NORTHRIM BANCORP INC
Form 10-Q
November 09, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q
(Mark One)
þ Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2016
o Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from_____to____
Commission File Number 000-33501
NORTHRIM BANCORP, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Alaska | 92-0175752 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

3111 C Street
Anchorage, Alaska 99503
(Address of principal executive offices) (Zip Code)

(907) 562-0062

(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
ý Yes ¨ No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
ý Yes ¨ No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:
Large Accelerated Filer ¨ Accelerated Filer ý Non-accelerated Filer ¨ Smaller Reporting Company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
¨ Yes ý No
The number of shares of the issuer's Common Stock, par value $1 per share, outstanding at November 8, 2016 was 6,897,890.

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PART I. FINANCIAL INFORMATION

These consolidated financial statements should be read in conjunction with the financial statements, accompanying notes and other relevant information included in Northrim BanCorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED FINANCIAL STATEMENTS
NORTHRIM BANCORP, INC.
Consolidated Balance Sheets
(Unaudited)

| (In Thousands, Except Share Data) | September 30, 2016 | December 31, 2015 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $37,955 | $30,989 |
| Interest bearing deposits in other banks | 7,911 | 27,684 |
| Investment securities available for sale, at fair value | 300,357 | 291,113 |
| Investment securities held to maturity, at amortized cost | 900 | 903 |
| Total portfolio investments | 301,257 | 292,016 |
| Investment in Federal Home Loan Bank stock | 1,965 | 1,816 |
| Loans held for sale | 76,452 | 50,553 |
| Loans | 997,076 | 980,787 |
| Allowance for loan losses | (19,479 ) | (18,153 ) |
| Net loans | 977,597 | 962,634 |
| Purchased receivables, net | 15,500 | 13,326 |
| Other real estate owned, net | 2,824 | 3,053 |
| Premises and equipment, net | 39,102 | 40,217 |
| Mortgage servicing rights, at fair value | 3,196 | 1,654 |
| Goodwill | 15,017 | 22,334 |
| Other intangible assets, net | 1,337 | 1,442 |
| Other assets | 60,007 | 51,774 |
| Total assets | $1,540,120 | $1,499,492 |
| LIABILITIES | | |
| Deposits: | | |
| Demand | $474,971 | $430,191 |
| Interest-bearing demand | 194,426 | 209,291 |
| Savings | 236,821 | 227,969 |
| Money market | 242,102 | 236,675 |
| Certificates of deposit less than $100,000 | 47,510 | 52,505 |
| Certificates of deposit $100,000 and greater | 82,536 | 84,161 |
| Total deposits | 1,278,366 | 1,240,792 |
| Securities sold under repurchase agreements | 27,701 | 31,420 |
| Borrowings | 4,350 | 2,120 |
| Junior subordinated debentures | 18,558 | 18,558 |
| Other liabilities | 25,387 | 29,388 |
| Total liabilities | 1,354,362 | 1,322,278 |
| SHAREHOLDERS' EQUITY | | |
| Preferred stock, $1 par value, 2,500,000 shares authorized, none issued or outstanding | — | — |
| Common stock, $1 par value, 10,000,000 shares authorized, 6,882,482 and 6,877,140 shares issued and outstanding at September 30, 2016 and December 31, 2015 | 6,882 | 6,877 |
| Additional paid-in capital | 62,851 | 62,420 |
| Retained earnings | 114,940 | 108,150 |

| | | |
|---|---|---|
| Accumulated other comprehensive income (loss) | 637 | (412 ) |
| Total Northrim BanCorp shareholders' equity | 185,310 | 177,035 |
| Noncontrolling interest | 448 | 179 |
| Total shareholders' equity | 185,758 | 177,214 |
| Total liabilities and shareholders' equity | $1,540,120 | $1,499,492 |

See notes to consolidated financial statements

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (In Thousands, Except Per Share Data) | 2016 | 2015 | 2016 | 2015 |
| Interest Income | | | | |
| Interest and fees on loans and loans held for sale | $13,866 | $14,484 | $41,354 | $42,086 |
| Interest on investment securities available for sale | 930 | 844 | 2,863 | 2,488 |
| Interest on investment securities held to maturity | 14 | 13 | 41 | 61 |
| Interest on deposits in other banks | 50 | 47 | 138 | 82 |
| Total Interest Income | 14,860 | 15,388 | 44,396 | 44,717 |
| Interest Expense | | | | |
| Interest expense on deposits, borrowings and junior subordinated debentures | 647 | 706 | 1,930 | 2,208 |
| Net Interest Income | 14,213 | 14,682 | 42,466 | 42,509 |
| Provision for loan losses | 652 | 676 | 1,555 | 1,378 |
| Net Interest Income After Provision for Loan Losses | 13,561 | 14,006 | 40,911 | 41,131 |
| Other Operating Income | | | | |
| Mortgage banking income | 8,341 | 8,138 | 22,547 | 23,303 |
| Employee benefit plan income | 999 | 1,004 | 2,899 | 2,712 |
| Bankcard fees | 687 | 689 | 1,995 | 1,947 |
| Purchased receivable income | 579 | 587 | 1,644 | 1,738 |
| Service charges on deposit accounts | 516 | 559 | 1,525 | 1,617 |
| Gain (loss) on sale of securities, net | — | 4 | (11) | 134 |
| Other income | 813 | 1,426 | 2,305 | 3,054 |
| Total Other Operating Income | 11,935 | 12,407 | 32,904 | 34,505 |
| Other Operating Expense | | | | |
| Salaries and other personnel expense | 12,158 | 11,440 | 35,420 | 33,115 |
| Compensation expense - RML acquisition payments | 3,250 | 780 | 4,067 | 2,869 |
| Occupancy expense | 1,567 | 1,522 | 4,872 | 4,720 |
| Data processing expense | 1,121 | 1,043 | 3,351 | 3,243 |
| Professional and outside services | 761 | 642 | 2,252 | 2,184 |
| Marketing expense | 500 | 565 | 1,853 | 1,824 |
| Insurance expense | 265 | 406 | 844 | 1,075 |
| Intangible asset amortization expense | 35 | 73 | 106 | 218 |
| Loss on sale of premises and equipment | 6 | — | 365 | 7 |
| OREO (income) expense, net rental income and gains on sale | (32) | 152 | 70 | 328 |
| Other operating expense | 1,555 | 1,580 | 4,726 | 4,835 |
| Total Other Operating Expense | 21,186 | 18,203 | 57,926 | 54,418 |
| Income Before Provision for Income Taxes | 4,310 | 8,210 | 15,889 | 21,218 |
| Provision for income taxes | 1,027 | 2,678 | 4,594 | 7,111 |
| Net Income | 3,283 | 5,532 | 11,295 | 14,107 |
| Less: Net income attributable to the noncontrolling interest | 188 | 197 | 474 | 431 |
| Net Income Attributable to Northrim BanCorp, Inc. | $3,095 | $5,335 | $10,821 | $13,676 |
| Earnings Per Share, Basic | $0.45 | $0.78 | $1.57 | $2.00 |
| Earnings Per Share, Diluted | $0.44 | $0.77 | $1.55 | $1.97 |
| Weighted Average Shares Outstanding, Basic | 6,882,482 | 6,856,059 | 6,878,921 | 6,854,862 |
| Weighted Average Shares Outstanding, Diluted | 6,973,354 | 6,952,209 | 6,968,557 | 6,941,861 |

See notes to consolidated financial statements

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

| (In Thousands) | Three Months Ended September 30, 2016 | 2015 | Nine Months Ended September 30, 2016 | 2015 |
|---|---|---|---|---|
| Net income | $3,283 | $5,532 | $11,295 | $14,107 |
| Other comprehensive income (loss), net of tax: | | | | |
| Securities available for sale: | | | | |
| Unrealized gains (losses) arising during the period | ($148) | $217 | $1,644 | $953 |
| Reclassification of net (gains) losses included in net income (net of tax (benefit) expense of $0 and $2 for the third quarter of 2016 and 2015, respectively and ($5) and $55 for the nine months ended September 30, 2016 and 2015, respectively) | — | (2) | 6 | (79) |
| Income tax (expense) benefit related to unrealized gains and losses | 43 | (74) | (601) | (337) |
| Other comprehensive income (loss), net of tax | (105) | 141 | 1,049 | 537 |
| Comprehensive income | 3,178 | 5,673 | 12,344 | 14,644 |
| Less: comprehensive income attributable to the noncontrolling interest | 188 | 197 | 474 | 431 |
| Comprehensive income attributable to Northrim BanCorp, Inc. | $2,990 | $5,476 | $11,870 | $14,213 |

See notes to consolidated financial statements

NORTHRIM BANCORP, INC.
Consolidated Statements of Changes in Shareholders’ Equity
(Unaudited)

| (In Thousands) | Common Stock Number of Shares | Par Value | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Non-controlling Interest | Total |
|---|---|---|---|---|---|---|---|
| Balance as of January 1, 2015 | 6,854 | $6,854 | $61,729 | $95,493 | $247 | $118 | $164,441 |
| Cash dividend declared | — | — | — | (5,126) | — | — | (5,126) |
| Stock-based compensation expense | — | — | 608 | — | — | — | 608 |
| Exercise of stock options | 23 | 23 | 27 | — | — | — | 50 |
| Excess tax benefits from stock based payment arrangements | — | — | 56 | — | — | — | 56 |
| Distributions to noncontrolling interest | — | — | — | — | — | (490) | (490) |
| Other comprehensive loss, net of tax | — | — | — | — | (659) | — | (659) |
| Net income attributable to the noncontrolling interest | — | — | — | — | — | 551 | 551 |
| Net income attributable to Northrim BanCorp, Inc. | — | — | — | 17,783 | — | — | 17,783 |
| Twelve Months Ended December 31, 2015 | 6,877 | $6,877 | $62,420 | $108,150 | ($412) | $179 | $177,214 |
| | | | | | | | |
| Cash dividend declared | — | — | — | (4,031) | — | — | (4,031) |
| Stock-based compensation expense | — | — | 531 | — | — | — | 531 |
| Exercise of stock options | 5 | 5 | (65) | — | — | — | (60) |
| Excess tax expense from share-based payment arrangements | — | — | (35) | — | — | — | (35) |
| Distributions to noncontrolling interest | — | — | — | — | — | (205) | (205) |
| Other comprehensive income, net of tax | — | — | — | — | 1,049 | — | 1,049 |
| Net income attributable to the noncontrolling interest | — | — | — | — | — | 474 | 474 |
| Net income attributable to Northrim BanCorp, Inc. | — | — | — | 10,821 | — | — | 10,821 |
| Nine Months Ended September 30, 2016 | 6,882 | $6,882 | $62,851 | $114,940 | $637 | $448 | $185,758 |

See notes to consolidated financial statements

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

| | Nine Months Ended September 30, | |
|---|---|---|
| (In Thousands) | 2016 | 2015 |
| Operating Activities: | | |
| Net income | $11,295 | $14,107 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Loss (gain) on sale of securities, net | 11 | (134) |
| Loss on sale of premises and equipment | 365 | 7 |
| Depreciation and amortization of premises and equipment | 1,800 | 1,670 |
| Amortization of software | 123 | 136 |
| Intangible asset amortization | 106 | 218 |
| Amortization of investment security premium, net of discount accretion | 3 | (196) |
| Deferred tax liability | (251) | (314) |
| Stock-based compensation | 531 | 357 |
| Excess tax expense (benefits) from share-based payment arrangements | 35 | (5) |
| Deferral of loan fees and costs, net | (204) | (203) |
| Provision for loan losses | 1,555 | 1,378 |
| Recovery from purchased receivables | (18) | (95) |
| Gain on sale of loans | (19,426) | (21,181) |
| Proceeds from the sale of loans held for sale | 560,092 | 592,675 |
| Origination of loans held for sale | (566,565) | (594,225) |
| Gain on sale of other real estate owned | (239) | (136) |
| Impairment on other real estate owned | 187 | 360 |
| Net changes in assets and liabilities: | | |
| Increase in accrued interest receivable | (54) | (103) |
| Decrease in other assets | 3,926 | 3,829 |
| Decrease in other liabilities | (10,944) | (5,937) |
| Net Cash Used in Operating Activities | (17,672) | (7,792) |
| Investing Activities: | | |
| Investment in securities: | | |
| Purchases of investment securities available for sale | (90,412) | (107,873) |
| Purchases of FHLB stock | (151) | — |
| Proceeds from sales/calls/maturities of securities available for sale | 82,812 | 156,491 |
| Proceeds from calls/maturities of securities held to maturity | — | 1,285 |
| Proceeds from maturities of domestic certificates of deposit | — | 3,500 |
| Proceeds from redemption of FHLB stock | 2 | 1,588 |
| (Increase) decrease in purchased receivables, net | (2,156) | 1,617 |
| Increase in loans, net | (16,515) | (50,359) |
| Proceeds from sale of other real estate owned | 793 | 1,971 |
| Investment in other real estate owned | (311) | — |
| Elliott Cove divestiture, net of cash received | — | 219 |
| Sales of premises and equipment | 1,379 | — |
| Purchases of premises and equipment | (2,429) | (5,461) |
| Net Cash (Used in) Provided by Investing Activities | (26,988) | 2,978 |
| Financing Activities: | | |

| | | |
|---|---|---|
| Increase in deposits | 37,574 | 85,172 |
| (Decrease) increase in securities sold under repurchase agreements | (3,719 ) | 13,570 |
| Increase (decrease) in borrowings | 2,230 | (13,846 ) |
| Distributions to noncontrolling interest | (205 ) | (402 ) |
| Proceeds from the issuance of common stock | — | 97 |
| Excess tax benefits from share-based payment arrangements | (35 ) | 5 |
| Cash dividends paid | (3,992 ) | (3,772 ) |

| | | |
|---|---|---|
| Net Cash Provided by Financing Activities | 31,853 | 80,824 |
| Net Change in Cash and Cash Equivalents | (12,807 ) | 76,010 |
| Cash and Cash Equivalents at Beginning of Period | 58,673 | 68,556 |
| Cash and Cash Equivalents at End of Period | $45,866 | $144,566 |
| | | |
| Supplemental Information: | | |
| Income taxes paid | $4,412 | $4,136 |
| Interest paid | $1,823 | $2,174 |
| Noncash commitments to invest in Low Income Housing Tax Credit Partnerships | $6,809 | $55 |
| Transfer of loans to other real estate owned | $201 | $1,133 |
| Cash dividends declared but not paid | $39 | $34 |

See notes to consolidated financial statements

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation and Significant Accounting Policies

The accompanying unaudited consolidated financial statements and corresponding footnotes have been prepared by Northrim BanCorp, Inc. (the “Company”) in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and with instructions to Form 10-Q under the Securities Exchange Act of 1934, as amended. The year-end Consolidated Balance Sheet data was derived from the Company's audited financial statements. Accordingly, they do not include all of the information and footnotes required by Generally Accepted Accounting Principles ("GAAP") for complete financial statements. The Company owns a 100% interest in Residential Mortgage Holding Company, LLC ("RML"), the parent company of Residential Mortgage, LLC ("Residential Mortgage") and a 50.1% interest in Northrim Benefits Group, LLC ("NBG") and consolidates their balance sheets and income statements into its financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain immaterial reclassifications have been made to prior year amounts to maintain consistency with the current year with no impact on net income or total shareholders’ equity. The Company determined that it operates in two primary operating segments: Community Banking and Home Mortgage Lending. The Company has evaluated subsequent events and transactions for potential recognition or disclosure. Operating results for the interim period ended September 30, 2016, are not necessarily indicative of the results anticipated for the year ending December 31, 2016. These consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. The Company’s significant accounting policies are discussed in Note 1 to the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Correction of an Error

The Company identified and has corrected an error regarding the accounting for payments to be made by the Company to the four former equity owners of RML that were negotiated as part of the Company’s acquisition of 76.5% of the equity interest in RML on December 1, 2014. Three of the four former equity owners of RML have continuing employment contracts with the Company, and under the terms of the acquisition agreement, the payments are terminated for future periods if any two of these three continuing employees terminate employment before November 30, 2019. The fair value of the estimated payments was recorded as acquisition consideration on December 1, 2014, and accrued as a contingent liability. The Company has determined that these payments are more appropriately accounted for as compensation expense in the period they are incurred. Changes in the value of the contingent liability that was initially recorded when the Company acquired RML have previously been reflected on the Company’s Consolidated Statements of Income in the “Change in fair value, RML earn-out liability” line item in prior periods. As of September 30, 2016, this line item has been renamed to “Compensation expense - RML acquisition payments”, and the payments to the sellers of RML are expensed and recorded in the Consolidated Statements of Income in that same line item. Management evaluated the materiality of the error from qualitative and quantitative perspectives and concluded that the error was immaterial to the prior period financial statements taken as a whole. Consequently, the financial statements contained in this report have been revised for the three- and nine-month periods ended September 30, 2016, and prior period financial statements have not been restated.

