

WESTAMERICA BANCORPORATION

Form 10-Q

November 02, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

or

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

For the transition period from _____ to _____.

Commission file number: 001-09383

WESTAMERICA BANCORPORATION

(Exact Name of Registrant as Specified in Its Charter)

CALIFORNIA

94-2156203

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

1108 FIFTH AVENUE, SAN RAFAEL, CALIFORNIA 94901

(Address of Principal Executive Offices) (Zip Code)

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Registrant's Telephone Number, Including Area Code (707) 863-6000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes No

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

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

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

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

Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

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Title of Class Shares outstanding as of October 29, 2018

Common Stock, 26,727,416

No Par Value

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FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements about Westamerica Bancorporation (the “Company”) for which it claims the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, future credit quality and performance, the appropriateness of the allowance for loan losses, loan growth or reduction, mitigation of risk in the Company’s loan and investment securities portfolios, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of the Company or its management or board of directors, including those relating to products or services; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as “believes”, “anticipates”, “expects”, “estimates”, “intends”, “targeted”, “projected”, “forecast”, “continue”, “remain”, “will”, “should”, “may” and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

These forward-looking statements are based on Management’s current knowledge and belief and include information concerning the Company’s possible or assumed future financial condition and results of operations. A number of factors, some of which are beyond the Company’s ability to predict or control, could cause future results to differ materially from those contemplated. These factors include but are not limited to (1) the length and severity of difficulties in the global, national and California economies and the effects of government efforts to address those difficulties; (2) liquidity levels in capital markets; (3) fluctuations in asset prices including, but not limited to stocks, bonds, real estate, and commodities; (4) the effect of acquisitions and integration of acquired businesses; (5) economic uncertainty created by terrorist threats and attacks on the United States, the actions taken in response, and the uncertain effect of these events on the national and regional economies; (6) changes in the interest rate environment; (7) changes in the regulatory environment; (8) competitive pressure in the banking industry; (9) operational risks including a failure or breach in data processing or security systems or those of third party vendors and other service providers, including as a result of cyber attacks or fraud; (10) volatility of interest rate sensitive loans, deposits and investments; (11) asset/liability management risks and liquidity risks; (12) the effect of natural disasters, including earthquakes, fire, flood, drought, and other disasters, on the uninsured value of the Company’s assets and of loan collateral, the financial condition of debtors and issuers of investment securities, the economic conditions affecting the Company’s market place, and commodities and asset values; (13) changes in the securities markets and (14) the outcome of contingencies, such as legal proceedings. However, the reader should not consider the above-mentioned factors to be a complete set of all potential risks or uncertainties.

Forward-looking statements speak only as of the date they are made. The Company undertakes no obligation to update any forward-looking statements in this report to reflect circumstances or events that occur after the date forward looking statements are made, except as may be required by law. The reader is directed to the Company's annual report on Form 10-K for the year ended December 31, 2017, for further discussion of factors which could affect the Company's business and cause actual results to differ materially from those expressed in any forward-looking statement made in this report.

PART I - FINANCIAL INFORMATION**Item 1****Financial Statements**

WESTAMERICA BANCORPORATION

CONSOLIDATED BALANCE SHEETS

(unaudited)

(In thousands)

| | At September 30, 2018 | At December 31, 2017 |
|---|--------------------------------|-------------------------------|
| Assets: | | |
| Cash and due from banks | \$522,660 | \$575,002 |
| Equity securities | 1,734 | 1,800 |
| Debt securities available for sale | 2,478,908 | 2,191,707 |
| Debt securities held to maturity, with fair values of: \$1,002,648 at September 30, 2018 and \$1,155,342 at December 31, 2017 | 1,025,699 | 1,158,864 |
| Loans | 1,196,955 | 1,287,982 |
| Allowance for loan losses | (22,027) | (23,009) |
| Loans, net of allowance for loan losses | 1,174,928 | 1,264,973 |
| Other real estate owned | 620 | 1,426 |
| Premises and equipment, net | 35,391 | 35,301 |
| Identifiable intangibles, net | 2,376 | 3,850 |
| Goodwill | 121,673 | 121,673 |
| Other assets | 165,474 | 158,450 |
| Total Assets | \$5,529,463 | \$5,513,046 |
| Liabilities: | | |
| Noninterest-bearing deposits | \$2,211,028 | \$2,197,526 |
| Interest-bearing deposits | 2,624,809 | 2,630,087 |
| Total deposits | 4,835,837 | 4,827,613 |
| Short-term borrowed funds | 61,756 | 58,471 |
| Other liabilities | 39,279 | 36,723 |
| Total Liabilities | 4,936,872 | 4,922,807 |

Contingencies (Note 10)

Shareholders' Equity:

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| | | |
|--|-------------|-------------|
| Common stock (no par value), authorized - 150,000 shares Issued and outstanding: 26,727 at September 30, 2018 and 26,425 at December 31, 2017 | 447,785 | 431,734 |
| Deferred compensation | 1,395 | 1,533 |
| Accumulated other comprehensive loss | (54,066) | (16,832) |
| Retained earnings | 197,477 | 173,804 |
| Total Shareholders' Equity | 592,591 | 590,239 |
| Total Liabilities and Shareholders' Equity | \$5,529,463 | \$5,513,046 |

See accompanying notes to unaudited consolidated financial statements.

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WESTAMERICA BANCORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

| | For the Three Months Ended September 30, | | For the Nine Months | |
|--|--|-----------|---------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands, except per share data) | | | |
| Interest and Loan Fee Income: | | | | |
| Loans | \$ 14,593 | \$ 15,082 | \$ 44,247 | \$ 46,330 |
| Equity securities | 85 | 70 | 256 | 214 |
| Debt securities available for sale | 15,644 | 11,277 | 43,518 | 32,091 |
| Debt securities held to maturity | 5,931 | 6,716 | 18,321 | 20,997 |
| Total Interest and Loan Fee Income | 36,253 | 33,145 | 106,342 | 99,632 |
| Interest Expense: | | | | |
| Deposits | 518 | 461 | 1,417 | 1,395 |
| Short-term borrowed funds | 9 | 12 | 28 | 34 |
| Total Interest Expense | 527 | 473 | 1,445 | 1,429 |
| Net Interest and Loan Fee Income | 35,726 | 32,672 | 104,897 | 98,203 |
| Reversal of Provision for Loan Losses | - | - | - | (1,900) |
| Net Interest and Loan Fee Income After Reversal of Provision for Loan Losses | 35,726 | 32,672 | 104,897 | 100,103 |
| Noninterest Income: | | | | |
| Service charges on deposit accounts | 4,615 | 4,989 | 14,012 | 14,857 |
| Merchant processing services | 2,464 | 2,153 | 7,190 | 6,080 |
| Debit card fees | 1,656 | 1,784 | 4,959 | 4,851 |
| Trust fees | 733 | 718 | 2,202 | 2,136 |
| ATM processing fees | 687 | 684 | 2,049 | 1,914 |
| Other service fees | 665 | 652 | 1,946 | 1,964 |
| Life insurance gains | 585 | - | 585 | - |
| Financial services commissions | 132 | 148 | 387 | 484 |
| Equity securities losses | (16) | - | (66) | - |
| Other noninterest income | 1,007 | 1,420 | 2,988 | 4,042 |
| Total Noninterest Income | 12,528 | 12,548 | 36,252 | 36,328 |
| Noninterest Expense: | | | | |
| Salaries and related benefits | 13,415 | 12,816 | 39,952 | 38,867 |
| Occupancy and equipment | 4,809 | 4,907 | 14,365 | 14,571 |
| Loss contingency | 3,500 | - | 3,500 | - |
| Outsourced data processing services | 2,292 | 2,383 | 6,930 | 6,710 |
| Professional fees | 621 | 512 | 2,277 | 1,533 |
| Amortization of identifiable intangibles | 451 | 760 | 1,474 | 2,322 |

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| | | | | |
|---|----------|----------|----------|----------|
| Courier service | 448 | 451 | 1,333 | 1,310 |
| Other noninterest expense | 1,469 | 2,285 | 5,365 | 7,812 |
| Total Noninterest Expense | 27,005 | 24,114 | 75,196 | 73,125 |
| Income Before Income Taxes | 21,249 | 21,106 | 65,953 | 63,306 |
| Provision for income taxes | 4,256 | 6,089 | 13,444 | 17,441 |
| Net Income | \$16,993 | \$15,017 | \$52,509 | \$45,865 |
| | | | | |
| Average Common Shares Outstanding | 26,701 | 26,309 | 26,622 | 26,260 |
| Average Diluted Common Shares Outstanding | 26,815 | 26,404 | 26,736 | 26,379 |
| Per Common Share Data: | | | | |
| Basic earnings | \$0.64 | \$0.57 | \$1.97 | \$1.75 |
| Diluted earnings | 0.63 | 0.57 | 1.96 | 1.74 |
| Dividends paid | 0.40 | 0.39 | 1.20 | 1.17 |

See accompanying notes to unaudited consolidated financial statements.

WESTAMERICA BANCORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

| | For the Three Months Ended September 30, | | For the Nine Months | |
|---|--|----------|---------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands) | | | |
| Net income | \$16,993 | \$15,017 | \$52,509 | \$45,865 |
| Other comprehensive (loss) income: | | | | |
| Changes in unrealized gains on debt securities available for sale | (5,915) | 4,179 | (47,915) | 11,413 |
| Deferred tax benefit(expense) | 1,749 | (1,757) | 14,164 | (4,799) |
| Changes in unrealized gains on debt securities available for sale, net of tax | (4,166) | 2,422 | (33,751) | 6,614 |
| Post-retirement benefit transition obligation amortization | - | 15 | - | 45 |
| Deferred tax expense | - | (6) | - | (18) |
| Post-retirement benefit transition obligation amortization, net of tax | - | 9 | - | 27 |
| Total other comprehensive (loss) income | (4,166) | 2,431 | (33,751) | 6,641 |
| Total comprehensive income | \$12,827 | \$17,448 | \$18,758 | \$52,506 |

See accompanying notes to unaudited consolidated financial statements.

WESTAMERICA BANCORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(unaudited)

| | Common Shares Outstanding | Common Stock | Deferred Compensation | Accumulated Other Comprehensive (Loss) Income | Retained Earnings | Total |
|---|---------------------------------|-----------------|--------------------------|--|----------------------|-----------|
| | (In thousands) | | | | | |
| Balance, December 31, 2016 | 25,907 | \$404,606 | \$ 1,533 | \$ (10,074) | \$165,302 | \$561,367 |
| Net income for the period | | | | | 45,865 | 45,865 |
| Other comprehensive income | | | | 6,641 | | 6,641 |
| Exercise of stock options | 403 | 18,988 | | | | 18,988 |
| Restricted stock activity | 13 | 707 | | | | 707 |
| Stock based compensation | | 1,368 | | | | 1,368 |
| Stock awarded to employees | 2 | 76 | | | | 76 |
| Retirement of common stock | (6) | (90) | | | (224) | (314) |
| Dividends | | | | | (30,741) | (30,741) |
| Balance, September 30, 2017 | 26,319 | \$425,655 | \$ 1,533 | \$ (3,433) | \$180,202 | \$603,957 |
| Balance, December 31, 2017 | 26,425 | \$431,734 | \$ 1,533 | \$ (16,832) | \$173,804 | \$590,239 |
| Cumulative effect of equity securities losses reclassified | | | | 142 | (142) | - |
| Adjusted Balance, January 1, 2018 | 26,425 | 431,734 | 1,533 | (16,690) | 173,662 | 590,239 |
| Reclass stranded tax effects resulting from the Tax Cuts and Jobs Act | | | | (3,625) | 3,625 | - |
| Net income for the period | | | | | 52,509 | 52,509 |
| Other comprehensive loss | | | | (33,751) | | (33,751) |
| Exercise of stock options | 289 | 13,245 | | | | 13,245 |
| Restricted stock activity | 20 | 1,281 | (138) | | | 1,143 |
| Stock based compensation | | 1,575 | | | | 1,575 |
| Stock awarded to employees | 2 | 99 | | | | 99 |
| Retirement of common stock | (9) | (149) | | | (375) | (524) |
| Dividends | | | | | (31,944) | (31,944) |
| Balance, September 30, 2018 | 26,727 | \$447,785 | \$ 1,395 | \$ (54,066) | \$197,477 | \$592,591 |

See accompanying notes to unaudited consolidated financial statements.

WESTAMERICA BANCORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

| | For the Nine Months Ended September 30, | |
|---|--|-----------|
| | 2018 | 2017 |
| | (In thousands) | |
| Operating Activities: | | |
| Net income | \$52,509 | \$45,865 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 18,964 | 18,807 |
| Reversal of provision for loan losses | - | (1,900) |
| Net amortization of deferred loan (fees) cost | (181) | 34 |
| (Increase) decrease in interest income receivable | (177) | 713 |
| Life insurance premiums paid | (609) | (126) |
| Increase in other assets | (1,287) | (2,088) |
| Increase in income taxes payable | 7,760 | 2,461 |
| (Increase) decrease in net deferred tax asset | (1,345) | 895 |
| Stock option compensation expense | 1,575 | 1,368 |
| Increase (decrease) in interest expense payable | 5 | (8) |
| Increase (decrease) in other liabilities | 3,793 | (1,142) |
| Life insurance gains | (585) | - |
| Equity securities losses | 66 | - |
| Net writedown of premises and equipment | 3 | 60 |
| Net gain on sale of foreclosed assets | (94) | (72) |
| Writedown of foreclosed assets | 27 | 219 |
| Net Cash Provided by Operating Activities | 80,424 | 65,086 |
| Investing Activities: | | |
| Net repayments of loans | 91,594 | 69,319 |
| Net payments under FDIC ⁽¹⁾ indemnification agreements | - | (63) |
| Proceeds from life insurance | 1,183 | - |
| Purchases of debt securities available for sale | (634,113) | (433,525) |
| Proceeds from sale/maturity/calls of debt securities available for sale | 290,663 | 238,888 |
| Proceeds from maturity/calls of debt securities held to maturity | 127,578 | 135,208 |
| Purchases of premises and equipment | (2,830) | (1,980) |
| Net change in FRB ⁽²⁾ stock | - | 1 |
| Proceeds from sale of foreclosed assets | 873 | 1,521 |
| Net Cash (Used in) Provided by Investing Activities | (125,052) | 9,369 |
| Financing Activities: | | |
| Net change in deposits | 8,224 | 29,839 |
| Net change in short-term borrowings | 3,285 | 7,259 |

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| | | |
|--|-----------|-----------|
| Exercise of stock options | 13,245 | 18,988 |
| Retirement of common stock | (524) | (314) |
| Common stock dividends paid | (31,944) | (30,741) |
| Net Cash (Used in) Provided by Financing Activities | (7,714) | 25,031 |
| Net Change In Cash and Due from Banks | (52,342) | 99,486 |
| Cash and Due from Banks at Beginning of Period | 575,002 | 462,271 |
| Cash and Due from Banks at End of Period | \$522,660 | \$561,757 |
| Supplemental Cash Flow Disclosures: | | |
| Supplemental disclosure of non cash activities: | | |
| Loan collateral transferred to other real estate owned | \$- | \$- |
| Securities purchases pending settlement | - | 811 |
| Supplemental disclosure of cash flow activities: | | |
| Interest paid for the period | 1,440 | 1,437 |
| Income tax payments for the period | 7,028 | 14,657 |

See accompanying notes to unaudited consolidated financial statements.

(1) Federal Deposit Insurance Corporation ("FDIC")

(2) Federal Reserve Bank ("FRB")

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission and follow general practices within the banking industry. The results of operations reflect interim adjustments, all of which are of a normal recurring nature and which, in the opinion of Management, are necessary for a fair presentation of the results for the interim periods presented. The interim results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results expected for the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes as well as other information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Note 2: Accounting Policies

The most significant accounting policies followed by the Company are presented in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, it is reasonably possible conditions could change materially affecting results of operations and financial conditions.

Application of these principles requires the Company to make certain estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain accounting policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment writedown or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

Certain amounts in prior periods have been reclassified to conform to the current presentation.

Recently Adopted Accounting Standards

In the nine months ended September 30, 2018, the Company adopted the following new accounting guidance:

FASB Accounting Standard Update (ASU) 2014-09, Revenue (Topic 606): Revenue from Contracts with Customers, was issued May 2014. The ASU specifies a standardized approach for revenue recognition across industries and transactions. The ASU also requires additional disclosures. The scope of the ASU does not include revenue streams covered by other ASU topics; thus, Topic 606 does not apply to revenue related to financial instruments, guarantees and leases, which are the primary sources of the Company's net interest income.

Approximately 73% of the Company's revenue, including all of its net interest income and a portion of its noninterest income, is out of scope of the guidance. The contracts that are in scope of the guidance are primarily related to service charges and fees on deposit accounts, merchant processing fees, debit card fees, ATM processing fees, trust fees and other service charges, commissions and fees. The Company's revenue recognition practices within the scope of the ASU as described below did not change in any material regard upon adoption of the ASU.

Service Charges on Deposit Accounts: The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based 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 relate 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.

Merchant Processing Services and Debit Card Fees: The Company earns interchange fees from cardholder transactions conducted through the payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Trust Fees: The Company earns trust fees from its contracts with customers to manage assets for investment or custody services. These fees are primarily earned over time as the Company provides the contracted monthly services and are generally assessed based on a tiered scale of the market value of assets under management (AUM) at month-end. Other related services provided, which are based on a fixed fee schedule, are recognized when the services are rendered.

Gains/Losses on Sales of OREO: The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. The Company does not finance the sale of OREO.

The Company adopted the ASU on January 1, 2018 and no cumulative adjustment was required.

FASB ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued January 2016. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most notably, the ASU changes the income statement impact of equity investments held by the Company and the requirement for the Company to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes (Note 9).

The Company was required to adopt the ASU provisions on January 1, 2018, and for those equity securities with readily determinable fair values, the Company elected the retrospective transition approach with a cumulative effect adjustment to the balance sheet and for those equity securities that do not have readily determinable fair values, the Company elected the prospective transition approach. The impact of the adoption of this accounting standard on the Company's consolidated financial statements will be subject to the price volatility of the equity investments. As a result of implementing the ASU provisions, effective January 1, 2018, the Company recorded a cumulative effect adjustment to retained earnings of \$142 thousand.

