

Edgar Filing: Bank of Marin Bancorp - Form 10-Q

Bank of Marin Bancorp
Form 10-Q
August 07, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number 001-33572

Bank of Marin Bancorp
(Exact name of Registrant as specified in its charter)
California 20-8859754
(State or other jurisdiction of incorporation) (IRS Employer Identification No.)

504 Redwood Blvd., Suite 100, Novato, CA 94947
(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (415) 763-4520

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

Yes No

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

Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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Emerging growth company

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

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

Yes No

As of July 31, 2018, there were 6,993,452 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CONDITION

June 30, 2018 and December 31, 2017

| (in thousands, except share data; unaudited) | June 30, 2018 | December 31, 2017 |
|--|------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$83,855 | \$ 203,545 |
| Investment securities | | |
| Held-to-maturity, at amortized cost | 170,652 | 151,032 |
| Available-for-sale, at fair value | 388,137 | 332,467 |
| Total investment securities | 558,789 | 483,499 |
| Loans, net of allowance for loan losses of \$15,813 and \$15,767 at June 30, 2018 and December 31, 2017, respectively | 1,701,798 | 1,663,246 |
| Bank premises and equipment, net | 7,965 | 8,612 |
| Goodwill | 30,140 | 30,140 |
| Core deposit intangible | 6,032 | 6,492 |
| Interest receivable and other assets | 76,463 | 72,620 |
| Total assets | \$2,465,042 | \$2,468,154 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Non-interest bearing | \$1,057,745 | \$ 1,014,103 |
| Interest bearing | | |
| Transaction accounts | 132,272 | 169,195 |
| Savings accounts | 179,187 | 178,473 |
| Money market accounts | 631,479 | 626,783 |
| Time accounts | 137,040 | 160,116 |
| Total deposits | 2,137,723 | 2,148,670 |
| Subordinated debentures | 5,802 | 5,739 |
| Interest payable and other liabilities | 17,319 | 16,720 |
| Total liabilities | 2,160,844 | 2,171,129 |
| Stockholders' Equity | | |
| Preferred stock, no par value, Authorized - 5,000,000 shares, none issued | — | — |
| Common stock, no par value, Authorized - 15,000,000 shares; Issued and outstanding - 6,991,821 and 6,921,542 at June 30, 2018 and December 31, 2017, respectively | 146,195 | 143,967 |
| Retained earnings | 166,281 | 155,544 |
| Accumulated other comprehensive loss, net of taxes | (8,278 |)(2,486) |
| Total stockholders' equity | 304,198 | 297,025 |
| Total liabilities and stockholders' equity | \$2,465,042 | \$2,468,154 |

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

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BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| (in thousands, except per share amounts; unaudited) | Three months ended | | Six months ended | |
|--|--------------------|---------------|------------------|---------------|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Interest income | | | | |
| Interest and fees on loans | \$19,624 | \$16,423 | \$38,511 | \$32,272 |
| Interest on investment securities | | | | |
| Securities of U.S. government agencies | 2,860 | 1,534 | 5,335 | 3,052 |
| Obligations of state and political subdivisions | 604 | 553 | 1,242 | 1,121 |
| Corporate debt securities and other | 35 | 36 | 79 | 73 |
| Interest on Federal funds sold and due from banks | 285 | 157 | 688 | 217 |
| Total interest income | 23,408 | 18,703 | 45,855 | 36,735 |
| Interest expense | | | | |
| Interest on interest-bearing transaction accounts | 48 | 21 | 100 | 50 |
| Interest on savings accounts | 18 | 16 | 36 | 31 |
| Interest on money market accounts | 236 | 114 | 452 | 227 |
| Interest on time accounts | 140 | 139 | 296 | 285 |
| Interest on Federal Home Loan Bank ("FHLB") and other borrowings | 1 | — | 1 | — |
| Interest on subordinated debentures | 123 | 109 | 237 | 217 |
| Total interest expense | 566 | 399 | 1,122 | 810 |
| Net interest income | 22,842 | 18,304 | 44,733 | 35,925 |
| Provision for loan losses | — | — | — | — |
| Net interest income after provision for loan losses | 22,842 | 18,304 | 44,733 | 35,925 |
| Non-interest income | | | | |
| Service charges on deposit accounts | 455 | 447 | 932 | 899 |
| Wealth Management and Trust Services | 488 | 504 | 1,003 | 1,007 |
| Debit card interchange fees | 360 | 384 | 756 | 756 |
| Merchant interchange fees | 118 | 112 | 198 | 208 |
| Earnings on bank-owned life insurance | 230 | 210 | 458 | 419 |
| Dividends on FHLB stock | 192 | 176 | 388 | 408 |
| Gains on investment securities, net | 11 | 10 | 11 | 10 |
| Other income | 384 | 253 | 734 | 504 |
| Total non-interest income | 2,238 | 2,096 | 4,480 | 4,211 |
| Non-interest expense | | | | |
| Salaries and related benefits | 8,316 | 7,287 | 17,333 | 14,762 |
| Occupancy and equipment | 1,511 | 1,380 | 3,018 | 2,699 |
| Depreciation and amortization | 546 | 463 | 1,093 | 944 |
| Federal Deposit Insurance Corporation insurance | 191 | 162 | 382 | 323 |
| Data processing | 1,023 | 963 | 2,404 | 1,902 |
| Professional services | 810 | 522 | 2,109 | 1,044 |
| Directors' expense | 183 | 224 | 357 | 382 |
| Information technology | 264 | 186 | 533 | 384 |
| Provision for losses on off-balance sheet commitments | — | (208) | — | (43) |
| Other expense | 1,665 | 1,652 | 3,361 | 3,245 |
| Total non-interest expense | 14,509 | 12,631 | 30,590 | 25,642 |
| Income before provision for income taxes | 10,571 | 7,769 | 18,623 | 14,494 |
| Provision for income taxes | 2,680 | 2,583 | 4,343 | 4,760 |

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| | | | | |
|---|---------|---------|----------|----------|
| Net income | \$7,891 | \$5,186 | \$14,280 | \$9,734 |
| Net income per common share: | | | | |
| Basic | \$1.14 | \$0.85 | \$2.06 | \$1.60 |
| Diluted | \$1.12 | \$0.84 | \$2.03 | \$1.58 |
| Weighted average shares: | | | | |
| Basic | 6,944 | 6,110 | 6,929 | 6,101 |
| Diluted | 7,033 | 6,174 | 7,019 | 6,173 |
| Dividends declared per common share | \$0.31 | \$0.27 | \$0.60 | \$0.54 |
| Comprehensive income: | | | | |
| Net income | \$7,891 | \$5,186 | \$14,280 | \$9,734 |
| Other comprehensive (loss) income | | | | |
| Change in net unrealized gain or loss on available-for-sale securities | (1,131) |)1,961 | (7,301) |)3,635 |
| Reclassification adjustment for gains on available-for-sale securities in net income | (11) |)(10) |)(11) |)(10) |
| Net unrealized loss on securities transferred from available-for-sale to held-to-maturity | (278) |)— | (278) |)— |
| Amortization of net unrealized losses on securities transferred from available-for-sale to held-to-maturity | 132 | 124 | 268 | 165 |
| Subtotal | (1,288) |)2,075 | (7,322) |)3,790 |
| Deferred tax (benefit) expense | (384) |)892 | (2,168) |)1,596 |
| Other comprehensive (loss) income, net of tax | (904) |)1,183 | (5,154) |)2,194 |
| Comprehensive income | \$6,987 | \$6,369 | \$9,126 | \$11,928 |

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
for the year ended December 31, 2017 and the six months ended June 30, 2018

| (in thousands, except share data; unaudited) | Common Stock | | Retained Earnings | Accumulated | Total |
|---|--------------|-----------|-------------------|---|-----------|
| | Shares | Amount | | Other Comprehensive Loss ("AOCI"), Net of Taxes | |
| Balance at December 31, 2016 | 6,127,314 | \$87,392 | \$146,464 | \$ (3,293) | \$230,563 |
| Net income | — | — | 15,976 | — | 15,976 |
| Other comprehensive income | — | — | — | 807 | 807 |
| Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings | 9,266 | 28 | — | — | 28 |
| Stock issued under employee stock purchase plan | 512 | 32 | — | — | 32 |
| Stock issued under employee stock ownership plan ("ESOP") | 29,547 | 1,850 | — | — | 1,850 |
| Restricted stock granted | 16,230 | — | — | — | — |
| Stock-based compensation - stock options | — | 529 | — | — | 529 |
| Stock-based compensation - restricted stock | — | 742 | — | — | 742 |
| Cash dividends paid on common stock | — | — | (6,896) | — | (6,896) |
| Stock purchased by directors under director stock plan | 531 | 35 | — | — | 35 |
| Stock issued in payment of director fees | 2,878 | 188 | — | — | 188 |
| Stock and stock options issued to Bank of Napa shareholders (net of payment for fractional shares of \$14 thousand) | 735,264 | 53,171 | — | — | 53,171 |
| Balance at December 31, 2017 | 6,921,542 | \$143,967 | \$155,544 | \$ (2,486) | \$297,025 |
| Net income | — | — | 14,280 | — | 14,280 |
| Other comprehensive loss | — | — | — | (5,154) | (5,154) |
| Reclassification of stranded tax effects in AOCI | — | — | 638 | (638) | — |
| Stock options exercised, net of shares surrendered for cashless exercises and tax withholdings | 50,075 | 534 | — | — | 534 |
| Stock issued under employee stock purchase plan | 265 | 19 | — | — | 19 |
| Stock issued under ESOP | 7,900 | 601 | — | — | 601 |
| Restricted stock granted | 18,520 | — | — | — | — |
| Restricted stock surrendered for tax withholdings upon vesting | (658) | (45) | — | — | (45) |
| Restricted stock forfeited / cancelled | (6,028) | — | — | — | — |
| Stock-based compensation - stock options | — | 442 | — | — | 442 |
| Stock-based compensation - restricted stock | — | 672 | — | — | 672 |
| Cash dividends paid on common stock | — | — | (4,181) | — | (4,181) |
| Stock purchased by directors under director stock plan | 260 | 18 | — | — | 18 |
| Stock issued in payment of director fees | 1,343 | 91 | — | — | 91 |
| Stock repurchased, net of commissions | (1,398) | (104) | — | — | (104) |
| Balance at June 30, 2018 | 6,991,821 | 146,195 | 166,281 | (8,278) | 304,198 |

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

BANK OF MARIN BANCORP
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the six months ended June 30, 2018 and 2017

| (in thousands; unaudited) | June 30, 2018 | June 30, 2017 |
|---|------------------|------------------|
| Cash Flows from Operating Activities: | | |
| Net income | \$14,280 | \$9,734 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Reversal of losses on off-balance sheet commitments | — | (43) |
| Noncash contribution expense to employee stock ownership plan | 601 | — |
| Noncash director compensation expense | 146 | 106 |
| Stock-based compensation expense | 1,114 | 710 |
| Amortization of core deposit intangible | 460 | 236 |
| Amortization of investment security premiums, net of accretion of discounts | 1,496 | 1,496 |
| Accretion of discount on acquired loans | (428) | (498) |
| Accretion of discount on subordinated debentures | 63 | 80 |
| Net change in deferred loan origination costs/fees | 18 | 60 |
| Gain on sale of investment securities | (11) | (10) |
| Depreciation and amortization | 1,093 | 944 |
| Gain on sale of repossessed assets | — | (1) |
| Earnings on bank-owned life insurance policies | (458) | (419) |
| Net change in operating assets and liabilities: | | |
| Deferred rent and other rent-related expenses | (179) | 114 |
| Interest receivable and other assets | (971) | 93 |
| Interest payable and other liabilities | 1,543 | (389) |
| Total adjustments | 4,487 | 2,479 |
| Net cash provided by operating activities | 18,767 | 12,213 |
| Cash Flows from Investing Activities: | | |
| Purchase of held-to-maturity securities | (1,989) | (4,496) |
| Purchase of available-for-sale securities | (121,269) | (9,377) |
| Proceeds from sale of available-for-sale securities | 5,006 | 1,321 |
| Proceeds from paydowns/maturities of held-to-maturity securities | 9,615 | 14,601 |
| Proceeds from paydowns/maturities of available-for-sale securities | 24,540 | 15,385 |
| Loans originated and principal collected, net | (38,835) | (4,563) |
| Purchase of premises and equipment | (446) | (814) |
| Proceeds from sale of other real estate owned or repossessed assets | — | 170 |
| Cash paid for low-income housing tax credit investment | (373) | (628) |
| Net cash (used in) provided by investing activities | (123,751) | 11,599 |
| Cash Flows from Financing Activities: | | |
| Net (decrease) increase in deposits | (10,947) | 67,840 |
| Proceeds from stock options exercised | 585 | 88 |
| Payment of tax withholdings for stock options exercised and vesting of restricted stock | (96) | (60) |
| Proceeds from stock issued under employee and director stock purchase plans | 37 | 737 |
| Stock repurchased, net of commissions | (104) | — |
| Cash dividends paid on common stock | (4,181) | (3,315) |
| Net cash (used in) provided by financing activities | (14,706) | 65,290 |
| Net (decrease) increase in cash and cash equivalents | (119,690) | 89,102 |
| Cash and cash equivalents at beginning of period | 203,545 | 48,804 |
| Cash and cash equivalents at end of period | \$83,855 | \$137,906 |

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Supplemental disclosure of cash flow information:

| | | |
|--|------------|-----------|
| Cash paid in interest | \$1,083 | \$751 |
| Cash paid in income taxes | \$2,000 | \$4,620 |
| Supplemental disclosure of noncash investing and financing activities: | | |
| Change in net unrealized gain or loss on available-for-sale securities | \$(7,301) | \$3,635 |
| Securities transferred from available-for-sale to held-to-maturity | \$27,422 | \$128,965 |
| Amortization of net unrealized loss on available-for-sale securities transferred to held-to-maturity | \$268 | \$165 |
| Stock issued to ESOP | \$601 | \$— |
| Stock issued in payment of director fees | \$91 | \$82 |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1: Basis of Presentation

The consolidated financial statements include the accounts of Bank of Marin Bancorp (“Bancorp”), a bank holding company, and its wholly-owned bank subsidiary, Bank of Marin (the “Bank”), a California state-chartered commercial bank. References to “we,” “our,” “us” mean Bancorp and the Bank that are consolidated for financial reporting purposes. The accompanying unaudited consolidated interim financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to those rules and regulations. Although we believe that the disclosures are adequate and the information presented is not misleading, we suggest that these interim financial statements be read in conjunction with the annual financial statements and the notes thereto included in our 2017 Annual Report on Form 10-K. In the opinion of Management, the unaudited consolidated financial statements reflect all adjustments, which are necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in stockholders’ equity, and cash flows for the periods presented. All material intercompany transactions have been eliminated. The results of these interim periods may not be indicative of the results for the full year or for any other period.

