal, if applicable, and collateral is generally secured by liens. The Company's access to this collateral is through judicial procedures.

NOTE Q – REGULATORY MATTERS

The Bank is subject to the dividend restrictions set forth by the FDIC. Under such restrictions, the Bank may not, without the prior approval of the FDIC, declare dividends in excess of the sum of the current year's net income plus the retained earnings from the prior two years. As of December 31, 2018, $6,857,632 was available for cash dividend distribution without prior approval.

The Bank is subject to various regulatory capital requirements administered by its primary federal regulator, the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under U.S. GAAP, regulatory reporting requirements and regulatory capital standards. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

NOTE Q – REGULATORY MATTERS (Continued)

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2018, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank's as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, Common Equity Tier 1 risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(in thousands)			
As of December 31, 2018						
Total Capital (to Risk Weighted Assets)	$ 35,598	12.85%	≥ $ 22,170	≥ 8.00%	≥ $ 27,713	≥ 10.00%
Tier I Capital (to Risk Weighted Assets)	$ 32,126	11.59%	≥ $ 16,628	≥ 6.00%	≥ $ 22,170	≥ 8.00%
Common Equity Tier I Capital (to Risk Weighted Assets)	$ 32,126	11.59%	$ 12,471	≥ 4.50%	≥ $ 24,108	≥ 6.50%
Tier I Capital (to Average Assets)	$ 32,126	8.66%	≥ $ 14,836	≥ 4.00%	≥ $ 18,544	≥ 5.00%
As of December 31, 2017						
Total Capital (to Risk Weighted Assets)	$ 32,085	12.93%	≥ $ 19,858	≥ 8.00%	≥ $ 24,822	≥ 10.00%
Tier I Capital (to Risk Weighted Assets)	$ 28,975	11.67%	≥ $ 14,893	≥ 6.00%	≥ $ 19,858	≥ 8.00%
Common Equity Tier I Capital (to Risk Weighted Assets)	$ 28,975	11.67%	$ 11,170	≥ 4.50%	≥ $ 23,607	≥ 6.50%
Tier I Capital (to Average Assets)	$ 28,975	7.98%	≥ $ 14,528	≥ 4.00%	≥ $ 18,160	≥ 5.00%

The Federal Deposit Insurance Corporation ("FDIC") published interim final rules (the "Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. Under the Basel III Capital Rules, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity tier 1 capital above its minimum risk-based capital requirements. The effects of accumulated other comprehensive income items are not excluded from common equity tier 1 capital; however, the Bank made a one-time permanent election to exclude these items in order to avoid significant variations in the level of capital depending on the impact of interest rate fluctuations on the fair value of the Bank's investments portfolio. Phase-in of the capital conservation buffer requirements will begin January 1, 2016 and be fully phased-in on January 1, 2019. A banking organization with a buffer greater than 2.5 percent would not be subject to limits on capital distributions or discretionary bonus payments. The Bank does not expect to be subject to limits on capital distributions or discretionary bonus payments due to these requirements.

NOTE R – FAIR VALUE MEASUREMENT

The following tables present information about financial instruments, whether or not recognized or recorded at fair value in the balance sheet. In general, fair values are determined by:

> Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.
>
> Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.
>
> Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any market activity for the asset or liability.

In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3.

NOTE R – FAIR VALUE MEASUREMENT (Continued)

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

	Carrying	Fair Value			
	Amount	Level 1	Level 2	Level 3	Total
December 31, 2018					
Financial assets:					
Cash and due from banks	$ 10,575,709	$ 10,575,709			$ 10,575,709
Federal funds sold	19,612,000	19,612,000			19,612,000
Interest-bearing deposits in other banks	9,187,810	9,187,810			9,187,810
Investment securities available-for-sale	33,172,889		$ 33,172,889		33,172,889
Mortgages held for sale	629,331		638,537		638,537
Loans, net	274,244,497			$ 270,279,707	270,279,707
Cash surrender value of life insurance	8,072,796	8,072,796			8,072,796
Federal Home Loan Bank and correspondent bank stock	2,046,270	2,046,270			2,046,270
Accrued interest receivable	1,099,175	1,099,175			1,099,175
Mortgage servicing rights	1,001,757			1,001,757	1,001,757
Financial liabilities:					
Deposits					
Non interest-bearing	95,624,755		95,624,755		95,624,755
Interest-bearing	239,113,579		239,119,225		239,119,225
Borrowings	4,221,875		4,188,348		4,188,348
Accrued interest payable	24,056	24,056			24,056

	Carrying	Fair Value			
	Amount	Level 1	Level 2	Level 3	Total
December 31, 2017					
Financial assets:					
Cash and due from banks	$ 10,356,922	$ 10,356,922			$ 10,356,922
Federal funds sold	3,139,000	3,139,000			3,139,000
Interest-bearing deposits in other banks	25,669,044	25,669,044			25,669,044
Investment securities available-for-sale	34,488,848		$ 34,488,848		34,488,848
Mortgages held for sale	642,901		655,686		655,686
Loans, net	250,910,583			$ 249,643,218	249,643,218
Cash surrender value of life insurance	6,620,332	6,620,332			6,620,332
Federal Home Loan Bank and correspondent bank stock	1,977,470	1,977,470			1,977,470
Accrued interest receivable	1,015,128	1,015,128			1,015,128
Mortgage servicing rights	785,432			785,432	785,432
Financial liabilities:					
Deposits					
Non interest-bearing	93,603,793		93,603,793		93,603,793
Interest-bearing	218,129,024		217,915,899		217,915,899
Borrowings	4,825,000	4,825,000			4,825,000
Accrued interest payable	19,798	19,798			19,798

NOTE R – FAIR VALUE MEASUREMENT (Continued)

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions. The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks, federal funds sold and interest-bearing deposits in other financial institutions: The carrying amount approximates fair value and is classified as level 1.