FASB ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, was issued February 2018. The ASU eliminates the stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017 by allowing a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017. The Company early adopted the provisions of the ASU effective January 1, 2018, by reclassifying the

Company's \$3,625 thousand stranded tax effect.

Recently Issued Accounting Standards

FASB ASU 2016-02, Leases (Topic 842), was issued February 25, 2016. The provisions of the new standard require lessees to recognize most leases on-balance sheet, increasing reported assets and liabilities. Lessor accounting remains substantially similar to current U.S. GAAP.

The Company will be required to adopt the ASU provisions effective January 1, 2019, and plans to elect the modified retrospective transition approach. Management is evaluating the impact that the ASU will have on the Company's financial statements. As of December 31, 2017, the Company leased 58 of its operating facilities; the remaining minimum lease payments were \$17.5 million. The Company does not expect a material change in noninterest expenses upon adoption of the new standard.

FASB ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, was issued on June 16, 2016. The ASU significantly changes estimates for credit losses related to financial assets measured at amortized cost and certain other contracts. For estimating credit losses, the FASB is replacing the incurred loss model with the current expected credit loss (CECL) model, which will accelerate recognition of credit losses. Additionally, credit losses relating to debt securities available-for-sale will be recorded through an allowance for credit losses under the new standard. The Company will also be required to provide additional disclosures related to the financial assets within the scope of the new standard.

The Company will be required to adopt the ASU provisions on January 1, 2020. Management has commenced an implementation project to include evaluating available data, defining portfolio segments of loans with similar attributes, and selecting loss estimate models for each identified loan portfolio segment. The ultimate adjustment to the allowance for loan losses will be accomplished through an offsetting after-tax adjustment to shareholders' equity. Management has also segmented debt securities held to maturity and selected methods to estimate losses for each segment. Economic conditions and the composition of the Company's loan portfolio at the time of adoption will influence the extent of the adopting accounting adjustment.

FASB ASU 2017-08, *Receivables – Non-Refundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*, was issued March 2017. The ASU will shorten the amortization period for certain callable debt securities held at a premium. Specifically, the ASU requires the premium to be amortized to the earliest call date. The ASU does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity.

The Company will be required to adopt the ASU provisions on January 1, 2019. Management has evaluated the impact the ASU will have on the Company's financial statements relative to shareholder's equity and the change in monthly earnings and the impact is not expected to be material.

FASB ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, was issued August 2017. The ASU will expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. The ASU also provides for a one-time reclassification of prepayable assets from held-to-maturity (HTM) to available for sale (AFS) regardless of derivative use.

The Company will be required to adopt the ASU provisions on January 1, 2019. The Company does not currently engage in trading activities or use derivative instruments to control interest rate risk, even though such activities may be permitted with the approval of the Company's Board of Directors. The Company has evaluated the prepayable assets in the HTM portfolio and will not effect a one-time reclassification of prepayable assets from HTM to the AFS upon implementation.

FASB ASU 2018-13, *Fair Value Measurements (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*, was issued August 2018. The ASU is part of the disclosure framework project, where the primary focus is to improve the effectiveness of disclosures in the financial statements. The ASU removes, modifies and adds disclosure requirements related to Fair Value Measurements.

The provisions of the ASU are effective January 1, 2020 with the option to early adopt any removed or modified disclosures upon issuance of the ASU. The Company early adopted the provisions to remove and/or modify relevant disclosures in Note 9 to the unaudited consolidated financial statements. The requirement to include additional disclosures will be adopted by the Company January 1, 2020. The additional disclosures will not affect the financial results upon adoption.

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Note 3: Investment Securities

Effective January 1, 2018, upon adoption of ASU 2016-01, equity securities included in the Company's available for sale portfolio of \$1,800 thousand were reclassified to equity securities. The reclassification of equity securities resulted in recording a cumulative effect adjustment to retained earnings of \$142 thousand, net of tax.

At September 30, 2018, the market value of equity securities was \$1,734 thousand. During the nine months ended September 30, 2018, the Company recognized gross unrealized holding losses of \$66 thousand in earnings.

An analysis of the amortized cost and fair value by major categories of debt securities available for sale, which are carried at fair value with net unrealized gains (losses) reported on an after-tax basis as a component of cumulative other comprehensive income, and debt securities held to maturity, which are carried at amortized cost, follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| At September 30, 2018 | (In thousands) | | | |
| Debt securities available for sale | | | | |
| Securities of U.S. Government sponsored entities | \$ 167,222 | \$ - | \$(5,478) | \$ 161,744 |
| Agency residential mortgage-backed securities (MBS) | 919,381 | 243 | (41,595) | 878,029 |
| Non-agency residential MBS | 122 | 2 | - | 124 |
| Agency commercial MBS | 1,877 | - | (30) | 1,847 |
| Securities of U.S. Government entities | 1,223 | - | (13) | 1,210 |
| Obligations of states and political subdivisions | 182,851 | 1,841 | (4,349) | 180,343 |
| Corporate securities | 1,282,991 | 411 | (27,791) | 1,255,611 |
| Total debt securities available for sale | 2,555,667 | 2,497 | (79,256) | 2,478,908 |
| Debt securities held to maturity | | | | |
| Agency residential MBS | 468,354 | 200 | (21,100) | 447,454 |
| Non-agency residential MBS | 3,524 | 72 | - | 3,596 |
| Obligations of states and political subdivisions | 553,821 | 2,526 | (4,749) | 551,598 |
| Total debt securities held to maturity | 1,025,699 | 2,798 | (25,849) | 1,002,648 |
| Total | \$3,581,366 | \$ 5,295 | \$(105,105) | \$3,481,556 |

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|----------------------|-------------------|------------------------------|-------------------------------|---------------|
| At December 31, 2017 | (In thousands) | | | |

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| | | | | |
|--|--------------|-----------|--------------|--------------|
| Debt securities available for sale | | | | |
| Securities of U.S. Government sponsored entities | \$ 122,285 | \$ 1 | \$ (2,967) | \$ 119,319 |
| Agency residential MBS | 787,679 | 522 | (20,495) | 767,706 |
| Non-agency residential MBS | 153 | 1 | - | 154 |
| Agency commercial MBS | 2,244 | - | (25) | 2,219 |
| Securities of U.S. Government entities | 1,612 | - | (22) | 1,590 |
| Obligations of states and political subdivisions | 182,907 | 3,796 | (1,482) | 185,221 |
| Corporate securities | 1,123,671 | 1,104 | (9,277) | 1,115,498 |
| Total debt securities available for sale | 2,220,551 | 5,424 | (34,268) | 2,191,707 |
| Debt securities held to maturity | | | | |
| Agency residential MBS | 545,883 | 606 | (9,850) | 536,639 |
| Non-agency residential MBS | 4,462 | 70 | - | 4,532 |
| Agency commercial MBS | 9,041 | - | (66) | 8,975 |
| Obligations of states and political subdivisions | 599,478 | 7,736 | (2,018) | 605,196 |
| Total debt securities held to maturity | 1,158,864 | 8,412 | (11,934) | 1,155,342 |
| Total | \$ 3,379,415 | \$ 13,836 | \$ (46,202) | \$ 3,347,049 |

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The amortized cost and fair value of debt securities by contractual maturity are shown in the following tables at the dates indicated:

| | At September 30, 2018 | | | |
|--------------------|---------------------------------------|---------------|-------------------------------------|---------------|
| | Debt Securities Available for Sale | | Debt Securities Held to Maturity | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (In thousands) | | | |
| Maturity in years: | | | | |
| 1 year or less | \$128,356 | \$128,080 | \$90,266 | \$90,491 |
| Over 1 to 5 years | 1,355,592 | 1,323,725 | 220,377 | 219,016 |
| Over 5 to 10 years | 111,553 | 110,850 | 242,137 | 241,023 |
| Over 10 years | 38,786 | 36,253 | 1,041 | 1,068 |
| Subtotal | 1,634,287 | 1,598,908 | 553,821 | 551,598 |
| MBS | 921,380 | 880,000 | 471,878 | 451,050 |
| Total | \$2,555,667 | \$2,478,908 | \$1,025,699 | \$1,002,648 |

| | At December 31, 2017 | | | |
|--------------------|---------------------------------------|---------------|-------------------------------------|---------------|
| | Debt Securities Available for Sale | | Debt Securities Held to Maturity | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (In thousands) | | | |
| Maturity in years: | | | | |
| 1 year or less | \$193,337 | \$193,385 | \$50,295 | \$51,105 |
| Over 1 to 5 years | 1,031,807 | 1,023,047 | 269,050 | 269,471 |
| Over 5 to 10 years | 159,266 | 160,042 | 277,170 | 281,546 |
| Over 10 years | 46,065 | 45,154 | 2,963 | 3,074 |
| Subtotal | 1,430,475 | 1,421,628 | 599,478 | 605,196 |
| MBS | 790,076 | 770,079 | 559,386 | 550,146 |
| Total | \$2,220,551 | \$2,191,707 | \$1,158,864 | \$1,155,342 |

Expected maturities of mortgage-related securities can differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. In addition, such factors as prepayments and interest rates may affect the yield on the carrying value of mortgage-related securities. At September

30, 2018 and December 31, 2017, the Company had no high-risk collateralized mortgage obligations as defined by regulatory guidelines.

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An analysis of the gross unrealized losses of the debt securities available for sale portfolio follows:

| Debt Securities Available for Sale | | | | | | | | | |
|--|-----------------------------|---------------------|-------------------|-----------------------------|---------------------|-------------------|-----------------------------|-------------|-------------------|
| At September 30, 2018 | | | | | | | | | |
| | No. of Investment Positions | Less than 12 months | | No. of Investment Positions | 12 months or longer | | No. of Investment Positions | Total | |
| | | Fair Value | Unrealized Losses | | Fair Value | Unrealized Losses | | Fair Value | Unrealized Losses |
| (\$ in thousands) | | | | | | | | | |
| Securities of U.S. Government sponsored entities | 5 | \$46,531 | \$(461) | 8 | \$115,213 | \$(5,017) | 13 | \$161,744 | \$(5,478) |
| Agency residential MBS | 23 | 421,962 | (9,816) | 50 | 447,104 | (31,779) | 73 | 869,066 | (41,595) |
| Agency commercial MBS | - | - | - | 1 | 1,847 | (30) | 1 | 1,847 | (30) |
| Securities of U.S. Government entities | - | - | - | 2 | 1,210 | (13) | 2 | 1,210 | (13) |
| Obligations of states and political subdivisions | 43 | 32,193 | (392) | 74 | 67,715 | (3,957) | 117 | 99,908 | (4,349) |
| Corporate securities | 86 | 826,287 | (16,386) | 37 | 333,319 | (11,405) | 123 | 1,159,606 | (27,791) |
| Total | 157 | \$1,326,973 | \$(27,055) | 172 | \$966,408 | \$(52,201) | 329 | \$2,293,381 | \$(79,256) |

An analysis of gross unrecognized losses of the debt securities held to maturity portfolio follows:

| Debt Securities Held to Maturity | | | | | | | | | |
|--|-----------------------------|---------------------|---------------------|-----------------------------|---------------------|---------------------|-----------------------------|------------|---------------------|
| At September 30, 2018 | | | | | | | | | |
| | No. of Investment Positions | Less than 12 months | | No. of Investment Positions | 12 months or longer | | No. of Investment Positions | Total | |
| | | Fair Value | Unrecognized Losses | | Fair Value | Unrecognized Losses | | Fair Value | Unrecognized Losses |
| (\$ in thousands) | | | | | | | | | |
| Agency residential MBS | 26 | \$34,278 | \$(952) | 70 | \$404,842 | \$(20,148) | 96 | \$439,120 | \$(21,100) |
| Obligations of states and political subdivisions | 224 | 191,579 | (1,540) | 162 | 164,011 | (3,209) | 386 | 355,590 | (4,749) |
| Total | 250 | \$225,857 | \$(2,492) | 232 | \$568,853 | \$(23,357) | 482 | \$794,710 | \$(25,849) |

The unrealized losses on the Company's debt securities were caused by market conditions for these types of investments, particularly changes in risk-free interest rates. The Company evaluates debt securities on a quarterly basis including changes in security ratings issued by rating agencies, changes in the financial condition of the issuer, and, for mortgage-backed and asset-backed securities, delinquency and loss information with respect to the underlying collateral, changes in the levels of subordination for the Company's particular position within the repayment structure and remaining credit enhancement as compared to expected credit losses of the security. Substantially all of these securities continue to be investment grade rated by a major rating agency. One corporate bond with a carrying value of \$15.0 million and a market value of \$14.1 million at September 30, 2018, is rated below investment grade. In addition to monitoring credit rating agency evaluations, Management performs its own evaluations regarding the credit worthiness of the issuer or the securitized assets underlying asset backed securities.

The Company does not intend to sell any debt securities and has concluded that it is more likely than not that it will not be required to sell the debt securities prior to recovery of the amortized cost basis. Therefore, the Company does not consider these debt securities to be other-than-temporarily impaired as of September 30, 2018.

The fair values of the debt securities could decline in the future if the general economy deteriorates, inflation increases, credit ratings decline, the issuer's financial condition deteriorates, or the liquidity for debt securities declines. As a result, other than temporary impairments may occur in the future.

As of September 30, 2018 and December 31, 2017, the Company had debt securities pledged to secure public deposits and short-term borrowed funds of \$740,177 thousand and \$715,774 thousand, respectively.

An analysis of gross unrealized losses of debt securities available for sale follows:

| Debt Securities Available for Sale | | | | | | | | | |
|--|-------------------|---------------------|------------|------------|---------------------|-------------|------------|-------------|-------------|
| At December 31, 2017 | | | | | | | | | |
| | No. of | Less than 12 months | Unrealized | No. of | 12 months or longer | Unrealized | No. of | Total | Unrealized |
| | Investment | Fair Value | Losses | Investment | Fair Value | Losses | Investment | Fair Value | Losses |
| | Positions | | | Positions | | | Positions | | |
| | (\$ in thousands) | | | | | | | | |
| Securities of U.S. Government sponsored entities | 1 | \$996 | \$(2) | 8 | \$117,252 | \$(2,965) | 9 | \$118,248 | \$(2,967) |
| Agency residential MBS | 7 | 238,554 | (1,501) | 51 | 516,711 | (18,994) | 58 | 755,265 | (20,495) |
| Non-agency residential MBS | 1 | 1 | - | - | - | - | 1 | 1 | - |
| Agency commercial; MBS | 2 | 2,219 | (25) | - | - | - | 2 | 2,219 | (25) |
| Securities of U.S. Government entities | - | - | - | 3 | 1,590 | (22) | 3 | 1,590 | (22) |
| Obligations of states and political subdivisions | 50 | 21,453 | (228) | 35 | 52,071 | (1,254) | 85 | 73,524 | (1,482) |
| Corporate securities | 64 | 571,112 | (4,047) | 38 | 282,924 | (5,230) | 102 | 854,036 | (9,277) |
| Total | 125 | \$834,335 | \$(5,803) | 135 | \$970,548 | \$(28,465) | 260 | \$1,804,883 | \$(34,268) |

An analysis of gross unrecognized losses of the debt securities held to maturity portfolio follows:

| Debt Securities Held to Maturity | | | | | | | | | |
|----------------------------------|-------------------|---------------------|--------------|------------|---------------------|--------------|------------|------------|--------------|
| At December 31, 2017 | | | | | | | | | |
| | No. of | Less than 12 months | Unrecognized | No. of | 12 months or longer | Unrecognized | No. of | Total | Unrecognized |
| | Investment | Fair Value | Losses | Investment | Fair Value | Losses | Investment | Fair Value | Losses |
| | Positions | | | Positions | | | Positions | | |
| | (\$ in thousands) | | | | | | | | |
| | 15 | \$30,218 | \$(201) | 65 | \$479,775 | \$(9,649) | 80 | \$509,993 | \$(9,850) |

| | | | | | | | | | |
|--|-----|-----------|-----------|-----|-----------|--------------|-----|-----------|--------------|
| Agency residential MBS | | | | | | | | | |
| Agency commercial MBS | 1 | 1,913 | (4) | 1 | 7,062 | (62) | 2 | 8,975 | (66) |
| Obligations of states and political subdivisions | 146 | 131,032 | (553) | 59 | 58,979 | (1,465) | 205 | 190,011 | (2,018) |
| Total | 162 | \$163,163 | \$ (758) | 125 | \$545,816 | \$ (11,176) | 287 | \$708,979 | \$ (11,934) |

The following table provides information about the amount of interest income earned on investment securities which is fully taxable and which is exempt from regular federal income tax:

| | For the Three Months Ended September 30, 2018 | | For the Nine Months 2017 | |
|--|--|----------|--------------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands) | | | |
| Taxable | \$16,780 | \$12,957 | \$47,327 | \$37,584 |
| Tax-exempt from regular federal income tax | 4,880 | 5,106 | 14,768 | 15,718 |
| Total interest income from investment securities | \$21,660 | \$18,063 | \$62,095 | \$53,302 |

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Note 4: Loans, Allowance for Loan Losses and Other Real Estate Owned

A summary of the major categories of loans outstanding is shown in the following table at the dates indicated.

| | At September 30, 2018 | At December 31, 2017 |
|------------------------------|--------------------------------|-------------------------------|
| | (In thousands) | |
| Commercial | \$276,031 | \$335,996 |
| Commercial Real Estate | 567,213 | 568,584 |
| Construction | 3,939 | 5,649 |
| Residential Real Estate | 48,150 | 65,183 |
| Consumer Installment & Other | 301,622 | 312,570 |
| Total | \$1,196,955 | \$1,287,982 |

Total loans outstanding reported above include loans purchased from the FDIC of \$65,868 thousand and \$83,478 thousand at September 30, 2018 and December 31, 2017, respectively. Loans purchased from the FDIC were separately reported in prior periods and have been reclassified into their respective categories in the current presentation.