The NorCal Community Bancorp Trusts I and II, respectively (the “Trusts”) were formed for the sole purpose of issuing trust preferred securities. Bancorp is not considered the primary beneficiary of the Trusts (variable interest entities), therefore the Trusts are not consolidated in our consolidated financial statements, but rather the subordinated debentures are shown as a liability on our consolidated statements of condition (See Note 6, Borrowings). Bancorp accounts for its investment in the securities of the Trusts under the equity method, which is included in interest receivable and other assets in the consolidated statements of condition.

The following table shows: 1) weighted average basic shares, 2) potentially dilutive weighted average common shares related to stock options and unvested restricted stock awards, and 3) weighted average diluted shares. Basic earnings per share (“EPS”) are calculated by dividing net income by the weighted average number of common shares outstanding during each period, excluding unvested restricted stock awards. Diluted EPS are calculated using the weighted average number of potentially dilutive common shares. The number of potentially dilutive common shares included in the quarterly diluted EPS is computed using the average market prices during the three months included in the reporting period under the treasury stock method. The number of potentially dilutive common shares included in year-to-date diluted EPS is a year-to-date weighted average of potentially dilutive common shares included in each quarterly diluted EPS computation. In computing diluted EPS, we exclude anti-dilutive shares such as options whose exercise prices exceed the current common stock price, as they would not reduce EPS under the treasury method. We have two forms of outstanding common stock: common stock and unvested restricted stock awards. Holders of unvested restricted stock awards receive non-forfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings. Under the two-class method, the difference in EPS is nominal for these participating securities.

| | Three months ended | | Six months ended | |
|--|--------------------|---------------|------------------|---------------|
| (in thousands, except per share data) | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Weighted average basic shares outstanding | 6,944 | 6,110 | 6,929 | 6,101 |
| Potentially dilutive common shares related to: | | | | |
| Stock options | 74 | 52 | 74 | 57 |
| Unvested restricted stock awards | 15 | 12 | 16 | 15 |
| Weighted average diluted shares outstanding | 7,033 | 6,174 | 7,019 | 6,173 |

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| | | | | |
|--|---------|---------|----------|---------|
| Net income | \$7,891 | \$5,186 | \$14,280 | \$9,734 |
| Basic EPS | \$1.14 | \$0.85 | \$2.06 | \$1.60 |
| Diluted EPS | \$1.12 | \$0.84 | \$2.03 | \$1.58 |
| Weighted average anti-dilutive shares not included in the calculation of diluted EPS | 30 | 33 | 35 | 23 |

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Note 2: Recently Adopted and Issued Accounting Standards

Accounting Standards Adopted in 2018

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The core principle of this ASU (and all subsequent updates) is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. This ASU establishes a five-step model that must be used to recognize revenue that requires the entity to identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the entity satisfies the performance obligation. The ASU does not apply to the majority of our revenue, including revenue associated with financial instruments, such as loans and investment securities, and certain non-interest income, such as earnings on bank-owned life insurance, dividends on Federal Home Loan Bank ("FHLB") stock, gains or losses on sales of investment securities, and deposit overdraft charges. The standard allowed the use of either the full retrospective or modified retrospective transition method. We elected to apply the modified retrospective transition method to incomplete contracts as of the initial date of application on January 1, 2018. The adoption of the new standards did not have a material impact on our financial condition or results of operations as revenue recognition under the new standards did not change significantly from our current practice of recognizing the in-scope non-interest income. In addition, we did not retroactively revise prior period amounts or record a cumulative adjustment to retained earnings upon adoption. We considered the nature, amount, timing, and uncertainty of revenue from contracts with customers and determined that significant revenue streams are sufficiently disaggregated in the consolidated statements of comprehensive income.

Descriptions of our significant revenue-generating transactions that are within the scope of the new revenue recognition standards, which are presented in the consolidated statements of comprehensive income as components of non-interest income, are as follows:

Wealth Management & Trust ("WM&T") fees - WM&T services include, but are not limited to: customized investment advisory and management; administrative services such as bill pay and tax reporting; trust administration, estate settlement, custody and fiduciary services. Performance obligations for investment advisory and management services are generally satisfied over time. Revenue is recognized monthly according to a tiered fee schedule based on the client's month-end market value of assets under our management. WM&T does not earn revenue based on performance or incentives. Costs associated with WM&T revenue-generating activities, such as payments to sub-advisors, are recorded separately as part of professional service expenses when incurred.

Deposit account service charges - Service charges on deposit accounts consist of monthly maintenance fees, business account analysis fees, business online banking fees, check order charges, and other deposit account-related fees. Performance obligations for monthly maintenance fees and account analysis fees are satisfied, and the related revenue recognized, when we complete our performance obligation each month. Performance obligations related to transaction-based services (such as check orders) are satisfied, and the related revenue recognized, at a point in time when completed, except for business accounts subject to analysis where the transaction-based fees are part of the monthly account analysis fees.

Debit card interchange fees - We issue debit cards to our consumer and small business customers that allow them to purchase goods and services from merchants in person, online, or via mobile devices using funds held in their demand deposit accounts held with us. Debit cards issued to our customers are part of global electronic payment networks (such as Visa) who pass a portion of the merchant interchange fees to debit card-issuing member banks like us when our customers make purchases through their networks. Performance obligations for debit card services are satisfied

and revenue is recognized daily as the payment networks process transactions. Because we act in an agent capacity, we determined that network costs previously recorded as a component of non-interest expense should be netted with interchange fees recorded in non-interest income. Network costs were immaterial for the six months ended June 30, 2018 and 2017.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this ASU make improvements to accounting standards related to financial instruments, including the following:

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Requires equity investments, except for 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.

Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When impairment exists, an entity is required to measure the investment at fair value.

Eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value required under current standards for financial instruments measured at amortized cost on the consolidated balance sheet.

Requires public companies to use the exit price notion when measuring and disclosing the fair value of financial instruments.

Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.

Clarifies 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.

We adopted the requirements of this ASU effective January 1, 2018, which did not have a material impact on our financial condition and results of operations. The fair value of our loans held for investment, which is recorded at amortized cost, now incorporates the exit price notion reflecting factors such as a liquidity premium. See Note 3, Fair Value of Assets and Liabilities.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This ASU provides guidance on how to present and classify eight specific cash flow topics in the statement of cash flows. The ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments should be applied using a retrospective transition method to each period presented, if practical. We adopted the requirements of this ASU effective January 1, 2018, which did not impact our financial condition, results of operations, or related financial statement disclosures for the periods presented.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. The amendments are intended to help companies evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses and provide a more robust framework to use in determining when a set of assets and activities is a business. The amendments should be applied prospectively and are effective for annual periods after December 31, 2017, including interim periods within those periods. We adopted the amendments effective January 1, 2018, which did not impact our financial condition, results of operations, or related financial statement disclosures in the first quarter of 2018.

In May 2017, the FASB issued ASU No. 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. This ASU applies to entities that change the terms or conditions of a share-based payment award. The FASB adopted this ASU to provide clarity in what constitutes a modification and to reduce diversity in practice in applying Topic 718. In order for a change to a share-based arrangement to not require Topic 718 modification accounting treatment, all of the following must be met: no change in fair value, no change in vesting conditions and no change in the balance sheet classification of the modified award. The ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those periods. Early adoption is permitted, including adoption in an interim period. The amendments should be applied prospectively to an award modified on or after the adoption date. We adopted the requirements of this ASU effective January 1, 2018, which did not impact our

financial condition, results of operation, or related financial statement disclosures.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This amendment changes both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. It is intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting and increase transparency as to the scope and results of hedging programs. The ASU is effective for fiscal years beginning after

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December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. We early-adopted the amendments of this ASU in the second quarter of 2018, and elected to perform hedge effectiveness assessments using a qualitative approach instead of quantitative regression analysis going forward. The adoption of this ASU had an immaterial impact to our financial results. The amendments also require additional disclosures, which are included in Note 9, Derivative Financial Instruments and Hedging Activities.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This amendment helps organizations address certain stranded income tax effects in accumulated other comprehensive income (AOCI) resulting from the enactment of the Tax Cuts and Jobs Act of 2017. The ASU requires financial statement preparers to disclose a description of the accounting policy for releasing income tax effects from AOCI, whether or not they elect to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act of 2017, and information about the other income tax effects that are reclassified. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The amendments in this ASU should be applied in either the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate tax rate in the Tax Cuts and Jobs Act of 2017 is recognized. We early adopted this ASU in the first quarter of 2018. See Note 7, Stockholders' Equity.

Accounting Standards Not Yet Effective

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The amendments in this ASU intend to increase transparency and comparability among organizations by recognizing an asset, which represents the right to use the asset for the lease term, and a lease liability, which is a lessee's obligation to make lease payments measured on a discounted basis. This ASU generally applies to leasing arrangements exceeding a twelve-month term. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective method of adoption. In July 2018, the FASB issued ASU No. 2018-10, Codification Improvements to Topic 842, Leases, which provides various corrections and clarifications to ASU 2016-02. Early application of the amendments is permitted. We intend to adopt this ASU during the first quarter of 2019, as required. We completed an inventory of our lease agreements and continue to evaluate potential accounting software solutions that will aid in the transition to the new leasing guidance. As of June 30, 2018, our undiscounted operating lease obligations that were off-balance sheet totaled \$16.5 million (See Note 8, Commitments and Contingencies). Upon adoption of this ASU, the present values of leases currently classified as operating leases will be recognized as lease assets and liabilities on our consolidated balance sheets. Additional disclosures of key information about our leasing arrangements will also be required. We do not expect that the ASU will have a material impact on our capital ratios or return on average assets when adopted and we are currently evaluating the effect that the ASU will have on other components of our financial condition and results of operations.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Under the new guidance, entities will be required to present financial assets at the net amount expected to be collected. The measurement of expected credit losses will be based on historical experience, current conditions and reasonable and supportable forecasts that affect the collectability of a credit over its remaining life. In addition, the ASU amends the accounting for expected credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We have formed an internal Current Expected Credit Loss ("CECL") committee and are working with our third party vendor to determine the appropriate methodologies and resources to utilize in preparation for transition to the new accounting standards. The impact of this ASU on our financial condition and results of operations is not known at this time.

In June 2018, the FASB issued ASU No. 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. This update simplifies the accounting for share-based payment transactions for acquiring goods and services from nonemployees, applying some of the same requirements as employee share-based payment transactions. The ASU will not affect the accounting for share-based payment awards to nonemployee directors, which will continue to be treated as employee share-based transactions under the current standards. ASU 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. We do not expect that the ASU will have a material impact on our financial condition or results of operations, as it is not our practice to issue stock-based awards to pay for goods and services from nonemployees, other than nonemployee directors.

Note 3: Fair Value of Assets and Liabilities

Fair Value Hierarchy and Fair Value Measurement

We group our assets and liabilities that are measured at fair value in three levels within the fair value hierarchy, 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: Valuations are based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2: Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuations for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3: Valuations are based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Values are determined using pricing models and discounted cash flow models and may include significant Management judgment and estimation.

Transfers between levels of the fair value hierarchy are recognized through our monthly and/or quarterly valuation process in the reporting period during which the event or circumstances that caused the transfer occurred.

The following table summarizes our assets and liabilities that were required to be recorded at fair value on a recurring basis.

| (in thousands) Description of Financial Instruments | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Measurement Categories: Changes in Fair Value Recorded In ¹ |
|---|-------------------|--|---|--|--|
| June 30, 2018 | | | | | |
| Securities available-for-sale: | | | | | |
| Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies | \$240,794 | \$ | -\$240,794 | \$ | OCI |
| SBA-backed securities | 23,954 | — | 23,954 | — | OCI |
| Debentures of government sponsored agencies | 32,139 | — | 32,139 | — | OCI |
| Privately-issued collateralized mortgage obligations | 435 | — | 435 | — | OCI |
| Obligations of state and political subdivisions | 87,788 | — | 87,788 | — | OCI |
| Corporate bonds | 3,027 | — | 3,027 | — | OCI |
| Derivative financial assets (interest rate contracts) | 327 | — | 327 | — | NI |
| Derivative financial liabilities (interest rate contracts) | 276 | — | 276 | — | NI |
| December 31, 2017 | | | | | |

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Securities available-for-sale:

| | | | | | |
|---|------------|------|-------------|------|-----|
| Mortgage-backed securities and collateralized mortgage obligations issued by U.S. government agencies | \$ 188,061 | \$ — | -\$ 188,061 | \$ — | OCI |
| SBA-backed securities | 25,982 | — | 25,817 | 165 | OCI |
| Debentures of government sponsored agencies | 12,938 | — | 12,938 | — | OCI |
| Privately-issued collateralized mortgage obligations | 1,431 | — | 1,431 | — | OCI |
| Obligations of state and political subdivisions | 97,491 | — | 97,491 | — | OCI |
| Corporate bonds | 6,564 | — | 6,564 | — | OCI |
| Derivative financial assets (interest rate contracts) | 74 | — | 74 | — | NI |
| Derivative financial liabilities (interest rate contracts) | 740 | — | 740 | — | NI |

¹ Other comprehensive income ("OCI") or net income ("NI").