The error correction reduces the total purchase price of RML from $29.5 million to $22.2 million and reduces the amount of goodwill recorded in the RML acquisition from $14.8 million to $7.5 million. The error correction eliminates the contingent liability originally recorded as part of the purchase consideration and results in the accrual of compensation expense, which is included in other liabilities on the Consolidated Balance Sheet. Accrued compensation expense related to these payments is $3.3 million as of September 30, 2016 and represents compensation accrued for the period of December 1, 2015 through September 30, 2016. The error correction reduced net income by $1.4 million and covered the period from December 1, 2014, through June 30, 2016. Additionally, the change in the accounting treatment of these payments also reduced net income for the third quarter of 2016 by $213,000 for a total decrease in net income of $1.6 million in the third quarter of 2016. The change did not affect the total cash flows from operating, investing or financing activities in the Consolidated Statement of Cash Flows.

Recent Accounting Pronouncements

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 requires that equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets. ASU 2016-01 is effective for the Company’s financial statements for annual and interim periods beginning on or after December 15, 2017, and the Company will apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption and the amendments related to equity securities without readily determinable fair values (including disclosure requirements) will be applied prospectively to equity investments that exist as of the date of adoption of ASU 2016-01. The Company does not believe that the adoption of this standard will have a material impact on the Company’s consolidated financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) (“ASU 2016-02”). ASU 2016-02 increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about lease arrangements. ASU 2016-02 is effective for the Company’s financial statements for annual and interim periods beginning on or after December 15, 2018, and must be applied prospectively. The Company is currently evaluating how the adoption of this standard will impact the Company’s consolidated financial position and results of operations.

In March 2016, the FASB issued ASU 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Option in Debt Instruments (“ASU 2016-06”). ASU 2016-06 simplifies the embedded derivative analysis for debt instruments containing contingent call or put options by removing the requirement to assess whether a contingent event is related to interest rates or credit risks. ASU 2016-06 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2016, and interim periods within those fiscal years. The Company does not believe that the adoption of this standard will have a material impact on the Company’s consolidated financial position or results of operations.

In March 2016, the FASB issued ASU 2016-07, Simplifying the Transition to the Equity Method of Accounting (“ASU 2016-07”). ASU 2016-07 eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. ASU 2016-07 requires that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. ASU 2016-17 requires that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. ASU 2016-07 is effective for the Company’s financial statements for annual and interim periods beginning on or after December 15, 2016, and must be applied prospectively. The Company does not believe that the adoption of this standard will have a material impact on the Company’s consolidated financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2016, and must be applied prospectively. The Company does not believe that the adoption of this standard will have a material impact on the Company's consolidated financial position or results of operations.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses ("ASU 2016-13"). ASU 2016-13 requires a financial asset (or a group of financial assets) that is measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset or assets to present the net carrying value at the amount expected to be collected on the financial asset. The

income statement reflects the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. The allowance for credit losses for purchased financial assets with a more-than insignificant amount of credit deterioration since origination ("PCD assets") that are measured at amortized cost basis is determined in a similar manner to other financial assets measured at amortized cost basis; however, the initial allowance for credit losses is added to the purchase price rather than being reported as a credit loss expense. Only subsequent changes in the allowance for credit losses are recorded as a credit loss expense for these assets. Interest income for PCD assets should be recognized based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition. ASU 2016-13 requires credit losses relating to available-for-sale debt securities to be recorded through an allowance for credit losses. Available-for-sale accounting recognizes that value may be realized either through collection of contractual cash flows or through sale of the security. Therefore, the amendments limit the amount of the allowance for credit losses to the amount by which fair value is below amortized cost because the classification as available for sale is premised on an investment strategy that recognizes that the investment could be sold at fair value, if cash collection would result in the realization of an amount less than fair value. The allowance for credit losses for purchased available-for-sale securities with a more-than-insignificant amount of credit deterioration since origination is determined in a similar manner to other available-for-sale debt securities; however, the initial allowance for credit losses is added to the purchase price rather than reported as a credit loss expense. Only subsequent changes in the allowance for credit losses are recorded in credit loss expense. Interest income should be recognized based on the effective interest rate, excluding the discount embedded in the purchase price. ASU 2016-13 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2019, and must be applied prospectively. The Company is currently evaluating the impact that the adoption of this standard will have on the Company's consolidated financial position and results of operations.
In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 provides guidance on eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. ASU 2016-15 is effective for the Company's financial statements for annual and interim periods beginning on or after December 15, 2017, and must be applied retrospectively for each period presented. The Company does not believe that the adoption of this standard will have a material impact on the Company's consolidated financial position or results of operations.

2. Business Combinations
Residential Mortgage Holding Company, LLC

On December 1, 2014, the Company completed the acquisition of 76.5% of the equity interest in RML, the parent company of Residential Mortgage. The primary reason for the acquisition was to expand the Company's presence in the mortgage lending business in Alaska. The fair value of the Company's 23.5% equity interest in RML immediately prior to the acquisition was $9.0 million. The Company recorded a $3.0 million gain in the fourth quarter of 2014 as a result of remeasuring the Company's equity interest in RML immediately prior to the acquisition, which was included in the Company's Consolidated Statement of Income in the line item entitled "Gain on purchase of mortgage affiliate". The Company utilized a market value approach to value its 23.5% equity interest in RML which included analysis of current trading values and historical acquisition multiples of comparable mortgage companies. The consideration transferred or transferable to the former owners of RML and the assets acquired and liabilities assumed have been accounted for under the acquisition method of accounting and were recorded at their estimated fair values as of the December 1, 2014 acquisition date.

The former owners of RML (the "sellers") receive additional cash proceeds (the “payments”) based on the adjusted earnings of RML in all or a portion of the calendar years 2014, 2015, 2016, 2017, 2018 and 2019. The estimated value of these payments was initially recorded as a $7.3 million contingent liability as of December 1, 2014 as part of its acquisition accounting for future earn-out payments. The total contingent liability as of December 31, 2015 was $6.6 million. For the three- and nine-month periods ended September 30, 2015, the Company recorded adjustments of $780,000 and $2.9 million, respectively, to increase the contingent liability. The increase in the contingent liability resulted from the excess of RML's pretax income for these periods over and above estimates made at the close of the purchase of RML. The Company made its first payment to the sellers in the fourth quarter of 2015 for approximately $4.9 million.

As described in Note 1, the Company has identified that accounting for these payments as purchase consideration was an error at the time of the purchase, and when this error was corrected in the third quarter of 2016, the contingent liability previously recorded for these payments was eliminated. Following the error correction, payments owed to the sellers of RML are recorded as “compensation expense - RML acquisition payments” in the Consolidated Statements of Income and are accrued in other liabilities in the period in which they are incurred. The Company did not restate prior period financial statements for the correction of this error because management determined that the impact was not material.

Per the purchase agreement, the payments are calculated as follows:

| | | |
|---|---|---|
| First tier earn-out payment | Adjusted pretax earnings greater than $1,000,000 and less than or equal to $2,000,000 | Payment will be calculated as product of amount of adjusted pretax earnings times 40% |
| Second tier earn-out payment | Adjusted pretax earnings greater than $2,000,000 and less than or equal to $3,000,000 | The first tier earn-out payment, plus the product of amount of adjusted pretax earnings greater than $2,000,000 and less than $3,000,000 times 50% |
| Third tier earn-out payment | Adjusted pretax earnings greater than $3,000,000 and less than or equal to $4,000,000 | The first tier plus the second tier earn-out payment, plus the product of amount of adjusted pretax earnings greater than $3,000,000 and less than $4,000,000 times 70% |
| Fourth tier earn- out payment | Adjusted pretax earnings greater than $4,000,000 and less than or equal to $6,000,000 | The first, second and third tier earn-out payment, plus the product of amount of adjusted pretax earnings greater than $4,000,000 and less than $6,000,000 times 85% |
| Fifth tier earn-out payment | Adjusted pretax earnings greater than $6,000,000 | The first, second, third and fourth tier earn-out payment, plus the product of amount of adjusted pretax earnings greater than $6,000,000 times 55% |

The Company estimates the amount of compensation expense for RML acquisition payments based on internal projections of adjusted earnings of RML, and this expense was $3.3 million and $4.1 million for the three and nine-month periods ended September 30, 2016, respectively, including $2.8 million in expense to correct the error described in Note 1. The accrued liability relating to the RML acquisition payments is $3.3 million as of September 30, 2016. The RML acquisition payments are paid to the sellers annually in December.

3. Cash and Cash Equivalents

The Company is required to maintain a $500,000 minimum average daily balance with the Federal Reserve Bank of San Francisco ("Federal Reserve Bank") for purposes of settling financial transactions and charges for Federal Reserve Bank services. The Company is also required to maintain cash balances or deposits with the Federal Reserve Bank sufficient to meet its statutory reserve requirements.

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

4. Investment Securities

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

| (In Thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| September 30, 2016 | | | | |
| Securities available for sale | | | | |
| U.S. Treasury and government sponsored entities | $244,805 | $709 | $9 | $245,505 |
| Municipal securities | 9,261 | 35 | 27 | 9,269 |
| U.S. Agency mortgage-backed securities | 4 | — | — | 4 |
| Corporate bonds | 40,357 | 177 | — | 40,534 |
| Preferred stock | 4,922 | 134 | 11 | 5,045 |
| Total securities available for sale | $299,349 | $1,055 | $47 | $300,357 |
| Securities held to maturity | | | | |
| Municipal securities | $900 | $32 | $— | $932 |
| Total securities held to maturity | $900 | $32 | $— | $932 |
| December 31, 2015 | | | | |
| Securities available for sale | | | | |
| U.S. Treasury and government sponsored entities | $238,116 | $150 | $830 | $237,436 |
| Municipal securities | 10,227 | 117 | 18 | 10,326 |
| U.S. Agency mortgage-backed securities | 818 | 1 | 10 | 809 |
| Corporate bonds | 39,049 | 57 | 88 | 39,018 |
| Preferred stock | 3,549 | 8 | 33 | 3,524 |
| Total securities available for sale | $291,759 | $333 | $979 | $291,113 |
| Securities held to maturity | | | | |
| Municipal securities | $903 | $56 | $— | $959 |
| Total securities held to maturity | $903 | $56 | $— | $959 |

Gross unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2016 and December 31, 2015 were as follows:

| | Less Than 12 Months | | More Than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| (In Thousands) | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2016: | | | | | | |
| Securities Available for Sale | | | | | | |
| U.S. Treasury and government sponsored entities | $14,432 | $5 | $489 | $4 | $14,921 | $9 |
| Municipal Securities | 4,859 | 14 | 1,479 | 13 | 6,338 | 27 |
| Preferred Stock | 1,031 | 11 | — | — | 1,031 | 11 |
| Total | $20,322 | $30 | $1,968 | $17 | $22,290 | $47 |
| | | | | | | |
| December 31, 2015: | | | | | | |
| Securities Available for Sale | | | | | | |
| U.S. Treasury and government sponsored entities | $146,433 | $829 | $36 | $1 | $146,469 | $830 |
| Corporate Bonds | 19,874 | 88 | — | — | 19,874 | 88 |
| Municipal Securities | 4,454 | 18 | — | — | 4,454 | 18 |
| Mortgage-backed Securities | 637 | 9 | 100 | 1 | 737 | 10 |
| Preferred Stock | 2,514 | 33 | — | — | 2,514 | 33 |
| Total | $173,912 | $977 | $136 | $2 | $174,048 | $979 |

The unrealized losses on investments in U.S. treasury and government sponsored entities, preferred stock, and municipal securities in both periods were caused by changes in interest rates. At September 30, 2016 and December 31, 2015, respectively, there were eight and thirty-nine available-for-sale securities with unrealized losses that have been in a loss position for less than twelve months. There were two and six securities as of September 30, 2016 and December 31, 2015 that have been in an unrealized loss position for more than twelve months. The contractual terms of the investments in a loss position do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because it is more likely than not that the Company will hold these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

At September 30, 2016 and December 31, 2015, $51.6 million and $59.7 million in securities were pledged for deposits and borrowings.