Changes in the accretable yield for purchased loans were as follows:

| | For the Nine Months Ended September 30, 2018 | For the Year Ended December 31, 2017 |
|--|---|--|
| | (In thousands) | |
| Accretable yield: | | |
| Balance at the beginning of the period | \$738 | \$1,237 |
| Reclassification from nonaccretable difference | 896 | 1,852 |
| Accretion | (1,380) | (2,351) |
| Balance at the end of the period | \$254 | \$738 |
| Accretion | \$(1,380) | \$(2,351) |
| Change in FDIC indemnification | 2 | 192 |
| (Increase) in interest income | \$(1,378) | \$(2,159) |

The following summarizes activity in the allowance for loan losses:

Allowance for Loan Losses
For the Three Months Ended September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at beginning of period | \$8,275 | \$ 3,789 | \$ 210 | \$ 1,064 | \$ 5,943 | \$ 3,759 | \$23,040 |
| (Reversal) provision | (184) | 372 | 44 | (120) | (137) | 25 | - |
| Chargeoffs | (384) | (240) | - | - | (845) | - | (1,469) |
| Recoveries | 103 | - | - | - | 353 | - | 456 |
| Total allowance for loan losses | \$7,810 | \$ 3,921 | \$ 254 | \$ 944 | \$ 5,314 | \$ 3,784 | \$22,027 |

Allowance for Loan Losses
For the Nine Months Ended September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at beginning of period | \$7,746 | \$ 3,849 | \$ 335 | \$ 995 | \$ 6,418 | \$ 3,666 | \$23,009 |
| (Reversal) provision | (863) | 312 | (81) | (51) | 565 | 118 | - |
| Chargeoffs | (425) | (240) | - | - | (3,015) | - | (3,680) |
| Recoveries | 1,352 | - | - | - | 1,346 | - | 2,698 |
| Total allowance for loan losses | \$7,810 | \$ 3,921 | \$ 254 | \$ 944 | \$ 5,314 | \$ 3,784 | \$22,027 |

Allowance for Loan Losses
For the Three Months Ended September 30, 2017

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at beginning of period | \$8,167 | \$ 3,545 | \$ 160 | \$ 1,105 | \$ 7,215 | \$ 3,911 | \$24,103 |
| (Reversal) provision | (391) | 288 | 136 | (50) | 167 | (150) | - |
| Chargeoffs | (132) | - | - | - | (886) | - | (1,018) |
| Recoveries | 128 | - | - | - | 415 | - | 543 |
| Total allowance for loan losses | \$7,772 | \$ 3,833 | \$ 296 | \$ 1,055 | \$ 6,911 | \$ 3,761 | \$23,628 |

Allowance for Loan Losses
For the Nine Months Ended September 30, 2017

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at beginning of period | \$8,327 | \$ 3,330 | \$ 152 | \$ 1,330 | \$ 7,980 | \$ 4,835 | \$25,954 |
| (Reversal) provision | (220) | 415 | (1,755) | (275) | 1,009 | (1,074) | (1,900) |
| Chargeoffs | (961) | - | - | - | (3,783) | - | (4,744) |
| Recoveries | 626 | 88 | 1,899 | - | 1,705 | - | 4,318 |
| Total allowance for loan losses | \$7,772 | \$ 3,833 | \$ 296 | \$ 1,055 | \$ 6,911 | \$ 3,761 | \$23,628 |

The allowance for loan losses and recorded investment in loans evaluated for impairment were as follows:

Allowance for Loan Losses and Recorded Investment in Loans Evaluated for
Impairment
At September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|--|------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------------|----------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Individually evaluated for impairment | \$4,668 | \$ 172 | \$ - | \$ - | \$ - | \$ - | \$4,840 |
| Collectively evaluated for impairment | 3,142 | 3,749 | 254 | 944 | 5,314 | 3,784 | 17,187 |
| Purchased loans with evidence of credit deterioration | - | - | - | - | - | - | - |
| Total | \$7,810 | \$3,921 | \$ 254 | \$944 | \$5,314 | \$ 3,784 | \$22,027 |
| Carrying value of loans: | | | | | | | |

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| | | | | | | | |
|---|------------|------------|----------|-----------|------------|------|--------------|
| Individually evaluated for impairment | \$ 10,254 | \$ 10,816 | \$ - | \$ 202 | \$ - | \$ - | \$ 21,272 |
| Collectively evaluated for impairment | 265,740 | 556,173 | 3,939 | 47,948 | 301,473 | - | 1,175,273 |
| Purchased loans with evidence of credit deterioration | 37 | 224 | - | - | 149 | - | 410 |
| Total | \$ 276,031 | \$ 567,213 | \$ 3,939 | \$ 48,150 | \$ 301,622 | \$ - | \$ 1,196,955 |

Allowance for Loan Losses and Recorded Investment in Loans Evaluated for Impairment

At December 31, 2017

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---|----------------|------------------------|--------------|-------------------------|--------------------------------|-------------|--------------|
| | (In thousands) | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Individually evaluated for impairment | \$ 4,814 | \$ 171 | \$ - | \$ - | \$ - | \$ - | \$ 4,985 |
| Collectively evaluated for impairment | 2,932 | 3,678 | 335 | 995 | 6,418 | 3,666 | 18,024 |
| Purchased loans with evidence of credit deterioration | - | - | - | - | - | - | - |
| Total | \$ 7,746 | \$ 3,849 | \$ 335 | \$ 995 | \$ 6,418 | \$ 3,666 | \$ 23,009 |
| Carrying value of loans: | | | | | | | |
| Individually evaluated for impairment | \$ 10,675 | \$ 14,234 | \$ - | \$ 208 | \$ - | \$ - | \$ 25,117 |
| Collectively evaluated for impairment | 325,291 | 553,769 | 5,649 | 64,975 | 312,406 | - | 1,262,090 |
| Purchased loans with evidence of credit deterioration | 30 | 581 | - | - | 164 | - | 775 |
| Total | \$ 335,996 | \$ 568,584 | \$ 5,649 | \$ 65,183 | \$ 312,570 | \$ - | \$ 1,287,982 |

The Company's customers are small businesses, professionals and consumers. Given the scale of these borrowers, corporate credit rating agencies do not evaluate the borrowers' financial condition. The Company's subsidiary, Westamerica Bank (the "Bank") maintains a Loan Review Department which reports directly to the Audit Committee of the Board of Directors. The Loan Review Department performs independent evaluations of loans and validates management assigned credit risk grades on evaluated loans using grading standards employed by bank regulatory agencies. Loans judged to carry lower-risk attributes are assigned a "pass" grade, with a minimal likelihood of loss. Loans judged to carry higher-risk attributes are referred to as "classified loans," and are further disaggregated, with increasing expectations for loss recognition, as "substandard," "doubtful," and "loss." Loan Review Department performs continuous evaluations throughout the year. If the Bank becomes aware of deterioration in a borrower's performance or financial condition between Loan Review Department examinations, assigned risk grades are re-evaluated promptly. Credit risk grades assigned by management and validated by the Loan Review Department are subject to review by the Bank's regulatory authorities during regulatory examinations.

The following summarizes the loan credit risk profile by internally assigned grade:

Loan Credit Risk Profile by Internally Assigned Grade

At September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Total |
|----------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|
| (In thousands) | | | | | | |
| Grade: | | | | | | |
| Pass | \$264,908 | \$551,956 | \$3,939 | \$46,901 | \$299,590 | \$1,167,294 |
| Substandard | 11,123 | 15,257 | - | 1,249 | 1,618 | 29,247 |
| Doubtful | - | - | - | - | 56 | 56 |
| Loss | - | - | - | - | 358 | 358 |
| Total | \$276,031 | \$567,213 | \$3,939 | \$48,150 | \$301,622 | \$1,196,955 |

Credit risk profile reflects internally assigned grades of purchased covered loans without regard to FDIC indemnification on \$6,086 thousand residential real estate and consumer loans.

Loan Credit Risk Profile by Internally Assigned Grade

At December 31, 2017

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Total |
|----------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|
| (In thousands) | | | | | | |
| Grade: | | | | | | |
| Pass | \$324,185 | \$548,853 | \$5,649 | \$62,253 | \$310,429 | \$1,251,369 |
| Substandard | 11,811 | 19,731 | - | 2,930 | 1,370 | 35,842 |
| Doubtful | - | - | - | - | 1 | 1 |
| Loss | - | - | - | - | 770 | 770 |
| Total | \$335,996 | \$568,584 | \$5,649 | \$65,183 | \$312,570 | \$1,287,982 |

Credit risk profile reflects internally assigned grades of purchased covered loans without regard to FDIC indemnification on \$7,766 thousand residential real estate and consumer loans.

The following tables summarize loans by delinquency and nonaccrual status:

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Summary of Loans by Delinquency and Nonaccrual Status
At September 30, 2018

| | Current and Accruing | 30-59 Days Past Due and Accruing | 60-89 Days Past Due and Accruing | Past Due 90 Days or More and Accruing | Nonaccrual | Total Loans |
|--------------------------------|-------------------------|--|--|--|------------|-------------|
| (In thousands) | | | | | | |
| Commercial | \$275,259 | \$425 | \$347 | \$- | \$- | \$276,031 |
| Commercial real estate | 559,441 | 2,334 | - | - | 5,438 | 567,213 |
| Construction | 3,939 | - | - | - | - | 3,939 |
| Residential real estate | 47,634 | 516 | - | - | - | 48,150 |
| Consumer installment and other | 297,416 | 3,001 | 801 | 361 | 43 | 301,622 |
| Total | \$1,183,689 | \$6,276 | \$1,148 | \$361 | \$5,481 | \$1,196,955 |

Summary of Loans by Delinquency and Nonaccrual Status
At December 31, 2017

| | Current and Accruing | 30-59 Days Past Due and Accruing | 60-89 Days Past Due and Accruing | Past Due 90 Days or More and Accruing | Nonaccrual | Total Loans |
|--------------------------------|-------------------------|--|--|--|------------|-------------|
| (In thousands) | | | | | | |
| Commercial | \$334,908 | \$627 | \$164 | \$- | \$297 | \$335,996 |
| Commercial real estate | 561,883 | 1,143 | 125 | - | 5,433 | 568,584 |
| Construction | 5,649 | - | - | - | - | 5,649 |
| Residential real estate | 65,183 | - | - | - | - | 65,183 |
| Consumer installment and other | 307,445 | 3,321 | 1,077 | 531 | 196 | 312,570 |
| Total | \$1,275,068 | \$5,091 | \$1,366 | \$531 | \$5,926 | \$1,287,982 |

There were no commitments to lend additional funds to borrowers whose loans were on nonaccrual status at September 30, 2018 and December 31, 2017.

The following summarizes impaired loans:

| | Impaired Loans At September 30, 2018 | | | At December 31, 2017 | | |
|--|--|--------------------------------|----------------------|-------------------------|--------------------------------|----------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| | (In thousands) | | | | | |
| With no related allowance recorded: | | | | | | |
| Commercial | \$809 | \$845 | \$ - | \$1,212 | \$1,271 | \$ - |
| Commercial real estate | 9,690 | 11,632 | - | 13,169 | 14,985 | - |
| Residential real estate | 202 | 232 | - | 208 | 239 | - |
| Consumer installment and other | 192 | 298 | - | 360 | 466 | - |
| Total with no related allowance recorded | 10,893 | 13,007 | - | 14,949 | 16,961 | - |
| With an allowance recorded: | | | | | | |
| Commercial | 9,482 | 9,482 | 4,668 | 9,764 | 9,764 | 4,814 |
| Commercial real estate | 1,750 | 1,752 | 172 | 1,790 | 1,792 | 171 |
| Total with an allowance recorded | 11,232 | 11,234 | 4,840 | 11,554 | 11,556 | 4,985 |
| Total | \$22,125 | \$24,241 | \$ 4,840 | \$26,503 | \$28,517 | \$ 4,985 |

Impaired loans include troubled debt restructured loans. Impaired loans at September 30, 2018, included \$8,747 thousand of restructured loans, \$4,270 thousand of which were on nonaccrual status. Impaired loans at December 31, 2017, included \$12,081 thousand of restructured loans, \$4,285 thousand of which were on nonaccrual status.

| | Impaired Loans For the Three Months Ended September 30, | | | | For the Nine Months Ended September 30, | | | |
|-------------------------|---|----------------------------------|-----------------------------------|----------------------------------|---|----------------------------------|-----------------------------------|----------------------------------|
| | 2018 | | 2017 | | 2018 | | 2017 | |
| | Average Recorded Investment | Recognized Interest Income | Average Recorded Investment | Recognized Interest Income | Average Recorded Investment | Recognized Interest Income | Average Recorded Investment | Recognized Interest Income |
| | (In thousands) | | | | | | | |
| Commercial | \$10,426 | \$ 175 | \$11,125 | \$ 130 | \$10,671 | \$ 495 | \$11,203 | \$ 366 |
| Commercial real estate | 11,282 | 189 | 14,681 | 208 | 12,291 | 615 | 14,826 | 669 |
| Residential real estate | 203 | 4 | 365 | 4 | 205 | 12 | 494 | 13 |

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| | | | | | | | | |
|--------------------------------|----------|--------|----------|--------|----------|----------|----------|----------|
| Consumer installment and other | 173 | 4 | 340 | 3 | 261 | 10 | 466 | 17 |
| Total | \$22,084 | \$ 372 | \$26,511 | \$ 345 | \$23,428 | \$ 1,132 | \$26,989 | \$ 1,065 |

The following tables provide information on troubled debt restructurings:

Troubled Debt Restructurings
At September 30, 2018

| | Number of Contracts | Pre-Modification Carrying Value | Period-End Carrying Value | Period-End Individual Impairment Allowance |
|-------------------------|---------------------|---------------------------------|---------------------------|--|
| | (\$ in thousands) | | | |
| Commercial | 5 | \$ 2,324 | \$ 904 | \$ 34 |
| Commercial real estate | 8 | 9,237 | 7,642 | - |
| Residential real estate | 1 | 241 | 201 | - |
| Total | 14 | \$ 11,802 | \$ 8,747 | \$ 34 |

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Troubled Debt Restructurings
At December 31, 2017

| | Number of Contracts | Pre-Modification Carrying Value | Period-End Carrying Value | Period-End Individual Impairment Allowance |
|-------------------------|---------------------------|------------------------------------|---------------------------------|---|
| | | (\$ in thousands) | | |
| Commercial | 7 | \$ 2,393 | \$ 1,085 | \$ 43 |
| Commercial real estate | 10 | 11,528 | 10,788 | - |
| Residential real estate | 1 | 241 | 208 | - |
| Total | 18 | \$ 14,162 | \$ 12,081 | \$ 43 |

During the three and nine months ended September 30, 2018, the Company did not modify any loans that were considered troubled debt restructurings. During the three and nine months ended September 30, 2017, the Company modified one loan with a carrying value of \$50 thousand and four loans with a carrying value of \$699 thousand, respectively, that were considered troubled debt restructurings. The four concessions granted in the first nine months of 2017 consisted of modifications of payment terms to extend the maturity date to allow for deferred principal repayment and under-market terms. There were no chargeoffs related to troubled debt restructurings made during the three and nine months ended September 30, 2018. During the three and nine months ended September 30, 2017, one troubled debt restructured loan with a carrying value of \$58 thousand was charged off. During the three and nine months ended September 30, 2018 and 2017, no troubled debt restructured loans defaulted within 12 months of the modification date. A troubled debt restructuring is considered to be in default when payments are ninety days or more past due.

There were no loans restricted due to collateral requirements at September 30, 2018 and December 31, 2017.

There were no loans held for sale at September 30, 2018 and December 31, 2017.

At September 30, 2018 and December 31, 2017, the Company held total other real estate owned (OREO) of \$620 thousand net of reserve of \$-0- thousand and \$1,426 thousand net of reserve of \$1,905 thousand, respectively, of which there were no foreclosed residential real estate properties or covered OREO at both dates, respectively. The amount of consumer mortgage loans outstanding secured by residential real estate properties for which formal foreclosure proceedings were in process was \$19 thousand at September 30, 2018 and \$196 thousand at December 31, 2017.

Note 5: Concentration of Credit Risk

Under the California Financial Code, credit extended to any one person owing to a commercial bank at any one time shall not exceed the following limitations: (a) unsecured loans shall not exceed 15 percent of the sum of the shareholders' equity, allowance for loan losses, capital notes, and debentures of the bank, or (b) secured and unsecured loans in all shall not exceed 25 percent of the sum of the shareholders' equity, allowance for loan losses, capital notes, and debentures of the bank. At September 30, 2018, the Bank did not have credit extended to any one entity exceeding these limits. At September 30, 2018, the Bank had 35 lending relationships each with aggregate amounts of \$5 million or more. The Company has significant credit arrangements that are secured by real estate collateral. In addition to real estate loans outstanding as disclosed in Note 4, the Company had loan commitments related to real estate loans of \$52,842 thousand and \$53,874 thousand at September 30, 2018 and December 31, 2017, respectively. The Company requires collateral on all real estate loans with loan-to-value ratios at origination generally no greater than 75% on commercial real estate loans and no greater than 80% on residential real estate loans. At September 30, 2018, the Bank held corporate bonds in 80 issuing entities that exceeded \$5 million for each issuer.

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Note 6: Other Assets

Other assets consisted of the following:

| | At September 30, 2018 | At December 31, 2017 |
|--|--------------------------------|-------------------------------|
| | (In thousands) | |
| Equity securities without readily determinable fair values: | | |
| Federal Reserve Bank stock ⁽¹⁾ | \$ 14,069 | \$ 14,069 |
| Other investments | 158 | 158 |
| Total equity securities without readily determinable fair values | 14,227 | 14,227 |
| Life insurance cash surrender value | 55,442 | 54,101 |
| Net deferred tax asset | 48,622 | 33,112 |
| Limited partnership investments | 10,919 | 10,119 |
| Interest receivable | 23,734 | 23,557 |
| Prepaid assets | 4,119 | 4,906 |
| Other assets | 8,411 | 18,428 |
| Total other assets | \$ 165,474 | \$ 158,450 |

A bank applying for membership in the Federal Reserve System is required to subscribe to stock in the Federal Reserve Bank (FRB) in its district in a sum equal to six percent of the bank's paid-up capital stock and surplus. ⁽¹⁾ One-half of the amount of the bank's subscription shall be paid to the FRB and the remaining half will be subject to call when deemed necessary by the Board of Governors of the Federal Reserve System.

The Company owns 211 thousand shares of Visa Inc. class B common stock which have transfer restrictions; the carrying value is \$-0- thousand. On July 5, 2018, Visa Inc. announced a new conversion rate applicable to its class B common stock resulting from its June 28, 2018 deposit of funds into its litigation escrow account. This funding reduced the conversion rate of class B common stock into class A common stock, which is unrestricted and trades actively on the New York Stock Exchange, from 1.6483 to 1.6298. Visa Inc. class A common stock had a closing price of \$150.09 per share on September 28, 2018, the last day of stock market trading for the third quarter 2018. The ultimate value of the Company's Visa Inc. class B shares is subject to the extent of Visa Inc.'s future litigation escrow fundings; the resulting conversion rate to class A common stock, and current and future trading restrictions on the class B common stock.