Securities available-for-sale are recorded at fair value on a recurring basis. When available, quoted market prices (Level 1) are used to determine the fair value of securities available-for-sale. If quoted market prices are not available, we obtain pricing information from a reputable third-party service provider, who may utilize valuation techniques that use current market-based or independently sourced parameters, such as bid/ask prices, dealer-quoted prices, interest rates, benchmark yield curves, prepayment speeds, probability of default, loss severity and credit spreads (Level 2). Level 2 securities include obligations of state and political subdivisions, U.S. agencies or government-sponsored agencies' debt securities, mortgage-backed securities, government agency-issued, privately-issued collateralized mortgage obligations, and corporate bonds. As of June 30, 2018 and December 31, 2017, there were no Level 1 securities. As of December 31, 2017, we had one Level 3 available-for-sale U.S. government agency obligation, which was paid off during the second quarter of 2018.

Securities held-to-maturity may be written down to fair value (determined using the same techniques discussed above for securities available-for-sale) as a result of other-than-temporary impairment, and we did not record any write-downs during the six months ended June 30, 2018 or June 30, 2017.

On a recurring basis, derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs, reflecting market expectations of future interest rates as of the measurement date. Standard valuation techniques are used to calculate the present value of the future expected cash flows assuming an orderly transaction. Valuation adjustments may be made to reflect both our own credit risk and the counterparties' credit risk in determining the fair value of the derivatives. Level 2 inputs for the valuations are limited to observable market prices for London Interbank Offered Rate ("LIBOR") and Overnight Index Swap ("OIS") rates (for the very short term), quoted prices for LIBOR futures contracts, observable market prices for LIBOR and OIS swap rates, and one-month and three-month LIBOR basis spreads at commonly quoted intervals. Mid-market pricing of the inputs is used as a practical expedient in the fair value measurements. We project spot rates at reset days specified by each swap contract to determine future cash flows, then discount to present value using either LIBOR or OIS curves depending on whether the swap positions are fully collateralized as of the measurement date. When the value of any collateral placed with counterparties is less than the interest rate derivative liability, a credit valuation adjustment ("CVA") is applied to reflect the credit risk we pose to counterparties. We have used the spread between the Standard & Poor's BBB rated U.S. Bank Composite rate and LIBOR for the closest maturity term corresponding to the duration of the swaps to derive the CVA. A similar credit risk adjustment, correlated to the credit standing of the counterparty, is made when collateral posted by the counterparty does not fully cover their liability to the Bank. For further discussion on our methodology in valuing our derivative financial instruments, refer to Note 9, Derivative Financial Instruments and Hedging Activities.

Certain financial assets may be measured at fair value on a non-recurring basis. These assets are subject to fair value adjustments that result from the application of the lower of cost or fair value accounting or write-downs of individual assets, such as impaired loans that are collateral dependent and other real estate owned ("OREO"). As of June 30, 2018 and December 31, 2017, we did not carry any assets measured at fair value on a non-recurring basis.

Disclosures about Fair Value of Financial Instruments

The following table summarizes fair value estimates for financial instruments as of June 30, 2018 and December 31, 2017, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note). The carrying amounts in the following table are recorded in the consolidated statements of condition under the indicated captions. Further, we have not disclosed the fair value of financial instruments specifically excluded from disclosure requirements such as bank-owned life insurance policies ("BOLI") and non-maturity deposit liabilities. Additionally, we hold shares of FHLB stock and Visa Inc. Class B common stock at cost. These shares are restricted from resale, except among member banks, and their values are discussed in Note 4, Investment Securities.

| (in thousands) | June 30, 2018 | | | December 31, 2017 | | |
|--|---------------------|---------------|-------------------------|---------------------|---------------|-------------------------|
| | Carrying Amounts | Fair Value | Fair Value Hierarchy | Carrying Amounts | Fair Value | Fair Value Hierarchy |
| Financial assets (recorded at amortized cost) | | | | | | |
| Cash and cash equivalents | \$83,855 | \$83,855 | Level 1 | \$203,545 | \$203,545 | Level 1 |
| Investment securities held-to-maturity | 170,652 | 166,127 | Level 2 | 151,032 | 151,032 | Level 2 |
| Loans, net | 1,701,798 | 1,666,409 | Level 3 | 1,663,246 | 1,650,198 | Level 3 |
| Interest receivable | 7,814 | 7,814 | Level 2 | 7,501 | 7,501 | Level 2 |
| Financial liabilities (recorded at amortized cost) | | | | | | |
| Time deposits | 137,040 | 136,023 | Level 2 | 160,116 | 159,540 | Level 2 |
| Subordinated debentures | 5,802 | 6,988 | Level 3 | 5,739 | 5,118 | Level 3 |
| Interest payable | 167 | 167 | Level 2 | 191 | 191 | Level 2 |

Commitments - The value of unrecognized financial instruments is estimated based on the fee income associated with the commitments which, in the absence of credit exposure, is considered to approximate their settlement value. The fair value of commitment fees was not material at June 30, 2018 and December 31, 2017.

Note 4: Investment Securities

Our investment securities portfolio consists of obligations of state and political subdivisions, corporate bonds, U.S. government agency securities, including residential and commercial mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMOs") issued or guaranteed by Federal National Mortgage Association ("FNMA"), Federal Home Loan Mortgage Corporation ("FHLMC"), Small Business Administration ("SBA"), or Government National Mortgage Association ("GNMA"), debentures issued by government-sponsored agencies such as FNMA, Federal Farm Credit Bureau, FHLB and FHLMC, and privately issued CMOs, as reflected in the following table.

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| (in thousands) | June 30, 2018 | | | | December 31, 2017 | | | |
|--|---------------|------------|------------------|-------------------|-------------------|------------|------------------|-------------------|
| | Amortized | | Gross | | Amortized | | Gross | |
| | Cost | Fair Value | Unrealized Gains | Unrealized Losses | Cost | Fair Value | Unrealized Gains | Unrealized Losses |
| Held-to-maturity: | | | | | | | | |
| Securities of U.S. government agencies: | | | | | | | | |
| MBS pass-through securities issued by FHLMC and FNMA | \$94,203 | \$90,824 | \$— | \$(3,379) | \$100,376 | \$100,096 | \$234 | \$(514) |
| SBA-backed securities | 8,882 | 8,743 | — | (139) | — | — | — | — |
| CMOs issued by FNMA | 11,881 | 11,766 | — | (115) | — | — | — | — |
| CMOs issued by FHLMC | 34,668 | 33,591 | — | (1,077) | 31,010 | 30,938 | 2 | (74) |
| CMOs issued by GNMA | 3,730 | 3,713 | — | (17) | — | — | — | — |
| Obligations of state and political subdivisions | 17,288 | 17,490 | 235 | (33) | 19,646 | 19,998 | 383 | (31) |
| Total held-to-maturity | 170,652 | 166,127 | 235 | (4,760) | 151,032 | 151,032 | 619 | (619) |
| Available-for-sale: | | | | | | | | |
| Securities of U.S. government agencies: | | | | | | | | |
| MBS pass-through securities issued by FHLMC and FNMA | 90,082 | 87,590 | 17 | (2,509) | 65,559 | 65,262 | 126 | (423) |
| SBA-backed securities | 24,620 | 23,954 | — | (666) | 25,979 | 25,982 | 58 | (55) |
| CMOs issued by FNMA | 21,026 | 20,571 | 7 | (462) | 35,340 | 35,125 | 33 | (248) |
| CMOs issued by FHLMC | 123,359 | 120,411 | 1 | (2,949) | 70,514 | 69,889 | 3 | (628) |
| CMOs issued by GNMA | 12,641 | 12,222 | 2 | (421) | 17,953 | 17,785 | 26 | (194) |
| Debentures of government-sponsored agencies | 32,395 | 32,139 | — | (256) | 12,940 | 12,938 | 3 | (5) |
| Privately issued CMOs | 431 | 435 | 4 | — | 1,432 | 1,431 | 1 | (2) |
| Obligations of state and political subdivisions | 89,699 | 87,788 | 77 | (1,988) | 98,027 | 97,491 | 298 | (834) |
| Corporate bonds | 3,015 | 3,027 | 24 | (12) | 6,541 | 6,564 | 26 | (3) |
| Total available-for-sale | 397,268 | 388,137 | 132 | (9,263) | 334,285 | 332,467 | 574 | (2,392) |
| Total investment securities | \$567,920 | \$554,264 | \$367 | \$(14,023) | \$485,317 | \$483,499 | \$1,193 | \$(3,011) |

The amortized cost and fair value of investment debt securities by contractual maturity at June 30, 2018 and December 31, 2017 are shown in the following table. Expected maturities may differ from contractual maturities if the issuers of the securities have the right to call or prepay obligations with or without call or prepayment penalties.

| (in thousands) | June 30, 2018 | | | | December 31, 2017 | | | |
|------------------------------------|------------------|------------|--------------------|------------|-------------------|------------|--------------------|------------|
| | Held-to-Maturity | | Available-for-Sale | | Held-to-Maturity | | Available-for-Sale | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Within one year | \$2,859 | \$2,882 | \$8,272 | \$8,263 | \$2,151 | \$2,172 | \$10,268 | \$10,272 |
| After one but within five years | 13,063 | 13,147 | 79,662 | 78,514 | 15,577 | 15,791 | 71,576 | 71,237 |
| After five years through ten years | 63,321 | 61,350 | 216,584 | 210,650 | 54,641 | 54,554 | 129,723 | 128,954 |
| After ten years | 91,409 | 88,748 | 92,750 | 90,710 | 78,663 | 78,515 | 122,718 | 122,004 |
| Total | \$170,652 | \$166,127 | \$397,268 | \$388,137 | \$151,032 | \$151,032 | \$334,285 | \$332,467 |

Sales of investment securities and gross gains and losses are shown in the following table.

| (in thousands) | Three months ended | Six months ended |
|----------------|--------------------|------------------|
|----------------|--------------------|------------------|

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June 30, June 30, June 30, June 30,
2018 2017 2018 2017

Available-for-sale:

| | | | | |
|-----------------------|---------|---------|---------|---------|
| Sales proceeds | \$5,006 | \$1,321 | \$5,006 | \$1,321 |
| Gross realized gains | 27 | 13 | 27 | 13 |
| Gross realized losses | (16) | (3) | (16) | (3) |

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Pledged investment securities are shown in the following table.

| (in thousands) | June 30, 2018 | December 31, 2017 |
|---|------------------|----------------------|
| Pledged to the State of California: | | |
| Secure public deposits in compliance with the Local Agency Security Program | \$ 103,097 | \$ 107,829 |
| Collateral for trust deposits | 749 | 761 |
| Total investment securities pledged to the State of California | \$ 103,846 | \$ 108,590 |
| Collateral for Wealth Management and Trust Services checking account | \$ 2,014 | \$ 2,026 |

As part of our ongoing review of our investment securities portfolio, we reassessed the classification of certain securities issued by government sponsored agencies. During 2018 and 2017, we transferred \$27.4 million and \$129.0 million, respectively, of these securities from available-for-sale to held-to-maturity at fair value. We intend and have the ability to hold these securities to maturity. The net unrealized pre-tax loss of \$278 thousand and \$3.0 million, at the respective transfer dates, remained in accumulated other comprehensive income and are amortized over the remaining lives of the securities. Amortization of the net unrealized pre-tax losses totaled \$268 thousand and \$165 thousand for the six months ended June 30, 2018 and 2017, respectively.

Other-Than-Temporarily Impaired ("OTTI") Debt Securities

We have evaluated the credit of our investment securities and their issuers and/or insurers. Based on our evaluation, Management has determined that no investment security in our investment portfolio is other-than-temporarily impaired as of June 30, 2018. We do not have the intent and it is more likely than not that we will not have to sell the remaining securities temporarily impaired at June 30, 2018 before recovery of the amortized cost basis.