The amortized cost and estimated fair values of debt securities at September 30, 2016, are distributed by contractual maturity as shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Although preferred stock has no stated maturity, it is aggregated in the calculation of weighted average yields presented below in the category of investments that mature in ten years or more.

| (In Thousands) | Amortized Cost | Fair Value | Weighted Average Yield | |
|---|---|---|---|---|
| US Treasury and government sponsored entities | | | | |
| Within 1 year | $9,998 | $10,009 | 0.84 | % |
| 1-5 years | 234,807 | 235,496 | 1.11 | % |
| Total | $244,805 | $245,505 | 1.10 | % |
| U.S. Agency mortgage-backed securities | | | | |
| 1-5 years | $4 | $4 | 1.47 | % |
| Total | $4 | $4 | 1.47 | % |
| Corporate bonds | | | | |
| Within 1 year | $6,613 | $6,621 | 1.67 | % |
| 1-5 years | 33,744 | 33,913 | 3.87 | % |
| Total | $40,357 | $40,534 | 3.51 | % |
| Preferred stock | | | | |
| Over 10 years | $4,922 | $5,045 | 6.41 | % |
| Total | $4,922 | $5,045 | 6.41 | % |
| Municipal securities | | | | |
| Within 1 year | $476 | $476 | 2.10 | % |
| 1-5 years | 7,655 | 7,704 | 2.91 | % |
| 5-10 years | 2,030 | 2,021 | 4.13 | % |
| Total | $10,161 | $10,201 | 3.12 | % |

The proceeds and resulting gains and losses, computed using specific identification, from sales of investment securities for the nine months ending September 30, 2016 and 2015, respectively, are as follows:

| (In Thousands) | Proceeds | Gross Gains | Gross Losses |
|---|---|---|---|
| 2016 | | | |
| Available for sale securities | $5,785 | $12 | $23 |
| 2015 | | | |
| Available for sale securities | $3,633 | $134 | $— |

A summary of interest income for the nine months ending September 30, 2016 and 2015, on available for sale investment securities is as follows:

| (In Thousands) | 2016 | 2015 |
|---|---|---|
| US Treasury and government sponsored entities | $1,979 | $1,713 |
| U.S. Agency mortgage-backed securities | 4 | 20 |
| Other | 667 | 507 |
| Total taxable interest income | $2,650 | $2,240 |
| Municipal securities | $213 | $248 |
| Total tax-exempt interest income | $213 | $248 |
| Total | $2,863 | $2,488 |

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5. Loans and Credit Quality

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

| (In Thousands) | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Total |
|---|---|---|---|---|---|---|---|---|---|
| September 30, 2016 | | | | | | | | | |
| AQR Pass | $322,095 | $33,030 | $70,179 | $149,409 | $288,766 | $41,660 | $24,945 | $26,014 | $956,098 |
| AQR Special Mention | 766 | — | — | 693 | — | 204 | 135 | 6 | 1,804 |
| AQR Substandard | 19,771 | 3,972 | 1,912 | 16,839 | 209 | — | 877 | 2 | 43,582 |
| Subtotal | $342,632 | $37,002 | $72,091 | $166,941 | $288,975 | $41,864 | $25,957 | $26,022 | $1,001,484 |
| Less: Unearned origination fees, net of origination costs | | | | | | | | | (4,408 ) |
| Total loans | | | | | | | | | $997,076 |
| December 31, 2015 | | | | | | | | | |
| AQR Pass | $313,689 | $44,488 | $74,931 | $112,248 | $313,710 | $37,938 | $26,015 | $28,882 | $951,901 |
| AQR Special Mention | 536 | — | — | — | — | 91 | 171 | 10 | 808 |
| AQR Substandard | 15,309 | — | — | 16,515 | 359 | — | 487 | 20 | 32,690 |
| Subtotal | $329,534 | $44,488 | $74,931 | $128,763 | $314,069 | $38,029 | $26,673 | $28,912 | $985,399 |
| Less: Unearned origination fees, net of origination costs | | | | | | | | | (4,612 ) |
| Total loans | | | | | | | | | $980,787 |

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

Nonaccrual loans: Nonaccrual loans net of government guarantees totaled $9.3 million and $2.1 million at September 30, 2016 and December 31, 2015, respectively. Nonaccrual loans at the periods indicated, by segment, are presented below:

| (In Thousands) | September 30, 2016 | December 31, 2015 |
|---|---|---|
| Commercial | $4,384 | $3,013 |
| Real estate construction one-to-four family | 3,972 | — |
| Real estate construction other | 1,912 | — |
| Real estate term owner occupied | 32 | 38 |
| Real estate term non-owner occupied | 209 | 359 |
| Consumer secured by 1st deeds of trust | 376 | 256 |
| Consumer other | — | 20 |
| Total nonaccrual loans | $10,885 | $3,686 |
| Government guarantees on nonaccrual loans | (1,624 ) | (1,561 ) |
| Net nonaccrual loans | $9,261 | $2,125 |

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

| (In Thousands) | 30-59 Days Past Due Still Accruing | 60-89 Days Past Due Still Accruing | Greater Than 90 Days Still Accruing | Total Past Due | Nonaccrual | Current | Total |
|---|---|---|---|---|---|---|---|
| September 30, 2016 | | | | | | | |
| Commercial | $332 | $308 | $— | $640 | $4,384 | $337,608 | $342,632 |
| Real estate construction one-to-four family | — | — | — | — | 3,972 | 33,030 | 37,002 |
| Real estate construction other | — | — | — | — | 1,912 | 70,179 | 72,091 |
| Real estate term owner occupied | — | — | — | — | 32 | 166,909 | 166,941 |
| Real estate term non-owner occupied | — | — | — | — | 209 | 288,766 | 288,975 |
| Real estate term other | 141 | 299 | — | 440 | — | 41,424 | 41,864 |
| Consumer secured by 1st deed of trust | 138 | 10 | — | 148 | 376 | 25,433 | 25,957 |
| Consumer other | 61 | 1 | | 62 | — | 25,960 | 26,022 |
| Subtotal | $672 | $618 | $— | $1,290 | $10,885 | $989,309 | $1,001,484 |
| | | | | | | | (4,408 ) |
| Total | | | | | | | $997,076 |
| December 31, 2015 | | | | | | | |
| Commercial | $242 | $21 | $— | $263 | $3,013 | $326,258 | $329,534 |
| Real estate construction one-to-four family | — | — | — | — | — | 44,488 | 44,488 |
| Real estate construction other | — | — | — | — | — | 74,931 | 74,931 |
| Real estate term owner occupied | — | — | — | — | 38 | 128,725 | 128,763 |
| Real estate term non-owner occupied | — | — | — | — | 359 | 313,710 | 314,069 |
| Real estate term other | 289 | — | — | 289 | — | 37,740 | 38,029 |
| Consumer secured by 1st deed of trust | 568 | — | — | 568 | 256 | 25,849 | 26,673 |
| Consumer other | 30 | — | — | 30 | 20 | 28,862 | 28,912 |
| Subtotal | $1,129 | $21 | $— | $1,150 | $3,686 | $980,563 | $985,399 |
| | | | | | | | (4,612 ) |
| Total | | | | | | | $980,787 |

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

At September 30, 2016 and December 31, 2015, the recorded investment in loans that are considered to be impaired was $44.8 million and $34.6 million, respectively. The following table presents information about impaired loans by class as of the periods indicated:

| (In Thousands) | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|---|---|---|---|
| September 30, 2016 | | | |
| With no related allowance recorded | | | |
| Commercial - AQR special mention | $150 | $150 | $— |
| Commercial - AQR substandard | 19,623 | 20,303 | — |
| Real estate construction other - AQR substandard | 1,912 | 1,912 | — |
| Real estate term owner occupied- AQR pass | 254 | 254 | — |
| Real estate term owner occupied- AQR substandard | 16,765 | 16,765 | — |
| Real estate term non-owner occupied- AQR pass | 412 | 412 | — |
| Real estate term non-owner occupied- AQR substandard | 204 | 204 | — |
| Real estate term other - AQR pass | 644 | 644 | — |
| Consumer secured by 1st deeds of trust - AQR substandard | 829 | 852 | — |
| Subtotal | $40,793 | $41,496 | $— |
| With an allowance recorded | | | |
| Real estate construction one-to-four family - AQR substandard | $3,972 | $3,972 | $535 |
| Subtotal | $3,972 | $3,972 | $535 |
| Total | | | |
| Commercial - AQR special mention | $150 | $150 | $— |
| Commercial - AQR substandard | 19,623 | 20,303 | — |
| Real estate construction one-to-four family - AQR substandard | 3,972 | 3,972 | 535 |
| Real estate construction other - AQR substandard | 1,912 | 1,912 | — |
| Real estate term owner-occupied - AQR pass | 254 | 254 | — |
| Real estate term owner-occupied - AQR substandard | 16,765 | 16,765 | — |
| Real estate term non-owner occupied - AQR pass | 412 | 412 | — |
| Real estate term non-owner occupied - AQR substandard | 204 | 204 | — |
| Real estate term other - AQR pass | 644 | 644 | — |
| Consumer secured by 1st deeds of trust - AQR substandard | 829 | 852 | — |
| Total | $44,765 | $45,468 | $535 |

| (In Thousands) | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|---|---|---|---|
| December 31, 2015 | | | |
| With no related allowance recorded | | | |
| Commercial - AQR special mention | $157 | $157 | $— |
| Commercial - AQR substandard | 14,030 | 14,443 | — |
| Real estate term owner occupied - AQR pass | 753 | 753 | — |
| Real estate term owner occupied - AQR substandard | 16,476 | 16,476 | — |
| Real estate term non-owner occupied - AQR pass | 473 | 473 | — |
| Real estate term non-owner occupied - AQR substandard | 352 | 352 | — |
| Real estate term other - AQR pass | 699 | 699 | — |
| Real estate term other - AQR special mention | 91 | 91 | |
| Consumer secured by 1st deeds of trust - AQR pass | 76 | 76 | — |
| Consumer secured by 1st deeds of trust - AQR substandard | 472 | 472 | — |
| Subtotal | $33,579 | $33,992 | $— |

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| | | | |
|---|---|---|---|
| With an allowance recorded | | | |
| Commercial - AQR substandard | $1,061 | $1,061 | $344 |
| Subtotal | $1,061 | $1,061 | $344 |
| Total | | | |
| Commercial - AQR special mention | $157 | $157 | $— |
| Commercial - AQR substandard | 15,091 | 15,504 | 344 |
| Real estate term owner occupied - AQR pass | 753 | 753 | — |
| Real estate term owner occupied - AQR substandard | 16,476 | 16,476 | — |
| Real estate term non-owner occupied - AQR pass | 473 | 473 | — |
| Real estate term non-owner occupied - AQR substandard | 352 | 352 | — |
| Real estate term other - AQR pass | 699 | 699 | — |
| Real estate term other - AQR special mention | 91 | 91 | — |
| Consumer secured by 1st deeds of trust - AQR pass | 76 | 76 | — |
| Consumer secured by 1st deeds of trust - AQR substandard | 472 | 472 | — |
| Total | $34,640 | $35,053 | $344 |

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

The following tables summarize our average recorded investment and interest income recognized on impaired loans for the three and nine month periods ended September 30, 2016 and 2015, respectively:

| Three Months Ended September 30, | 2016 | | 2015 | |
|---|---|---|---|---|
| (In Thousands) | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded | | | | |
| Commercial - AQR special mention | $150 | $6 | $161 | $3 |
| Commercial - AQR substandard | 19,681 | 428 | 13,661 | 155 |
| Real estate construction other - AQR pass | — | — | 726 | 13 |
| Real estate construction other - AQR substandard | 1,912 | — | 5,678 | — |
| Real estate term owner occupied- AQR pass | 256 | 10 | 761 | 17 |
| Real estate term owner occupied- AQR substandard | 16,787 | 466 | 5,203 | 85 |
| Real estate term non-owner occupied- AQR pass | 434 | 36 | 516 | 19 |
| Real estate term non-owner occupied- AQR special mention | — | — | 101 | 10 |
| Real estate term non-owner occupied- AQR substandard | 210 | — | 269 | — |
| Real estate term other - AQR pass | 653 | 23 | — | — |
| Real estate term other - AQR special mention | — | — | 148 | 3 |
| Consumer secured by 1st deeds of trust - AQR special mention | — | — | 78 | 1 |
| Consumer secured by 1st deeds of trust - AQR substandard | 844 | 12 | 461 | 2 |
| Subtotal | $40,927 | $981 | $27,763 | $308 |
| With an allowance recorded | | | | |
| Commercial - AQR substandard | $— | $— | $944 | $— |
| Real estate construction one-to-four family - AQR substandard | 3,972 | — | — | — |
| Consumer other - AQR substandard | — | — | 40 | — |
| Subtotal | $3,972 | $— | $984 | $— |

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| | | | | |
|---|---|---|---|---|
| Total | | | | |
| Commercial - AQR special mention | $150 | $6 | $161 | $3 |
| Commercial - AQR substandard | 19,681 | 428 | 14,605 | 155 |
| Real estate construction one-to-four family - AQR substandard | 3,972 | — | — | — |
| Real estate construction other - AQR pass | — | — | 726 | 13 |
| Real estate construction other - AQR substandard | 1,912 | — | 5,678 | — |
| Real estate term owner-occupied - AQR pass | 256 | 10 | 761 | 17 |
| Real estate term owner-occupied - AQR substandard | 16,787 | 466 | 5,203 | 85 |
| Real estate term non-owner occupied - AQR pass | 434 | 36 | 516 | 19 |
| Real estate term non-owner occupied - AQR special mention | — | — | 101 | 10 |
| Real estate term non-owner occupied - AQR substandard | 210 | — | 269 | — |
| Real estate term other - AQR pass | 653 | 23 | — | — |
| Real estate term other - AQR special mention | — | — | 148 | 3 |
| Consumer secured by 1st deeds of trust - AQR special mention | — | — | 78 | 1 |
| Consumer secured by 1st deeds of trust - AQR substandard | 844 | 12 | 461 | 2 |
| Consumer other - AQR substandard | — | — | 40 | — |
| Total Impaired Loans | $44,899 | $981 | $28,747 | $308 |

| Nine Months Ended September 30, | 2016 | | 2015 | |
|---|---|---|---|---|
| (In Thousands) | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded | | | | |
| Commercial - AQR special mention | $153 | $12 | $165 | $10 |
| Commercial - AQR substandard | 18,660 | 801 | 9,711 | 225 |
| Real estate construction one-to-four family - AQR substandard | 1,319 | — | — | — |
| Real estate construction other - AQR pass | — | — | 744 | 72 |
| Real estate construction other - AQR substandard | 1,912 | — | 1,913 | — |
| Real estate term owner occupied- AQR pass | 420 | 29 | 677 | 46 |
| Real estate term owner occupied- AQR special mention | — | — | 90 | 5 |
| Real estate term owner occupied- AQR substandard | 16,491 | 934 | 3,720 | 113 |
| Real estate term non-owner occupied- AQR pass | 455 | 73 | 534 | 57 |
| Real estate term non-owner occupied- AQR special mention | — | — | 1,444 | 97 |
| Real estate term non-owner occupied- AQR substandard | 223 | — | 1,423 | — |
| Real estate term other - AQR pass | 623 | 47 | — | — |
| Real estate term other - AQR special mention | 58 | 4 | 50 | 3 |
| Real estate term other - AQR substandard | — | — | 99 | 7 |
| Consumer secured by 1st deeds of trust - AQR pass | 50 | 2 | 80 | 3 |
| Consumer secured by 1st deeds of trust - AQR substandard | 600 | 20 | 526 | 6 |
| Subtotal | $40,964 | $1,922 | $21,176 | $644 |
| With an allowance recorded | | | | |
| Commercial - AQR substandard | $197 | $— | $1,863 | $— |
| Real estate construction one-to-four family - AQR substandard | 2,653 | — | — | — |
| Real estate term other - AQR substandard | — | — | 93 | — |
| Consumer secured by 1st deeds of trust - AQR substandard | 97 | — | — | — |
| Consumer other - AQR substandard | — | — | 14 | — |
| Subtotal | $2,947 | $— | $1,970 | $— |

| | | | | |
|---|---|---|---|---|
| Total | | | | |
| Commercial - AQR special mention | $153 | $12 | $165 | $10 |
| Commercial - AQR substandard | 18,857 | 801 | 11,574 | 225 |
| Real estate construction one-to-four family - AQR substandard | 3,972 | — | — | — |
| Real estate construction other - AQR pass | — | — | 744 | 72 |
| Real estate construction other - AQR substandard | 1,912 | — | 1,913 | — |
| Real estate term owner-occupied - AQR pass | 420 | 29 | 677 | 46 |
| Real estate term owner-occupied - AQR special mention | — | — | 90 | 5 |
| Real estate term owner-occupied - AQR substandard | 16,491 | 934 | 3,720 | 113 |
| Real estate term non-owner occupied - AQR pass | 455 | 73 | 534 | 57 |
| Real estate term non-owner occupied - AQR special mention | — | — | 1,444 | 97 |
| Real estate term non-owner occupied - AQR substandard | 223 | — | 1,423 | — |
| Real estate term other - AQR pass | 623 | 47 | — | — |
| Real estate term other - AQR special mention | 58 | 4 | 50 | 3 |
| Real estate term other - AQR substandard | — | — | 192 | 7 |
| Consumer secured by 1st deeds of trust - AQR pass | 50 | 2 | 80 | 3 |
| Consumer secured by 1st deeds of trust - AQR substandard | 697 | 20 | 526 | 6 |
| Consumer other - AQR substandard | — | — | 14 | — |
| Total Impaired Loans | $43,911 | $1,922 | $23,146 | $644 |

Purchased Credit Impaired Loans: The Company acquired 18 purchased credit impaired loans in connection with its acquisition of Alaska Pacific Bancshares, Inc. on April 1, 2014 subject to the requirements of FASB ASC 310-30 Loans and Debt Securities Acquired with Deteriorated Credit Quality. This group of loans consists primarily of commercial and commercial real estate loans, and unlike a pool of consumer mortgages, it is not practicable for the Company to analyze the accretable yield of these loans. As such, the Company has elected the cost recovery method of income recognition for these loans, and thus no accretable yield has been identified for these loans. At the acquisition date, April 1, 2014, the fair value of this group of loans was $3.9 million. The carrying value of these loans as of September 30, 2016 is $1.2 million.