Investment securities: Fair values for investment securities are based on quoted market prices, where available, and are classified as level 1. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments and indications of value provided by brokers and are classified as level 2. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Mortgages held for sale: The fair value for mortgages held for sale is based on the actual selling price, if available or quoted market prices of comparable loans, which are classified as level 2.

Loans, net: For variable-rate loans that reprice frequently and fixed rate loans that mature in the near future, with no significant change in credit risk, fair values are based on carrying amounts, resulting in a level 3 classification. The fair values for other fixed rate loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality, resulting in a level 3 classification. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics and are adjusted for the allowance for loan losses. The carrying amount of accrued interest receivable approximates its fair value and is classified as level 1.

Cash surrender value of life insurance: The carrying amount approximates fair value and is classified as level 1.

FHLB and correspondent bank stock: For FHLB and correspondent bank stock, the carrying amount is equal to the par value at which the stock may be sold back to FHLB or the correspondent bank, which approximates fair value and is classified as level 1.

Deposits: The fair values disclosed for demand deposits (for example, interest-bearing checking, money market and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts), resulting in a level 1 classification. The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on the certificates to a schedule of aggregated contractual maturities on such time deposits, resulting in a level 2 classification. The carrying amount of accrued interest payable approximates fair value and is classified as level 1.

Borrowings: The fair value is estimated using a discounted cash flow calculation that applies interest rates on similar borrowings.

NOTE R – FAIR VALUE MEASUREMENT (Continued)

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring and nonrecurring basis as of December 31, 2018 and 2017, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

	Fair Value	Level 1	Level 2	Level 3	Total Gains (Losses)
December 31, 2018:					
Measured at fair value on a recurring basis					
Investment securities	$ 33,172,889		$ 33,172,889		$ (483,753)
Mortgage servicing rights	1,001,757			$ 1,001,757	14,604
Total recurring	$ 34,174,646	$ -	$ 33,172,889	$ 1,001,757	$ (469,149)
Measured at fair value on a nonrecurring basis					
Impaired loans	$ 583,296			$ 583,296	$ (241,711)
Total nonrecurring	$ 583,296	$ -	$ -	$ 583,296	$ (241,711)
December 31, 2017:					
Measured at fair value on a recurring basis					
Investment securities	$ 34,488,848		$ 34,488,848		$ (229,924)
Mortgage servicing rights	785,432			$ 785,432	19,919
Total recurring	$ 35,274,280	$ -	$ 34,488,848	$ 785,432	$ (210,005)
Measured at fair value on a nonrecurring basis					
Impaired loans	$ 656,012			$ 656,012	$ (177,529)
Total nonrecurring	$ 656,012	$ -	$ -	$ 656,012	$ (177,529)

The following methods were used to estimate the fair value of each class of financial instrument above:

Securities Available-for-Sale: To value securities available-for-sale, the Company obtains fair value measurements from an independent pricing service. The fair value measurement considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions among other things.

Mortgage Servicing Rights: Mortgage servicing rights do not trade in an active market with readily observable prices. Accordingly, the Company determines the fair value of mortgage servicing rights using a valuation model that calculates the present value of estimated future net servicing income. Fair value measurements of the mortgage servicing rights use significant unobservable inputs and, accordingly, are classified as Level 3. Total (losses) gains recognized in earnings during 2018 and 2017 were $14,604 and $19,919, respectively, which are reflected in mortgage banking revenue, on the consolidated statements of operations.

NOTE R – FAIR VALUE MEASUREMENT (Continued)

Impaired Loans: The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraisal value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3. Management typically reduces the appraisal value by 10% to determine the fair value of the collateral.

Foreclosed Real Estate: Foreclosed real estate is held for sale and is initially recorded at fair value less estimated costs of disposition at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or estimated fair value less costs of disposition. The fair value of foreclosed real estate is determined using various valuation techniques which are not readily observable in the market place, including consideration of appraised values and other pertinent real estate market data. Management typically reduces the appraisal value by 10% to determine the fair value of the property.

No amounts were transferred among level 1, level 2 or level 3 during 2018 or 2017.

The following table presents quantitative information about level 3 fair value measurement for assets measured at fair value at December 31, 2018 and 2017:

	Fair Value	Valuation Techniques	Unobservable Inputs	Range	Weighted Average
December 31, 2018:					
Nonrecurring:					
Impaired loans	$ 583,296	Sales comparison approach	Collateral discounts and estimated costs to sell	10.00%	10.00%
Recurring:					
Mortgage servicing rights	1,001,757	Discounted cash flow approach	Constant prepayment rate	7.19% to 8.29%	8.15%
			Discount rate	10.00%	
December 31, 2017:					
Nonrecurring:					
Impaired loans	$ 656,012	Sales comparison approach	Collateral discounts and estimated costs to sell	10.00%	10.00%
Recurring:					
Mortgage servicing rights	785,432	Discounted cash flow approach	Constant prepayment rate	8.50% to 10.59%	10.29%
			Discount rate	11.00%	

Redwood Capital Bancorp

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