There were 266 and 198 investment securities in unrealized loss positions at June 30, 2018 and December 31, 2017, respectively. Those securities are summarized and classified according to the duration of the loss period in the following tables:

| June 30, 2018 (in thousands) | < 12 continuous months | | ≥ 12 continuous months | | Total securities in a loss position | |
|--|---------------------------|--------------------|---------------------------|--------------------|--|--------------------|
| | Fair value | Unrealized loss | Fair value | Unrealized loss | Fair value | Unrealized loss |
| Held-to-maturity: | | | | | | |
| MBS pass-through securities issued by FHLMC and FNMA | \$ 22,100 | \$ (830) | \$ 68,724 | \$ (2,549) | \$ 90,824 | \$ (3,379) |
| SBA-backed securities | 8,742 | (139) | — | — | \$ 8,742 | \$ (139) |
| CMOs issued by FNMA | 11,766 | (115) | — | — | 11,766 | (115) |
| CMOs issued by FHLMC | 19,798 | (564) | 13,793 | (513) | 33,591 | (1,077) |
| CMOs issued by GNMA | — | — | 3,713 | (17) | 3,713 | (17) |
| Obligations of state and political subdivisions | 3,816 | (33) | — | — | 3,816 | (33) |
| Total held-to-maturity | 66,222 | (1,681) | 86,230 | (3,079) | 152,452 | (4,760) |
| Available-for-sale: | | | | | | |
| MBS pass-through securities issued by FHLMC and FNMA | 68,906 | (1,843) | 17,713 | (666) | 86,619 | (2,509) |
| SBA-backed securities | 23,954 | (666) | — | — | 23,954 | (666) |
| CMOs issued by FNMA | 15,687 | (321) | 4,642 | (141) | 20,329 | (462) |
| CMOs issued by FHLMC | 115,370 | (2,949) | — | — | 115,370 | (2,949) |
| CMOs issued by GNMA | 11,297 | (419) | 603 | (2) | 11,900 | (421) |

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| | | | | | | | | | |
|---|------------|----------|---|------------|----------|--------|------------|-----------|---|
| Debentures of government- sponsored agencies | 32,139 | (256 |) | — | — | 32,139 | (256 |) | |
| Privately issued CMOs | — | — | | — | — | — | — | | |
| Obligations of state and political subdivisions | 57,217 | (835 |) | 18,832 | (1,153 |) | 76,049 | (1,988 |) |
| Corporate bonds | 1,522 | (12 |) | — | — | 1,522 | (12 |) | |
| Total available-for-sale | 326,092 | (7,301 |) | 41,790 | (1,962 |) | 367,882 | (9,263 |) |
| Total temporarily impaired securities | \$ 392,314 | \$(8,982 |) | \$ 128,020 | \$(5,041 |) | \$ 520,334 | \$(14,023 |) |

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| December 31, 2017 (in thousands) | < 12 continuous months | | ≥ 12 continuous months | | Total securities in a loss position | |
|--|---------------------------|--------------------|---------------------------|--------------------|--|--------------------|
| | Fair value | Unrealized loss | Fair value | Unrealized loss | Fair value | Unrealized loss |
| Held-to-maturity: | | | | | | |
| Obligations of state and political subdivisions | \$3,648 | \$(31) | \$— | \$— | \$3,648 | \$(31) |
| MBS pass-through securities issued by FHLMC and FNMA | 16,337 | (143) | 46,845 | (371) | 63,182 | (514) |
| CMOs issued by FHLMC | 11,066 | (31) | 13,824 | (43) | 24,890 | (74) |
| Total held-to-maturity | 31,051 | (205) | 60,669 | (414) | 91,720 | (619) |
| Available-for-sale: | | | | | | |
| MBS pass-through securities issued by FHLMC and FNMA | 32,189 | (121) | 15,325 | (302) | 47,514 | (423) |
| SBA-backed securities | 11,028 | (53) | 165 | (2) | 11,193 | (55) |
| CMOs issued by FNMA | 26,401 | (171) | 5,440 | (77) | 31,841 | (248) |
| CMOs issued by FHLMC | 69,276 | (628) | — | — | 69,276 | (628) |
| CMOs issued by GNMA | 14,230 | (194) | — | — | 14,230 | (194) |
| Debentures of government-sponsored agencies | 2,984 | (5) | — | — | 2,984 | (5) |
| Privately issued CMO's | 1,310 | (2) | — | — | 1,310 | (2) |
| Obligations of state and political subdivisions | 52,197 | (288) | 19,548 | (546) | 71,745 | (834) |
| Corporate bonds | 3,060 | (3) | — | — | 3,060 | (3) |
| Total available-for-sale | 212,675 | (1,465) | 40,478 | (927) | 253,153 | (2,392) |
| Total temporarily impaired securities | \$243,726 | \$(1,670) | \$101,147 | \$(1,341) | \$344,873 | \$(3,011) |

As of June 30, 2018, sixty-four investment securities in our portfolio had been in a continuous loss position for twelve months or more. They consisted of five CMOs issued by FHLMC, three CMOs issued by FNMA, two CMOs issued by GNMA, twenty-two agency MBS securities and thirty-two obligations of U.S. state and political subdivisions securities. We have evaluated the securities and believe that the decline in fair value is primarily driven by factors other than credit. It is probable that we will be able to collect all amounts due according to the contractual terms and no other-than-temporary impairment exists on these securities. The debenture of government-sponsored agency security is supported by the U.S. Federal Government, which protects us from credit losses. Based upon our assessment of the credit fundamentals, we concluded that these securities were not other-than-temporarily impaired at June 30, 2018.

There were two hundred one investment securities in our portfolio that had been in temporary loss positions for less than twelve months as of June 30, 2018, and their temporary loss positions mainly arose from changes in interest rates since purchase. They consisted of eleven SBA-backed securities, eight debentures of a U.S. government-sponsored agency, ninety-eight obligations of U.S. state and political subdivisions, thirty-six MBS securities, forty-six CMOs issued by government-sponsored agencies, and three corporate bonds. Securities of government-sponsored agencies are supported by the U.S. Federal Government, which protects us from credit losses. Other temporarily impaired securities are deemed creditworthy after internal analysis of the issuers' latest financial information and credit enhancement. Additionally, all are rated as investment grade by at least one major rating agency. As a result of this impairment analysis, we concluded that these securities were not other-than-temporarily impaired at June 30, 2018.

Non-Marketable Securities

As a member of the FHLB, we are required to maintain a minimum investment in FHLB capital stock determined by the Board of Directors of the FHLB. The minimum investment requirements can increase in the event we increase our total asset size or borrowings with the FHLB. Shares cannot be purchased or sold except between the FHLB and its

members at the \$100 per share par value. We held \$11.1 million of FHLB stock recorded at cost in other assets in the consolidated statements of condition at both June 30, 2018 and December 31, 2017. The carrying amounts of these investments are reasonable estimates of fair value because the securities are restricted to member banks and they do not have a readily determinable market value. Management does not believe that the FHLB stock is other-than-temporarily-impaired, due to FHLB's current financial condition. On July 26, 2018, FHLB announced a cash

dividend to be distributed in mid-August 2018 at an annualized dividend rate of 7.00%. Cash dividends paid on FHLB capital stock are recorded as non-interest income.

As a member bank of Visa U.S.A., we hold 16,939 shares of Visa Inc. Class B common stock with a carrying value of zero, which is equal to our cost basis. These shares are restricted from resale until their conversion into Class A (voting) shares upon the termination of Visa Inc.'s Covered Litigation escrow account. Because of the restriction, these shares are not considered available-for-sale and are not carried at fair value. When converting this Class B common stock to Class A common stock based on the conversion rate of 1.6298 as of June 30, 2018 and 1.6483 as of December 31, 2017, and the closing stock price of Class A shares, the value of our shares of Class B common stock would have been \$3.7 million and \$3.2 million at June 30, 2018 and December 31, 2017, respectively. The conversion rate is subject to further reduction upon the final settlement of the covered litigation against Visa Inc. and its member banks. As such, the fair value of these Class B shares can differ significantly from their if-converted values. For further information, refer to Note 8, Commitments and Contingencies.

We invest in low-income housing tax credit funds as a limited partner, which totaled \$4.9 million and \$2.1 million recorded in other assets as of June 30, 2018 and December 31, 2017, respectively. In the first six months of 2018, we recognized \$282 thousand of low-income housing tax credits and other tax benefits, net of \$237 thousand of amortization expense of low-income housing tax credit investment, as a component of income tax expense. As of June 30, 2018, our unfunded commitments for these low-income housing tax credit funds totaled \$3.2 million. We did not recognize any impairment losses on these low-income housing tax credit investments during the six months ended June 30, 2018 or 2017, as the value of the future tax benefits exceeds the carrying value of the investments.

Note 5: Loans and Allowance for Loan Losses

Credit Quality of Loans

The following table shows outstanding loans by class and payment aging as of June 30, 2018 and December 31, 2017.
Loan Aging Analysis by Loan Class

| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential ¹ | Installment and other consumer | Total |
|--------------------------------|---------------------------|--|----------------------------------|--------------|-------------|--------------------------------|--------------------------------|--------------|
| June 30, 2018 | | | | | | | | |
| 30-59 days past due | \$ — | \$ — | \$ — | \$ — | \$ 77 | \$ — | \$ 11 | \$ 88 |
| 60-89 days past due | — | — | — | — | — | — | — | — |
| 90 days or more past due | — | — | — | — | — | — | — | — |
| Total past due | — | — | — | — | 77 | — | 11 | 88 |
| Current | 241,994 | 317,587 | 839,667 | 57,015 | 125,954 | 108,829 | 26,477 | 1,717,523 |
| Total loans ³ | \$ 241,994 | \$ 317,587 | \$ 839,667 | \$ 57,015 | \$ 126,031 | \$ 108,829 | \$ 26,488 | \$ 1,717,611 |
| Non-accrual loans ² | \$ — | \$ — | \$ — | \$ — | \$ 385 | \$ — | \$ — | \$ 385 |
| December 31, 2017 | | | | | | | | |
| 30-59 days past due | \$ — | \$ — | \$ — | \$ — | \$ 99 | \$ 255 | \$ 330 | \$ 684 |
| 60-89 days past due | 1,340 | — | — | — | — | — | — | 1,340 |
| 90 days or more past due | — | — | — | — | 307 | — | — | 307 |
| Total past due | 1,340 | — | — | — | 406 | 255 | 330 | 2,331 |
| Current | 234,495 | 300,963 | 822,984 | 63,828 | 132,061 | 95,271 | 27,080 | 1,676,682 |
| Total loans ³ | \$ 235,835 | \$ 300,963 | \$ 822,984 | \$ 63,828 | \$ 132,467 | \$ 95,526 | \$ 27,410 | \$ 1,679,013 |
| Non-accrual loans ² | \$ — | \$ — | \$ — | \$ — | \$ 406 | \$ — | \$ — | \$ 406 |

¹ Our residential loan portfolio does not include sub-prime loans, nor is it our practice to underwrite loans commonly referred to as "Alt-A mortgages", the characteristics of which are loans lacking full documentation, borrowers having low FICO scores or higher loan-to-value ratios.

² One purchased credit impaired ("PCI") loan with an unpaid balance of \$6 thousand and no carrying value was not accreting interest at June 30, 2018. Three PCI loans with unpaid balances totaling \$131 thousand and no carrying values were not accreting interest at December 31, 2017. Amounts exclude accreting PCI loans totaling \$2.1 million at both June 30, 2018 and December 31, 2017 as we have a reasonable expectation about future cash flows to be collected and we continue to recognize accretable yield on these loans in interest income. There were no accruing loans past due more than ninety days at June 30, 2018 or December 31, 2017.

³ Amounts include net deferred loan origination costs of \$800 thousand and \$818 thousand at June 30, 2018 and December 31, 2017, respectively. Amounts are also net of unaccreted purchase discounts on non-PCI loans of \$956 thousand and \$1.2 million at June 30, 2018 and December 31, 2017, respectively.

We generally make commercial loans to established small and mid-sized businesses to provide financing for their growth and working capital needs, equipment purchases and acquisitions. Management examines historical, current, and projected cash flows to determine the ability of the borrower to repay obligations as agreed. Commercial loans

are made based primarily on the identified cash flows of the borrower and secondarily on the underlying collateral and guarantor support. The cash flows of borrowers, however, may not occur as expected, and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed, such as accounts receivable and inventory, and typically include personal guarantees. We target stable businesses with guarantors who provide additional sources of repayment and have proven to be resilient in periods of economic stress.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans discussed above. We underwrite these loans to be repaid from cash flow and to be supported by real property collateral. Underwriting standards for commercial real estate loans include, but are not limited to, debt coverage and loan-to-value ratios. Furthermore, the owners of the properties guarantee substantially all of our commercial real estate loans. Conditions in the real estate markets or in the general economy may adversely affect our commercial real estate loans. In the event of a vacancy, we expect guarantors to carry the loans until they find a replacement tenant. The owner's substantial equity investment provides a strong economic incentive to continue to support the commercial real estate projects. As such, we have generally experienced a relatively low level of loss and delinquencies in this portfolio.

We generally make construction loans to developers and builders to finance construction, renovation and occasionally land acquisitions in anticipation of near-term development. These loans are underwritten after evaluation of the borrower's financial strength, reputation, prior track record, and independent appraisals. Significant events can affect the construction industry, including: the inherent volatility of real estate markets and vulnerability to delays due to weather, change orders, inability to obtain construction permits, labor or material shortages, and price changes. Estimates of construction costs and value associated with the completed project may be inaccurate. Repayment of construction loans is largely dependent on the ultimate success of the project.

Consumer loans primarily consist of home equity lines of credit, other residential loans and floating homes, along with a small number of installment loans. Our other residential loans include tenancy-in-common fractional interest loans ("TIC") located almost entirely in San Francisco County. We originate consumer loans utilizing credit score information, debt-to-income ratio and loan-to-value ratio analysis. Diversification among consumer loan types, coupled with relatively small loan amounts that are spread across many individual borrowers, mitigates risk.

We use a risk rating system to evaluate asset quality, and to identify and monitor credit risk in individual loans, and in the loan portfolio. Our definitions of "Special Mention" risk graded loans, or worse, are consistent with those used by the Federal Deposit Insurance Corporation ("FDIC"). Our internally assigned grades are as follows:

Pass and Watch: Loans to borrowers of acceptable or better credit quality. Borrowers in this category demonstrate fundamentally sound financial positions, repayment capacity, credit history, and management expertise. Loans in this category must have an identifiable and stable source of repayment and meet the Bank's policy regarding debt-service-coverage ratios. These borrowers are capable of sustaining normal economic, market or operational setbacks without significant financial consequences. Negative external industry factors are generally not present. The loan may be secured, unsecured or supported by non-real estate collateral for which the value is more difficult to determine and/or marketability is more uncertain. This category also includes "Watch" loans, where the primary source of repayment has been delayed. "Watch" is intended to be a transitional grade, with either an upgrade or downgrade within a reasonable period.

Special Mention: Potential weaknesses that deserve close attention. If left uncorrected, those potential weaknesses may result in deterioration of the payment prospects for the asset. Special Mention assets do not present sufficient risk to warrant adverse classification.