Troubled Debt Restructurings: Loans classified as troubled debt restructurings (“TDR”) totaled $16.3 million and $13.7 million at September 30, 2016 and December 31, 2015, respectively. A TDR is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession that it would not grant otherwise. The Company has granted a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

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

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

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

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

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

The following table presents the breakout between newly restructured loans that occurred during the nine months ended September 30, 2016 and restructured loans that occurred prior to 2016 that are still included in portfolio loans:

| (In Thousands) | Accrual Status | Nonaccrual Status | Total Modifications |
|---|---|---|---|
| New Troubled Debt Restructurings | | | |
| Commercial - AQR substandard | $4,234 | $— | $4,234 |
| Subtotal | $4,234 | $— | $4,234 |
| Existing Troubled Debt Restructurings | $10,702 | $1,319 | $12,021 |
| Total | $14,936 | $1,319 | $16,255 |

The following table presents newly restructured loans that occurred during the nine months ended September 30, 2016, by concession (terms modified):

| | | September 30, 2016 | | | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Number of Contracts | Rate Modification | Term Modification | Payment Modification | Combination Modification | Total Modifications |
| Pre-Modification Outstanding Recorded Investment: | | | | | | |
| Commercial - AQR substandard | 1 | $— | $— | $4,234 | $— | $4,234 |
| Total | 1 | $— | $— | $4,234 | $— | $4,234 |
| Post-Modification Outstanding Recorded Investment: | | | | | | |
| Commercial - AQR substandard | 1 | $— | $— | $4,234 | $— | $4,234 |
| Total | 1 | $— | $— | $4,234 | $— | $4,234 |

The Company had no commitments to extend additional credit to borrowers whose terms have been modified in TDRs. There were no charge offs in the nine months ended September 30, 2016 on loans that were later classified as TDRs.

All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the Allowance. There were no TDRs with specific impairment at September 30, 2016 and December 31, 2015, respectively.

The Company had no TDRs that subsequently defaulted within the first twelve months of restructure, during the periods ending September 30, 2016 and December 31, 2015, respectively.

6. Allowance for Loan Losses

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

| Three Months Ended September 30, | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deed of trust | Consumer other | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| 2016 | | | | | | | | | | |
| Balance, beginning of period | $5,867 | $892 | $1,097 | $2,285 | $5,298 | $670 | $346 | $420 | $1,510 | $18,385 |
| Charge-Offs | — | — | — | — | — | — | (22) | — | — | (22) |
| Recoveries | 450 | — | — | — | — | — | — | 14 | — | 464 |
| Provision (benefit) | (278) | 306 | 312 | 314 | 103 | 73 | 2 | (28) | (152) | 652 |
| Balance, end of period | $6,039 | $1,198 | $1,409 | $2,599 | $5,401 | $743 | $326 | $406 | $1,358 | $19,479 |
| Balance, end of period: Individually evaluated for impairment | $— | $535 | $— | $— | $— | $— | $— | $— | $— | $535 |
| Balance, end of period: Collectively evaluated for impairment | $6,039 | $663 | $1,409 | $2,599 | $5,401 | $743 | $326 | $406 | $1,358 | $18,944 |
| 2015 | | | | | | | | | | |
| Balance, beginning of period | $5,687 | $689 | $1,863 | $1,470 | $4,888 | $671 | $265 | $415 | $1,470 | $17,418 |
| Charge-Offs | (367) | — | — | — | — | — | (28) | (5) | — | (400) |
| Recoveries | 152 | — | — | — | — | — | — | 2 | — | 154 |
| Provision (benefit) | 308 | 202 | (81) | 54 | 54 | (69) | 31 | 64 | 113 | 676 |
| Balance, end of period | $5,780 | $891 | $1,782 | $1,524 | $4,942 | $602 | $268 | $476 | $1,583 | $17,848 |
| Balance, end of period: Individually evaluated for impairment | $433 | $— | $— | $— | $— | $— | $— | $80 | $— | $513 |
| Balance, end of period: Collectively evaluated for impairment | $5,347 | $891 | $1,782 | $1,524 | $4,942 | $602 | $268 | $396 | $1,583 | $17,335 |

| Nine Months Ended September 30, | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deed of trust | Consumer other | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| 2016 | | | | | | | | | | |
| Balance, beginning of period | $5,906 | $854 | $1,439 | $1,657 | $5,515 | $628 | $264 | $397 | $1,493 | $18,153 |
| Charge-Offs | (868 ) | — | — | — | — | — | (22 ) | (1 ) | — | (891 ) |
| Recoveries | 643 | — | — | — | — | — | — | 19 | — | 662 |
| Provision (benefit) | 358 | 344 | (30 ) | 942 | (114 ) | 115 | 84 | (9 ) | (135 ) | 1,555 |
| Balance, end of period | $6,039 | $1,198 | $1,409 | $2,599 | $5,401 | $743 | $326 | $406 | $1,358 | $19,479 |
| Balance, end of period: Individually evaluated for impairment | $— | $535 | $— | $— | $— | $— | $— | $— | $— | $535 |
| Balance, end of period: Collectively evaluated for impairment | $6,039 | $663 | $1,409 | $2,599 | $5,401 | $743 | $326 | $406 | $1,358 | $18,944 |
| 2015 | | | | | | | | | | |
| Balance, beginning of period | $5,643 | $644 | $1,653 | $1,580 | $4,704 | $656 | $285 | $410 | $1,148 | $16,723 |
| Charge-Offs | (474 ) | — | — | — | — | (81 ) | (28 ) | (5 ) | — | (588 ) |
| Recoveries | 310 | — | — | — | — | 17 | — | 8 | — | 335 |
| Provision (benefit) | 301 | 247 | 129 | (56 ) | 238 | 10 | 11 | 63 | 435 | 1,378 |
| Balance, end of period | $5,780 | $891 | $1,782 | $1,524 | $4,942 | $602 | $268 | $476 | $1,583 | $17,848 |
| Balance, end of period: Individually evaluated for impairment | $433 | $— | $— | $— | $— | $— | $— | $80 | $— | $513 |
| Balance, end of period: Collectively evaluated for impairment | $5,347 | $891 | $1,782 | $1,524 | $4,942 | $602 | $268 | $396 | $1,583 | $17,335 |

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

| (In Thousands) | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deed of trust | Consumer other | Total |
|---|---|---|---|---|---|---|---|---|---|
| September 30, 2016 | | | | | | | | | |
| Balance, end of period | $342,632 | $37,002 | $72,091 | $166,941 | $288,975 | $41,864 | $25,957 | $26,022 | $1,001,484 |
| Balance, end of period: Individually evaluated for impairment | $19,773 | $3,972 | $1,912 | $17,019 | $616 | $644 | $829 | $— | $44,765 |
| Balance, end of period: Collectively evaluated for impairment | $322,859 | $33,030 | $70,179 | $149,922 | $288,359 | $41,220 | $25,128 | $26,022 | $956,719 |
| December 31, 2015 | | | | | | | | | |
| Balance, end of period | $329,534 | $44,488 | $74,931 | $128,763 | $314,069 | $38,029 | $26,673 | $28,912 | $985,399 |
| Balance, end of period: Individually evaluated for impairment | $15,248 | $— | $— | $17,229 | $825 | $790 | $548 | $— | $34,640 |
| Balance, end of period: Collectively evaluated for impairment | $314,286 | $44,488 | $74,931 | $111,534 | $313,244 | $37,239 | $26,125 | $28,912 | $950,759 |

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

| (In Thousands) | Commercial | Real estate construction 1-4 family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| September 30, 2016 | | | | | | | | | | |
| Individually evaluated for impairment: | | | | | | | | | | |
| AQR Substandard | $— | $535 | $— | $— | $— | $— | $— | $— | $— | $535 |
| Collectively: evaluated for impairment: | | | | | | | | | | |
| AQR Pass | 6,015 | 663 | 1,409 | 2,575 | 5,401 | 739 | 323 | 406 | — | 17,531 |
| AQR Special Mention | 20 | — | — | 24 | — | 4 | 3 | — | — | 51 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| AQR Substandard | 4 | — | — | — | — | — | — | — | — | 4 |
| Unallocated | — | — | — | — | — | — | — | — | 1,358 | 1,358 |
| | $6,039 | $1,198 | $1,409 | $2,599 | $5,401 | $743 | $326 | $406 | $1,358 | $19,479 |
| December 31, 2015 | | | | | | | | | | |
| Individually evaluated for impairment: | | | | | | | | | | |
| AQR Substandard | $344 | $— | $— | $— | $— | $— | $— | $— | $— | $344 |
| Collectively: evaluated for impairment: | | | | | | | | | | |
| AQR Pass | 5,543 | 854 | 1,439 | 1,657 | 5,515 | 624 | 261 | 397 | — | 16,290 |
| AQR Special Mention | 11 | — | — | — | — | 4 | 3 | — | — | 18 |
| AQR Substandard | 8 | — | — | — | — | — | — | — | — | 8 |
| Unallocated | — | — | — | — | — | — | — | — | 1,493 | 1,493 |
| | $5,906 | $854 | $1,439 | $1,657 | $5,515 | $628 | $264 | $397 | $1,493 | $18,153 |

7. Purchased Receivables

Purchased receivables are carried at their principal amount outstanding, net of a reserve for anticipated losses that have not yet been identified, and have a maturity of less than one year. Purchased receivable balances are charged against this reserve when management believes that collection of principal is unlikely. Management evaluates the adequacy of the reserve for purchased receivable losses based on historical loss experience by class of receivable and its assessment of current economic conditions. As of September 30, 2016, the Company has one class of purchased receivables. There were no purchased receivables past due at September 30, 2016 or December 31, 2015, respectively, and there were no restructured purchased receivables at September 30, 2016 or December 31, 2015. Income on purchased receivables is accrued and recognized on the principal amount outstanding using an effective interest method except when management believes doubt exists as to the collectability of the income or principal. As of September 30, 2016, the Company is accruing income on all purchased receivable balances outstanding.

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

| (In Thousands) | September 30, 2016 | December 31, 2015 |
|---|---|---|
| Purchased receivables | $15,663 | $13,507 |
| Reserve for purchased receivable losses | (163) | (181) |
| Total | $15,500 | $13,326 |

The following table sets forth information regarding changes in the purchased receivable reserve for the three and nine month periods ending September 30, 2016 and 2015, respectively:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (In Thousands) | 2016 | 2015 | 2016 | 2015 |
| Balance at beginning of period | $163 | $247 | $181 | $289 |
| Charge-offs | — | — | — | — |
| Recoveries | — | — | — | 30 |
| Charge-offs net of recoveries | — | — | — | 30 |
| Reserve for (recovery from) purchased receivables | — | (23) | (18) | (95) |
| Balance at end of period | $163 | $224 | $163 | $224 |

The Company did not record any charge-offs in the first nine months of 2016 and 2015, respectively.

8. Derivatives

The Company enters into commercial loan interest rate swap agreements with commercial banking customers which are offset with a corresponding swap agreement with a third party financial institution ("counterparty"). The Company has agreements with its counterparties that contain provisions that provide that if the Company fails to maintain its status as a well-capitalized institution, then the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements. These agreements also require that the Company and the counterparty collateralize any fair value shortfalls that exceed $250,000 with eligible collateral, which includes cash and securities backed with the full faith and credit of the federal government. Similarly, the Company could be required to settle its obligations under the agreement if specific regulatory events occur, such as if the Company were issued a prompt corrective action directive or a cease and desist order, or if certain regulatory ratios fall below specified levels. The Company pledged $303,000 and $216,000 in available for sale securities to collateralize fair value shortfalls on interest rate swap agreements as of September 30, 2016 and December 31, 2015, respectively.

The Company had interest rate swaps with an aggregate notional amount of $19.5 million and $21.3 million at September 30, 2016 and December 31, 2015, respectively. At September 30, 2016, the notional amount of interest rate swaps is made up of two variable to fixed rate swaps to commercial loan customers totaling $9.8 million, and two fixed to variable rate swaps with a counterparty totaling $9.8 million. Changes in fair value from these four interest rate swaps offset each other in the first nine months of 2016. The Company did not recognize any fee income related to interest rate swaps in the three or nine month

periods ending September 30, 2016 or 2015, respectively. Interest rate swap income is recorded in other income on the Consolidated Statements of Income.
The Company also uses derivatives to hedge the risk of changes in the fair values of interest rate lock commitments. The Company enters into commitments to originate residential mortgage loans at specific rates; the value of these commitments are detailed in the table below as "interest rate lock commitments". The Company also hedges the interest rate risk associated with its residential mortgage loan commitments, which are referred to as retail interest rate contracts in the table below. Market risk with respect to commitments to originate loans arises from changes in the value of contractual positions due to changes in interest rates. RML had commitments to originate mortgage loans held for sale totaling $72.3 million and $71.3 million at September 30, 2016 and December 31, 2015, respectively. Changes in the value of RML's interest rate derivatives are recorded in the mortgage banking income on the Consolidated Statements of Income.
The following table presents the fair value of derivatives not designated as hedging instruments at September 30, 2016 and December 31, 2015:

| (In Thousands) | Asset Derivatives | | |
|---|---|---|---|
| | Balance Sheet Location | September 30, 2016 Fair Value | December 31, 2015 Fair Value |
| Commercial interest rate swaps | Other assets | $296 | $125 |
| Interest rate lock commitments | Other assets | 1,764 | 1,514 |
| Total | | $2,060 | $1,639 |

| (In Thousands) | Liability Derivatives | | |
|---|---|---|---|
| | Balance Sheet Location | September 30, 2016 Fair Value | December 31, 2015 Fair Value |
| Commercial interest rate swaps | Other liabilities | $296 | $125 |
| Retail interest rate contracts | Other liabilities | 134 | 91 |
| Total | | $430 | $216 |

The following table presents the net gains of derivatives not designated as hedging instruments for the nine month periods ending September 30, 2016 and 2015, respectively:

| (In Thousands) | Income Statement Location | September 30, 2016 | September 30, 2015 |
|---|---|---|---|
| Interest rate contracts | Mortgage banking income | ($1,533) | ($569) |
| Interest rate lock commitments | Mortgage banking income | 239 | 887 |
| Total | | ($1,294) | $318 |

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

The following table summarizes the derivatives that have a right of offset as of September 30, 2016 and December 31, 2015, respectively:

| September 30, 2016 | | | | Gross amounts not offset in the Statement of Financial Position | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Gross amounts of recognized assets and liabilities | Gross amounts offset in the Statement of Financial Position | Net amounts of assets and liabilities presented in the Statement of Financial Position | Financial Instruments | Collateral Posted | Net Amount |
| Asset Derivatives | | | | | | |
| Commercial interest rate swaps | $296 | $— | $296 | $— | $— | $296 |
| Liability Derivatives | | | | | | |
| Commercial interest rate swaps | $296 | $— | $296 | $— | $296 | $— |
| Retail interest rate contracts | 134 | — | 134 | — | — | 134 |

| December 31, 2015 | | | | Gross amounts not offset in the Statement of Financial Position | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Gross amounts of recognized assets and liabilities | Gross amounts offset in the Statement of Financial Position | Net amounts of assets and liabilities presented in the Statement of Financial Position | Financial Instruments | Collateral Posted | Net Amount |
| Asset Derivatives | | | | | | |
| Commercial interest rate swaps | $125 | $— | $125 | $— | $— | $125 |
| Liability Derivatives | | | | | | |
| Commercial interest rate swaps | $125 | $— | $125 | $— | $125 | $— |
| Retail interest rate contracts | 91 | — | 91 | — | — | 91 |

9. Stock Incentive Plan

The Company adopted the 2014 Stock Option Plan ("2014 Plan") following shareholder approval of the 2014 Plan at the 2014 Annual Meeting. Subsequent to the adoption of the 2014 Plan, no additional grants may be issued under the prior plans. The 2014 Plan provides for grants of up to 350,000 shares of common stock.