The Company invests in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for low-income housing tax credits. At September 30, 2018, this investment totaled \$10,919 thousand and \$5,088 thousand of this amount represents outstanding equity capital commitments that are included in other

liabilities. At December 31, 2017, this investment totaled \$10,119 thousand and \$2,299 thousand of this amount represented outstanding equity capital commitments. At September 30, 2018, the \$5,088 thousand of outstanding equity capital commitments are expected to be paid as follows, \$552 thousand in 2018, \$364 thousand in 2019, \$2,026 thousand in 2020, \$138 thousand in 2021, \$261 thousand in 2022, \$134 thousand in 2023, \$1,041 thousand in 2024 and \$572 thousand in 2025 or thereafter.

The amounts recognized in net income for these investments include:

| | For the Three Months Ended September 30, 2018 2017 | | For the Nine Months Ended 2018 2017 | |
|--|---|-------|---|---------|
| | (In thousands) | | | |
| Investment loss included in pre-tax income | \$900 | \$450 | \$2,200 | \$1,350 |
| Tax credits recognized in provision for income taxes | 336 | 463 | 1,008 | 1,388 |

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Note 7: Goodwill and Identifiable Intangible Assets

The Company has recorded goodwill and other identifiable intangibles associated with purchase business combinations. Goodwill is not amortized, but is evaluated for impairment at least annually. The Company did not recognize impairment during the three and nine months ended September 30, 2018 and year ended December 31, 2017. Identifiable intangibles are amortized to their estimated residual values over their expected useful lives. Such lives and residual values are also periodically reassessed to determine if any amortization period adjustments are indicated. During the three and nine months ended September 30, 2018 and year ended December 31, 2017 no such adjustments were recorded.

The carrying values of goodwill were:

| | At September 30, 2018 | At December 31, 2017 |
|----------|-----------------------------|----------------------------|
| | (In thousands) | |
| Goodwill | \$ 121,673 | \$ 121,673 |

The gross carrying amount of identifiable intangible assets and accumulated amortization was:

| | At September 30, 2018 | | At December 31, 2017 | |
|--------------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| | (In thousands) | | | |
| Core Deposit Intangibles | \$ 56,808 | \$ (54,432) | \$ 56,808 | \$ (52,987) |
| Merchant Draft Processing Intangible | 10,300 | (10,300) | 10,300 | (10,271) |
| Total Identifiable Intangible Assets | \$ 67,108 | \$ (64,732) | \$ 67,108 | \$ (63,258) |

As of September 30, 2018, the current period and estimated future amortization expense for identifiable intangible assets was:

Total

Core Merchant
 Deposit Draft
 Intangible Processing
 Intangible

(In thousands)

| | | | |
|---|---------|-------|---------|
| For the Nine Months ended September 30, 2018 (actual) | \$1,445 | \$ 29 | \$1,474 |
| Estimate for the remainder of year ending December 31, 2018 | 447 | - | 447 |
| Estimate for year ending December 31, 2019 | 538 | - | 538 |
| 2020 | 287 | - | 287 |
| 2021 | 269 | - | 269 |
| 2022 | 252 | - | 252 |
| 2023 | 236 | - | 236 |

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Note 8: Deposits and Borrowed Funds

The following table provides additional detail regarding deposits.

| | Deposits | |
|---|--------------------------------|-------------------------------|
| | At September 30, 2018 | At December 31, 2017 |
| | (In thousands) | |
| Noninterest-bearing | \$2,211,028 | \$2,197,526 |
| Interest-bearing: | | |
| Transaction | 909,954 | 904,245 |
| Savings | 1,510,015 | 1,494,024 |
| Time deposits less than \$100 thousand | 107,755 | 117,848 |
| Time deposits \$100 thousand through \$250 thousand | 68,677 | 76,578 |
| Time deposits more than \$250 thousand | 28,408 | 37,392 |
| Total deposits | \$4,835,837 | \$4,827,613 |

Demand deposit overdrafts of \$950 thousand and \$2,786 thousand were included as loan balances at September 30, 2018 and December 31, 2017, respectively. Interest expense for aggregate time deposits with individual account balances in excess of \$100 thousand was \$91 thousand and \$283 thousand for the three and nine months ended September 30, 2018, respectively and \$103 thousand and \$314 thousand for the three and nine months ended September 30, 2017, respectively.

The following table provides additional detail regarding short-term borrowed funds.

| Repurchase Agreements (Sweep) Accounted for as Secured Borrowings Remaining Contractual Maturity of the Agreements Overnight and Continuous | |
|---|----------------|
| At September | At December |

| | 30, 2018 | 31, 2017 |
|--|-----------|-----------|
| Repurchase agreements: | | |
| Collateral securing borrowings: | | |
| Securities of U.S. Government sponsored entities | \$72,675 | \$74,173 |
| Agency residential MBS | 59,367 | 58,251 |
| Corporate securities | 91,818 | 105,113 |
| Total collateral carrying value | \$223,860 | \$237,537 |
| Total short-term borrowed funds | \$61,756 | \$58,471 |

Note 9: Fair Value Measurements

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Equity securities and debt securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as other real estate owned, impaired loans, certain loans held for investment, debt securities held to maturity, and other assets. These nonrecurring fair value adjustments typically involve the lower-of-cost or fair-value accounting of individual assets.

In accordance with the Fair Value Measurement and Disclosure topic of the FASB Accounting Standards Codification, the Company bases its fair values on the price that would be received to sell an asset or paid to transfer a liability in the principal market or most advantageous market for an asset or liability in an orderly transaction between market participants on the measurement date under current market conditions. A fair value measurement reflects all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of nonperformance.

The Company groups its assets and liabilities measured at fair value into a three-level hierarchy, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. When the valuation assumptions used to measure the fair value of the asset or liability are categorized within different levels of the fair value hierarchy, the asset or liability is categorized in its entirety within the lowest level of the hierarchy. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active exchange markets, such as the New York Stock Exchange. Level 1 includes U.S. Treasury and equity securities, which are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. Level 2 includes mutual funds, federal agency securities, mortgage-backed securities, corporate securities, asset-backed securities, and municipal bonds.

Level 3 – Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company’s estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The Company relies on independent vendor pricing services to measure fair value for equity securities, debt securities available for sale and debt securities held to maturity. The Company employs three pricing services. To validate the pricing of these vendors, the Company compares vendors’ pricing for each of the securities for consistency; significant pricing differences, if any, are evaluated using all available independent quotes with the quote most closely reflecting the market generally used as the fair value estimate. In addition, the Company conducts “other than temporary impairment (OTTI)” analysis on a quarterly basis; debt securities selected for OTTI analysis include all debt securities at a market price below 95 percent of par value. As with any valuation technique used to estimate fair value, changes in underlying assumptions used could significantly affect the results of current and future values. Accordingly, these fair value estimates may not be realized in an actual sale of the securities.

The Company regularly reviews the valuation techniques and assumptions used by its vendors and determines which valuation techniques are utilized based on observable market inputs for the type of securities being measured. The Company uses the information to determine the placement in the fair value hierarchy as level 1, 2 or 3.

Assets Recorded at Fair Value on a Recurring Basis

The tables below present assets measured at fair value on a recurring basis on the dates indicated.

At September 30, 2018

| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) ⁽¹⁾ |
|--|--------------|---|---|---|
| (In thousands) | | | | |
| Equity securities | | | | |
| Mutual funds | \$ 1,734 | \$ - | \$ 1,734 | \$ - |
| Total equity securities | 1,734 | - | 1,734 | - |
| Debt securities available for sale | | | | |
| Securities of U.S. Government sponsored entities | 161,744 | - | 161,744 | - |
| Agency residential MBS | 878,029 | - | 878,029 | - |
| Non-agency residential MBS | 124 | - | 124 | - |
| Agency commercial MBS | 1,847 | - | 1,847 | - |
| Securities of U.S. Government entities | 1,210 | - | 1,210 | - |
| Obligations of states and political subdivisions | 180,343 | - | 180,343 | - |
| Corporate securities | 1,255,611 | - | 1,255,611 | - |
| Total debt securities available for sale | 2,478,908 | - | 2,478,908 | - |
| Total | \$ 2,480,642 | \$ - | \$ 2,480,642 | \$ - |

⁽¹⁾ There were no transfers in to or out of level 3 during the nine months ended September 30, 2018.

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| | At December 31, 2017 | | | |
|--|----------------------|---|---|---|
| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) ⁽¹⁾ |
| | (In thousands) | | | |
| Equity securities | | | | |
| Mutual funds | \$ 1,800 | \$ - | \$ 1,800 | \$ - |
| Total equity securities | 1,800 | - | 1,800 | - |
| Debt securities available for sale | | | | |
| Securities of U.S. Government sponsored entities | 119,319 | - | 119,319 | - |
| Agency residential MBS | 767,706 | - | 767,706 | - |
| Non-agency residential MBS | 154 | - | 154 | - |
| Agency commercial MBS | 2,219 | - | 2,219 | - |
| Securities of U.S. Government entities | 1,590 | - | 1,590 | - |
| Obligations of states and political subdivisions | 185,221 | - | 185,221 | - |
| Corporate securities | 1,115,498 | - | 1,115,498 | - |
| Total debt securities available for sale | 2,191,707 | - | 2,191,707 | - |
| Total | \$ 2,193,507 | \$ - | \$ 2,193,507 | \$ - |

⁽¹⁾ There were no transfers in to or out of level 3 during the year ended December 31, 2017.

Assets Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower of cost or fair value accounting of individual assets. For assets measured at fair value on a nonrecurring basis that were recorded in the balance sheet at September 30, 2018 and December 31, 2017, the following tables provide the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets at period end.

For the
Nine
Months
Ended

At September 30, 2018

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| | Carrying Value (In thousands) | Level 1 | Level 2 | Level 3 | September 30, 2018 Total Losses |
|---|----------------------------------|---------|---------|----------|------------------------------------|
| Other real estate owned | \$620 | \$ - | \$ - | \$620 | \$ - |
| Impaired loans: | | | | | |
| Commercial | 4,815 | - | - | 4,815 | - |
| Commercial real estate | 5,448 | - | - | 5,448 | (240) |
| Total assets measured at fair value on a nonrecurring basis | \$10,883 | \$ - | \$ - | \$10,883 | \$ (240) |

| | At December 31, 2017 | | | | For the Year Ended December 31, 2017 Total Losses |
|---|----------------------------------|---------|---------|----------|--|
| | Carrying Value (In thousands) | Level 1 | Level 2 | Level 3 | |
| Other real estate owned | \$1,426 | \$ - | \$ - | \$1,426 | \$ (219) |
| Impaired loans: | | | | | |
| Commercial | 4,950 | - | - | 4,950 | - |
| Commercial real estate | 5,904 | - | - | 5,904 | - |
| Total assets measured at fair value on a nonrecurring basis | \$12,280 | \$ - | \$ - | \$12,280 | \$ (219) |

Level 3 – Valuation is based upon present value of expected future cash flows, independent market prices, estimated liquidation values of loan collateral or appraised value of the collateral as determined by third-party independent appraisers, less 10% for selling costs, generally. Level 3 includes other real estate owned that has been measured at fair value upon transfer to foreclosed assets and impaired loans collateralized by real property and other business asset collateral where a specific reserve has been established or a chargeoff has been recorded. Losses on other real estate owned represent losses recognized in earnings during the period subsequent to its initial classification as foreclosed assets. The unobservable inputs and qualitative information about the unobservable inputs are not presented as the inputs were not developed by the Company.

Disclosures about Fair Value of Financial Instruments

The following section describes the valuation methodologies used by the Company for estimating fair value of financial instruments not recorded at fair value in the balance sheet. The Company implemented the provisions of ASU 2016-01, *Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, effective January 1, 2018. The provisions require the Company to use the “exit price notion” when measuring the fair value of financial instruments for disclosure purposes.

Cash and Due from Banks Cash and due from banks represent U.S. dollar denominated coin and currency, deposits at the Federal Reserve Bank and correspondent banks, and amounts being settled with other banks to complete the processing of customers’ daily transactions. Collectively, the Federal Reserve Bank and financial institutions operate in a market in which cash and due from banks transactions are processed continuously in significant daily volumes honoring the face value of the U.S. dollar.

Debt Securities Held to Maturity The fair values of debt securities were estimated using quoted prices as described above for Level 2 valuation.

Loans Loans are valued using the exit price notion. The Company uses a net present value of cash flows methodology that seeks to incorporate interest rate, credit, liquidity and prepayment risks in the fair market value estimation. Inputs to calculation include market rates for similarly offered products, market interest rate projections, credit spreads, estimated credit losses and prepayment assumptions.

Prior to adoption of ASU 2016-01, loans were separated into two groups for valuation. Variable rate loans, except for those described below, that reprice frequently with changes in market rates were valued using historical cost. Fixed rate loans and variable rate loans that have reached their minimum contractual interest rates were valued by discounting the future cash flows expected to be received from the loans using current interest rates charged on loans with similar characteristics. Additionally, the allowance for loan losses of \$23,009 thousand at December 31, 2017 was applied against the estimated fair values to recognize estimated future defaults of contractual cash flows.

Deposit Liabilities Deposits with no stated maturity such as checking accounts, savings accounts and money market accounts can be readily converted to cash or used to settle transactions at face value through the broad financial system operated by the Federal Reserve Banks and financial institutions. The fair value of deposits with no stated maturity is equal to the amount payable on demand. The fair value of time deposits was estimated using a net present value of cash flows methodology, incorporating market interest rate projections and rates on alternative funding sources.

Prior to adoption of ASU 2016-01, the fair value of time deposits were estimated by discounting estimated future contractual cash flows using current market rates for financial instruments with similar characteristics.

Short-Term Borrowed Funds The carrying amount of securities sold under agreement to repurchase and other short-term borrowed funds approximate fair value due to the relatively short period of time between their origination and their expected realization.

The tables below are a summary of fair value estimates for financial instruments and the level of the fair value hierarchy within which the fair value measurements are categorized, excluding financial instruments recorded at fair value on a recurring basis. The values assigned do not necessarily represent amounts which ultimately may be realized for assets or paid to settle liabilities. In addition, these values do not give effect to adjustments to fair value which may occur when financial instruments are sold or settled in larger quantities. The carrying amounts in the following tables are recorded in the balance sheet under the indicated captions.

The Company has not included assets and liabilities that are not financial instruments, such as goodwill, long-term relationships with deposit, merchant processing and trust customers, other purchased intangibles, premises and equipment, deferred taxes and other assets and liabilities. The total estimated fair values do not represent, and should not be construed to represent, the underlying value of the Company.

| At September 30, 2018 | | | | | |
|----------------------------------|-----------------|----------------------|--|--|--|
| | Carrying Amount | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets: (In thousands) | | | | | |
| Cash and due from banks | \$522,660 | \$522,660 | \$522,660 | \$- | \$- |
| Debt securities held to maturity | 1,025,699 | 1,002,648 | - | 1,002,648 | - |
| Loans | 1,174,928 | 1,176,889 | - | - | 1,176,889 |
| Financial Liabilities: | | | | | |
| Deposits | \$4,835,837 | \$4,832,135 | \$- | \$4,630,997 | \$ 201,138 |
| Short-term borrowed funds | 61,756 | 61,756 | - | 61,756 | - |

| At December 31, 2017 | | | | | |
|----------------------------------|-----------------|----------------------|--|--|--|
| | Carrying Amount | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets: (In thousands) | | | | | |
| Cash and due from banks | \$575,002 | \$575,002 | \$575,002 | \$- | \$- |
| Debt securities held to maturity | 1,158,864 | 1,155,342 | - | 1,155,342 | - |
| Loans | 1,264,973 | 1,257,811 | - | - | 1,257,811 |
| Financial Liabilities: | | | | | |
| Deposits | \$4,827,613 | \$4,824,586 | \$- | \$4,595,795 | \$ 228,791 |
| Short-term borrowed funds | 58,471 | 58,471 | - | 58,471 | - |

The majority of the Company's standby letters of credit and other commitments to extend credit carry current market interest rates if converted to loans. No premium or discount was ascribed to these commitments because virtually all funding would be at current market rates.

Note 10: Commitments and Contingent Liabilities

Loan commitments are agreements to lend to a customer provided there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future funding requirements. Loan commitments are subject to the Company's normal credit policies and collateral requirements. Unfunded loan commitments were \$292,704 thousand and \$272,646 thousand at September 30, 2018 and December 31, 2017, respectively. Standby letters of credit commit the Company to make payments on behalf of customers when certain specified future events occur. Standby letters of credit are primarily issued to support customers' short-term financing requirements and must meet the Company's normal credit policies and collateral requirements. Financial and performance standby letters of credit outstanding totaled \$2,904 thousand and \$19,263 thousand at September 30, 2018 and December 31, 2017, respectively. The Company had no commitments outstanding for commercial and similar letters of credit at September 30, 2018 and December 31, 2017. The Company had a reserve for unfunded commitments of \$2,308 thousand at September 30, 2018 and \$2,308 thousand at December 31, 2017, included in other liabilities.

Due to the nature of its business, the Company is subject to various threatened or filed legal cases. Based on the advice of legal counsel, the Company does not expect such cases will have a material, adverse effect on its financial position or results of operations. Legal liabilities are accrued when obligations become probable and the amount can be reasonably estimated. In the third quarter 2018, the Company achieved a mediated settlement to dismiss a lawsuit, subject to court approval, and has accrued a liability for \$3,500 thousand.

The Company has determined that it will be obligated to provide refunds of revenue recognized in years prior to 2017 to some customers. The Company estimates the probable amount of these obligations will be \$5,542 thousand and has accrued a liability for such amount; the estimated liability is subject to revision.