Substandard: Inadequately protected by either the current sound worth and paying capacity of the obligor or the collateral pledged, if any. A Substandard asset has a well-defined weakness or weaknesses that jeopardize(s) the liquidation of the debt. Substandard assets are characterized by the distinct possibility that we will sustain some loss if such weaknesses or deficiencies are not corrected. Well-defined weaknesses include adverse trends or developments of the borrower's financial condition, managerial weaknesses and/or significant collateral deficiencies.

Doubtful: Critical weaknesses that make collection or liquidation in full improbable. There may be specific pending events that work to strengthen the asset; however, the amount or timing of the loss may not be determinable. Pending events generally occur within one year of the asset being classified as Doubtful. Examples include: merger, acquisition, or liquidation; capital injection; guarantee; perfecting liens on additional collateral; and refinancing. Such loans are placed on non-accrual status and usually are collateral-dependent.

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We regularly review our credits for accuracy of risk grades whenever we receive new information. Borrowers are generally required to submit financial information at regular intervals. Typically, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk and complexity. In addition, investor commercial real estate borrowers are usually required to submit rent rolls or property income statements annually. We monitor construction loans monthly and review them on an ongoing basis. We review home equity and other consumer loans based on delinquency status. We also review loans graded “Watch” or worse, regardless of loan type, no less than quarterly.

The following table represents an analysis of the carrying amount in loans, net of deferred fees and costs and purchase premiums or discounts, by internally assigned risk grades, including PCI loans, at June 30, 2018 and December 31, 2017.

Credit Risk Profile by Internally Assigned Risk Grade

| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Purchased credit-impaired | Total |
|-------------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|---------------------------|--------------|
| June 30, 2018 | | | | | | | | | |
| Pass | \$ 224,707 | \$ 299,469 | \$ 836,634 | \$ 54,324 | \$ 124,103 | \$ 108,829 | \$ 26,389 | \$ 2,140 | \$ 1,676,595 |
| Special Mention | 14,842 | 8,904 | 2,232 | — | 1,121 | — | — | — | 27,099 |
| Substandard | 2,403 | 8,005 | — | 2,691 | 719 | — | 99 | — | 13,917 |
| Total loans | \$ 241,952 | \$ 316,378 | \$ 838,866 | \$ 57,015 | \$ 125,943 | \$ 108,829 | \$ 26,488 | \$ 2,140 | \$ 1,717,611 |
| December 31, 2017 | | | | | | | | | |
| Pass | \$ 214,636 | \$ 281,104 | \$ 818,570 | \$ 60,859 | \$ 130,558 | \$ 95,526 | \$ 27,287 | \$ 1,325 | \$ 1,629,865 |
| Special Mention | 9,318 | 9,284 | 1,850 | — | — | — | — | 790 | 21,242 |
| Substandard | 11,816 | 9,409 | 1,774 | 2,969 | 1,815 | — | 123 | — | 27,906 |
| Total loans | \$ 235,770 | \$ 299,797 | \$ 822,194 | \$ 63,828 | \$ 132,373 | \$ 95,526 | \$ 27,410 | \$ 2,115 | \$ 1,679,013 |

Troubled Debt Restructuring

Our loan portfolio includes certain loans modified in a troubled debt restructuring (“TDR”), where we have granted economic concessions to borrowers experiencing financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs on non-accrual status at the time of restructure may be returned to accruing status after Management considers the borrower’s sustained repayment performance for a reasonable period, generally six months, and obtains reasonable assurance of repayment and performance.

We may remove a loan from TDR designation if it meets all of the following conditions:

- The loan is subsequently refinanced or restructured at current market interest rates and the new terms are consistent with the treatment of creditworthy borrowers under regular underwriting standards;
- The borrower is no longer considered to be in financial difficulty;
- Performance on the loan is reasonably assured; and;
- Existing loan did not have any forgiveness of principal or interest.

The same Management level that approved the upgrading of the loan classification must approve the removal of TDR status. During the six months ended June 30, 2018, one TIC loan with a recorded investment of \$150 thousand was removed from TDR designation after meeting all of the conditions noted above. There were no loans removed from TDR designation during 2017.

The following table summarizes the carrying amount of TDR loans by loan class as of June 30, 2018 and December 31, 2017.

(in thousands)

| Recorded investment in Troubled Debt Restructurings ¹ | June 30, December | |
|--|-------------------|-----------|
| | 2018 | 31, 2017 |
| Commercial and industrial | \$ 1,917 | \$ 2,165 |
| Commercial real estate, owner-occupied | 7,002 | 6,999 |
| Commercial real estate, investor | 1,844 | 2,171 |
| Construction | 2,691 | 2,969 |
| Home equity | 348 | 347 |
| Other residential | 988 | 1,148 |
| Installment and other consumer | 704 | 721 |
| Total | \$ 15,494 | \$ 16,520 |

¹ There were no TDR loans on non-accrual status at June 30, 2018 and December 31, 2017.

The following table presents information for loans modified in a TDR during the presented periods, including the number of modified contracts, the recorded investment in the loans prior to modification, and the recorded investment in the loans at period end after being restructured. The table excludes fully charged-off TDR loans and loans modified in a TDR and subsequently paid-off during the years presented.

| (dollars in thousands) | Number of Contracts Modified | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment at Period End |
|---|------------------------------|--|---|---|
| TDRs during the three months ended June 30, 2018: | | | | |
| Commercial and industrial | 2 | \$ 254 | \$ 245 | \$ 235 |
| TDRs during the three months ended June 30, 2017: | | | | |
| None | — | \$ — | \$ — | \$ — |
| TDRs during the six months ended June 30, 2018: | | | | |
| Commercial and industrial | 2 | \$ 254 | \$ 245 | \$ 235 |
| TDRs during the six months ended June 30, 2017: | | | | |
| Installment and consumer | 1 | \$ 50 | \$ 50 | \$ 49 |

The two loans that were modified during the six months ended June 30, 2018 were to the same borrower and included loan extensions and other changes in loan terms. The modification during the six months ended June 30, 2017 primarily involved an interest rate concession and other changes to loan terms. During the first six months of 2018 and 2017, there were no defaults on loans that had been modified in a TDR within the prior twelve-month period. We report defaulted TDRs based on a payment default definition of more than ninety days past due.

Impaired Loans

The following tables summarize information by class on impaired loans and their related allowances. Total impaired loans include non-accrual loans, accruing TDR loans and accreting PCI loans that have experienced post-acquisition declines in cash flows expected to be collected.

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| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Total |
|---|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|----------|
| June 30, 2018 | | | | | | | | |
| Recorded investment in impaired loans: | | | | | | | | |
| With no specific allowance recorded | \$ 306 | \$ — | \$ — | \$ 2,691 | \$ 385 | \$ 989 | \$ 46 | \$4,417 |
| With a specific allowance recorded | 1,611 | 7,002 | 1,844 | — | 347 | — | 658 | 11,462 |
| Total recorded investment in impaired loans | \$ 1,917 | \$ 7,002 | \$ 1,844 | \$ 2,691 | \$ 732 | \$ 989 | \$ 704 | \$15,879 |
| Unpaid principal balance of impaired loans | \$ 1,905 | \$ 6,993 | \$ 1,837 | \$ 2,688 | \$ 729 | \$ 987 | \$ 703 | \$15,842 |
| Specific allowance | 232 | 126 | 47 | — | 6 | — | 92 | 503 |
| Average recorded investment in impaired loans during the quarter ended | 2,092 | 7,005 | 1,849 | 2,833 | 736 | 990 | 708 | 16,213 |
| June 30, 2018 | | | | | | | | |
| Interest income recognized on impaired loans during the quarter ended | 28 | 66 | 20 | 37 | 5 | 13 | 8 | 177 |
| June 30, 2018 ¹ | | | | | | | | |
| Average recorded investment in impaired loans during the six months ended | 2,104 | 7,003 | 1,956 | 2,878 | 742 | 1,043 | 712 | 16,438 |
| June 30, 2018 | | | | | | | | |
| Interest income recognized on impaired loans during the six months ended | 183 | 132 | 42 | 75 | 10 | 26 | 15 | 483 |
| June 30, 2018 ¹ | | | | | | | | |
| Average recorded investment in impaired loans during the quarter ended | 2,072 | 7,000 | 3,283 | 3,240 | 642 | 1,173 | 943 | 18,353 |
| June 30, 2017 | | | | | | | | |
| Interest income recognized on impaired loans during the quarter ended | 25 | 66 | 20 | 37 | 7 | 14 | 10 | 179 |
| June 30, 2017 ¹ | | | | | | | | |
| Average recorded investment in impaired loans during the six months ended | 2,117 | 6,998 | 2,941 | 3,241 | 667 | 1,437 | 939 | 18,340 |
| June 30, 2017 | | | | | | | | |
| Interest income recognized on impaired loans during the six months ended | 48 | 132 | 43 | 71 | 14 | 34 | 20 | 362 |
| June 30, 2017 ¹ | | | | | | | | |

¹ No interest income on impaired loans was recognized on a cash basis during the three months ended June 30, 2018. Interest income recognized on a cash basis totaled \$128 thousand during the six months ended June 30, 2018 and was primarily related to the pay-off of two non-accrual commercial PCI loans. No interest income on impaired loans was recognized on a cash basis during the three and six months ended June 30, 2017.

| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Total |
|--|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|---------|
| December 31, 2017 | | | | | | | | |
| Recorded investment in impaired loans: | | | | | | | | |
| With no specific allowance recorded | \$ 309 | \$ — | \$ — | \$ 2,689 | \$ 406 | \$ 995 | \$ 46 | \$4,445 |
| With a specific allowance recorded | 1,856 | 6,999 | 2,171 | 280 | 347 | 153 | 675 | 12,481 |

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| | | | | | | | | |
|---|----------|----------|----------|----------|--------|----------|--------|-----------|
| Total recorded investment in impaired loans | \$ 2,165 | \$ 6,999 | \$ 2,171 | \$ 2,969 | \$ 753 | \$ 1,148 | \$ 721 | \$ 16,926 |
| Unpaid principal balance of impaired loans | \$ 2,278 | \$ 6,993 | \$ 2,168 | \$ 2,963 | \$ 750 | \$ 1,147 | \$ 720 | \$ 17,019 |
| Specific allowance | \$ 50 | \$ 188 | \$ 159 | \$ 7 | \$ 6 | \$ 1 | \$ 102 | \$ 513 |

Management monitors delinquent loans continuously and identifies problem loans, generally loans graded Substandard or worse, loans on non-accrual status and loans modified in a TDR, to be evaluated individually for impairment. Generally, the recorded investment in impaired loans is net of any charge-offs from estimated losses related to specifically identified impaired loans when they are deemed uncollectible. There were no charged-off amounts on impaired loans at June 30, 2018 or December 31, 2017. In addition, the recorded investment in impaired loans is net of purchase discounts or premiums on acquired loans and deferred fees and costs. At June 30, 2018 and December 31, 2017, unused commitments to extend credit on impaired loans, including performing loans to borrowers whose terms have been modified in TDRs, totaled \$850 thousand and \$935 thousand, respectively.

The following tables disclose activity in the allowance for loan losses ("ALLL") and the recorded investment in loans by class, as well as the related ALLL disaggregated by impairment evaluation method.

Allowance for Loan Losses Rollforward for the Period

| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Unallocated | Total |
|----------------------------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-----------|
| Three months ended June 30, 2018 | | | | | | | | | |
| Beginning balance | \$ 3,693 | \$ 2,080 | \$ 6,455 | \$ 697 | \$ 979 | \$ 543 | \$ 351 | \$ 973 | \$ 15,771 |
| Provision (reversal) | (1,098) |)259 | 935 | (189) |) (27) |)203 | (66) |) (17) |) — |
| Charge-offs | (3) |)— | — | — | — | — | (2) |)— | (5) |
| Recoveries | 5 | — | — | — | — | — | 42 | — | 47 |
| Ending balance | \$ 2,597 | \$ 2,339 | \$ 7,390 | \$ 508 | \$ 952 | \$ 746 | \$ 325 | \$ 956 | \$ 15,813 |
| Three months ended June 30, 2017 | | | | | | | | | |
| Beginning balance | \$ 4,413 | \$ 1,992 | \$ 6,133 | \$ 546 | \$ 990 | \$ 444 | \$ 359 | \$ 342 | \$ 15,219 |
| Provision (reversal) | (490) |)90 | (68) |) (135) |) (9) |)65 | (23) |) 570 | — |
| Charge-offs | — | — | — | — | — | — | — | — | — |
| Recoveries | 9 | — | — | — | — | — | 4 | — | 13 |
| Ending balance | \$ 3,932 | \$ 2,082 | \$ 6,065 | \$ 411 | \$ 981 | \$ 509 | \$ 340 | \$ 912 | \$ 15,232 |

Allowance for Loan Losses Rollforward for the Period

| (in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Unallocated | Total |
|--------------------------------|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-----------|
| Six months ended June 30, 2018 | | | | | | | | | |
| Allowance for loan losses: | | | | | | | | | |
| Beginning balance | \$ 3,654 | \$ 2,294 | \$ 6,475 | \$ 681 | \$ 1,031 | \$ 536 | \$ 378 | \$ 718 | \$ 15,767 |
| Provision (reversal) | (1,063) |)45 | 915 | (173) |) (79) |)210 | (93) |) 238 | — |
| Charge-offs | (3) |)— | — | — | — | — | (2) |)— | (5) |
| Recoveries | 9 | — | — | — | — | — | 42 | — | 51 |
| Ending balance | \$ 2,597 | \$ 2,339 | \$ 7,390 | \$ 508 | \$ 952 | \$ 746 | \$ 325 | \$ 956 | \$ 15,813 |
| Six months ended June 30, 2017 | | | | | | | | | |
| Allowance for loan losses: | | | | | | | | | |
| Beginning balance | \$ 3,248 | \$ 1,753 | \$ 6,320 | \$ 781 | \$ 973 | \$ 454 | \$ 372 | \$ 1,541 | \$ 15,442 |
| Provision (reversal) | 896 | 329 | (255) |) (370) |) 8 | 55 | (34) |) (629) |) — |
| Charge-offs | (284) |)— | — | — | — | — | (3) |)— | (287) |
| Recoveries | 72 | — | — | — | — | — | 5 | — | 77 |
| Ending balance | \$ 3,932 | \$ 2,082 | \$ 6,065 | \$ 411 | \$ 981 | \$ 509 | \$ 340 | \$ 912 | \$ 15,232 |