Stock Options: Under the 2014 Plan and previous plans, certain key employees have been granted the option to purchase set amounts of common stock at the market price on the day the option was granted. Optionees, at their own discretion, may cover the cost of exercise through the exchange at the then fair value of already owned shares of the Company's stock. Options are granted for a 10-year period and vest on a pro-rata basis over the initial three years from grant.

The Company measures the fair value of each stock option at the date of grant using the Black-Scholes option pricing model. For the quarters ended September 30, 2016 and 2015, the Company recognized $34,000 and $22,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense. For the nine months ended September 30, 2016 and 2015, the Company recognized $121,000 and $66,000, respectively, in stock option compensation expense as a component of salaries and other personnel expense.

The Company issued 5,342 shares from the exercise of stock options for both the three and nine month ended September 30, 2016. Proceeds from the exercise of stock options in both the three and nine months ended September 30, 2016 were $847,000. The Company withheld $907,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the three and nine months ended September 30, 2016.

The Company issued 4,938 and 5,162 shares from the exercise of stock options in the three and nine months ended September 30, 2015, respectively. Proceeds from the exercise of stock options in the three and nine months ended September 30, 2015 were $160,000 and $209,000, respectively. The Company withheld $63,000 and $112,000 to pay for stock option exercises or income taxes that resulted from the exercise of stock options in the three and nine months ended September 30, 2015, respectively.
There were no stock options granted in the first nine months of 2016 and 2015, respectively.
Restricted Stock Units: The Company grants restricted stock units to certain key employees periodically. Recipients of restricted stock units do not pay any cash consideration to the Company for the shares and receive all dividends with respect to such shares when the shares vest. Restricted stock units cliff vest at the end of a three-year time period. For the three months ended September 30, 2016 and 2015, the Company recognized $120,000 and $98,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense. For the nine months ended September 30, 2016 and 2015, the Company recognized $410,000 and $291,000, respectively, in restricted stock unit compensation expense as a component of salaries and other personnel expense. There were no restricted stock units granted in the first nine months of 2016 and 2015, respectively.

10. Fair Value of Assets and Liabilities

The Company groups its assets and liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1: Valuation is based upon quoted prices for identical instruments traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2: Valuation is based upon quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's estimation 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 following methods and assumptions were used to estimate fair value disclosures. All financial instruments are held for other than trading purposes.
Cash and cash equivalents: Due to the short term nature of these instruments, the carrying amounts reported in the consolidated balance sheets represent their fair values.
Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. Investments in Federal Home Loan Bank stock are recorded at cost, which also represents fair value.
Loans held for sale: Due to the short term nature of these instruments, the carrying amounts reported in the consolidated balance sheets approximate their fair values.
Loans: Fair values were generally determined by discounting both principal and interest cash flows on pools of loans expected to be collected using a discount rate for similar instruments with adjustments that the Company believes a market participant would consider in determining fair value. The Company estimates the cash flows expected to be collected using internal credit risk, interest rate and prepayment risk models that incorporate the Corporation's best estimate of current key assumptions, such as default rates, loss severity and prepayment speeds for the life of the loan.
Purchased receivables: Fair values for purchased receivables are based on their carrying amounts due to their short duration and repricing frequency. Generally, purchased receivables have a duration of less than one year.
Mortgage servicing rights: MSR are held at fair value. These assets are classified as Level 3 as quoted prices are not available. In order to determine the fair value of MSRs, the present value of net expected future cash flows is estimated. Assumptions used

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

Accrued interest receivable: Due to the short term nature of these instruments, the carrying amounts reported in the consolidated balance sheets represent their fair values.

Deposits: The fair value for deposits with stated maturities was determined by discounting contractual cash flows using current market rates for instruments with similar maturities. For deposits with no stated maturities, the carrying value was considered to approximate fair value and does not take into account the significant value of the cost advantage and stability of the Company's long-term relationships with depositors.

Accrued interest payable: Due to the short term nature of these instruments, the carrying amounts reported in the consolidated balance sheets represent their fair values.

Securities sold under repurchase agreements: Fair values for securities sold under repurchase agreements are based on their carrying amounts due to their short duration and repricing frequency.

Borrowings: Due to the short term nature of these instruments, the carrying amount of short-term borrowings reported in the consolidated balance sheets approximate the fair value. Fair values for long-term borrowings are estimated using a discounted cash flow calculation that applies currently offered interest rates to a schedule of aggregate expected monthly payments.

Accrued liability, RML acquisition payments: The carrying value of the accrued liability for estimated acquisition payments represents management's estimate of amounts owed to the sellers that are earned, but unpaid, as of the balance sheet date. Adjustments to the liability are reported in other operating expense. The fair value for this liability represents management's estimate of the total amount owed to the sellers that is earned as of the balance sheet date plus management's estimate of amounts that will be earned and paid to the sellers under the terms of the acquisition RML agreement for future periods. The estimate is based on management's assessment of expected pre-tax income at RML over the remaining earn out period. Inputs to this assessment include the general economic conditions in our markets that impact mortgage loan originations, current and anticipated trends in local market demand for mortgage, including interest rates, and RML's estimated market share.

Junior subordinated debentures: Fair value adjustments for junior subordinated debentures are based on discounted cash flows to maturity using current interest rates for similar financial instruments. Management utilized a market approach to determine the appropriate discount rate for junior subordinated debentures.

Derivative instruments: The fair value of the interest rate lock commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. The pull-through rate assumptions are considered Level 3 valuation inputs and are significant to the interest rate lock commitment valuation; as such, the interest rate lock commitment derivatives are classified as Level 3. Interest rate contracts are valued in a model, which uses as its basis a discounted cash flow technique incorporating credit valuation adjustments to reflect nonperformance risk in the measurement of fair value. Although the Bank has determined that the majority of inputs used to value its interest rate derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of September 30, 2016, the Bank has assessed the significance of the impact of these adjustments on the overall valuation of its interest rate positions and has determined that they are not significant to the overall valuation of its interest rate derivatives. As a result, the Bank has classified its interest rate derivative valuations in Level 2 of the fair value hierarchy.

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

The Company uses either in-house evaluations or external appraisals to estimate the fair value of OREO and impaired loans as of each reporting date. In-house appraisals are considered Level 3 inputs and external appraisals are considered Level 2 inputs. The Company’s determination of which method to use is based upon several factors. The

Company takes into account compliance with legal and regulatory guidelines, the amount of the loan, the size of the assets, the location and type of property to be valued and how critical the timing of completion of the analysis is to the assessment of value.  Those factors are balanced with the level of internal expertise, internal experience and market information available, versus external expertise available such as qualified appraisers, brokers, auctioneers and equipment specialists.

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

Commitments to extend credit and standby letters of credit: The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligation with the counterparties at the reporting date.

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

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

| (In Thousands) | September 30, 2016 Carrying Amount | Fair Value | December 31, 2015 Carrying Amount | Fair Value |
|---|---|---|---|---|
| Financial assets: | | | | |
| Level 1 inputs: | | | | |
| Cash, due from banks and deposits in other banks | $45,866 | $45,866 | $58,673 | $58,673 |
| Investment securities | 52,641 | 52,641 | 43,033 | 43,033 |
| Level 2 inputs: | | | | |
| Investment securities | 248,616 | 248,648 | 248,983 | 249,039 |
| Investment in Federal Home Loan Bank stock | 1,965 | 1,965 | 1,816 | 1,816 |
| Accrued interest receivable | 3,674 | 3,674 | 3,620 | 3,620 |
| Commercial interest rate swaps | 296 | 296 | 125 | 125 |
| Level 3 inputs: | | | | |
| Loans and loans held for sale | 1,073,528 | 1,072,547 | 1,031,340 | 1,033,551 |
| Purchased receivables, net | 15,500 | 15,500 | 13,326 | 13,326 |
| Interest rate lock commitments | 1,764 | 1,764 | 1,514 | 1,514 |
| Mortgage servicing rights | 3,196 | 3,196 | 1,654 | 1,654 |
| Financial liabilities: | | | | |
| Level 2 inputs: | | | | |
| Deposits | $1,278,366 | $1,278,081 | $1,240,792 | $1,240,223 |
| Securities sold under repurchase agreements | 27,701 | 27,701 | 31,420 | 31,420 |
| Borrowings | 4,350 | 4,461 | 2,120 | 2,101 |
| Accrued interest payable | 163 | 163 | 56 | 56 |
| Commercial interest rate swaps | 296 | 296 | 216 | 216 |
| Retail interest rate contracts | 134 | 134 | 91 | 91 |
| Level 3 inputs: | | | | |
| Accrued liability, RML acquisition payments | 3,274 | 7,949 | 6,624 | 6,624 |
| Junior subordinated debentures | 18,558 | 20,418 | 18,558 | 17,433 |
| Unrecognized financial instruments: | | | | |
| Commitments to extend credit[1] | $222,438 | $2,224 | $222,387 | $2,224 |
| Standby letters of credit[1] | 9,135 | 91 | 6,399 | 64 |

[1] Carrying amounts reflect the notional amount of credit exposure under these financial instruments.

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

| (In Thousands) | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| September 30, 2016 | | | | |
| Assets: | | | | |
| Available for sale securities | | | | |
| U.S. Treasury and government sponsored entities | $245,505 | $30,224 | $215,281 | $— |
| Municipal securities | 9,269 | — | 9,269 | — |
| U.S. Agency mortgage-backed securities | 4 | — | 4 | — |
| Corporate bonds | 40,534 | 17,372 | 23,162 | — |
| Preferred stock | 5,045 | 5,045 | — | — |
| Total available for sale securities | $300,357 | $52,641 | $247,716 | $— |
| Commercial interest rate swaps | $296 | $— | $296 | $— |
| Interest rate lock commitments | 1,764 | — | — | 1,764 |
| Mortgage servicing rights | 3,196 | — | — | 3,196 |
| Total other assets | $5,256 | $— | $296 | $4,960 |
| Liabilities: | | | | |
| Commercial interest rate swaps | $296 | $— | $296 | $— |
| Retail interest rate contracts | 134 | — | 134 | — |
| Total other liabilities | $430 | $— | $430 | $— |
| December 31, 2015 | | | | |
| Assets: | | | | |
| Available for sale securities | | | | |
| U.S. Treasury and government sponsored entities | $237,436 | $35,008 | $202,428 | $— |
| Municipal securities | 10,326 | — | 10,326 | — |
| U.S. Agency mortgage-backed securities | 809 | — | 809 | — |
| Corporate bonds | 39,018 | 4,501 | 34,517 | — |
| Preferred stock | 3,524 | 3,524 | — | — |
| Total available for sale securities | $291,113 | $43,033 | $248,080 | $— |
| Commercial interest rate swaps | $125 | $— | $125 | $— |
| Interest rate lock commitments | 1,514 | — | — | 1,514 |
| Mortgage servicing rights | 1,654 | — | — | 1,654 |
| Total other assets | $3,293 | $— | $125 | $3,168 |
| Liabilities: | | | | |
| Commercial interest rate swaps | $125 | $— | $125 | $— |
| Retail interest rate contracts | 91 | — | 91 | — |
| Total other liabilities | $216 | $— | $216 | $— |

The following table provides a reconciliation of the assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine month periods ended September 30, 2016 and 2015, respectively:

| (In Thousands) | Beginning balance | Change included in earnings | Purchases and issuances | Sales and settlements | Ending balance | Net change in unrealized gains (losses) relating to items held at end of period |
|---|---|---|---|---|---|---|
| Three Months Ended September 30, 2016 | | | | | | |
| Interest rate lock commitments | $2,580 | ($589) | $6,003 | ($6,230) | $1,764 | $1,764 |
| Mortgage servicing rights | 2,602 | (166) | 760 | — | 3,196 | — |
| Total | $5,182 | ($755) | $6,763 | ($6,230) | $4,960 | $1,764 |
| Three Months Ended September 30, 2015 | | | | | | |
| Interest rate lock commitments | $1,487 | ($660) | $5,358 | ($4,398) | $1,787 | $1,787 |
| Mortgage servicing rights | 942 | (27) | 284 | — | 1,199 | — |
| Total | $2,429 | ($687) | $5,642 | ($4,398) | $2,986 | $1,787 |

| (In Thousands) | Beginning balance | Change included in earnings | Purchases and issuances | Sales and settlements | Ending balance | Net change in unrealized gains (losses) relating to items held at end of period |
|---|---|---|---|---|---|---|
| Nine Months Ended September 30, 2016 | | | | | | |
| Interest rate lock commitments | $1,514 | ($1,647) | $16,446 | ($14,549) | $1,764 | $1,764 |
| Mortgage servicing rights | 1,654 | (523) | 2,065 | — | 3,196 | — |
| Total | $3,168 | ($2,170) | $18,511 | ($14,549) | $4,960 | $1,764 |
| Nine Months Ended September 30, 2015 | | | | | | |
| Interest rate lock commitments | $841 | ($1,792) | $16,250 | ($13,512) | $1,787 | $1,787 |
| Mortgage servicing rights | 1,010 | (105) | 294 | — | 1,199 | — |
| Total | $1,851 | ($1,897) | $16,544 | ($13,512) | $2,986 | $1,787 |

As of and for the periods ending September 30, 2016 and December 31, 2015, respectively, no impairment or valuation adjustment was recognized for assets recognized at fair value on a nonrecurring basis, except for certain assets as shown in the following table. For loans measured for impairment, the Company classifies fair value measurements using observable inputs, such as external appraisals, as Level 2 valuations in the fair value hierarchy, and unobservable inputs, such as in-house evaluations, as Level 3 valuations in the fair value hierarchy.

| (In Thousands) | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total (gains) losses |
|---|---|---|---|---|---|
| September 30, 2016 | | | | | |
| Loans measured for impairment | $3,972 | $— | $— | $3,972 | $191 |
| Other real estate owned | 1,700 | — | — | 1,700 | 187 |
| Total | $5,672 | $— | $— | $5,672 | $378 |
| December 31, 2015 | | | | | |
| Loans measured for impairment | $1,061 | $— | $— | $1,061 | $269 |
| Other real estate owned | 830 | — | — | 830 | 361 |
| Total | $1,891 | $— | $— | $1,891 | $630 |

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

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring and nonrecurring basis at September 30, 2016:

| Financial Instrument | Valuation Technique | Unobservable Input | Weighted Average Rate Range | |
|---|---|---|---|---|
| Loans measured for impairment | In-house valuation of collateral | Discount rate | 9% | |
| Interest rate lock commitment | External pricing model | Pull through rate | 92.71 | % |
| Mortgage servicing rights | Discounted cash flow | Constant prepayment rate | 11.89% - 21.73% | |
| | | Discount rate | 8.79% - 10.50% | |

11. Segment Information

The Company's operations are managed along two operating segments: Community Banking and Home Mortgage Lending. The Community Banking segment's principal business focus is the offering of loan and deposit products to business and consumer customers in its primary market areas. As of September 30, 2016, the Community Banking segment operated 14 branches throughout Alaska. The Home Mortgage Lending segment's principal business focus is the origination and sale of mortgage loans for 1-4 family residential properties.