Note 11: Earnings Per Common Share

The table below shows earnings per common share and diluted earnings per common share. Basic earnings per common share are computed by dividing net income by the average number of common shares outstanding during the period. Diluted earnings per common share are computed by dividing net income by the average number of common shares outstanding during the period plus the impact of common stock equivalents.

| | For the Three Months Ended September 30, 2018 | | For the Nine Months 2017 | |
|---|--|-----------|--------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands, except per share data) | | | |
| Net income applicable to common equity (numerator) | \$ 16,993 | \$ 15,017 | \$ 52,509 | \$ 45,865 |
| Basic earnings per common share | | | | |
| Weighted average number of common shares outstanding - basic (denominator) | 26,701 | 26,309 | 26,622 | 26,260 |
| Basic earnings per common share | \$0.64 | \$0.57 | \$1.97 | \$1.75 |
| Diluted earnings per common share | | | | |
| Weighted average number of common shares outstanding - basic | 26,701 | 26,309 | 26,622 | 26,260 |
| Add common stock equivalents for options | 114 | 95 | 114 | 119 |
| Weighted average number of common shares outstanding - diluted (denominator) | 26,815 | 26,404 | 26,736 | 26,379 |
| Diluted earnings per common share | \$0.63 | \$0.57 | \$1.96 | \$1.74 |

For the three and nine months ended September 30, 2018, options to purchase 326 thousand and 432 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

For the three and nine months ended September 30, 2017, options to purchase 376 thousand and 343 thousand shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the option exercise price exceeded the fair value of the stock such that their inclusion would have had an anti-dilutive effect.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

WESTAMERICA BANCORPORATION

FINANCIAL SUMMARY

| | For the Three Months Ended September 30, | | For the Nine Months | |
|---|---|-------------|---------------------|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands, except per share data) | | | |
| Net Interest and Loan Fee Income (FTE) ⁽¹⁾ | \$37,137 | \$35,680 | \$109,189 | \$107,474 |
| Reversal of Provision for Loan Losses | - | - | - | (1,900) |
| Noninterest Income: | | | | |
| Life Insurance Gains | 585 | - | 585 | - |
| Securities Losses | (16) | - | (66) | - |
| Other Noninterest income | 11,959 | 12,548 | 35,733 | 36,328 |
| Total Noninterest Income | 12,528 | 12,548 | 36,252 | 36,328 |
| Noninterest Expense: | | | | |
| Loss Contingency | 3,500 | - | 3,500 | - |
| Other Noninterest Expense | 23,505 | 24,114 | 71,696 | 73,125 |
| Total Noninterest Expense | 27,005 | 24,114 | 75,196 | 73,125 |
| Income Before Income Taxes (FTE) ⁽¹⁾ | 22,660 | 24,114 | 70,245 | 72,577 |
| Income Tax Provision (FTE) ⁽¹⁾ | 5,667 | 9,097 | 17,736 | 26,712 |
| Net Income | \$16,993 | \$15,017 | \$52,509 | \$45,865 |
| Average Common Shares Outstanding | 26,701 | 26,309 | 26,622 | 26,260 |
| Average Diluted Common Shares Outstanding | 26,815 | 26,404 | 26,736 | 26,379 |
| Common Shares Outstanding at Period End | 26,727 | 26,319 | | |
| Per Common Share: | | | | |
| Basic Earnings | \$0.64 | \$0.57 | \$1.97 | \$1.75 |
| Diluted Earnings | 0.63 | 0.57 | 1.96 | 1.74 |
| Book Value | \$22.17 | \$22.95 | | |
| Financial Ratios: | | | | |
| Return on Assets | 1.19 | % 1.09 | % 1.25 | % 1.13 % |
| Return on Common Equity | 10.58 | % 9.94 | % 11.22 | % 10.36 % |
| Net Interest Margin (FTE) ⁽¹⁾ | 3.10 | % 3.10 | % 3.07 | % 3.12 % |
| Net Loan Losses to Average Loans | 0.34 | % 0.15 | % 0.11 | % 0.04 % |
| Efficiency Ratio ⁽²⁾ | 54.4 | % 50.0 | % 51.7 | % 50.9 % |
| Average Balances: | | | | |
| Assets | \$5,648,004 | \$5,441,612 | \$5,600,499 | \$5,407,661 |
| Earning Assets | 4,786,511 | 4,587,848 | 4,754,436 | 4,601,931 |

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| | | | | |
|------------------------------------|-------------|-------------|-----------|-----------|
| Loans | 1,194,874 | 1,287,740 | 1,215,712 | 1,325,128 |
| Deposits | 4,893,859 | 4,714,579 | 4,856,639 | 4,692,330 |
| Shareholders' Equity | 636,965 | 599,473 | 625,496 | 591,691 |
| Period End Balances: | | | | |
| Assets | \$5,529,463 | \$5,445,808 | | |
| Earning Assets | 4,703,296 | 4,579,499 | | |
| Loans | 1,196,955 | 1,284,782 | | |
| Deposits | 4,835,837 | 4,734,580 | | |
| Shareholders' Equity | 592,591 | 603,957 | | |
| Capital Ratios at Period End: | | | | |
| Total Risk Based Capital | 16.99 | % | 16.71 | % |
| Tangible Equity to Tangible Assets | 8.67 | % | 8.98 | % |
| Dividends Paid Per Common Share | \$0.40 | | \$0.39 | |
| Common Dividend Payout Ratio | 63 | % | 68 | % |
| | | | \$1.20 | |
| | | | \$1.17 | |
| | | | 61 | % |
| | | | 67 | % |

The above financial summary has been derived from the Company's unaudited consolidated financial statements. This information should be read in conjunction with those statements, notes and the other information included elsewhere herein. Percentages under the heading "Financial Ratios" are annualized with the exception of the efficiency ratio.

- (1) Yields on securities and certain loans have been adjusted upward to a "fully taxable equivalent" ("FTE") basis in order to reflect the effect of income which is exempt from federal income taxation at the current statutory tax rate.
- (2) The efficiency ratio is defined as noninterest expense divided by total revenue (net interest income on an FTE basis and noninterest income).

Financial Overview

Westamerica Bancorporation and subsidiaries' (collectively, the "Company") reported net income of \$17.0 million or \$0.63 diluted earnings per common share ("EPS") for the third quarter 2018 and net income of \$52.5 million or \$1.96 EPS for the nine months ended September 30, 2018. The third quarter 2018 results include a \$585 thousand tax-exempt life insurance policy gain and a \$3.5 million settlement, which on an aggregate basis reduced EPS \$0.07. In the third quarter 2018, the Company achieved a mediated settlement to dismiss a lawsuit, subject to court approval, and has accrued a liability for such amount. The results for the third quarter 2018 and the nine months ended September 30, 2018 compare to net income of \$15.0 million or \$0.57 EPS for the third quarter 2017 and net income of \$45.9 million or \$1.74 EPS for the nine months ended September 30, 2017. Results for the nine months ended September 30, 2017 include a \$1.9 million reversal of provision for loan losses which accounted for \$0.04 of the EPS.

The Company's principal source of revenue is net interest and loan fee income, which represents interest and fees earned on loans and investment securities ("earning assets") reduced by interest paid on deposits and other borrowings ("interest-bearing liabilities"). Market interest rates declined considerably following the recession of 2008 and 2009. Interest rates remained historically low through 2016 as the monetary policy of the Federal Open Market Committee (the "FOMC") was highly accommodative. During this period, Management avoided originating long-dated, low-yielding loans given the potential impact of such assets on forward earning potential; as a result, loans declined and investment securities increased. The changed composition of the earning assets and low market interest rates pressured the net interest margin to lower levels. The FOMC began removing monetary stimulus in December 2016 and has increased the federal funds rate by 1.75 percent to 2.25 percent through September 2018, although longer-term rates have not increased by a similar magnitude. This recent increase in market interest rates has begun benefiting the Company's earning asset yields. However, the rising market rates have not resulted in higher rates paid on deposits. The funding source of the Company's earning assets is primarily customer deposits. The Company's long-term strategy includes maximizing checking and savings deposits as these types of deposits are lower-cost and less sensitive to changes in interest rates compared to time deposits. During the nine months ended September 30, 2018 the average volume of checking and savings deposits was 95.5 percent of average total deposits. Net interest income was \$35.7 million and \$104.9 million for the three and nine months ended September 30, 2018, respectively, compared with \$32.7 million and \$98.2 million for the three and nine months ended September 30, 2017, respectively. The increase in net interest income is due to higher asset yields and higher levels of average earning assets.

Credit quality remained solid with nonperforming assets totaling \$6.5 million at September 30, 2018 and net loan losses of \$1.0 million for the nine months ended September 30, 2018. The Company did not recognize a provision for loan losses in the nine months ended September 30, 2018.

The Company presents its net interest margin and net interest income on an FTE basis using the current statutory federal tax rate. Management believes the FTE basis is valuable to the reader because the Company's loan and investment securities portfolios contain a relatively large portion of municipal loans and securities that are federally tax exempt. The Company's tax exempt loans and securities composition may not be similar to that of other banks, therefore in order to reflect the impact of the federally tax exempt loans and securities on the net interest margin and

net interest income for comparability with other banks, the Company presents its net interest margin and net interest income on an FTE basis. Yields on tax-exempt securities and loans have been adjusted upward to reflect the effect of income exempt from federal income taxation at the federal statutory tax rate of 35% for 2017. Due to the Tax Cuts and Jobs Act of 2017 (“Act”), the federal tax rate became 21% for 2018; as such, the upward adjustment to reflect the effect of income exempt from federal taxation is lower in 2018.

The Company’s significant accounting policies (see Note 1, “Summary of Significant Accounting Policies,” to Financial Statements in the Company’s 2017 Form 10-K) are fundamental to understanding the Company’s results of operations and financial condition.

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Net Income

Following is a summary of the components of net income for the periods indicated:

| | For the Three Months Ended September 30, | | For the Nine Months | |
|--|---|-------------|---------------------|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands, except per share data) | | | |
| Net interest and loan fee income | \$35,726 | \$32,672 | \$104,897 | \$98,203 |
| FTE adjustment | 1,411 | 3,008 | 4,292 | 9,271 |
| Net interest and loan fee income (FTE) | 37,137 | 35,680 | 109,189 | 107,474 |
| Reversal of provision for loan losses | - | - | - | (1,900) |
| Noninterest income | 12,528 | 12,548 | 36,252 | 36,328 |
| Noninterest expense | 27,005 | 24,114 | 75,196 | 73,125 |
| Income before taxes (FTE) | 22,660 | 24,114 | 70,245 | 72,577 |
| Income tax provision (FTE) | 5,667 | 9,097 | 17,736 | 26,712 |
| Net income | \$16,993 | \$15,017 | \$52,509 | \$45,865 |
| | | | | |
| Average diluted common shares | 26,815 | 26,404 | 26,736 | 26,379 |
| Diluted earnings per common share | \$0.63 | \$0.57 | \$1.96 | \$1.74 |
| | | | | |
| Average total assets | \$5,648,004 | \$5,441,612 | \$5,600,499 | \$5,407,661 |
| Net income to average total assets (annualized) | 1.19 | % 1.09 | % 1.25 | % 1.13 |
| Net income to average common shareholders' equity (annualized) | 10.58 | % 9.94 | % 11.22 | % 10.36 |

Net income for the third quarter of 2018 was \$2.0 million more than the same quarter of 2017. Net interest and loan fee income increased \$3.1 million in the third quarter 2018 compared with third quarter 2017 mostly attributable to higher average balances of investments and higher yield on earning assets as market interest rates rose. The increase was offset by lower average balances of loans. Net interest and loan fee income (FTE) in the third quarter 2018 included a lower FTE adjustment than in the third quarter 2017 due to the reduced federal corporate tax as a result of enactment of the Act. The provision for loan losses remained zero, reflecting Management's evaluation of losses inherent in the loan portfolio. Noninterest expense increased \$2.9 million in the third quarter 2018 compared with the same period in 2017 due to a \$3.5 million settlement. In the third quarter 2018, the Company achieved a mediated settlement to dismiss a lawsuit, subject to court approval, and has accrued a liability for such amount. The non-FTE book tax provision for the third quarter 2018, which reflected the tax-exempt nature of a \$585 thousand life insurance policy gain, was \$4.3 million compared with \$6.1 million for the third quarter 2017, representing effective tax rates of 20.0% and 28.8%, respectively. The non-FTE book tax provisions for the three months ended September 30, 2018 and September 30, 2017 include tax benefits of \$152 thousand and \$22 thousand, respectively, for tax deductions from the exercise of employee stock options which exceed related compensation expenses recognized in the financial statements.

Comparing the first nine months of 2018 with the first nine months of 2017, net income increased \$6.6 million. Net interest and loan fee income increased \$6.7 million in the first nine months of 2018 compared with the first nine months of 2017 mostly attributable to higher average balances of investments and higher yields on earning assets as market interest rates rose. The increase was offset by lower average balances of loans. Net interest and loan fee income (FTE) in the first nine months of 2018 included a lower FTE adjustment than in the first nine months of 2017 due to the reduced federal corporate tax as a result of enactment of the Act. The provision for loan losses remained zero, reflecting Management's evaluation of losses inherent in the loan portfolio. In the first nine months of 2018, noninterest expense increased \$2.1 million compared with the first nine months of 2017 due to a \$3.5 million settlement. In the third quarter 2018, the Company achieved a mediated settlement to dismiss a lawsuit, subject to court approval, and has accrued a liability for such amount. The non-FTE book tax provision for the first nine months of 2018, which reflected the tax-exempt nature of a \$585 thousand life insurance policy gain, was \$13.4 million compared with \$17.4 million for the first nine months of 2017, representing effective tax rates of 20.4% and 27.6%, respectively. The non-FTE book tax provisions for the nine months ended September 30, 2018 and September 30, 2017 include tax benefits of \$731 thousand and \$688 thousand, respectively, for tax deductions from the exercise of employee stock options which exceed related compensation expenses recognized in the financial statements.

Net Interest and Loan Fee Income (FTE)

Following is a summary of the components of net interest and loan fee income (FTE) for the periods indicated:

| | For the Three Months Ended September 30, | | For the Nine Months | |
|--|---|-------------|---------------------|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| | (\$ in thousands) | | | |
| Interest and loan fee income | \$36,253 | \$33,145 | \$106,342 | \$99,632 |
| Interest expense | 527 | 473 | 1,445 | 1,429 |
| Net interest and loan fee income | 35,726 | 32,672 | 104,897 | 98,203 |
| FTE adjustment | 1,411 | 3,008 | 4,292 | 9,271 |
| Net interest and loan fee income (FTE) | \$37,137 | \$35,680 | \$109,189 | \$107,474 |
| Average earning assets | \$4,786,511 | \$4,587,848 | \$4,754,436 | \$4,601,931 |
| Net interest margin (FTE) (annualized) | 3.10 | % 3.10 | % 3.07 | % 3.12 |

Net interest and loan fee income increased \$3.1 million in the third quarter 2018 compared with the third quarter 2017, mainly due to higher average balances of investments (up \$292 million) and higher yield on earning assets (up 0.14%), partially offset by lower average balances of loans (down \$93 million). The FTE adjustment was lower in the third quarter 2018 compared with the third quarter 2017 mainly due to the reduced federal corporate tax rate as a result of enactment of the Act.

Comparing the first nine months of 2018 with the first nine months of 2017, net interest and loan fee income increased \$6.7 million due to higher average balances of investments (up \$262 million) and higher yield on interest earning assets (up 0.10%), offset by lower average balances of loans (down \$109 million). The FTE adjustment was lower in the first nine months of 2018 compared with the first nine months of 2017 mainly due to the reduced federal corporate tax rate as a result of enactment of the Act.

The annualized net interest margin (FTE) was 3.10% in the third quarter 2018 and 3.07% in the nine months ended September 30, 2018 compared with 3.10% in the third quarter 2017 and 3.12% in the nine months ended September 30, 2017. The net interest margin (FTE) reflected higher market interest rates which offset the impact of the reduced federal corporate tax rate as a result of enactment of the Act. The net interest margin (FTE) was lower in the nine months ended September 30, 2018 than in the same period of 2017 primarily due to the reduced federal corporate tax rate as a result of enactment of the Act.

The Company's funding cost was 0.04% in the nine months ended September 30, 2018, unchanged from the nine months ended September 30, 2017. Average balances of time deposits declined \$35 million from the third quarter 2017 to the third quarter 2018 while lower-cost checking and savings deposits grew 5% in the same period. Average balances of checking and saving deposits accounted for 95.5% of average total deposits in the nine months ended September 30, 2018 compared with 94.7% in the nine months ended September 30, 2017.

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Net Interest Margin (FTE)

The following summarizes the components of the Company's net interest margin for the periods indicated (percentages are annualized.):

| | For the Three Months Ended September 30, | | For the Nine Months | |
|---|--|--------|------------------------|--------|
| | 2018 | 2017 | 2018 | 2017 |
| Yield on earning assets | 3.02 % | 2.88 % | 2.99 % | 2.89 % |
| Impact of FTE adjustment | 0.12 % | 0.26 % | 0.12 % | 0.27 % |
| Yield on earning assets (FTE) | 3.14 % | 3.14 % | 3.11 % | 3.16 % |
| Rate paid on interest-bearing liabilities | 0.08 % | 0.07 % | 0.07 % | 0.07 % |
| Net interest spread (FTE) | 3.06 % | 3.07 % | 3.04 % | 3.09 % |
| Impact of noninterest-bearing demand deposits | 0.04 % | 0.03 % | 0.03 % | 0.03 % |
| Net interest margin (FTE) | 3.10 % | 3.10 % | 3.07 % | 3.12 % |

The FOMC increased the federal funds rate between December 2016 and September 2018. In the nine months ended September 30, 2018, the yield on earning assets increased with rising market interest rates. The net interest spread and net interest margin stated on an FTE basis are lower in 2018 compared with 2017 because the FTE adjustment to reflect the effect of income exempt from federal taxation is lower in 2018 compared with 2017. Rates on interest-bearing liabilities were kept low by reducing the volume of higher-cost time deposits and increasing balances of checking and savings deposits, which earn relatively low interest rates and are less volatile than time deposits during periods of rising market interest rates.

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Summary of Average Balances, Yields/Rates and Interest Differential

The following tables present information regarding the consolidated average assets, liabilities and shareholders' equity, the amounts of interest income earned from average interest earning assets and the resulting yields, and the amounts of interest expense incurred on average interest-bearing liabilities and the resulting rates. Average loan balances include nonperforming loans. Interest income includes reversal of previously accrued interest on loans placed on non-accrual status during the period and proceeds from loans on nonaccrual status only to the extent cash payments have been received and applied as interest income and accretion of purchased loan discounts. Yields, rates and interest margins are annualized. Yields on tax-exempt securities and loans have been adjusted upward to reflect the effect of income exempt from federal income taxation at the federal statutory tax rate of 35 percent for 2017. Due to the Act, the federal tax rate became 21 percent for 2018; as such, the upward adjustment to reflect the effect of income exempt from federal taxation is lower in 2018.