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Allowance for Loan Losses and Recorded Investment in Loans

| (dollars in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Unallocated | Total |
|--|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-------------|
| June 30, 2018 | | | | | | | | | |
| Ending ALLL related to loans collectively evaluated for impairment | \$2,365 | \$2,213 | \$7,343 | \$508 | \$946 | \$746 | \$233 | \$956 | \$15,310 |
| Ending ALLL related to loans individually evaluated for impairment | 232 | 126 | 47 | — | 6 | — | 92 | — | 503 |
| Ending ALLL related to purchased credit-impaired loans | — | — | — | — | — | — | — | — | — |
| Ending balance | \$2,597 | \$2,339 | \$7,390 | \$508 | \$952 | \$746 | \$325 | \$956 | \$15,813 |
| Recorded Investment: | | | | | | | | | |
| Collectively evaluated for impairment | \$240,035 | \$309,376 | \$837,022 | \$54,324 | \$125,211 | \$107,840 | \$25,784 | \$— | \$1,699,592 |
| Individually evaluated for impairment | 1,917 | 7,002 | 1,844 | 2,691 | 732 | 989 | 704 | — | 15,879 |
| Purchased credit-impaired | 42 | 1,209 | 801 | — | 88 | — | — | — | 2,140 |
| Total | \$241,994 | \$317,587 | \$839,667 | \$57,015 | \$126,031 | \$108,829 | \$26,488 | \$— | \$1,717,611 |
| Ratio of allowance for loan losses to total loans | 1.07 | %0.74 | %0.88 | %0.89 | %0.76 | %0.69 | %1.23 | %NM | 0.92 |
| Allowance for loan losses to non-accrual loans | NM | NM | NM | NM | 247 | %NM | NM | NM | 4,107 |

NM - Not Meaningful

Allowance for Loan Losses and Recorded Investment in Loans

| (dollars in thousands) | Commercial and industrial | Commercial real estate, owner-occupied | Commercial real estate, investor | Construction | Home equity | Other residential | Installment and other consumer | Unallocated | Total |
|--|---------------------------|--|----------------------------------|--------------|-------------|-------------------|--------------------------------|-------------|-------------|
| December 31, 2017 | | | | | | | | | |
| Ending ALLL related to loans collectively evaluated for impairment | \$3,604 | \$2,106 | \$6,316 | \$674 | \$1,025 | \$535 | \$276 | \$718 | \$15,254 |
| Ending ALLL related to loans individually evaluated for impairment | 50 | 188 | 159 | 7 | 6 | 1 | 102 | — | 513 |
| Ending ALLL related to purchased credit-impaired loans | — | — | — | — | — | — | — | — | — |
| Ending balance | \$3,654 | \$2,294 | \$6,475 | \$681 | \$1,031 | \$536 | \$378 | \$718 | \$15,767 |
| Recorded Investment: | | | | | | | | | |
| Collectively evaluated for impairment | \$233,605 | \$292,798 | \$820,023 | \$60,859 | \$131,620 | \$94,378 | \$26,689 | \$— | \$1,659,972 |
| Individually evaluated for impairment | 2,165 | 6,999 | 2,171 | 2,969 | 753 | 1,148 | 721 | — | 16,926 |

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| | | | | | | | | | |
|---|-----------|-----------|-----------|----------|-----------|----------|----------|-----|-------------|
| Purchased credit-impaired | 65 | 1,166 | 790 | — | 94 | — | — | — | 2,115 |
| Total | \$235,835 | \$300,963 | \$822,984 | \$63,828 | \$132,467 | \$95,526 | \$27,410 | \$— | \$1,679,013 |
| Ratio of allowance for loan losses to total loans | 1.55 | %0.76 | %0.79 | %1.07 | %0.78 | %0.56 | %1.38 | %NM | 0.94 |
| Allowance for loan losses to non-accrual loans | NM | NM | NM | NM | 254 | %NM | NM | NM | 3,883 |

NM - Not Meaningful

Purchased Credit-Impaired Loans

Acquired loans are considered credit-impaired if there is evidence of significant deterioration of credit quality since origination and it is probable, at the acquisition date, that we will be unable to collect all contractually required payments receivable. Management has determined certain loans purchased in our three bank acquisitions to be PCI loans based on credit indicators such as nonaccrual status, past due status, loan risk grade, loan-to-value ratio, etc. Revolving credit agreements (e.g., home equity lines of credit and revolving commercial loans) are not considered PCI loans as cash flows cannot be reasonably estimated.

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The following table reflects the unpaid principal balance and related carrying value of PCI loans.

| PCI Loans (in thousands) | June 30, 2018 | | December 31, 2017 | |
|--|--------------------------|----------------|--------------------------|----------------|
| | Unpaid Principal Balance | Carrying Value | Unpaid Principal Balance | Carrying Value |
| Commercial and industrial | \$ 125 | \$ 42 | \$ 276 | \$ 65 |
| Commercial real estate, owner occupied | 1,271 | 1,209 | 1,297 | 1,166 |
| Commercial real estate, investor | 1,049 | 801 | 1,064 | 790 |
| Home equity | 220 | 88 | 231 | 94 |
| Total purchased credit-impaired loans | \$ 2,665 | \$ 2,140 | \$ 2,868 | \$ 2,115 |

The activities in the accretable yield, or income expected to be earned over the remaining lives of the PCI loans were as follows:

| Accretable Yield (in thousands) | Three months ended | | Six months ended | |
|------------------------------------|--------------------|---------------|------------------|---------------|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Balance at beginning of period | \$ 1,142 | \$ 1,386 | \$ 1,254 | \$ 1,476 |
| Accretion | (83) | (80) | (195) | (170) |
| Balance at end of period | \$ 1,059 | \$ 1,306 | \$ 1,059 | \$ 1,306 |

Pledged Loans

Our FHLB line of credit is secured under terms of a blanket collateral agreement by a pledge of certain qualifying loans with unpaid principal balances of \$996.9 million and \$887.9 million at June 30, 2018 and December 31, 2017, respectively. In addition, we pledge a certain residential loan portfolio, which totaled \$80.0 million and \$67.6 million at June 30, 2018 and December 31, 2017, respectively, to secure our borrowing capacity with the Federal Reserve Bank ("FRB"). Also, see Note 6, Borrowings.

Related Party Loans

The Bank has, and expects to have in the future, banking transactions in the ordinary course of its business with directors, officers, principal shareholders and their businesses or associates. These transactions, including loans, are granted on substantially the same terms, including interest rates and collateral on loans, as those prevailing at the same time for comparable transactions with persons not related to us. Likewise, these transactions do not involve more than the normal risk of collectability or present other unfavorable features. Related party loans totaled \$12.3 million at June 30, 2018 compared to \$11.9 million at December 31, 2017. In addition, undisbursed commitments to related parties totaled \$8.6 million and \$9.1 million at June 30, 2018 and December 31, 2017, respectively.

Note 6: Borrowings

Federal Funds Purchased – The Bank had unsecured lines of credit with correspondent banks for overnight borrowing totaling \$92.0 million at June 30, 2018 and \$100.4 million at December 31, 2017. In general, interest rates on these lines approximate the federal funds target rate. We had no overnight borrowings under these credit facilities at June 30, 2018 or December 31, 2017.

Federal Home Loan Bank Borrowings – As of June 30, 2018 and December 31, 2017, the Bank had lines of credit with the FHLB totaling \$627.4 million and \$538.9 million, respectively, based on eligible collateral of certain loans. There

were no FHLB overnight borrowings at June 30, 2018 or December 31, 2017.

Federal Reserve Line of Credit – The Bank has a line of credit with the FRBSF secured by certain residential loans. At June 30, 2018 and December 31, 2017, the Bank had borrowing capacity under this line totaling \$59.5 million and \$52.1 million, respectively, and had no outstanding borrowings with the FRBSF.

As part of an acquisition, Bancorp assumed two subordinated debentures due to NorCal Community Bancorp Trusts I and II (the "Trusts"), established for the sole purpose of issuing trust preferred securities on September 22, 2003 and December 29, 2005, respectively. The subordinated debentures were recorded at fair values totaling \$4.95 million at acquisition date with contractual values totaling \$8.2 million. The difference between the contractual balance and the fair value at acquisition date is accreted into interest expense over the lives of the debentures. Accretion on the subordinated debentures totaled \$63 thousand and \$80 thousand in the first six months of 2018 and 2017, respectively.

Bancorp has the option to defer payment of the interest on the subordinated debentures for a period of up to five years, as long as there is no default on the subordinated debentures. In the event of interest deferral, dividends to Bancorp common stockholders are prohibited. The trust preferred securities were sold and issued in private transactions pursuant to an exemption from registration under the Securities Act of 1933, as amended. Bancorp has guaranteed, on a subordinated basis, distributions and other payments due on trust preferred securities totaling \$8.0 million issued by the Trusts, which have identical maturity, repricing, and payment terms as the subordinated debentures.

The following table summarizes the contractual terms of the subordinated debentures due to the Trusts as of June 30, 2018:

(in thousands)

Subordinated debentures due to NorCal Community Bancorp Trust I on October 7, 2033 with interest payable quarterly, based on 3-month LIBOR plus 3.05%, repricing quarterly (5.40% as of June 30, 2018), redeemable, \$4,124 in whole or in part, on any interest payment date

Subordinated debentures due to NorCal Community Bancorp Trust II on March 15, 2036 with interest payable quarterly, based on 3-month LIBOR plus 1.40%, repricing quarterly (3.74% as of June 30, 2018), redeemable, 4,124 in whole or in part, on any interest payment date

| | |
|-------|---------|
| Total | \$8,248 |
|-------|---------|

Note 7: Stockholders' Equity

Dividends

The following table summarizes cash dividends paid to common shareholders, recorded as a reduction of retained earnings.

| (in thousands, except per share data) | Three months ended | | Six months ended | |
|---------------------------------------|--------------------|---------------|------------------|---------------|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Cash dividends to common stockholders | \$2,166 | \$1,660 | \$4,181 | \$3,315 |
| Cash dividends per common share | \$0.31 | \$0.27 | \$0.60 | \$0.54 |

On July 20, 2018, the Board of Directors declared a \$0.32 per share cash dividend, payable on August 10, 2018 to shareholders of record at the close of business on August 3, 2018.

Share-Based Payments

The fair value of stock options as of the grant date is recorded as stock-based compensation expense in the consolidated statements of comprehensive income over the requisite service period, which is generally the vesting period, with a corresponding increase in common stock. Stock-based compensation also includes compensation expense related to the issuance of restricted stock awards. The fair value of the restricted stock awards on the grant date, which equals the intrinsic value, is recorded as compensation expense over the requisite service period with a corresponding increase in common stock as the shares vest. Stock option and restricted stock awards issued in 2018 include a retirement eligibility clause whereby the requisite service period is satisfied at the retirement eligibility date. For those awards, we accelerate stock-based compensation if the award holder is eligible to retire. However, retirement eligibility does not affect the legal vesting schedule of the awards.

Performance-based stock awards (restricted stock awards) are issued to a selected group of employees. Stock award vesting is contingent upon the achievement of pre-established long-term performance goals set by the Compensation Committee of the Board of Directors. Performance is measured over a three-year period and the stock awards cliff

vest. These performance-based stock awards were granted at a maximum opportunity level, and based on the achievement of the pre-established goals, the actual payouts can range from 0% to 200% of the target award. For performance-based stock awards, an estimate is made of the number of shares expected to vest based on the probability that the performance criteria will be achieved to determine the amount of compensation expense to be recognized. The estimate is re-evaluated quarterly and total compensation expense is adjusted for any change in the current period.

In addition, we record excess tax benefits (deficiencies) resulting from the exercise of non-qualified stock options, the disqualifying disposition of incentive stock options and vesting of restricted stock awards as income tax benefits

(expense) in the consolidated statements of comprehensive income with a corresponding decrease (increase) to current taxes payable.

The holders of unvested restricted stock awards are entitled to dividends on the same per-share ratio as holders of common stock. Tax benefits on dividends paid on unvested restricted stock awards are recorded as tax benefits in the consolidated statements of comprehensive income with a corresponding decrease to current taxes payable.

Under the 2017 Equity Plan, stock options may be net settled by a reduction in the number of shares otherwise deliverable upon exercise in satisfaction of the exercise payment and applicable tax withholding requirements. During the six months ended June 30, 2018, option holders exchanged 19,863 shares totaling \$1.4 million at a weighted-average price of \$70.34 for cashless stock option exercises and tax withholdings upon vesting of performance-based stock awards. During the six months ended June 30, 2017, option holders exchanged 5,651 shares totaling \$385 thousand at a weighted-average price of \$68.04 for cashless stock option exercises. Shares exchanged under net settlement arrangements are available for future grants under the 2017 Equity Plan.

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

We early adopted ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, in the first quarter of 2018 and reclassified \$638 thousand from AOCI to retained earnings. This amount represents the stranded income tax effects related to the unrealized loss on available-for-sale securities in AOCI on the date of the enactment of the Tax Cuts and Jobs Act of 2017. For more information regarding ASU No. 2018-02, refer to Note 2, Accounting Standards Adopted in 2018.