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

| | Three Months Ended September 30, 2016 | | |
|---|---|---|---|
| (In Thousands) | Community Banking | Home Mortgage Lending | Consolidated |
| Interest income | $14,267 | $593 | $14,860 |
| Interest expense | 366 | 281 | 647 |
| Net interest income | 13,901 | 312 | 14,213 |
| Provision for loan losses | 652 | — | 652 |
| Other operating income | 3,594 | 8,341 | 11,935 |
| Compensation expense - RML acquisition payments | 3,250 | — | 3,250 |
| Other operating expense | 11,649 | 6,287 | 17,936 |
| Income before provision for income taxes | 1,944 | 2,366 | 4,310 |
| Provision for income taxes | 50 | 977 | 1,027 |
| Net income | 1,894 | 1,389 | 3,283 |
| Less: net income attributable to the noncontrolling interest | 188 | — | 188 |
| Net income attributable to Northrim BanCorp, Inc. | $1,706 | $1,389 | $3,095 |

| | Three Months Ended September 30, 2015 | | |
|---|---|---|---|
| (In Thousands) | Community Banking | Home Mortgage Lending | Consolidated |
| Interest income | $14,882 | $506 | $15,388 |
| Interest expense | 457 | 249 | 706 |
| Net interest income | 14,425 | 257 | 14,682 |
| Provision for loan losses | 676 | — | 676 |
| Other operating income | 4,269 | 8,138 | 12,407 |
| Compensation expense - RML acquisition payments | 780 | — | 780 |
| Other operating expense | 11,853 | 5,570 | 17,423 |
| Income before provision for income taxes | 5,385 | 2,825 | 8,210 |
| Provision for income taxes | 1,513 | 1,165 | 2,678 |
| Net income | 3,872 | 1,660 | 5,532 |
| Less: net income attributable to the noncontrolling interest | 197 | — | 197 |
| Net income attributable to Northrim BanCorp, Inc. | $3,675 | $1,660 | $5,335 |

| (In Thousands) | Nine Months Ended September 30, 2016 Community Banking | Home Mortgage Lending | Consolidated |
|---|---|---|---|
| Interest income | $42,962 | $1,434 | $44,396 |
| Interest expense | 1,299 | 631 | 1,930 |
| Net interest income | 41,663 | 803 | 42,466 |
| Provision for loan losses | 1,555 | — | 1,555 |
| Other operating income | 10,357 | 22,547 | 32,904 |
| Compensation expense - RML acquisition payments | 4,067 | — | 4,067 |
| Other operating expense | 36,459 | 17,400 | 53,859 |
| Income before provision for income taxes | 9,939 | 5,950 | 15,889 |
| Provision for income taxes | 2,140 | 2,454 | 4,594 |
| Net income | 7,799 | 3,496 | 11,295 |
| Less: net income attributable to the noncontrolling interest | 474 | — | 474 |
| Net income attributable to Northrim BanCorp, Inc. | $7,325 | $3,496 | $10,821 |

| (In Thousands) | Nine Months Ended September 30, 2015 Community Banking | Home Mortgage Lending | Consolidated |
|---|---|---|---|
| Interest income | $43,227 | $1,490 | $44,717 |
| Interest expense | 1,302 | 906 | 2,208 |
| Net interest income | 41,925 | 584 | 42,509 |
| Provision for loan losses | 1,378 | — | 1,378 |
| Other operating income | 11,202 | 23,303 | 34,505 |
| Compensation expense - RML acquisition payments | 2,869 | — | 2,869 |
| Other operating expense | 35,106 | 16,443 | 51,549 |
| Income before provision for income taxes | 13,774 | 7,444 | 21,218 |
| Provision for income taxes | 4,038 | 3,073 | 7,111 |
| Net income | 9,736 | 4,371 | 14,107 |
| Less: net income attributable to the noncontrolling interest | 431 | — | 431 |
| Net income attributable to Northrim BanCorp, Inc. | $9,305 | $4,371 | $13,676 |

September 30, 2016

| (In Thousands) | Community Banking | Home Mortgage Lending | Consolidated |
|---|---|---|---|
| Total assets | $1,440,441 | $99,679 | $1,540,120 |
| Loans held for sale | $— | $76,452 | $76,452 |

December 31, 2015

| (In Thousands) | Community Banking | Home Mortgage Lending | Consolidated |
|---|---|---|---|
| Total assets | $1,431,759 | $67,733 | $1,499,492 |
| Loans held for sale | $— | $50,553 | $50,553 |

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

This discussion should be read in conjunction with the unaudited consolidated financial statements of Northrim BanCorp, Inc. (the “Company”) and the notes thereto presented elsewhere in this report and with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

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

Note Regarding Forward Looking-Statements

This quarterly report on Form 10-Q includes “forward-looking statements,” as that term is defined for purposes of Section 21E of the Securities Exchange Act of 1934, as amended, which are not historical facts. These forward-looking statements describe management’s expectations about future events and developments such as future operating results, growth in loans and deposits, continued success of the Company’s style of banking, and the strength of the local economy. All statements other than statements of historical fact, including statements regarding industry prospects and future results of operations or financial position, made in this report are forward-looking. We use words such as “anticipate,” “believe,” “expect,” “intend” and similar expressions in part to help identify forward-looking statements. Forward-looking statements reflect management’s current plans and expectations and are inherently uncertain. Our actual results may differ significantly from management’s expectations, and those variations may be both material and adverse. Forward-looking statements are subject to various risks and uncertainties that may cause our actual results to differ materially and adversely from our expectations as indicated in the forward-looking statements. These risks and uncertainties include: the general condition of, and changes in, the Alaska economy; our ability to maintain or expand our market share or net interest margin; our ability to maintain asset quality; our ability to implement our marketing and growth strategies; and our ability to execute our business plan. Further, actual results may be affected by competition on price and other factors with other financial institutions; customer acceptance of new products and services; the regulatory environment in which we operate; and general trends in the local, regional and national banking industry and economy. Many of these risks, as well as other risks that may have a material adverse impact on our operations and business, are identified in Part II. Item 1A Risk Factors of this report and Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as well as in our other filings with the Securities and Exchange Commission. However, you should be aware that these factors are not an exhaustive list, and you should not assume these are the only factors that may cause our actual results to differ from our expectations. In addition, you should note that forward looking statements are made only as of the date of this report and that we do not intend to update any of the forward-looking statements or the uncertainties that may adversely impact those statements, other than as required by law.

Critical Accounting Policies

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

The accounting policies that involve significant estimates and assumptions by management, which have a material impact on the carrying value of certain assets and liabilities, are considered critical accounting policies. The Company’s critical accounting policies include those that address the accounting for the allowance for loan losses ("Allowance"), valuation of goodwill and other intangible assets, the valuation of other real estate owned, and the valuation of mortgage servicing rights.  These critical accounting policies are further described in Item 7, Management’s Discussion and Analysis, and in Note 1, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in the Company’s Form 10-K for the year ended December 31, 2015.

Management has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

Update on Economic Conditions

According to the Alaska Department of Labor, preliminary data shows that average employment in the Alaska economy was down an estimated 0.20% in the first nine months of 2016 as compared to the same period in 2015 as job losses in the oil and gas industry, construction, state government and professional and business services continue to be partially offset by growth in retail trade, health care, and leisure and hospitality jobs. However, estimated employment as of the end of September 2016 compared to September 2015 was down 1.0%. While the decreases in both average and period end estimated employment represent a more moderate overall impact from the decrease in the global price of oil compared to what other energy producing regions in the nation have experienced thus far, this is a larger decline than was originally predicted for 2016.

Highlights and Summary of Performance - Third Quarter of 2016

Net income attributable to the Company in the third quarter of 2016 was $3.1 million, or $0.44 per diluted share, compared to $5.3 million, or $0.77 per diluted share, in the third quarter of 2015. This decrease in net income attributable to the Company was mainly the result of a one-time, non-cash accounting error correction, higher operating expenses, and a decrease in net interest margin and mortgage income primarily due to slowing loan growth in both the commercial and mortgage market in Alaska.

- Year-to-date net income attributable to the Company decreased 21% to $10.8 million, or $1.55 per diluted share at September 30, 2016, from $13.7 million, or $1.97 per diluted share at September 30, 2015.
- Total revenues, which include net interest income plus other operating income, decreased 3% to $26.1 million in the third quarter of 2016 from total revenues of $27.1 million in the third quarter a year ago, mainly as a result of less gain on sale of loans acquired from Alaska Pacific Bancshares, Inc.
- Average portfolio loans decreased $3.1 million to $979.2 million for the third quarter of 2016 as compared to $982.3 million for the third quarter of 2015.
- Net interest income decreased 3% to $14.2 million in the third quarter of 2016, compared to $14.7 million in the quarter ended September 30, 2015 primarily due to a decrease in the yield on portfolio loans in the second quarter of 2016.
- Northrim paid a quarterly cash dividend of $0.20 per share in September of 2016, compared to the $0.19 per share dividend paid in September 2015. The dividend provides a yield of approximately 3.3% at current market share prices.
- Book value per share increased to $26.99 at the end of the third quarter of 2016 as compared to $25.77 at December 31, 2015.
- The Company remains well-capitalized with Tier 1 Capital to Risk Adjusted Assets at September 30, 2016, of 14.24%, compared to 13.34% at December 31, 2015.

The Company reported net income attributable to the Company and diluted earnings per share of $3.1 million and $0.44, respectively, for the third quarter of 2016 compared to net income and diluted earnings per share of $5.3 million and $0.77, respectively, for the third quarter of 2015. The Company reported net income and diluted earnings per share of $10.8 million and $1.55, respectively year to date as of September 30, 2016 compared to net income and diluted earnings per share of $13.7 million and $1.97, respectively, for the same period in 2015. The Company’s total assets were $1.5 billion at September 30, 2016 and December 31, 2015, respectively. Loans increased to $997.1 million at September 30, 2016 as compared to $980.8 million at December 31, 2015, mainly due to an increase in commercial real estate owner-occupied loans in the first nine months of 2016.

The Company's shareholders' equity to total assets was 12.06% and 11.82% at September 30, 2016 and December 31, 2015, respectively. The accounting correction resulted in the Company's return on average equity and return on average assets being lower by 180 basis points and 25 basis points , respectively, than they would have been without the accounting correction.

Other financial measures are shown in the table below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Return on average assets | 0.81 % | 1.42 % | 0.96 % | 1.26 % |
| Return on average shareholders' equity | 6.73 % | 12.37 % | 7.93 % | 10.85 % |
| Dividend payout ratio | 44.98 % | 24.63 % | 37.23 % | 27.82 % |

Credit Quality

Nonperforming assets: Nonperforming assets, net of government guarantees at September 30, 2016 increased $6.9 million, or 133% to $12.1 million as compared to $5.2 million at December 31, 2015, primarily as a result of the addition of two lending relationships to nonaccrual loans totaling $8.1 million. One $5.9 million relationship is related to a residential land development project in the greater Anchorage market. The loan has been included in adversely classified loans since December 31, 2015. The other $2.2 million relationship is made up of three loans to a commercial business in the transportation industry, and these loans have been adversely classified loans since March 31, 2016. The increase in nonaccrual loans was partially offset by a decrease in other real estate owned ("OREO") which decreased $229,000 to $2.8 million at September 30, 2016 as compared to $3.1 million at December 31, 2015, respectively. Nonperforming purchased receivables were zero at both September 30, 2016 and December 31, 2015.

The following table summarizes OREO activity for the three and nine month periods ending September 30, 2016 and 2015:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (In Thousands) | | | |
| Balance, beginning of the period | $2,558 | $2,807 | $3,053 | $4,607 |
| Transfers from loans | 201 | 796 | 201 | 1,133 |
| Proceeds from the sale of other real estate owned | (316 ) | — | (793 ) | (1,971 ) |
| Gain on sale of other real estate owned, net | 127 | — | 239 | 136 |
| Deferred gain on sale of other real estate owned | — | — | — | (34 ) |
| Impairment on other real estate owned | (57 ) | (92 ) | (187 ) | (360 ) |
| Balance at end of period | $2,824 | $3,511 | $2,824 | $3,511 |

Potential problem loans: Potential problem loans are loans which are currently performing in accordance with contractual terms but that have developed negative indications that the borrower may not be able to comply with present payment terms and which may later be included in nonaccrual, past due, or impaired loans. These loans are closely monitored and their performance is reviewed by management on a regular basis. At September 30, 2016, management had identified potential problem loans of $32.2 million as compared to potential problem loans of $28.9 million at December 31, 2015. The increase in potential problem loans from December 31, 2015 to September 30, 2016 is primarily the result of one $4.7 million relationship with a commercial business that provides equipment rental services to the oil and gas industry.

Troubled debt restructurings ("TDRs"): TDRs are those loans for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower, have been granted due to the borrower's weakened financial condition. Interest on TDRs will be accrued at the restructured rates when it is anticipated that no loss of original principal will occur, and the interest can be collected, which is generally after a period of six months. The Company had $14.9 million in loans classified as TDRs that were performing and $1.3 million in TDRs included in nonaccrual loans at September 30, 2016 for a total of approximately $16.2 million. At December 31, 2015 there were $11.8 million in loans classified as TDRs that were performing

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and $1.9 million in TDRs included in nonaccrual loans for a total of $13.7 million. See Note 5 of the Notes to Consolidated Financial Statements included in Item 1 of this report for further discussion of TDRs.

## RESULTS OF OPERATIONS

### Income Statement

#### Net Income

Net income attributable to the Company for the third quarter of 2016 decreased $2.2 million, or 42%, to $3.1 million as compared to $5.3 million for the same period in 2015. Net income attributable to the Company for the nine months ended September 30, 2016 decreased $2.9 million, or 21%, to $10.8 million as compared to the same period in 2015. The decrease in net income attributable to the Company for the three and nine month periods ending September 30, 2016 as compared to the same periods of 2015 was primarily the result of a one-time, non-cash accounting error correction, higher operating expenses, and a decrease in net interest margin and mortgage income primarily due to slowing loan growth in both the commercial and mortgage market in Alaska.