Distribution of Assets, Liabilities & Shareholders' Equity and Yields, Rates & Interest Margin

| | For the Three Months Ended September 30, 2018 | | |
|--|--|--------------------------------|------------------|
| | Average Balance | Interest Income/ Expense | Yields/ Rates |
| | (\$ in thousands) | | |
| Assets | | | |
| Investment securities: | | | |
| Taxable | \$2,849,187 | \$16,780 | 2.36% |
| Tax-exempt ⁽¹⁾ | 742,450 | 6,177 | 3.33% |
| Total investments ⁽¹⁾ | 3,591,637 | 22,957 | 2.56% |
| Loans: | | | |
| Taxable | 1,140,448 | 14,161 | 4.93% |
| Tax-exempt ⁽¹⁾ | 54,426 | 546 | 3.98% |
| Total loans ⁽¹⁾ | 1,194,874 | 14,707 | 4.88% |
| Total Interest-earning assets ⁽¹⁾ | 4,786,511 | 37,664 | 3.14% |
| Other assets | 861,493 | | |
| Total assets | \$5,648,004 | | |
| Liabilities and shareholders' equity | | | |
| Noninterest-bearing demand | \$2,223,678 | \$- | - % |
| Savings and interest-bearing transaction | 2,461,357 | 358 | 0.06% |
| Time less than \$100,000 | 118,156 | 69 | 0.23% |
| Time \$100,000 or more | 90,668 | 91 | 0.40% |
| Total interest-bearing deposits | 2,670,181 | 518 | 0.08% |
| Short-term borrowed funds | 63,489 | 9 | 0.06% |
| Total interest-bearing liabilities | 2,733,670 | 527 | 0.08% |

| | | |
|--|-------------|-------|
| Other liabilities | 53,691 | |
| Shareholders' equity | 636,965 | |
| Total liabilities and shareholders' equity | \$5,648,004 | |
| Net interest spread ^{(1) (2)} | | 3.06% |
| Net interest and fee income and interest margin ^{(1) (3)} | \$37,137 | 3.10% |

⁽¹⁾ Amounts calculated on an FTE basis using the current statutory federal tax rate.

⁽²⁾ Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

Net interest margin is computed by calculating the difference between interest income and expense, divided by the ⁽³⁾ average balance of interest-earning assets. The net interest margin is greater than the net interest spread due to the benefit of noninterest-bearing demand deposits.

Distribution of Assets, Liabilities & Shareholders' Equity and Yields, Rates & Interest Margin

| | For the Three Months Ended September 30, 2017 | | |
|--|--|--------------------------------|------------------|
| | Average Balance | Interest Income/ Expense | Yields/ Rates |
| | (\$ in thousands) | | |
| Assets | | | |
| Investment securities: | | | |
| Taxable | \$2,496,470 | \$12,957 | 2.08% |
| Tax-exempt ⁽¹⁾ | 803,638 | 7,847 | 3.91% |
| Total investments ⁽¹⁾ | 3,300,108 | 20,804 | 2.52% |
| Loans: | | | |
| Taxable | 1,225,937 | 14,586 | 4.72% |
| Tax-exempt ⁽¹⁾ | 61,803 | 763 | 4.90% |
| Total loans ⁽¹⁾ | 1,287,740 | 15,349 | 4.73% |
| Total Interest-earning assets ⁽¹⁾ | 4,587,848 | 36,153 | 3.14% |
| Other assets | 853,764 | | |
| Total assets | \$5,441,612 | | |
| Liabilities and shareholders' equity | | | |
| Noninterest-bearing demand | \$2,103,042 | \$- | - % |
| Savings and interest-bearing transaction | 2,367,501 | 280 | 0.05% |
| Time less than \$100,000 | 135,363 | 78 | 0.23% |
| Time \$100,000 or more | 108,673 | 103 | 0.38% |
| Total interest-bearing deposits | 2,611,537 | 461 | 0.07% |
| Short-term borrowed funds | 76,083 | 12 | 0.06% |
| Total interest-bearing liabilities | 2,687,620 | 473 | 0.07% |
| Other liabilities | 51,477 | | |
| Shareholders' equity | 599,473 | | |
| Total liabilities and shareholders' equity | \$5,441,612 | | |
| Net interest spread ^{(1) (2)} | | | 3.07% |
| Net interest and fee income and interest margin ^{(1) (3)} | | \$35,680 | 3.10% |

⁽¹⁾ Amounts calculated on an FTE basis using the current statutory federal tax rate.

⁽²⁾ Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

Net interest margin is computed by calculating the difference between interest income and expense, divided by the average balance of interest-earning assets. The net interest margin is greater than the net interest spread due to the benefit of noninterest-bearing demand deposits.

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Distribution of Assets, Liabilities & Shareholders' Equity and Yields, Rates & Interest Margin

| | For the Nine Months Ended September 30, 2018 | | |
|--|---|--------------------------------|------------------|
| | Average Balance | Interest Income/ Expense | Yields/ Rates |
| | (\$ in thousands) | | |
| Assets | | | |
| Investment securities: | | | |
| Taxable | \$2,781,814 | \$47,327 | 2.27% |
| Tax-exempt ⁽¹⁾ | 756,910 | 18,697 | 3.29% |
| Total investments ⁽¹⁾ | 3,538,724 | 66,024 | 2.49% |
| Loans: | | | |
| Taxable | 1,159,049 | 42,876 | 4.95% |
| Tax-exempt ⁽¹⁾ | 56,663 | 1,734 | 4.09% |
| Total loans ⁽¹⁾ | 1,215,712 | 44,610 | 4.91% |
| Total Interest-earning assets ⁽¹⁾ | 4,754,436 | 110,634 | 3.11% |
| Other assets | 846,063 | | |
| Total assets | \$5,600,499 | | |
| Liabilities and shareholders' equity | | | |
| Noninterest-bearing demand | \$2,186,250 | \$- | - % |
| Savings and interest-bearing transaction | 2,450,893 | 924 | 0.05% |
| Time less than \$100,000 | 121,619 | 210 | 0.23% |
| Time \$100,000 or more | 97,877 | 283 | 0.39% |
| Total interest-bearing deposits | 2,670,389 | 1,417 | 0.07% |
| Short-term borrowed funds | 62,131 | 28 | 0.06% |
| Total interest-bearing liabilities | 2,732,520 | 1,445 | 0.07% |
| Other liabilities | 56,233 | | |
| Shareholders' equity | 625,496 | | |
| Total liabilities and shareholders' equity | \$5,600,499 | | |
| Net interest spread ^{(1) (2)} | | | 3.04% |
| Net interest and fee income and interest margin ^{(1) (3)} | | \$109,189 | 3.07% |

⁽¹⁾ Amounts calculated on an FTE basis using the current statutory federal tax rate.

⁽²⁾ Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

Net interest margin is computed by calculating the difference between interest income and expense, divided by the average balance of interest-earning assets. The net interest margin is greater than the net interest spread due to the benefit of noninterest-bearing demand deposits.

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Distribution of Assets, Liabilities & Shareholders' Equity and Yields, Rates & Interest Margin

| | For the Nine Months Ended September 30, 2017 | | |
|--|---|--------------------------------|------------------|
| | Average Balance | Interest Income/ Expense | Yields/ Rates |
| | (\$ in thousands) | | |
| Assets | | | |
| Investment securities: | | | |
| Taxable | \$2,459,360 | \$37,584 | 2.04% |
| Tax-exempt ⁽¹⁾ | 817,443 | 24,154 | 3.94% |
| Total investments ⁽¹⁾ | 3,276,803 | 61,738 | 2.51% |
| Loans: | | | |
| Taxable | 1,261,726 | 44,777 | 4.74% |
| Tax-exempt ⁽¹⁾ | 63,402 | 2,388 | 5.04% |
| Total loans ⁽¹⁾ | 1,325,128 | 47,165 | 4.76% |
| Total Interest-earning assets ⁽¹⁾ | 4,601,931 | 108,903 | 3.16% |
| Other assets | 805,730 | | |
| Total assets | \$5,407,661 | | |
| Liabilities and shareholders' equity | | | |
| Noninterest-bearing demand | \$2,069,521 | \$- | - % |
| Savings and interest-bearing transaction | 2,373,814 | 839 | 0.05% |
| Time less than \$100,000 | 138,483 | 242 | 0.23% |
| Time \$100,000 or more | 110,512 | 314 | 0.38% |
| Total interest-bearing deposits | 2,622,809 | 1,395 | 0.07% |
| Short-term borrowed funds | 71,976 | 34 | 0.06% |
| Total interest-bearing liabilities | 2,694,785 | 1,429 | 0.07% |
| Other liabilities | 51,664 | | |
| Shareholders' equity | 591,691 | | |
| Total liabilities and shareholders' equity | \$5,407,661 | | |
| Net interest spread ^{(1) (2)} | | | 3.09% |
| Net interest and fee income and interest margin ^{(1) (3)} | | \$107,474 | 3.12% |

⁽¹⁾ Amounts calculated on an FTE basis using the current statutory federal tax rate.

⁽²⁾ Net interest spread represents the average yield earned on interest-earning assets less the average rate incurred on interest-bearing liabilities.

Net interest margin is computed by calculating the difference between interest income and expense, divided by the

⁽³⁾ average balance of interest-earning assets. The net interest margin is greater than the net interest spread due to the benefit of noninterest-bearing demand deposits.

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Summary of Changes in Interest Income and Expense due to Changes in Average Asset & Liability Balances and Yields Earned & Rates Paid

The following tables set forth a summary of the changes in interest income and interest expense due to changes in average assets and liability balances (volume) and changes in average interest yields/rates for the periods indicated. Changes not solely attributable to volume or yields/rates have been allocated in proportion to the respective volume and yield/rate components.

Summary of Changes in Interest Income and Expense

| | For the Three Months Ended September 30, 2018 | | |
|---|--|------------|---------|
| | Compared with | | |
| | For the Three Months Ended September 30, 2017 | | |
| | Volume | Yield/Rate | Total |
| | (In thousands) | | |
| Increase (decrease) in interest and loan fee income: | | | |
| Investment securities: | | | |
| Taxable | \$1,831 | \$ 1,992 | \$3,823 |
| Tax-exempt ⁽¹⁾ | (597) | (1,073) | (1,670) |
| Total investments ⁽¹⁾ | 1,234 | 919 | 2,153 |
| Loans: | | | |
| Taxable | (1,017) | 592 | (425) |
| Tax-exempt ⁽¹⁾ | (91) | (126) | (217) |
| Total loans ⁽¹⁾ | (1,108) | 466 | (642) |
| Total increase in interest and loan fee income ⁽¹⁾ | 126 | 1,385 | 1,511 |
| Increase (decrease) in interest expense: | | | |
| Deposits: | | | |
| Savings and interest-bearing transaction | 11 | 67 | 78 |
| Time less than \$100,000 | (10) | 1 | (9) |
| Time \$100,000 or more | (17) | 5 | (12) |
| Total interest-bearing deposits | (16) | 73 | 57 |
| Short-term borrowed funds | (2) | (1) | (3) |
| Total (decrease) increase in interest expense | (18) | 72 | 54 |
| Increase in net interest and loan fee income ⁽¹⁾ | \$144 | \$ 1,313 | \$1,457 |

⁽¹⁾ Amounts calculated on an FTE basis using the current statutory federal tax rate.

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Summary of Changes in Interest Income and Expense

| | For the Nine Months Ended September 30, 2018 Compared with For the Nine Months Ended September 30, 2017 | | |
|--|---|------------|----------|
| | Volume | Yield/Rate | Total |
| | (In thousands) | | |
| Increase (decrease) in interest and loan fee income: | | | |
| Investment securities: | | | |
| Taxable | \$4,928 | \$ 4,815 | \$9,743 |
| Tax-exempt ⁽¹⁾ | (1,789) | (3,668) | (5,457) |
| Total investments ⁽¹⁾ | 3,139 | 1,147 | 4,286 |
| Loans: | | | |
| Taxable | (3,644) | 1,743 | (1,901) |
| Tax-exempt ⁽¹⁾ | (254) | (400) | (654) |
| Total loans ⁽¹⁾ | (3,898) | 1,343 | (2,555) |
| Total (decrease) increase in interest and loan fee income ⁽¹⁾ | (759) | 2,490 | 1,731 |
| Increase (decrease) in interest expense: | | | |
| Deposits: | | | |
| Savings and interest-bearing transaction | 27 | 58 | 85 |
| Time less than \$100,000 | (29) | (3) | (32) |
| Time \$100,000 or more | (36) | 5 | (31) |
| Total interest-bearing deposits | (38) | 60 | 22 |
| Short-term borrowed funds | (5) | (1) | (6) |
| Total (decrease) increase in interest expense | (43) | 59 | 16 |
| (Decrease) increase in net interest and loan fee income ⁽¹⁾ | \$(716) | \$ 2,431 | \$ 1,715 |

⁽¹⁾ Amounts calculated on an FTE basis using the current statutory federal tax rate.

Provision for Loan Losses

The Company manages credit costs by consistently enforcing conservative underwriting and administration procedures and aggressively pursuing collection efforts with debtors experiencing financial difficulties. The provision for loan losses reflects Management's assessment of credit risk in the loan portfolio during each of the periods presented.

The Company provided no provision for loan losses in the three and nine months ended September 30, 2018. Classified loans declined \$6.6 million to \$30.0 million during the nine months ended September 30, 2018. This development was reflected in Management's evaluation of credit quality, the level of the provision for loan losses, and the adequacy of the allowance for loan losses at September 30, 2018. The Company provided no provision for loan losses in the three months ended September 30, 2017 and recorded a reversal of the provision for loan losses of \$1.9 million in the nine months ended September 30, 2017. During the nine months ended September 30, 2017, classified loans declined \$7.4 million to \$39.8 million (total classified loans included nonperforming loans of \$6.4 million). The Company realized net loan losses of \$426 thousand for the first nine months of 2017; these developments were reflected in Management's evaluation of credit quality, the level of the provision for loan losses, and the adequacy of the allowance for loan losses at September 30, 2017. At September 30, 2018, the Company had \$6.1 million in residential real estate secured loans which are indemnified from loss by the FDIC up to eighty percent of principal; the indemnification expires February 6, 2019. For further information regarding credit risk, the FDIC loss-sharing agreements, net credit losses and the allowance for loan losses, see the "Loan Portfolio Credit Risk" and "Allowance for Loan Losses" sections of this Report.

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Noninterest Income

The following table summarizes the components of noninterest income for the periods indicated.

| | For the Three Months Ended September 30, | | For the Nine Months | |
|-------------------------------------|--|----------|------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands) | | | |
| Service charges on deposit accounts | \$4,615 | \$4,989 | \$14,012 | \$14,857 |
| Merchant processing services | 2,464 | 2,153 | 7,190 | 6,080 |
| Debit card fees | 1,656 | 1,784 | 4,959 | 4,851 |
| Trust fees | 733 | 718 | 2,202 | 2,136 |
| ATM processing fees | 687 | 684 | 2,049 | 1,914 |
| Other service fees | 665 | 652 | 1,946 | 1,964 |
| Life insurance gains | 585 | - | 585 | - |
| Financial services commissions | 132 | 148 | 387 | 484 |
| Equity securities losses | (16) | - | (66) | - |
| Other noninterest income | 1,007 | 1,420 | 2,988 | 4,042 |
| Total | \$12,528 | \$12,548 | \$36,252 | \$36,328 |

Noninterest income for the third quarter 2018 decreased by \$20 thousand from the same period in 2017 as a result of other noninterest income decreasing \$413 thousand and a \$374 thousand decrease in service charges on deposit accounts due to lower fees for overdrafts and checking accounts. The decreases were offset by a \$585 thousand life insurance gain in the third quarter 2018 and a \$311 thousand increase in merchant processing services. Merchant processing services fees increased primarily due to successful sales efforts and higher transaction volumes.

In the first nine months of 2018, noninterest income decreased \$76 thousand compared with the first nine months of 2017 as a result of other noninterest income decreasing \$1.1 million and a decrease in service charges on deposit accounts of \$845 thousand due to lower fees for overdrafts and checking accounts. The decreases in other noninterest income were partially offset by an increase in merchant processing services fees of \$1.1 million due to successful sales efforts and higher transaction volumes and a \$585 thousand life insurance gain in the third quarter 2018.

Noninterest Expense

The following table summarizes the components of noninterest expense for the periods indicated.

| | For the Three Months Ended September 30, | | For the Nine Months | |
|--|--|-----------|------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands) | | | |
| Salaries and related benefits | \$ 13,415 | \$ 12,816 | \$ 39,952 | \$ 38,867 |
| Occupancy and equipment | 4,809 | 4,907 | 14,365 | 14,571 |
| Loss contingency | 3,500 | - | 3,500 | - |
| Outsourced data processing services | 2,292 | 2,383 | 6,930 | 6,710 |
| Amortization of identifiable intangibles | 451 | 760 | 1,474 | 2,322 |
| Professional fees | 621 | 512 | 2,277 | 1,533 |
| Courier service | 448 | 451 | 1,333 | 1,310 |
| Other noninterest expense | 1,469 | 2,285 | 5,365 | 7,812 |
| Total | \$ 27,005 | \$ 24,114 | \$ 75,196 | \$ 73,125 |

Noninterest expense increased \$2.9 million in the third quarter 2018 compared with the same period in 2017 due to a \$3.5 million loss contingency. In the third quarter 2018, the Company achieved a mediated settlement to dismiss a lawsuit, subject to court approval, and has accrued a liability for \$3.5 million. Salaries and related benefits increased \$599 thousand primarily due to increases in incentives and employee benefits. The increases were partially offset by an \$816 thousand decrease in other noninterest expense primarily due to decreases in correspondent bank service charges, expenses for foreclosed assets and operational losses, partially offset by an increase in operating losses on limited partnership investments. Amortization of intangibles decreased \$309 thousand as assets are amortized on a declining balance method.

In the first nine months of 2018, noninterest expense increased \$2.1 million compared with the first nine months of 2017 due to a \$3.5 million loss contingency. In the third quarter 2018, the Company achieved a mediated settlement to dismiss a lawsuit, subject to court approval, and has accrued a liability for \$3.5 million. Salaries and related benefits increased \$1.1 million primarily due to the annual merit increase cycle and higher incentives and employee benefit costs. Professional fees increased \$744 thousand due to higher legal and consulting fees. Other noninterest expense decreased \$2.4 million primarily due to decreases in correspondent bank service charges and operational losses, partially offset by an increase in operating losses on limited partnership investments. Amortization of intangibles decreased \$848 thousand as assets are amortized on a declining balance method.