Share Repurchase Program

On April 23, 2018, Bancorp announced that its Board of Directors approved a Share Repurchase Program under which Bancorp may repurchase up to \$25.0 million of its outstanding common stock through May 1, 2019.

Under the Share Repurchase Program, Bancorp may purchase shares of its common stock through various means such as open market transactions, including block purchases, and privately negotiated transactions. The number of shares repurchased and the timing, manner, price and amount of any repurchases will be determined at Bancorp's discretion. Factors include, but are not limited to, stock price, trading volume and general market conditions, along with Bancorp's general business conditions. The program may be suspended or discontinued at any time and does not obligate Bancorp to acquire any specific number of shares of its common stock.

As part of the Share Repurchase Program, Bancorp entered into a trading plan adopted in accordance with Rule 10b5-1 of the Securities Exchange Act of 1934, as amended. The 10b5-1 trading plan permits common stock to be repurchased at times that might otherwise be prohibited under insider trading laws or self-imposed trading restrictions. The 10b5-1 trading plan is administered by an independent broker and is subject to price, market volume and timing restrictions.

During the quarter ended June 30, 2018, Bancorp purchased 1,398 shares for a total amount of \$104 thousand.

Note 8: Commitments and Contingencies

Financial Instruments with Off-Balance Sheet Risk

We make commitments to extend credit in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because various commitments will expire without being fully drawn, the total commitment amount does not necessarily represent future cash requirements.

Our credit loss exposure is equal to the contractual amount of the commitment in the event of nonperformance by the borrower. We use the same credit underwriting criteria for all credit exposure. The amount of collateral obtained, if deemed necessary by us, is based on Management's credit evaluation of the borrower. Collateral types pledged may include accounts receivable, inventory, other personal property and real property.

The contractual amount of undrawn loan commitments and standby letters of credit not reflected in the consolidated statements of condition are as follows:

| (in thousands) | June 30, December 31, | |
|---|-----------------------|------------|
| | 2018 | 2017 |
| Commercial lines of credit | \$222,547 | \$ 224,370 |
| Revolving home equity lines | 186,652 | 177,678 |
| Undisbursed construction loans | 34,336 | 35,322 |
| Personal and other lines of credit | 12,408 | 11,758 |
| Standby letters of credit | 2,207 | 4,074 |
| Total commitments and standby letters of credit | \$458,150 | \$ 453,202 |

We record an allowance for losses on these off-balance sheet commitments based on an estimate of probabilities of the utilization of these commitments according to our historical experience on different types of commitments and expected loss. The allowance for losses on off-balance sheet commitments totaled \$958 thousand as of June 30, 2018 and December 31, 2017, which is recorded in interest payable and other liabilities in the consolidated statements of condition.

Operating Leases

We rent certain premises under long-term, non-cancelable operating leases expiring at various dates through the year 2032. Most of the leases contain certain renewal options and escalation clauses. At June 30, 2018, the approximate minimum future commitments payable under non-cancelable contracts for leased premises are as follows:

| (in thousands) | 2018 | 2019 | 2020 | 2021 | 2022 | Thereafter | Total |
|------------------|---------|---------|---------|---------|---------|------------|-----------|
| Operating leases | \$2,209 | \$4,198 | \$3,758 | \$2,138 | \$1,330 | \$ 2,904 | \$ 16,537 |

Rent expense included in occupancy expense totaled \$1.2 million and \$1.0 million for the three months ended June 30, 2018 and 2017, respectively. Rent expense totaled \$2.3 million and \$2.0 million for the six months ended June 30, 2018 and 2017, respectively.

Litigation Matters

We may be party to legal actions that arise from time to time during the normal course of business. We believe, after consultation with legal counsel, that litigation contingent liability, if any, would not have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

The Bank is responsible for a proportionate share of certain litigation indemnifications provided to Visa U.S.A. ("Visa") by its member banks in connection with lawsuits related to anti-trust charges and interchange fees ("Covered Litigation"). The outcome of the Covered Litigation affects the conversion rate of Visa Class B common stock held by us to Visa Class A common stock, as discussed in Note 4, Investment Securities. The conversion rate may decrease if Visa makes more Covered Litigation settlement payments in the future, and the full effect on member banks is still uncertain. Presently, we are not aware of any significant future cash settlement payments required by the Bank on the Covered Litigation.

In 2012, Visa had reached a \$4.0 billion interchange multidistrict litigation class settlement agreement for which it maintains an escrow account to be used for settlements or judgments in the Covered Litigation. Based on progress in recent settlement discussions in the U.S. interchange multi-district litigation, Visa recorded a \$600 million litigation provision in the quarter ended June 30, 2018 and on June 28, Visa deposited an additional \$600 million into the litigation escrow under the terms of the U.S. retrospective responsibility plan. Funding of the escrow triggers a

conversion rate reduction of the Class B common stock to shares of Class A common stock. At June 30, 2018, according to Visa's Form 10-Q filed on July 27, 2018, the escrow account balance was \$1.5 billion. As of the date of Visa's filing, it had reached settlement agreements with individual merchants representing 51% of the Visa-branded payment card sales volume of merchants who opted out of the 2012 settlement agreement. Litigation is ongoing and until the appeal process is complete, Visa is uncertain whether it will resolve the claims as contemplated by the settlement agreement and additional lawsuits may arise.

Note 9: Derivative Financial Instruments and Hedging Activities

We have entered into interest rate swap agreements, primarily as an interest rate risk management strategy, in order to mitigate the changes in the fair value of specified long-term fixed-rate loans (or firm commitments to enter into long-term fixed-rate loans) caused by changes in interest rates. These hedges allow us to offer long-term fixed-rate loans to customers without assuming the interest rate risk of a long-term asset. Converting our fixed-rate interest payments to floating-rate interest payments, generally benchmarked to the one-month U.S. dollar LIBOR index, protects us against changes in the fair value of our loans associated with fluctuating interest rates.

Our credit exposure, if any, on interest rate swap asset positions is limited to the fair value (net of any collateral pledged to us) and interest payments of all swaps by each counterparty. Conversely, when an interest rate swap is in a liability position exceeding a certain threshold, we may be required to post collateral to the counterparty in an amount determined by the agreements. Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap values.

As of June 30, 2018, we had five interest rate swap agreements, which are scheduled to mature in June 2031, October 2031, July 2032, August 2037 and October 2037. All of our derivatives are designated hedging instruments and are accounted for as fair value hedges. The notional amounts of the interest rate contracts are equal to the notional amounts of the hedged loans. Our interest rate swap payments are settled monthly with counterparties. Accrued interest on the swaps totaled \$5 thousand and \$8 thousand as of June 30, 2018 and December 31, 2017, respectively.

The following tables presents the notional amount and fair value of our derivatives designated as hedging instruments:

| (in thousands) | Derivative Assets | | Derivative Liabilities | |
|----------------|-------------------|------|------------------------|------|
| | June 30 | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |

Fair value hedges:

| | | | | |
|---|---------|----------|---------|-----------|
| Interest rate contracts notional amount | \$9,081 | \$ 4,019 | \$9,293 | \$ 14,810 |
| Interest rate contracts fair value ¹ | \$327 | \$ 74 | \$276 | \$ 740 |

¹ See Note 3, Fair Value of Assets and Liabilities, for valuation methodology.

The table below presents the carrying amount and associated cumulative basis adjustment related to the application of fair value hedge accounting that is included in the carrying amount of hedged assets as of June 30, 2018:

| (in thousands) of | Carrying Amounts | Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Loans |
|-------------------|------------------|--|
| Loans | \$ 18,112 | \$ (262) |

The table below presents the net gains (losses) recognized in interest income on loans on the consolidated statements of comprehensive income related to our derivatives designated as fair value hedges:

Three months ended

(in June 30, 2018)
 (in June 30, 2017)
 thousands

Increase
 (decrease)
 in
 value
 of \$187 \$(129)
 designated
 interest
 rate
 swaps
 Payment
 on
 interest rate
 swaps
 (Decrease)
 increase
 in
 value of
 hedged
 loans
 Decrease
 in
 value
 of \$(3) \$(4)
 yield
 maintenance
 agreement
 Net
 gain
 (loss)
 on
 fair
 value
 hedging
 relationships
 recognized
 in
 interest
 income

Six months
 ended
 (in June 30, 2018)
 (in June 30, 2017)
 thousands

Increase
 (decrease)
 in
 value
 of

designated
interest
rate
swaps
Payment
on
interest rate swaps
of \$(95) \$(185)
(Decrease)
increase
in
value of hedged
loans
Decrease
in
value
of \$(7) \$(7)
yield
maintenance
agreement
Net
loss
on
fair
value
hedging relationships
recognized
against
interest
income

Our derivative transactions with counterparties are under International Swaps and Derivative Association (“ISDA”) master agreements that 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 shows information on financial instruments that are eligible for offset in the consolidated statements of condition.

Offsetting of Financial Assets and Derivative Assets

| (in thousands) | Gross Amounts of Recognized Assets ¹ | Gross Amounts Offset in the Statements of Condition | Net Amounts Presented in the Statements of Condition ¹ | Gross Amounts Not Offset in the Statements of Financial Condition | Cash Collateral Received | Net Amount |
|------------------------------|---|---|---|---|--------------------------|------------|
| June 30, 2018 | | | | | | |
| Derivatives by Counterparty: | | | | | | |
| Counterparty A | \$ 327 | \$ | -\$ 327 | \$ (276) | \$ | -\$ 51 |
| December 31, 2017 | | | | | | |
| Derivatives by Counterparty: | | | | | | |
| Counterparty A | \$ 74 | \$ | -\$ 74 | \$ (74) | \$ | -\$ — |

¹ Amounts exclude accrued interest totaling less than \$1 thousand at both June 30, 2018 and December 31, 2017.

Offsetting of Financial Liabilities and Derivative Liabilities

| (in thousands) | Gross Amounts of Recognized Liabilities ² | Gross Amounts Offset in the Statements of Condition | Net Amounts Presented in the Statements of Condition ² | Gross Amounts Not Offset in the Statements of Financial Condition | Cash Collateral Placed | Net Amount |
|------------------------------|--|---|---|---|------------------------|------------|
| June 30, 2018 | | | | | | |
| Derivatives by Counterparty: | | | | | | |
| Counterparty A | \$ 276 | \$ | -\$ 276 | \$(276) | \$ | — |
| December 31, 2017 | | | | | | |
| Derivatives by Counterparty: | | | | | | |
| Counterparty A | \$ 740 | \$ | -\$ 740 | \$(74) | \$(666) | \$ — |

² Amounts exclude accrued interest totaling \$4 thousand and \$8 thousand at June 30, 2018 and December 31, 2017, respectively.

For more information on how we account for our interest rate swaps, refer to Note 1 to the Consolidated Financial Statements included in our 2017 Form 10-K filed with the SEC on March 14, 2018.

Note 10: Acquisition

On November 21, 2017, we completed the merger of Bank of Napa, N.A. (OTCQB: BNNP), to enhance our market presence in Napa, California. Bank of Napa was a national bank with two branch offices serving Napa. The acquisition added \$134.7 million in loans, \$249.9 million in deposits and \$75.5 million in investment securities to

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Bank of Marin as of the acquisition date. Bank of Napa shareholders received 0.307 shares of Bancorp common stock for each share of Bank of Napa common stock outstanding. We have accounted for the acquisition of Bank of Napa as a business combination under the acquisition method of accounting. The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of the acquisition date in accordance with ASC 805, Business Combinations. The acquisition was treated as a "reorganization" within the definition of section 368(a) of the Internal Revenue Code and is generally considered tax-free for U.S. federal income tax purposes.

The Bank of Napa acquisition resulted in \$23.7 million in goodwill, which represents the excess of the total purchase price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed. Goodwill mainly reflects expected value created through the combined operations of Bank of Napa and Bank of Marin, which we evaluate for impairment annually. We determined that the fair value of our traditional community banking activities (provided through our branch network) exceeded the carrying amount of the bank-level reporting unit. The goodwill is not deductible for tax purposes.

The core deposit intangible represents the estimated future benefits of acquired deposits and is booked separately from the related deposits. We recorded a core deposit intangible asset of \$4.4 million from the Bank of Napa acquisition on November 21, 2017, of which \$56 thousand was amortized in 2017 and \$254 thousand was amortized in the first six months of 2018. The core deposit intangible is amortized on an accelerated basis over an estimated ten-year life, and is evaluated periodically for impairment. No impairment loss was recognized as of June 30, 2018.

Acquisition-related expenses are recognized as incurred and continue until all systems have been converted and operational functions become fully integrated. Bank of Marin Bancorp incurred acquisition-related expenses in the consolidated statements of comprehensive income for the three and six months ended June 30, 2018 as follows:

| (in thousands) | Three months ended June 30, 2018 | Six months ended June 30, 2018 |
|------------------------------|---|---|
| Data processing ¹ | \$ 163 | \$ 555 |
| Professional services | 31 | 126 |
| Personnel severance | 35 | 141 |
| Other | 21 | 43 |
| Total | \$ 250 | \$ 865 |

¹ Primarily relates to Bank of Napa's core processing system contract termination and deconversion fees.

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

Management's discussion of the financial condition and results of operations, which is unaudited, should be read in conjunction with the related consolidated financial statements in this Form 10-Q and with the audited consolidated financial statements and accompanying notes included in our 2017 Annual Report on Form 10-K. Average balances, including balances used in calculating certain financial ratios, are generally comprised of average daily balances.