#### Net Interest Income/Net Interest Margin

Net interest income for the third quarter of 2016 decreased $469,000, or 3%, to $14.2 million as compared to $14.7 million for the third quarter in 2015. Net interest income was relatively flat at $42.5 million in both the first nine months of 2016 and 2015. Net interest margin decreased 21 basis points to 4.11% in the third quarter of 2016 as compared to 4.32% in the third quarter of 2015. Net interest margin decreased 17 basis points to 4.18% in the first nine months of 2016 as compared to 4.35% for the same period in 2015. The decrease in net interest income in the three-month period ending September 30, 2016 as compared to the same period in 2015 was primarily the result of the decrease in interest income on average interest-earning assets mainly due to a lower average yield on loans, which was partially offset by higher average portfolio investment balances and lower interest expense on interest-bearing liabilities, primarily due to lower average rates paid on both deposits and borrowings, as well as lower average balances of borrowings in the third quarter of 2016. Net interest income in the nine month period ended September 30, 2016 remained relatively consistent with net interest income in the same period of 2015 primarily as a result of a lower average yield on loans, which was more than offset by higher average portfolio investment balances and lower interest-bearing liabilities primarily due to lower average borrowings in 2016.

Average loan balances, the largest category of interest-earning assets, decreased by $3.1 million to $979.2 million in the three-month period ending September 30, 2016, and increased $11.0 million, or 1%, to $976.3 million in the nine-month period ending September 30, 2016, as compared to the same periods in 2015, respectively. Total interest income from loans decreased $640,000 for the third quarter of 2016 compared to the third quarter of 2015 and decreased $584,000 in the nine-month period ending September 30, 2016 as compared to the same period in 2015 mainly primarily due to a lower yield on loans in 2016. Average loan balances increased in the nine-month period ended September 30, 2016 compared to the same period in 2015 primarily as a result of growth in commercial real estate loans.

Average loans held for sale increased by $10.2 million, or 18% to $66.6 million in the three-month period ending September 30, 2016, and decreased $4.1 million, or 7% to $51.3 million in the nine-month period ending September 30, 2016, as compared to the same periods in 2015, respectively. Total interest income from loans held for sale increased $22,000 for the third quarter of 2016 as compared to the same period in 2015 primarily as a result of the increase in average balances of loans held for sale being partially offset by lower average yields in the third quarter of 2016. Total interest income from loans held for sale decreased $148,000 in the nine-month period ending September 30, 2016 as compared to the same periods in 2015, primarily as a result of the decrease in average balances of loans held for sale. Average balances and net interest income for loans held for sale decreased in the nine-month period ending September 30, 2016 as compared to the same period last year primarily as a result of decreased refinance activity in 2016.

Average total investments increased by $21.6 million, or 7% to $329.7 million in the three-month period ending September 30, 2016, and increased $41.3 million, or 14% to $328.7 million in the nine-month period ending September 30, 2016, as compared to the same periods in 2015. The increase in average investments for the three and six month periods ending June 30, 2016 as compared to the same periods in 2015 was mainly the result of purchases of long-term investments funded by increased deposit balances.

Average interest-bearing liabilities increased $8.4 million, or 1%, to $850.1 million during the third quarter of 2016 and increased $14.7 million, or 2%, to $853.2 million in the nine-month period ending September 30, 2016, as compared to $841.6 million and $838.5 million, for the same periods in 2015, respectively. These increases were primarily the result of increased interest-bearing deposit balances which were partially offset by a decrease in borrowings in 2016. The average cost of interest-bearing liabilities decreased $59,000, or 8%, and $278,000, or 13% for the three and nine-month periods ending September 30, 2016, as compared to the same periods in 2015, primarily due to decreased average balances for borrowings, as well as decreased average interest rates on deposits in 2016. Interest rates on deposits decreased mainly due to a change in the mix of the Company's deposits in 2016 compared to 2015. Average certificates of deposits accounted for 11% of total average deposits for the third quarters of 2016 and 2015, respectively, and 11% and 12% of total average deposits year-to-date at September 30, 2016 and 2015, respectively. Average non-interest-bearing demand deposits accounted for 37% and 36% of total average deposits for the third quarters of 2016 and 2015, respectively, and 35% of total average deposits year-to-date at September 30, 2016 and 2015, respectively.

Components of Net Interest Margin

The following table compares average balances and rates as well as net tax equivalent margins on earning assets for the three-month periods ended September 30, 2016 and 2015:

| (Dollars in Thousands) | Three Months Ended September 30, | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Average Balances | | Change | | Interest income/ expense | | Change | | Average Yields/Costs Tax Equivalent | | |
| | 2016 | 2015 | $ | % | 2016 | 2015 | $ | % | 2016 | 2015 | Change |
| Loans[1,2] | $979,164 | $982,301 | ($3,137) | —% | $13,289 | $13,929 | ($640) | (5)% | 5.44% | 5.67% | (0.23)% |
| Loans held for sale | 66,606 | 56,379 | 10,227 | 18% | 577 | 555 | 22 | 4% | 3.51% | 3.90% | (0.39)% |
| Short-term investments[3] | 39,762 | 74,895 | (35,133) | (47)% | 50 | 47 | 3 | 6% | 0.49% | 0.25% | 0.24% |
| Long-term investments[4] | 289,938 | 233,255 | 56,683 | 24% | 944 | 857 | 87 | 10% | 1.42% | 1.58% | (0.16)% |
| Total investments | 329,700 | 308,150 | 21,550 | 7% | 994 | 904 | 90 | 10% | 1.30% | 1.25% | 0.05% |
| Interest-earning assets | 1,375,470 | 1,346,830 | 28,640 | 2% | 14,860 | 15,388 | (528) | (3)% | 4.35% | 4.58% | (0.23)% |
| Nonearning assets | 149,856 | 145,747 | 4,109 | 3% | | | | | | | |
| Total | $1,525,326 | $1,492,577 | $32,749 | 2% | | | | | | | |
| Interest-bearing demand | $189,251 | $179,310 | $9,941 | 6% | $17 | $15 | $2 | 13% | 0.03% | 0.03% | —% |
| Savings deposits | 235,133 | 224,203 | 10,930 | 5% | 124 | 116 | 8 | 7% | 0.10% | 0.11% | (0.01)% |
| Money market deposits | 239,469 | 233,777 | 5,692 | 2% | 104 | 102 | 2 | 2% | 0.09% | 0.09% | —% |
| Time deposits | 136,588 | 146,431 | (9,843) | (7)% | 228 | 256 | (28) | (11)% | 0.66% | 0.69% | (0.03)% |
| Total interest-bearing deposits | 800,441 | 783,721 | 16,720 | 2% | 473 | 490 | (17) | (3)% | 0.23% | 0.25% | (0.02)% |
| Borrowings | 49,627 | 57,916 | (8,289) | (14)% | 174 | 216 | (42) | (19)% | 1.36% | 1.45% | (0.09)% |
| Total interest-bearing liabilities | 850,068 | 841,637 | 8,431 | 1% | 647 | 706 | (59) | (8)% | 0.30% | 0.33% | (0.03)% |
| Demand deposits and other noninterest-bearing liabilities | 492,339 | 479,843 | 12,496 | 3% | | | | | | | |
| Equity | 182,919 | 171,097 | 11,822 | 7% | | | | | | | |
| Total | $1,525,326 | $1,492,577 | $32,749 | 2% | | | | | | | |
| Net interest income | | | | | $14,213 | $14,682 | ($469) | (3)% | | | |
| Net interest margin | | | | | | | | | 4.11% | 4.32% | (0.21)% |
| Average loans to average interest-earning assets | 71.19% | 72.93% | | | | | | | | | |
| Average loans to average total deposits | 77.48% | 79.85% | | | | | | | | | |
| Average non-interest deposits to average | 36.66% | 36.30% | | | | | | | | | |

| | | |
|---|---|---|
| total deposits | | |
| Average interest-earning assets to average interest-bearing liabilities | 161.81 % | 160.03 % |

[1]Interest income includes loan fees. Loan fees recognized during the period and included in the yield calculation totaled $805,000 and $923,000 in the third quarter of 2016 and 2015, respectively.
[2]Nonaccrual loans are included with a zero effective yield. Average nonaccrual loans included in the computation of the average loan balances were $11.1 million and $4.1 million in the third quarter of 2016 and 2015, respectively.
[3]Consists of interest bearing deposits in other banks.
[4]Consists of investment securities available for sale, investment securities held to maturity, and investment in Federal Home Loan Bank stock.

The following tables set forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the three-month periods ending September 30, 2016 and 2015.  Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rates:

| (In Thousands) | Three Months Ended September 30, 2016 vs. 2015 Increase (decrease) due to | | |
|---|---|---|---|
| | Volume | Rate | Total |
| Interest Income: | | | |
| Loans | ($164) | ($476) | ($640) |
| Loans held for sale | 49 | (27) | 22 |
| Short-term investments | (3) | 6 | 3 |
| Long-term investments | 149 | (62) | 87 |
| Total interest income | $31 | ($559) | ($528) |
| | | | |
| Interest Expense: | | | |
| Interest-bearing deposits | $10 | ($27) | ($17) |
| Borrowings | (29) | (13) | (42) |
| Total interest expense | ($19) | ($40) | ($59) |

The following table compares average balances and rates as well as net tax equivalent margins on earning assets for the nine-month periods ended September 30, 2016 and 2015:

| (Dollars in Thousands) | Nine Months Ended September 30, | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Average Balances | | Change | | Interest income/ expense | | Change | | Average Yields/Costs Tax Equivalent | | |
| | 2016 | 2015 | $ | % | 2016 | 2015 | $ | % | 2016 | 2015 | Change |
| Loans[1,2] | $976,254 | $965,241 | $11,013 | 1% | $39,965 | $40,549 | ($584) | (1)% | 5.51% | 5.66% | (0.15)% |
| Loans held for sale | 51,255 | 55,319 | (4,064) | (7)% | 1,389 | 1,537 | (148) | (10)% | 3.71% | 3.72% | (0.01)% |
| Short-term investments[3] | 36,989 | 43,122 | (6,133) | (14)% | 138 | 82 | 56 | 68% | 0.49% | 0.25% | 0.24% |
| Long-term investments[4] | 291,747 | 244,357 | 47,390 | 19% | 2,904 | 2,549 | 355 | 14% | 1.45% | 1.52% | (0.07)% |
| Total investments | 328,736 | 287,479 | 41,257 | 14% | 3,042 | 2,631 | 411 | 16% | 1.35% | 1.34% | 0.01% |
| Interest-earning assets | 1,356,245 | 1,308,039 | 48,206 | 4% | 44,396 | 44,717 | (321) | (1)% | 4.43% | 4.62% | (0.19)% |
| Nonearning assets | 145,154 | 147,830 | (2,676) | (2)% | | | | | | | |
| Total | $1,501,399 | $1,455,869 | $45,530 | 3% | | | | | | | |
| Interest-bearing demand | $193,184 | $179,182 | $14,002 | 8% | $51 | $45 | $6 | 13% | 0.04% | 0.03% | 0.01% |
| Savings deposits | 232,737 | 224,879 | 7,858 | 3% | 361 | 354 | 7 | 2% | 0.12% | 0.12% | —% |
| Money market deposits | 241,296 | 230,158 | 11,138 | 5% | 312 | 298 | 14 | 5% | 0.10% | 0.10% | —% |
| Time deposits | 136,507 | 147,101 | (10,594) | (7)% | 699 | 763 | (64) | (8)% | 0.68% | 0.69% | (0.01)% |
| Total interest-bearing deposits | 803,724 | 781,320 | 22,404 | 3% | 1,423 | 1,460 | (37) | (3)% | 0.24% | 0.25% | (0.01)% |
| Borrowings | 49,496 | 57,177 | (7,681) | (13)% | 507 | 748 | (241) | (32)% | 1.34% | 1.71% | (0.37)% |
| Total interest-bearing liabilities | 853,220 | 838,497 | 14,723 | 2% | 1,930 | 2,208 | (278) | (13)% | 0.30% | 0.35% | (0.05)% |
| Demand deposits and other noninterest-bearing liabilities | 465,816 | 448,917 | 16,899 | 4% | | | | | | | |
| Equity | 182,363 | 168,455 | 13,908 | 8% | | | | | | | |
| Total | $1,501,399 | $1,455,869 | $45,530 | 3% | | | | | | | |
| Net interest income | | | | | $42,466 | $42,509 | ($43) | —% | | | |
| Net interest margin | | | | | | | | | 4.18% | 4.35% | (0.17)% |
| Average loans to average interest-earning assets | 71.98% | 73.79% | | | | | | | | | |
| Average loans to average total deposits | 78.40% | 80.75% | | | | | | | | | |
| Average non-interest deposits to average total deposits | 35.46% | 34.63% | | | | | | | | | |

| | | | | |
|---|---|---|---|---|
| Average interest-earning assets to average interest-bearing liabilities | 158.96 | % | 156.00 | % |

[1]Interest income includes loan fees. Loan fees recognized during the period and included in the yield calculation totaled $2.4 million and $2.7 million in the first nine months of 2016 and 2015, respectively.
[2]Nonaccrual loans are included with a zero effective yield. Average nonaccrual loans included in the computation of the average loan balances were $6.4 million and $4.5 million in the first nine months of 2016 and 2015, respectively.
[3]Consists of interest bearing deposits in other banks.
[4]Consists of investment securities available for sale, investment securities held to maturity, and investment in Federal Home Loan Bank stock.

The following tables set forth the changes in consolidated net interest income attributable to changes in volume and to changes in interest rates for the nine-month periods ending September 30, 2016 and 2015. Changes attributable to the combined effect of volume and interest rate have been allocated proportionately to the changes due to volume and the changes due to interest rates:

| (In Thousands) | Nine Months Ended September 30, 2016 vs. 2015 Increase (decrease) due to | | |
|---|---|---|---|
| | Volume | Rate | Total |
| Interest Income: | | | |
| Loans | $282 | ($866) | ($584) |
| Loans held for sale | (153) | 5 | (148) |
| Short-term investments | (10) | 66 | 56 |
| Long-term investments | 462 | (107) | 355 |
| Total interest income | $581 | ($902) | ($321) |
| | | | |
| Interest Expense: | | | |
| Interest-bearing deposits | $42 | ($79) | ($37) |
| Borrowings | (92) | (149) | (241) |
| Total interest expense | ($50) | ($228) | ($278) |

Provision for Loan Losses

The provision for loan losses was $652,000 for the third quarter of 2016 compared to $676,000 in the same period of 2015 and was $1.6 million and $1.4 million for the nine month periods ending September 30, 2016 and 2015, respectively. The increase in the provision for loan losses in the first nine months of 2016 as compared to the same period in 2015 is primarily the result of an increase in adversely classified loans in 2016 and due to the Company's assessment of current economic conditions in our market. See "Analysis of the Allowance for Loan Losses" under the "Financial Condition-Balance Sheet Overview" and Note 6 of the Notes to Consolidated Financial Statements included in Part I of this report for more information on changes in the Company's Allowance.

Other Operating Income

Other operating income for the three-month period ending September 30, 2016, decreased $472,000, or 4%, to $11.9 million as compared to the same period in 2015. This decrease is primarily the result of a $613,000 decrease in other income mainly due to decreased gains on loans acquired in connection with the acquisition of Alaska Pacific Bancshares, Inc. ("Alaska Pacific") in 2014 at a discount to par values that were paid off in the third quarter of 2015. This decrease was partially offset by an increase of $203,000 in mortgage banking income due to increased mortgage servicing revenue.