Provision for Income Tax

The Company's income tax provision was \$4.3 million and \$13.4 million for the three and nine months ended September 30, 2018, respectively, representing effective tax rates of 20.0% and 20.4%, respectively. The income tax provision was \$6.1 million and \$17.4 million for the three and nine months ended September 30, 2017, respectively, representing effective tax rates of 28.8% and 27.6%, respectively. The book tax provisions for the nine months ended September 30, 2018 and September 30, 2017 include tax benefits of \$731 thousand and \$688 thousand, respectively, for tax deductions from the exercise of employee stock options which exceed related compensation expenses recognized in the financial statements. The lower effective tax rate for the three and nine months ended September 30, 2018 reflects a reduction in the federal corporate tax rate as a result of enactment of the Act and the tax-exempt nature of a \$585 thousand life insurance policy gain.

Investment Portfolio

The Company maintains an investment securities portfolio consisting of securities issued by U.S. Government sponsored entities, agency and non-agency mortgage backed securities, state and political subdivisions, corporations, and other securities.

Management has increased the investment securities portfolio in response to deposit growth and loan volume declines. The average carrying value of the Company's investment securities portfolio was \$3.5 billion for the nine months ended September 30, 2018 compared with \$3.3 billion for the nine months ended September 30, 2017.

Management continually evaluates the Company's investment securities portfolio in response to established asset/liability management objectives, changing market conditions that could affect profitability, liquidity, and the level of interest rate risk to which the Company is exposed. These evaluations may cause Management to change the level of funds the Company deploys into investment securities and change the composition of the Company's investment securities portfolio. In the nine months ended September 30, 2018, Management increased the holdings of

corporate securities in order to improve yields without extending the duration of the bond portfolio.

At September 30, 2018, substantially all of the Company's investment securities continue to be investment grade rated by one or more major rating agencies. In addition to monitoring credit rating agency evaluations, Management performs its own evaluations regarding the credit worthiness of the issuer or the securitized assets underlying asset-backed securities. The Company's procedures for evaluating investments in securities are in accordance with guidance issued by the Board of Governors of the Federal Reserve System, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Agencies" (SR 12-15) and other regulatory guidance. There have been no significant differences in the Company's internal analyses compared with the ratings assigned by the third party credit rating agencies.

During the third quarter 2018, the Atlantic hurricane season caused severe damage within many U.S. states. Management evaluated investment security exposures within the counties receiving disaster designations. The Company's exposures are limited to municipal bond and utility provider corporate debt from issuers within South Carolina counties, the state of North Carolina and the Florida panhandle, and has determined that the storms had no material impact on the valuation of its investment securities.

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The following table summarizes total corporate securities by the industry sector in which the issuing companies operate:

| | At September 30, 2018 | | | At December 31, 2017 | | |
|----------------------------|--------------------------|---|-------------|-------------------------|---|--|
| | Market value | As a percent of total corporate securities | | Market value | As a percent of total corporate securities | |
| | (\$ in thousands) | | | | | |
| Basic materials | \$34,080 | 3 % | \$35,219 | 3 % | | |
| Communications | 49,408 | 4 % | 50,763 | 5 % | | |
| Consumer, cyclical | 60,562 | 5 % | 12,592 | 1 % | | |
| Consumer, non-cyclical | 179,951 | 14 % | 133,476 | 12 % | | |
| Energy | 19,554 | 2 % | - | 0 % | | |
| Financial | 457,986 | 36 % | 525,932 | 47 % | | |
| Industrial | 152,097 | 12 % | 129,989 | 12 % | | |
| Technology | 104,743 | 8 % | 71,708 | 6 % | | |
| Utilities | 197,230 | 16 % | 155,819 | 14 % | | |
| Total corporate securities | \$1,255,611 | 100 % | \$1,115,498 | 100 % | | |

The following tables summarize the total general obligation and revenue bonds issued by states and political subdivisions held in the Company's investment securities portfolios as of the dates indicated, identifying the state in which the issuing government municipality or agency operates.

At September 30, 2018, the Company's investment securities portfolios included securities issued by 610 state and local government municipalities and agencies located within 44 states. None of the Company's investment securities were issued by Puerto Rican government entities. The largest exposure to any one municipality or agency was \$9.2 million (fair value) represented by eight general obligation bonds.

| | At September 30, 2018 | |
|---|--------------------------|---------------|
| | Amortized Cost | Fair Value |
| (In thousands) | | |
| Obligations of states and political subdivisions: | | |
| General obligation bonds: | | |
| California | \$105,874 | \$106,323 |
| Texas | 56,835 | 56,190 |

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| | | |
|--|-----------|-----------|
| New Jersey | 35,583 | 35,411 |
| Minnesota | 29,679 | 29,503 |
| Other (36 states) | 274,480 | 271,264 |
| Total general obligation bonds | \$502,451 | \$498,691 |
| Revenue bonds: | | |
| California | \$36,539 | \$36,706 |
| Kentucky | 20,728 | 20,609 |
| Iowa | 15,386 | 15,178 |
| Colorado | 14,895 | 14,787 |
| Washington | 13,050 | 13,222 |
| Indiana | 12,539 | 12,486 |
| Other (29 states) | 121,084 | 120,262 |
| Total revenue bonds | \$234,221 | \$233,250 |
| Total obligations of states and political subdivisions | \$736,672 | \$731,941 |

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At December 31, 2017, the Company's investment securities portfolios included securities issued by 647 state and local government municipalities and agencies located within 44 states. None of the Company's investment securities were issued by Puerto Rican government entities. The largest exposure to any one municipality or agency was \$10.0 million (fair value) represented by nine general obligation bonds.

| | At December 31, 2017 | |
|--|-------------------------|-----------|
| | Amortized Fair | |
| | Cost | Value |
| | (In thousands) | |
| Obligations of states and political subdivisions: | | |
| General obligation bonds: | | |
| California | \$104,330 | \$106,311 |
| Texas | 66,636 | 66,699 |
| New Jersey | 39,387 | 39,612 |
| Minnesota | 30,485 | 30,707 |
| Other (36 states) | 292,102 | 294,779 |
| Total general obligation bonds | \$532,940 | \$538,108 |
| Revenue bonds: | | |
| California | \$38,838 | \$39,660 |
| Kentucky | 21,731 | 21,958 |
| Iowa | 17,304 | 17,287 |
| Colorado | 14,956 | 15,086 |
| Washington | 13,506 | 13,963 |
| Indiana | 12,914 | 13,054 |
| Other (29 states) | 130,196 | 131,301 |
| Total revenue bonds | \$249,445 | \$252,309 |
| Total obligations of states and political subdivisions | \$782,385 | \$790,417 |

At September 30, 2018 and December 31, 2017, the revenue bonds in the Company's investment securities portfolios were issued by state and local government municipalities and agencies to fund public services such as water utility, sewer utility, recreational and school facilities, and general public and economic improvements. The revenue bonds were payable from 22 revenue sources at September 30, 2018 and at December 31, 2017. The revenue sources that represent 5% or more individually of the total revenue bonds are summarized in the following tables.

| | At September 30, 2018 | |
|----------------------------------|--------------------------|-------|
| | Amortized Fair | |
| | Cost | Value |
| | (In thousands) | |
| Revenue bonds by revenue source: | | |

| | | |
|---------------------------------------|-----------|-----------|
| Water | \$48,652 | \$48,924 |
| Sewer | 28,390 | 28,432 |
| Sales tax | 28,303 | 28,397 |
| Lease (renewal) | 19,030 | 18,930 |
| College & University | 17,078 | 16,731 |
| Other (17 sources) | 92,768 | 91,836 |
| Total revenue bonds by revenue source | \$234,221 | \$233,250 |

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| | At December 31, 2017 | |
|---------------------------------------|-------------------------|------------|
| | Amortized Cost | Fair Value |
| | (In thousands) | |
| Revenue bonds by revenue source: | | |
| Water | \$50,737 | \$51,854 |
| Sewer | 30,427 | 31,030 |
| Sales tax | 30,233 | 30,777 |
| Lease (renewal) | 20,007 | 20,235 |
| College & University | 17,230 | 17,087 |
| Other (17 sources) | 100,811 | 101,326 |
| Total revenue bonds by revenue source | \$249,445 | \$252,309 |

See Note 3 to the unaudited consolidated financial statements for additional information related to the investment securities.

Loan Portfolio Credit Risk

The Company extends loans to commercial and consumer customers which expose the Company to the risk borrowers will default, causing loan losses. The Company's lending activities are exposed to various qualitative risks. All loan segments are exposed to risks inherent in the economy and market conditions. Significant risk characteristics related to the commercial loan segment include the borrowers' business performance and financial condition, and the value of collateral for secured loans. Significant risk characteristics related to the commercial real estate segment include the borrowers' business performance and the value of properties collateralizing the loans. Significant risk characteristics related to the construction loan segment include the borrowers' performance in successfully developing the real estate into the intended purpose and the value of the property collateralizing the loans. Significant risk characteristics related to the residential real estate segment include the borrowers' financial wherewithal to service the mortgages and the value of the property collateralizing the loans. Significant risk characteristics related to the consumer loan segment include the financial condition of the borrowers and the value of collateral securing the loans.

The preparation of the financial statements requires Management to estimate the amount of losses inherent in the loan portfolio and establish an allowance for credit losses. The allowance for credit losses is maintained by assessing or reversing a provision for loan losses through the Company's earnings. In estimating credit losses, Management must exercise judgment in evaluating information deemed relevant, such as financial information regarding individual borrowers, overall credit loss experience, the amount of past due, nonperforming and classified loans, recommendations of regulatory authorities, prevailing economic conditions and other information. The amount of ultimate losses on the loan portfolio can vary from the estimated amounts. Management follows a systematic methodology to estimate loss potential in an effort to reduce the differences between estimated and actual losses.

The Company closely monitors the markets in which it conducts its lending operations and follows a strategy to control exposure to loans with high credit risk. The Bank's organization structure separates the functions of business development and loan underwriting; Management believes this segregation of duties avoids inherent conflicts of combining business development and loan approval functions. In measuring and managing credit risk, the Company adheres to the following practices.

The Bank maintains a Loan Review Department which reports directly to the audit committee of the Board of Directors. The Loan Review Department performs independent evaluations of loans to challenge the credit risk grades assigned by Management using grading standards employed by bank regulatory agencies. Those loans judged to carry higher risk attributes are referred to as "classified loans." Classified loans receive elevated Management attention to maximize collection.

The Bank maintains two loan administration offices whose sole responsibility is to manage and collect classified loans.

Classified loans with higher levels of credit risk are further designated as "nonaccrual loans." Management places classified loans on nonaccrual status when full collection of contractual interest and principal payments is in doubt. Uncollected interest previously accrued on loans placed on nonaccrual status is reversed as a charge against interest income. The Company does not accrue interest income on loans following placement on nonaccrual status. Interest payments received on nonaccrual loans are applied to reduce the carrying amount of the loan unless the carrying amount is well secured by loan collateral. "Nonperforming assets" include nonaccrual loans, loans 90 or more days past due and still accruing, and repossessed loan collateral (commonly referred to as "Other Real Estate Owned").

Nonperforming Assets

| | At September 30, | | At December 31, |
|---|---------------------|---------|-----------------------|
| | 2018 | 2017 | 2017 |
| | (In thousands) | | |
| Nonperforming nonaccrual loans | \$1,611 | \$1,498 | \$ 1,641 |
| Performing nonaccrual loans | 3,870 | 4,285 | 4,285 |
| Total nonaccrual loans | 5,481 | 5,783 | 5,926 |
| Accruing loans 90 or more days past due | 361 | 434 | 531 |
| Total nonperforming loans | 5,842 | 6,217 | 6,457 |
| Other real estate owned | 620 | 1,426 | 1,426 |
| Total nonperforming assets | \$6,462 | \$7,643 | \$ 7,883 |

Nonperforming assets have declined during the nine months ended September 30, 2018 due to payoffs, chargeoffs and sale of Other Real Estate Owned. At September 30, 2018, one loan secured by commercial real estate with a balance of \$3.9 million was on nonaccrual status. The remaining six nonaccrual loans held at September 30, 2018 had an average carrying value of \$269 thousand and the largest carrying value was \$769 thousand.

Management believes the overall credit quality of the loan portfolio is reasonably stable; however, classified and nonperforming assets could fluctuate from period to period. The performance of any individual loan can be affected by external factors such as the interest rate environment, economic conditions, and collateral values or factors particular to the borrower. No assurance can be given that additional increases in nonaccrual and delinquent loans will not occur in the future.

Allowance for Loan Losses

The Company's allowance for loan losses represents Management's estimate of loan losses inherent in the loan portfolio. In evaluating credit risk for loans, Management measures loss potential of the carrying value of loans. As described above, payments received on nonaccrual loans may be applied against the principal balance of the loans until such time as full collection of the remaining recorded balance is expected.

The following table summarizes the allowance for loan losses, chargeoffs and recoveries for the periods indicated:

| | For the Three Months Ended September 30, | | For the Nine Months | |
|---|---|----------|---------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| | (\$ in thousands) | | | |
| Analysis of the Allowance for Loan Losses | | | | |
| Balance, beginning of period | \$23,040 | \$24,103 | \$23,009 | \$25,954 |
| Reversal of provision for loan losses | - | - | - | (1,900) |
| Loans charged off | | | | |
| Commercial | (384) | (132) | (425) | (961) |
| Commercial real estate | (240) | | (240) | |
| Consumer installment and other | (845) | (886) | (3,015) | (3,783) |
| Total chargeoffs | (1,469) | (1,018) | (3,680) | (4,744) |
| Recoveries of loans previously charged off | | | | |
| Commercial | 103 | 128 | 1,352 | 626 |
| Commercial real estate | - | - | - | 88 |
| Construction | - | - | - | 1,899 |
| Consumer installment and other | 353 | 415 | 1,346 | 1,705 |
| Total recoveries | 456 | 543 | 2,698 | 4,318 |
| Net loan losses | (1,013) | (475) | (982) | (426) |
| Balance, end of period | \$22,027 | \$23,628 | \$22,027 | \$23,628 |
| Net loan losses as a percentage of average total loans (annualized) | 0.34 % | 0.15 % | 0.11 % | 0.04 % |

The Company's allowance for loan losses is maintained at a level considered appropriate to provide for losses that can be estimated based upon specific and general conditions. These include conditions unique to individual borrowers, as well as overall loan loss experience, the amount of past due, nonperforming and classified loans, recommendations of regulatory authorities, prevailing economic conditions and other factors. A portion of the allowance is individually allocated to impaired loans whose full collectability of principal is uncertain. Such allocations are determined by Management based on loan-by-loan analyses. The Company evaluates for impairment all loans with outstanding principal balances in excess of \$500 thousand which are classified or on nonaccrual status and all "troubled debt restructured" loans. The remainder of the loan portfolio is collectively evaluated for impairment based in part on quantitative analyses of historical loan loss experience of loan portfolio segments to determine standard loss rates for each segment. The loss rate for each loan portfolio segment reflects both the historical loss experience during a look-back period and a loss emergence period. Liquidating purchased consumer installment loans are evaluated separately by applying historical loss rates to forecasted liquidating principal balances to measure losses inherent in this portfolio segment. The loss rates are applied to segmented loan balances to allocate the allowance to the segments of the loan portfolio.

The remainder of the allowance is considered to be unallocated. The unallocated allowance is established to provide for probable losses that have been incurred as of the reporting date but not reflected in the allocated allowance. The unallocated allowance addresses additional qualitative factors consistent with Management's analysis of the level of risks inherent in the loan portfolio, which are related to the risks of the Company's general lending activity. Included in the unallocated allowance is the risk of losses that are attributable to national or local economic or industry trends which have occurred but have not yet been recognized in loan chargeoff history (external factors). The primary external factor evaluated by the Company and the judgmental amount of unallocated reserve assigned by Management as of September 30, 2018 is economic and business conditions \$0.5 million. Also included in the unallocated allowance is the risk of losses attributable to general attributes of the Company's loan portfolio and credit administration (internal factors). The internal factors evaluated by the Company and the judgmental amount of unallocated reserve assigned by Management are: loan review system \$1.0 million, adequacy of lending Management and staff \$0.9 million and concentrations of credit \$1.2 million.

Allowance for Loan Losses
For the Three Months Ended September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---------------------------------|----------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| | (In thousands) | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at beginning of period | \$8,275 | \$ 3,789 | \$ 210 | \$ 1,064 | \$ 5,943 | \$ 3,759 | \$23,040 |
| (Reversal) provision | (184) | 372 | 44 | (120) | (137) | 25 | - |
| Chargeoffs | (384) | (240) | - | - | (845) | - | (1,469) |
| Recoveries | 103 | - | - | - | 353 | - | 456 |
| Total allowance for loan losses | \$7,810 | \$ 3,921 | \$ 254 | \$ 944 | \$ 5,314 | \$ 3,784 | \$22,027 |

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Allowance for Loan Losses
For the Nine Months Ended September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|---------------------------------|------------|---------------------------|--------------|----------------------------|--------------------------------------|-------------|----------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Balance at beginning of period | \$7,746 | \$ 3,849 | \$ 335 | \$ 995 | \$ 6,418 | \$ 3,666 | \$23,009 |
| (Reversal) provision | (863) | 312 | (81) | (51) | 565 | 118 | - |
| Chargeoffs | (425) | (240) | - | - | (3,015) | - | (3,680) |
| Recoveries | 1,352 | - | - | - | 1,346 | - | 2,698 |
| Total allowance for loan losses | \$7,810 | \$ 3,921 | \$ 254 | \$ 944 | \$ 5,314 | \$ 3,784 | \$22,027 |

Allowance for Loan Losses and Recorded Investment in Loans Evaluated for
Impairment
At September 30, 2018

| | Commercial | Commercial Real Estate | Construction | Residential Real Estate | Consumer Installment and Other | Unallocated | Total |
|--|------------|---------------------------|--------------|-------------------------------|--------------------------------------|-------------|-------------|
| (In thousands) | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Individually evaluated for impairment | \$4,668 | \$ 172 | \$ - | \$ - | \$ - | \$ - | \$4,840 |
| Collectively evaluated for impairment | 3,142 | 3,749 | 254 | 944 | 5,314 | 3,784 | 17,187 |
| Purchased loans with evidence of credit deterioration | - | - | - | - | - | - | - |
| Total | \$7,810 | \$3,921 | \$ 254 | \$ 944 | \$ 5,314 | \$ 3,784 | \$22,027 |
| Carrying value of loans: | | | | | | | |
| Individually evaluated for impairment | \$10,254 | \$ 10,816 | \$ - | \$ 202 | \$ - | \$ - | \$21,272 |
| Collectively evaluated for impairment | 265,740 | 556,173 | 3,939 | 47,948 | 301,473 | - | 1,175,273 |
| Purchased loans with evidence of credit deterioration | 37 | 224 | - | - | 149 | - | 410 |
| Total | \$276,031 | \$ 567,213 | \$ 3,939 | \$ 48,150 | \$ 301,622 | \$ - | \$1,196,955 |

The portion of the allowance for loan losses ascribed to consumer installment and other loans decreased from December 31, 2017 to September 30, 2018 based on Management's evaluation of a shortened loss emergence period.

Management considers the \$22.0 million allowance for loan losses to be adequate as a reserve against loan losses inherent in the loan portfolio as of September 30, 2018.

See Note 4 to the unaudited consolidated financial statements for additional information related to the loan portfolio, loan portfolio credit risk, allowance for loan losses and other real estate owned.

Asset/Liability and Market Risk Management

Asset/liability management involves the evaluation, monitoring and management of interest rate risk, market risk, liquidity and funding. The fundamental objective of the Company's management of assets and liabilities is to maximize its economic value while maintaining adequate liquidity and a conservative level of interest rate risk.

Interest Rate Risk

Interest rate risk is a significant market risk affecting the Company. Many factors affect the Company's exposure to interest rates, such as general economic and financial conditions, customer preferences, historical pricing relationships, and re-pricing characteristics of financial instruments. Assets and liabilities may mature or re-price at different times. Assets and liabilities may re-price at the same time but by different amounts. Short-term and long-term market interest rates may change by different amounts. The timing and amount of cash flows of various assets or liabilities may change as interest rates change. In addition, the changing levels of interest rates may have an impact on loan demand, demand for various deposit products, credit losses, and other elements of earnings such as account analysis fees on commercial deposit accounts and correspondent bank service charges.

The Company's earnings are affected not only by general economic conditions, but also by the monetary and fiscal policies of the United States government and its agencies, particularly the FOMC. The monetary policies of the FOMC can influence the overall growth of loans, investment securities, and deposits and the level of interest rates earned on assets and paid for liabilities. The nature and impact of future changes in monetary policies are generally not predictable.

Management's most likely earnings forecast for the twelve months ending September 30, 2019 assumes short-term market interest rates will gradually rise, with the extent of movement of long-term rates uncertain.

Management attempts to manage interest rate risk while enhancing the net interest margin and net interest income. At times, depending on expected increases or decreases in general interest rates, the relationship between long and short-term interest rates, market conditions and competitive factors, Management may adjust the Company's interest rate risk position. The Company's results of operations and net portfolio values remain subject to changes in interest rates and to fluctuations in the difference between long and short-term interest rates.

The Company's asset and liability position was slightly "asset sensitive" at September 30, 2018, depending on the interest rate assumptions applied to the simulation model employed by Management to measure interest rate risk. An "asset sensitive" position results in a slightly larger change in interest income than in interest expense resulting from application of assumed interest rate changes. Simulation estimates depend on, and will change with, the size and mix of the actual and projected balance sheet at the time of each simulation. Management continues to monitor the interest rate environment as well as economic conditions and other factors it deems relevant in managing the Company's exposure to interest rate risk.

The Company does not currently engage in trading activities or use derivative instruments to manage interest rate risk, even though such activities may be permitted with the approval of the Company's Board of Directors.

Market Risk - Equity Markets

Equity price risk can affect the Company. Preferred or common stock holdings, as permitted by banking regulations, can fluctuate in value. Changes in value of preferred or common stock holdings are recognized in the Company's income statement.

Fluctuations in the Company's common stock price can impact the Company's financial results in several ways. First, the Company has at times repurchased and retired its common stock; the market price paid to retire the Company's common stock affects the level of the Company's shareholders' equity, cash flows and shares outstanding. Second, the Company's common stock price impacts the number of dilutive equivalent shares used to compute diluted earnings per share. Third, fluctuations in the Company's common stock price can motivate holders of options to purchase Company common stock through the exercise of such options thereby increasing the number of shares outstanding and potentially adding volatility to the book tax provision. Finally, the amount of compensation expense and tax deductions associated with share based compensation fluctuates with changes in and the volatility of the Company's common stock price.

Market Risk - Other

Market values of loan collateral can directly impact the level of loan chargeoffs and the provision for loan losses. The financial condition and liquidity of debtors issuing bonds and debtors whose mortgages or other obligations are securitized can directly impact the credit quality of the Company's investment securities portfolio requiring the Company to recognize other than temporary impairment charges. Other types of market risk, such as foreign currency exchange risk, are not significant in the normal course of the Company's business activities.

Liquidity and Funding

The objective of liquidity management is to manage cash flow and liquidity reserves so that they are adequate to fund the Company's operations and meet obligations and other commitments on a timely basis and at a reasonable cost. The Company achieves this objective through the selection of asset and liability maturity mixes that it believes best meet its needs. The Company's liquidity position is enhanced by its ability to raise additional funds as needed in the wholesale markets.

In recent years, the Company's deposit base has provided the majority of the Company's funding requirements. This relatively stable and low-cost source of funds, along with shareholders' equity, provided 98 percent of funding for average total assets in the first nine months ended September 30, 2018 and in 2017. The stability of the Company's funding from customer deposits is in part reliant on the confidence clients have in the Company. The Company places a very high priority in maintaining this confidence through conservative credit and capital management practices and by maintaining an appropriate level of liquidity.

Liquidity is further provided by assets such as balances held at the Federal Reserve Bank, investment securities, and amortizing loans. The Company's investment securities portfolio provides a substantial secondary liquidity. The Company held \$3.5 billion in total investment securities at September 30, 2018. Under certain deposit, borrowing and other arrangements, the Company must hold and pledge investment securities as collateral. At September 30, 2018, such collateral requirements totaled approximately \$740 million.

Liquidity risk can result from the mismatching of asset and liability cash flows, or from disruptions in the financial markets. The Company performs liquidity stress tests on a periodic basis to evaluate the sustainability of its liquidity. Under the stress testing, the Company assumes outflows of funds increase beyond expected levels. Measurement of such heightened outflows considers the composition of the Company's deposit base, including any concentration of deposits, non-deposit funding such as short-term borrowings, and unfunded lending commitments. The Company

evaluates its stock of highly liquid assets to meet the assumed higher levels of outflows. Highly liquid assets include cash and amounts due from other banks from daily transaction settlements, reduced by branch cash needs and Federal Reserve Bank reserve requirements, and investment securities based on regulatory risk-weighting guidelines. Based on the results of the most recent liquidity stress test, Management is satisfied with the liquidity condition of the Bank and the Company. However, no assurance can be given the Bank or Company will not experience a period of reduced liquidity.

Management continually monitors the Company's cash levels. Loan demand from credit worthy borrowers will be dictated by economic and competitive conditions. The Company aggressively solicits non-interest bearing demand deposits and money market checking deposits, which are the least sensitive to changes in interest rates. The growth of these deposit balances is subject to heightened competition, the success of the Company's sales efforts, delivery of superior customer service, new regulations and market conditions. The Company does not aggressively solicit higher-costing time deposits; as a result, Management anticipates such deposits will decline. Changes in interest rates, most notably rising interest rates, could impact deposit volumes. Depending on economic conditions, interest rate levels, liquidity management and a variety of other conditions, deposit growth may be used to fund loans or purchase investment securities. However, due to possible volatility in economic conditions, competition and political uncertainty, loan demand and levels of customer deposits are not certain. Shareholder dividends are expected to continue subject to the Board's discretion and continuing evaluation of capital levels, earnings, asset quality and other factors.

Westamerica Bancorporation ("Parent Company") is a separate entity apart from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Parent Company is responsible for the payment of dividends declared for its shareholders, and interest and principal on any outstanding debt. The Parent Company currently has no debt. Substantially all of the Parent Company's revenues are obtained from subsidiary dividends and service fees.

The Bank's dividends paid to the Parent Company, proceeds from the exercise of stock options, and Parent Company cash balances provided adequate cash for the Parent Company to pay shareholder dividends of \$32 million in the nine months ended September 30, 2018 and \$41 million in 2017, and retire common stock in the amount of \$524 thousand in the nine months ended September 30, 2018 and \$314 thousand in 2017. Payment of dividends to the Parent Company by the Bank is limited under California and Federal laws. The Company believes these regulatory dividend restrictions will not have an impact on the Parent Company's ability to meet its ongoing cash obligations.

Capital Resources

The Company has historically generated high levels of earnings, which provide a means of accumulating capital. The Company's net income as a percentage of average shareholders' equity ("return on equity" or "ROE") has been 11.2% in the nine months ended September 30, 2018 and 8.4% in 2017. The Company also raises capital as employees exercise stock options. Capital raised through the exercise of stock options was \$13 million in the nine months ended September 30, 2018 and \$25 million in 2017.

The Company paid common dividends totaling \$32 million in the nine months ended September 30, 2018 and \$41 million in 2017, which represent dividends per common share of \$1.20 and \$1.57, respectively. The Company's earnings have historically exceeded dividends paid to shareholders. The amount of earnings in excess of dividends provides the Company resources to finance growth and maintain appropriate levels of shareholders' equity. In the absence of profitable growth opportunities, the Company has at times repurchased and retired its common stock as another means to return earnings to shareholders. The Company repurchased and retired 9 thousand shares valued at \$524 thousand in the nine months ended September 30, 2018 and 6 thousand shares valued at \$314 thousand in 2017.

The Company's primary capital resource is shareholders' equity, which was \$593 million at September 30, 2018 compared with \$590 million at December 31, 2017. The Company's ratio of equity to total assets was 10.72% at September 30, 2018 and 10.71% at December 31, 2017.

The Company performs capital stress tests on a periodic basis to evaluate the sustainability of its capital. Under the stress testing, the Company assumes various scenarios such as deteriorating economic and operating conditions, unanticipated asset devaluations, and significant operational lapses. The Company measures the impact of these scenarios on its earnings and capital. Based on the results of the most recent stress tests, Management is satisfied with the capital condition of the Bank and the Company. However, no assurance can be given the Bank or Company will not experience a period of reduced earnings or a reduction in capital from unanticipated events and circumstances.

Capital to Risk-Adjusted Assets

On July 2, 2013, the Federal Reserve Board approved a final rule that implements changes to the regulatory capital framework for all banking organizations. The rule's provisions which most affected the regulatory capital requirements of the Company and the Bank:

- Introduced a new "Common Equity Tier 1" capital measurement,
- Established higher minimum levels of capital,
- Introduced a "capital conservation buffer,"
- Increased the risk-weighting of certain assets, and
- Established limits on the amount of deferred tax assets with any excess treated as a deduction from Tier 1 capital.

Under the final rule, a banking organization that is not subject to the "advanced approaches rule" may make a one-time election not to include most elements of Accumulated Other Comprehensive Income, including net-of-tax unrealized gains and losses on available for sale investment securities, in regulatory capital. Neither the Company nor the Bank is subject to the "advanced approaches rule" and both made the election not to include most elements of Accumulated Other Comprehensive Income in regulatory capital.

Banking organizations that are not subject to the "advanced approaches rule" began complying with the final rule on January 1, 2015; on such date, the Company and the Bank became subject to the revised definitions of regulatory capital, the new minimum regulatory capital ratios, and various regulatory capital adjustments and deductions according to transition provisions and timelines. All banking organizations began calculating standardized total risk-weighted assets on January 1, 2015. The transition period for the capital conservation buffer for all banking organizations began on January 1, 2016 and will end January 1, 2019. Any bank subject to the rule which is unable to maintain its "capital conservation buffer" will be restricted in the payment of discretionary executive compensation and shareholder distributions, such as dividends and share repurchases.

The final rule did not supersede provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) requiring federal banking agencies to take prompt corrective action (PCA) to resolve problems of insured depository institutions. The final rule revised the PCA thresholds to incorporate the higher minimum levels of capital, including the “common equity tier 1” ratio.

The capital ratios for the Company and the Bank under the new capital framework are presented in the tables below, on the dates indicated.

| | At September 30, 2018 | | Required for Capital Adequacy Purposes | | To Be Well-capitalized Under Prompt Corrective Action Regulations (Bank) | |
|------------------------------|--------------------------|---------|--|---------------------------------|--|---|
| | | | Effective January 1, 2018 | Effective January 1, 2019 | | |
| Common Equity Tier I Capital | 16.23 % | 13.07 % | 6.375 % ⁽¹⁾ | 7.00 % ⁽²⁾ | 6.50 | % |
| Tier I Capital | 16.23 % | 13.07 % | 7.875 % ⁽¹⁾ | 8.50 % ⁽²⁾ | 8.00 | % |
| Total Capital | 16.99 % | 14.03 % | 9.875 % ⁽¹⁾ | 10.50 % ⁽²⁾ | 10.00 | % |
| Leverage Ratio | 9.40 % | 7.53 % | 4.000 % | 4.00 % | 5.00 | % |

⁽¹⁾ Includes 1.875% capital conservation buffer.

⁽²⁾ Includes 2.5% capital conservation buffer.

| | At December 31, 2017 | | Required for Capital Adequacy Purposes | | To Be Well-capitalized Under Prompt Corrective Action Regulations (Bank) | |
|------------------------------|-------------------------|---------|--|---------------------------------|--|---|
| | | | Effective January 1, 2017 | Effective January 1, 2019 | | |
| Common Equity Tier I Capital | 15.36 % | 12.50 % | 5.75 % ⁽³⁾ | 7.00 % ⁽⁴⁾ | 6.50 | % |
| Tier I Capital | 15.36 % | 12.50 % | 7.25 % ⁽³⁾ | 8.50 % ⁽⁴⁾ | 8.00 | % |
| Total Capital | 16.17 % | 13.52 % | 9.25 % ⁽³⁾ | 10.50 % ⁽⁴⁾ | 10.00 | % |

| | | | | | | | | | |
|----------------|------|---|------|---|-------|------|---|------|---|
| Leverage Ratio | 8.86 | % | 7.16 | % | 4.00% | 4.00 | % | 5.00 | % |
|----------------|------|---|------|---|-------|------|---|------|---|

(3) Includes 1.25% capital conservation buffer.

(4) Includes 2.5% capital conservation buffer.

The Company and the Bank routinely project capital levels by analyzing forecasted earnings, credit quality, securities valuations, shareholder dividends, asset volumes, share repurchase activity, stock option exercise proceeds, and other factors. Based on current capital projections, the Company and the Bank expect to maintain regulatory capital levels exceeding the highest effective regulatory standard and pay quarterly dividends to shareholders. No assurance can be given that changes in capital management plans will not occur.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company does not currently engage in trading activities or use derivative instruments to control interest rate risk, even though such activities may be permitted with the approval of the Company's Board of Directors.

Credit risk and interest rate risk are the most significant market risks affecting the Company, and equity price risk can also affect the Company's financial results. These risks are described in the preceding sections regarding "Loan Portfolio Credit Risk," and "Asset/Liability and Market Risk Management." Other types of market risk, such as foreign currency exchange risk and commodity price risk, are not significant in the normal course of the Company's business activities.

Item 4. Controls and Procedures

The Company's principal executive officer and principal financial officer have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended, as of September 30, 2018.

Based upon their evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that material information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported as and when required and that such information is communicated to the Company's management, including the principal executive officer and the principal financial officer, to allow for timely decisions regarding required disclosures. The evaluation did not identify any change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2018 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Neither the Company nor any of its subsidiaries is a party to any material pending legal proceeding, nor is their property the subject of any material pending legal proceeding, other than ordinary routine legal proceedings arising in the ordinary course of the Company's business. None of these proceedings is expected to have a material adverse impact upon the Company's business, financial position or results of operations.

Item 1A. Risk Factors

The Company's Form 10-K as of December 31, 2017 includes detailed disclosure about the risks faced by the Company's business; such risks have not materially changed since the Form 10-K was filed.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None

(b) None

(c) Issuer Purchases of Equity Securities

The table below sets forth the information with respect to purchases made by or on behalf of Westamerica Bancorporation or any “affiliated purchaser” (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of common stock during the quarter ended September 30, 2018.

| Period | 2018 | | (c) Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------------------|---|--|---|---|
| | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | | |
| | (In thousands, except price paid) | | | |
| July 1 through July 31 | - | \$ - | - | 1,750 |
| August 1 through August 31 | - | - | - | 1,750 |
| September 1 through September 30 | - | - | - | 1,750 |
| Total | - | \$ - | - | 1,750 |

The Company repurchases shares of its common stock in the open market on a discretionary basis to optimize the Company’s use of equity capital and enhance shareholder value and with the intention of lessening the dilutive impact of issuing new shares under stock option plans, and other ongoing requirements.

No shares were repurchased during the period from July 1, 2018 through September 30, 2018. A replacement program approved by the Board of Directors on July 26, 2018 authorizes the purchase of up to 1,750 thousand shares of the Company’s common stock from time to time prior to September 1, 2019.

Item 3. Defaults upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None

Item 6. Exhibits

The exhibit list required by this item is incorporated by reference to the Exhibit Index filed with this report.

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SIGNATURES

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

WESTAMERICA BANCORPORATION

(Registrant)

/s/ JOHN "ROBERT" THORSON

John "Robert" Thorson

Senior Vice President and Chief Financial Officer

(Principal Financial and Chief Accounting Officer)

Date: November 2, 2018

EXHIBIT INDEX

Exhibit 31.1: Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)

Exhibit 31.2: Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14(a)/15d-14(a)

Exhibit 32.1: Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2: Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 101.INS: XBRL Instance Document

Exhibit 101.SCH: XBRL Taxonomy Extension Schema Document

Exhibit 101.CAL: XBRL Taxonomy Extension Calculation Linkbase Document

Exhibit 101.DEF: XBRL Taxonomy Extension Definitions Linkbase Document

Exhibit 101.LAB: XBRL Taxonomy Extension Label Linkbase Document

Exhibit 101.PRE: XBRL Taxonomy Extension Presentation Linkbase Document

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