Other operating income for the nine-month period ending September 30, 2016, decreased $1.6 million, or 5%, to $32.9 million as compared to the same period in 2015 primarily as a result of a $756,000 decrease in mortgage banking income mainly due to lower refinance activity in the first quarter of 2016 as compared to the first quarter of 2015, as well as a $749,000 decrease in other income primarily due to a decrease in gains on loans acquired in connection with the acquisition of Alaska Pacific Alaska Pacific in 2014 at a discount to par values that were paid off in 2015.

Other Operating Expense

Other operating expense for the third quarter of 2016 increased $3.0 million, or 16%, to $21.2 million as compared to the same period in 2015. The increase from the previous quarter was primarily the result of a change in the accounting treatment for the earn-out payments related to the acquisition of RML, including a correction for prior periods, that added $2.8 million to pre-tax expenses in the current quarter. Additionally, salaries and other personnel expense increased in the third quarter of 2016 compared to the same quarter of 2015 by $718,000 primarily due to increased salary expense due to the addition of a new management position and a new marketing position at RML, normal annual salary increases, as well as increased originator commission expense due to increased production. These increases were partially offset by a $184,000 decrease in OREO expense mostly due to increased gains on sales of OREO properties and a $141,000 decrease in insurance expense primarily due to a decrease in Keyman insurance expense.

Other operating expense for the first nine months of 2016 increased $3.5 million, or 6%, to $57.9 million as compared to the same period in 2015, mainly as a result of increased salaries and personnel expense combined with the effects of the one-time, non-cash accounting error correction during 2016. Compensation expense related to the RML acquisition payments increased $1.2 million primarily due to the change in accounting and the error correction discussed above. Salaries and personnel expense increased $2.3 million during the first nine months of 2016 compared to the same period in 2015, of which $1.3 million of this increase was attributable to the community banking segment. The increase in salaries and personnel expense in the community banking segment for the first nine months of 2016 was primarily the result of higher medical costs, higher base salaries, and increases in various benefits costs including equity compensation and the estimated profit sharing payment for Northrim Bank employees for 2016. The increase in salaries and personnel expense of approximately $1.0 million in the home mortgage lending segment in the first nine months of 2016 compared to the same period of 2015 was primarily due to the same items noted above for the change in the third quarter of 2016 compared to the same period in 2015. These increases for the first nine months of 2016 as compared to the same period in 2015 were partially offset by a decrease of $258,000 in OREO expense and a decrease of $231,000 in insurance expense in 2016 for the reasons outlined above.

Income Taxes

The provision for income taxes for the three and nine-month periods ending September 30, 2016 decreased $1.7 million and $2.5 million or 62% and 35%, respectively, as compared to the same periods in 2015 primarily due to a decrease in pre-tax net income. The effective tax rate for the three-month period ending September 30, 2016 decreased to 24% from 33% for the three-month period ending September 30, 2015. The effective tax rate for the nine-month period ending September 30, 2016 decreased to 29% from 34% for the nine-month period ending September 30, 2015. The decrease in tax rate for both the three and nine-month periods ended September 30, 2016 was primarily due to increased tax credits as compared to 2015.

FINANCIAL CONDITION

Balance Sheet Overview

Investment Securities

Investment securities at September 30, 2016 increased 3%, or $9.2 million, to $301.3 million from $292.0 million at December 31, 2015. The Company continues to reinvest proceeds from sales, maturities, and security calls in available for sale securities. The table below details portfolio investment balances by portfolio investment type:

| (In Thousands) | September 30, 2016 Dollar Amount | Percent of Total | December 31, 2015 Dollar Amount | Percent of Total |
|---|---|---|---|---|
| | Balance | % of total | Balance | % of total |
| U.S. Treasury and government sponsored entities | $245,505 | 81.5 % | $237,436 | 81.3 % |
| Municipal securities | 10,169 | 3.4 % | 11,229 | 3.8 % |
| U.S. Agency mortgage-backed securities | 4 | 0.0 % | 809 | 0.3 % |
| Corporate bonds | 40,534 | 13.5 % | 39,018 | 13.4 % |
| Preferred stock | 5,045 | 1.7 % | 3,524 | 1.2 % |
| Total portfolio investments | $301,257 | | $292,016 | |

Loans and Lending Activities

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

Portfolio loans increased by $16.3 million, or 2%, to $997.1 million at September 30, 2016 from $980.8 million at December 31, 2015, primarily the result of increased real estate term loans relating to owner occupied properties, being partially offset by decreased real estate term loans relating to non-owner occupied properties in 2016. Real estate construction one-to-four family loans, which are mostly residential housing construction loans remained consistent at approximately 4% of portfolio loans at September 30, 2016.

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

| (In Thousands) | September 30, 2016 Dollar Amount | Percent of Total | December 31, 2015 Dollar Amount | Percent of Total |
|---|---|---|---|---|
| Commercial | $342,632 | 34.4 % | $329,534 | 33.6 % |
| Real estate construction one-to-four family | 37,002 | 3.7 % | 44,488 | 4.5 % |
| Real estate construction other | 72,091 | 7.2 % | 74,931 | 7.6 % |
| Real estate term owner occupied | 166,941 | 16.7 % | 128,763 | 13.1 % |
| Real estate term non-owner occupied | 288,975 | 29.0 % | 314,069 | 32.0 % |
| Real estate term other | 41,864 | 4.2 % | 38,029 | 3.9 % |
| Consumer secured by 1st deeds of trust | 25,957 | 2.6 % | 26,673 | 2.7 % |
| Consumer other | 26,022 | 2.6 % | 28,912 | 2.9 % |
| Subtotal | $1,001,484 | | $985,399 | |
| Less: Unearned origination fee, net of origination costs | (4,408) | (0.3 )% | (4,612) | (0.3 )% |
| Total loans | $997,076 | | $980,787 | |

Information about loans directly exposed to the oil and gas industry

The Company defines "direct exposure" to the oil and gas industry as companies that it has identified as significantly reliant upon activity related to the oil and gas industry, such as oilfield services, lodging, equipment rental, transportation, and other logistic services specific to the industry. The Company currently has no loans to oil producers or exploration companies. The Company estimates that $51.9 million, or approximately 5% of loans as of September 30, 2016 have direct exposure to the oil and gas industry as compared to $47.3 million, or approximately 5% of loans as of December 31, 2015. The Company's unfunded commitments to borrowers that have direct exposure to the oil and gas industry were $44.4 million and $48.1 million at September 30, 2016 and December 31, 2015, respectively. The portion of the Company's allowance for loan losses that related to the loans with direct exposure to the oil and gas industry was estimated at $1.3 million and $978,000 as of September 30, 2016 and December 31, 2015, respectively.

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

| (In Thousands) | Commercial | Real estate construction one-to-four family | Real estate construction other | Real estate term owner occupied | Real estate term non-owner occupied | Real estate term other | Consumer secured by 1st deeds of trust | Consumer other | Total |
|---|---|---|---|---|---|---|---|---|---|
| September 30, 2016 | | | | | | | | | |
| AQR Pass | $32,776 | $— | $— | $6,639 | $8,268 | $— | $— | $— | $47,683 |
| AQR Substandard | 4,234 | — | — | — | — | — | — | — | 4,234 |
| Total | $37,010 | $— | $— | $6,639 | $8,268 | $— | $— | $— | $51,917 |
| December 31, 2015 | | | | | | | | | |
| AQR Pass | $31,746 | $— | $— | $6,990 | $8,544 | $— | $— | $— | $47,280 |
| Total | $31,746 | $— | $— | $6,990 | $8,544 | $— | $— | $— | $47,280 |

Analysis of Allowance for Loan Losses

The Company maintains an Allowance to reflect losses inherent in the loan portfolio. The Allowance is increased by provisions for loan losses and loan recoveries and decreased by loan charge-offs. The size of the Allowance is determined through quarterly assessments of probable estimated losses in the loan portfolio.

Our methodology for making such assessments and determining the adequacy of the Allowance includes the following key elements:

A specific allocation for impaired loans. Management determines the fair value of the majority of these loans based on the underlying collateral values. This analysis is based upon a specific analysis for each impaired loan, including external appraisals on loans secured by real property, management’s assessment of the current market, recent payment history, and an evaluation of other sources of repayment. In-house evaluations of fair value are used in the impairment analysis in some situations. Inputs to the in-house evaluation process include information about sales of comparable properties in the appropriate markets and changes in tax assessed values. The Company obtains appraisals on real and personal property that secure its loans during the loan origination process in accordance with regulatory guidance and its loan policy. The Company obtains updated appraisals on loans secured by real or personal property based upon its assessment of changes in the current market or particular projects or properties, information from other current appraisals, and other sources of information. Appraisals may be adjusted downward by the Company based on its evaluation of the facts and circumstances on a case by case basis. External appraisals may be discounted when management believes that the absorption period used in the appraisal is unrealistic, when expected liquidation costs exceed those included in the appraisal, or when management’s evaluation of deteriorating market conditions warrants an adjustment. Additionally, the Company may also adjust appraisals in the above circumstances between appraisal dates. The Company uses the information provided in these updated appraisals along with its evaluation of all other information available on a particular property as it assesses the collateral coverage on its performing and nonperforming loans and the impact that may have on the adequacy of its Allowance. The specific allowance for impaired loans, as well as the overall Allowance, may increase based on the Company's assessment of updated appraisals. When the Company determines that a loss has occurred on an impaired loan, a charge-off equal to the difference between carrying value and fair value is recorded. If a specific allowance is deemed necessary for a loan, and then that loan is partially charged off, the loan remains classified as a nonperforming loan after the charge-off is recognized. Loans measured for impairment based on collateral value and all other loans measured for impairment are accounted for in the same way. As of September 30, 2016 and December 31, 2015, 20% and 48% of net nonperforming loans, which totaled $9.3 million and $2.1 million, respectively, had partially charged-off balances. The ratio of net charge-offs to average loans outstanding during the third quarter of 2016 was negative 0.05% as compared to 0.03% during the same period in 2015.

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

The Company has the following loan segments: commercial, real estate construction one-to-four family, real estate construction other, real estate term owner occupied, real estate term non-owner occupied, real estate term other, consumer secured by 1st deeds of trust, and other consumer loans. The Company has five loan classes: pass, special mention, substandard, doubtful, and loss.

After the portfolio has been disaggregated into segments and classes, the Company calculates a general reserve for each segment and class based on the average year loss history for each segment and class using a five year look-back period.

After the Company calculates a general allocation using its loss history, the general reserve is then adjusted for qualitative factors by segment and class. Qualitative factors are based on management's assessment of current trends that may cause losses inherent in the current loan portfolio to differ significantly from historical losses. Some factors that management considers in determining the qualitative adjustment to the general reserve include loan quality trends in our own portfolio, national and local economic trends, business conditions, underwriting policies and standards, trends in local real estate markets, effects of various political activities, peer group data, and internal factors such as underwriting policies and expertise of the Company's employees.

An unallocated reserve. The unallocated portion of the Allowance provides for other credit losses inherent in the Company's loan portfolio that may not have been contemplated in the specific and general components of the Allowance, and it acknowledges the inherent imprecision of all loss prediction models. The unallocated component is reviewed periodically based on trends in credit losses and overall economic conditions.

The unallocated portion of the Allowance as a percentage of the total Allowance was 7% and 8% at September 30, 2016 and December 31, 2015, respectively.

Further discussion of the enhancement to the Company's Allowance methodology can be found in Item 7 in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Allowance related to acquired loans: In accordance with generally accepted accounting principles, loans acquired in connection with the acquisition of Alaska Pacific on April 1, 2014 were recorded at their fair value at the acquisition date. Credit discounts were included in the determination of fair value; therefore, an allowance for loan losses was not recorded at the acquisition date. Purchased credit impaired loans were evaluated on a loan by loan basis and the valuation allowance for these loans was netted against the carrying value. Deterioration in credit quality of the acquired loans subsequent to acquisition date results in the establishments of an allowance. Management assesses credit impairment for the loans that were acquired from Alaska Pacific as part of the on-going monitoring of the credit quality of the Company's entire loan portfolio. Management tracks certain credit quality indicators including trends in past due and nonaccrual loans, gross and net charge offs, and movement in loan balances within the risk classifications. As of September 30, 2016, $992,000 of the original $141.5 million of purchased loans, or 0.70%, had migrated from pass grade loans to substandard loans. As of December 31, 2015, $1.0 million of the original $141.5 million of purchased loans, or 0.73%, had migrated from pass grade loans to substandard loans. These loans are included in impaired loans as of September 30, 2016, and have been evaluated for specific impairment as part of the calculation of the Allowance. There was no specific impairment on these loans at December 31, 2015 or September 30, 2016. There was no Allowance related to acquired loans at September 30, 2016.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| (In Thousands) | 2016 | 2015 | 2016 | 2015 |
| Balance at beginning of period | $18,385 | $17,418 | $18,153 | $16,723 |
| Charge-offs: | | | | |
| Commercial | — | 367 | 868 | 474 |
| Real estate term other | — | — | — | 81 |
| Consumer other | — | 5 | 1 | 5 |
| Total charge-offs | 22 | 400 | 891 | 588 |
| Recoveries: | | | | |
| Commercial | 450 | 152 | 643 | 310 |
| Real estate term other | — | — | — | 17 |
| Consumer other | 14 | 2 | 19 | 8 |
| Total recoveries | 464 | 154 | 662 | 335 |
| Net, charge-offs | (442) | 246 | 229 | 253 |
| Provision for loan losses | 652 | 676 | 1,555 | 1,378 |
| Balance at end of period | $19,479 | $17,848 | $19,479 | $17,848 |

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

Deposits

Deposits are the Company’s primary source of funds. Total deposits increased $37.6 million, or 3%, to $1.3 billion at September 30, 2016 from $1.2 billion at December 31, 2015, respectively. The following table summarizes the Company's composition of deposits as of the periods indicated:

| | September 30, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| (In thousands) | Balance | % of total | Balance | % of total |
| Demand deposits | $474,971 | 37 % | $430,191 | 35 % |
| Interest-bearing demand | 194,426 | 15 % | 209,291 | 17 % |
| Savings deposits | 236,821 | 19 % | 227,969 | 18 % |
| Money market deposits | 242,102 | 19 % | 236,675 | 19 % |
| Time deposits | 130,046 | 10 % | 136,666 | 11 % |
| Total deposits | $1,278,366 | | $1,240,792 | |

The Company’s mix of deposits continues to contribute to a low cost of funds with balances in transaction accounts representing 90% and 89% of total deposits September 30, 2016 and December 31, 2015, respectively.

The only deposit category with stated maturity dates is certificates of deposit. At September 30, 2016, the Company had $130.0 million in certificates of deposit as compared to certificates of deposit of $136.7 million at December 31, 2015. At September 30, 2016, $88.9 million, or 69%, of the Company’s certificates of deposits are scheduled to mature over the next 12 months as compared to $87.3 million, or 64%, of total certificates of deposit at December 31, 2015. The aggregate amount of certificates of deposit in amounts of $100,000 and greater at September 30, 2016 and December 31, 2015, was $82.5 million and $84.2 million, respectively. The following table sets forth the amount outstanding of deposits in amounts of $100,000 and greater by time remaining until maturity and percentage of total deposits as of September 30, 2016:

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| (In Thousands) | Time Certificates of Deposit of $100,000 or More Amount | Percent of Total Deposits |
|---|---|---|
| Amounts maturing in: | | |
| Three months or less | $12,915 | |