Forward-Looking Statements

This discussion of financial results includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the "1933 Act") and Section 21E of the Securities Exchange Act of 1934, as amended, (the "1934 Act"). Those sections of the 1933 Act and 1934 Act provide a "safe harbor" for forward-looking statements to encourage companies to provide prospective information about their financial performance so long as they provide meaningful, cautionary statements identifying important factors that could cause actual results to differ significantly from projected results.

Our forward-looking statements include descriptions of plans or objectives of Management for future operations, products or services, and forecasts of revenues, earnings or other measures of economic performance. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include the words "believe," "expect," "intend," "estimate" or words of similar meaning, or future or conditional verbs preceded by "will," "would," "should," "could" or "may."

Forward-looking statements are based on Management's current expectations regarding economic, legislative, and regulatory issues, and the successful integration of acquisitions that may affect our earnings in future periods. A number of factors, many of which are beyond Management's control, could cause future results to vary materially from current Management expectations. Such factors include, but are not limited to, general economic conditions and the economic uncertainty in the United States and abroad, including changes in interest rates, deposit flows, real estate values, and expected future cash flows on loans and securities; costs or effects of acquisitions; competition; changes in accounting principles, policies or guidelines; changes in legislation or regulation (including the Tax Cuts and Jobs Act of 2017); natural disasters (such as the 2017 wildfires in our area); adverse weather conditions; and other economic, competitive, governmental, regulatory and technological factors (including external fraud and cyber-security threats) affecting our operations, pricing, products and services.

Important factors that could cause results or performance to materially differ from those expressed in our prior forward-looking statements are detailed in the Risk Factors section of this Form 10-Q and in Item 1A. Risk Factors section of our 2017 Form 10-K as filed with the SEC, copies of which are available from us at no charge. Forward-looking statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.

Critical Accounting Policies and Estimates

Critical accounting policies are those that are both important to the portrayal of our financial condition and results of operations and require Management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and imprecise. There have been no material changes to our critical accounting policies, which include: Allowance for Loan Losses, Other-than-temporary Impairment of Investment Securities, Accounting for Income Taxes, and Fair Value Measurements. For a detailed discussion, refer to Note 1 to the Consolidated Financial Statements included in our 2017 Form 10-K filed with the SEC on March 14, 2018 and Note 2, Recently Adopted and Issued Accounting Standards, to the Consolidated

Financial Statements in this Form 10-Q.

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Executive Summary

Earnings in the second quarter of 2018 totaled \$7.9 million, compared to \$5.2 million in the second quarter of 2017. Diluted earnings per share were \$1.12 in the second quarter of 2018, compared to \$0.84 in the same quarter a year ago. Earnings for the first six months of 2018 totaled \$14.3 million compared to \$9.7 million in the same period last year. Diluted earnings per share were \$2.03 and \$1.58 in the first six months of 2018 and 2017, respectively.

The following are highlights of our operating and financial performance for the periods presented:

The Board of Directors declared a cash dividend of \$0.32 per share on July 20, 2018, a \$0.01 increase from the prior quarter. This represents the 53rd consecutive quarterly dividend paid by Bank of Marin Bancorp. The dividend is payable on August 10, 2018, to shareholders of record at the close of business on August 3, 2018.

Loans totaled \$1,717.6 million at June 30, 2018, compared to \$1,679.0 million at December 31, 2017, raising the loan to deposit ratio from 78.1% to 80.3%. New loan volume of \$113.2 million in the first half of 2018 was partially offset by payoffs of \$68.8 million, and combined with changes in lines of credit utilization and amortization on existing loans, resulted in the net increase of \$38.6 million.

Strong credit quality remains a cornerstone of the Bank's consistent performance. Non-accrual loans totaled \$385 thousand, or 0.02% of the loan portfolio at June 30, 2018, compared to \$406 thousand, or 0.02% at December 31, 2017. Classified loans totaled \$13.9 million at June 30, 2018, compared to \$27.9 million at December 31, 2017. The decrease in classified loans is primarily due to two borrowing relationships whose risk grades were upgraded from substandard to special mention in the second quarter of 2018. Accruing loans past due 30 to 89 days totaled \$88 thousand at June 30, 2018, compared to \$1.9 million at December 31, 2017. There was no provision for either loan losses or off-balance sheet commitments recorded in the first six months of 2018.

Total deposits decreased \$10.9 million in the first half of 2018 to \$2,137.7 million at June 30, 2018. The decrease in deposits was primarily due to normal cash fluctuations of our large business clients. Additionally, some businesses moved balances into off-balance sheet time deposit products to realize higher interest rates while maintaining their relationships with the Bank. A small number of account holders who were focused solely on obtaining the highest rates in the marketplace moved to other institutions. Non-interest bearing deposits represented 49.5% of total deposits, and the annualized cost of total deposits for the first six months of 2018 was 0.08%.

Reported net interest margin was 3.87% in the second quarter of 2018, which increased 16 basis points compared to the second quarter of 2017, resulting primarily from higher loan and investment yields.

Pre-tax net income was up \$2.8 million, or 36.1%, compared to the same quarter last year. Due to recent tax reform, the federal statutory income tax rate decreased to 21% beginning January 1, 2018. Bancorp's effective tax rate in the second quarter of 2018 was 25.4%, compared to 33.2% in the second quarter of 2017. Earnings in the second quarter of 2018 were favorably impacted by both the tax reform and higher earning assets from the Bank of Napa acquisition. Cost savings from the Bank of Napa acquisition are meeting expectations and should be fully embedded in the third quarter of 2018.

Return on assets was 1.28% for the quarter ended June 30, 2018, compared to 1.01% for the quarter ended June 30, 2017. Return on equity was 10.54% for the quarter ended June 30, 2018, compared to 8.74% for the quarter ended June 30, 2017.

All capital ratios are well above regulatory requirements for a well-capitalized institution. The total risk-based capital ratio for Bancorp was 15.2% at June 30, 2018, compared to 14.9% at December 31, 2017.

Looking forward into 2018, we believe that our core values - relationship banking, disciplined fundamentals and commitment to the communities that we serve - will continue to drive the success of the Bank. By building strong relationships in vibrant markets, we are able to grow our loan portfolio and deposit franchise organically. Disciplined fundamentals ensure that our credit quality remains high, our deposit base is reasonably priced, and our operations are highly efficient, all of which contribute to profitability and net interest margin expansion. Our success helps us to attract the most qualified professionals in the marketplace.

Our strong liquidity and capital supports our organic growth as well as acquisitions. This gives us a great deal of flexibility as we seek opportunities that add value to the Company.

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RESULTS OF OPERATIONS

Highlights of the financial results are presented in the following tables:

| (dollars in thousands) | June 30, 2018 | December 31, 2017 | |
|--|---------------|----------------------|---|
| Selected financial condition data: | | | |
| Total assets | \$2,465,042 | \$2,468,154 | |
| Loans, net | 1,701,798 | 1,663,246 | |
| Deposits | 2,137,723 | 2,148,670 | |
| Borrowings | 5,802 | 5,739 | |
| Stockholders' equity | 304,198 | 297,025 | |
| Asset quality ratios: | | | |
| Allowance for loan losses to total loans | 0.92% | 0.94 | % |
| Allowance for loan losses to non-accrual loans | 41.11 | x 38.88x | |
| Non-accrual loans to total loans | 0.02% | 0.02 | % |
| Capital ratios: | | | |
| Equity to total assets ratio | 12.34 | % 12.03 | % |
| Total capital (to risk-weighted assets) | 15.15 | % 14.91 | % |
| Tier 1 capital (to risk-weighted assets) | 14.30 | % 14.04 | % |
| Tier 1 capital (to average assets) | 11.57 | % 12.13 | % |
| Common equity Tier 1 capital (to risk weighted assets) | 14.01 | % 13.75 | % |

| (dollars in thousands, except per share data) | Three months ended | | Six months ended | |
|---|-----------------------|------------------|---------------------|------------------|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Selected operating data: | | | | |
| Net interest income | \$22,842 | \$18,304 | \$44,733 | \$35,925 |
| Non-interest income | 2,238 | 2,096 | 4,480 | 4,211 |
| Non-interest expense ¹ | 14,509 | 12,631 | 30,590 | 25,642 |
| Net income ¹ | 7,891 | 5,186 | 14,280 | 9,734 |
| Net income per common share: | | | | |
| Basic | \$1.14 | \$0.85 | \$2.06 | \$1.60 |
| Diluted | \$1.12 | \$0.84 | \$2.03 | \$1.58 |
| Performance and other financial ratios: | | | | |
| Return on average assets | 1.28% | 1.01% | 1.17% | 0.96% |
| Return on average equity | 10.54% | 8.74% | 9.63% | 8.34% |
| Tax-equivalent net interest margin ³ | 3.92% | 3.85% | 3.89% | 3.82% |
| Efficiency ratio | 57.85% | 61.92% | 62.16% | 63.89% |
| Cash dividend payout ratio on common stock ² | 27.19% | 31.76% | 29.13% | 33.75% |

¹ Includes merger-related costs totaling \$250 thousand and \$865 thousand for the three and six months ended June 30, 2018.

² Calculated as dividends on common shares divided by basic net income per common share.

³ Tax-equivalent net interest margin is computed by dividing taxable equivalent net interest income, which is adjusted for taxable equivalent income on tax-exempt loans and securities based on Federal statutory rate of 21 percent in 2018 and 35 percent in 2017, by total average interest-earning assets.

Net Interest Income

Net interest income is the difference between the interest earned on loans, investments and other interest-earning assets and the interest expense incurred on deposits and other interest-bearing liabilities. Net interest income is impacted by changes in general market interest rates and by changes in the amounts and composition of interest-earning assets and interest-bearing liabilities. Interest rate changes can create fluctuations in the net interest income and/or margin due to an imbalance in the timing of repricing and maturity of assets and liabilities. We manage interest rate risk exposure with the goal of minimizing the impact of interest rate volatility on net interest income. For more information, refer to Item 3. Quantitative and Qualitative Disclosure about Market Risk in this Form 10-Q.

Net interest margin is expressed as net interest income divided by average interest-earning assets. Net interest rate spread is the difference between the average rate earned on total interest-earning assets and the average rate incurred on total interest-bearing liabilities. Both of these measures are reported on a taxable-equivalent basis. Net interest margin is the higher of the two because it reflects interest income earned on assets funded with non-interest-bearing sources of funds, which include demand deposits and stockholders' equity.

Average Statements of Condition and Analysis of Net Interest Income

The following table compares interest income, average interest-earning assets, interest expense, and average interest-bearing liabilities for the periods presented. The table also presents net interest income, net interest margin and net interest rate spread for each period reported.

| | Three months ended June 30, 2018 | | | Three months ended June 30, 2017 | | |
|--|-------------------------------------|-----------------------------|----------------|-------------------------------------|-----------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate |
| (dollars in thousands) | | | | | | |
| Assets | | | | | | |
| Interest-bearing due from banks ¹ | \$62,665 | \$285 | 1.80 % | \$56,597 | \$157 | 1.10 % |
| Investment securities ^{2, 3} | 574,669 | 3,611 | 2.51 % | 408,335 | 2,355 | 2.31 % |
| Loans ^{1, 3, 4} | 1,700,057 | 19,852 | 4.62 % | 1,487,419 | 16,868 | 4.49 % |
| Total interest-earning assets ¹ | 2,337,391 | 23,748 | 4.02 % | 1,952,351 | 19,380 | 3.93 % |
| Cash and non-interest-bearing due from banks | 40,383 | | | 46,204 | | |
| Bank premises and equipment, net | 8,203 | | | 8,390 | | |
| Interest receivable and other assets, net | 87,183 | | | 60,115 | | |
| Total assets | \$2,473,160 | | | \$2,067,060 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| Interest-bearing transaction accounts | \$142,133 | \$48 | 0.14 % | \$94,799 | \$21 | 0.09 % |
| Savings accounts | 178,956 | 18 | 0.04 % | 163,424 | 16 | 0.04 % |
| Money market accounts | 612,612 | 236 | 0.15 % | 539,192 | 114 | 0.08 % |
| Time accounts including CDARS | 140,799 | 140 | 0.40 % | 146,042 | 139 | 0.38 % |
| Overnight borrowings ¹ | 231 | 1 | 1.84 % | — | — | — % |
| Subordinated debentures ¹ | 5,786 | 123 | 8.40 % | 5,646 | 109 | 7.59 % |
| Total interest-bearing liabilities | 1,080,517 | 566 | 0.21 % | 949,103 | 399 | 0.17 % |
| Demand accounts | 1,072,976 | | | 868,070 | | |
| Interest payable and other liabilities | 19,443 | | | 11,771 | | |
| Stockholders' equity | 300,224 | | | 238,116 | | |
| Total liabilities & stockholders' equity | \$2,473,160 | | | \$2,067,060 | | |
| Tax-equivalent net interest income/margin ¹ | | \$23,182 | 3.92 % | | \$18,981 | 3.85 % |
| Reported net interest income/margin ¹ | | \$22,842 | 3.87 % | | \$18,304 | 3.71 % |

Tax-equivalent net interest rate spread

3.81%

3.76%

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| (dollars in thousands) | Six months ended June 30, 2018 | | | Six months ended June 30, 2017 | | |
|--|-----------------------------------|-----------------------------|----------------|-----------------------------------|-----------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate |
| Assets | | | | | | |
| Interest-bearing due from banks ¹ | \$83,641 | \$688 | 1.64 % | \$43,043 | \$217 | 1.00 % |
| Investment securities ^{2, 3} | 553,723 | 6,887 | 2.49 % | 411,427 | 4,716 | 2.29 % |
| Loans ^{1, 3, 4} | 1,687,841 | 38,971 | 4.59 % | 1,482,977 | 33,090 | 4.44 % |
| Total interest-earning assets ¹ | 2,325,205 | 46,546 | 3.98 % | 1,937,447 | 38,023 | 3.90 % |
| Cash and non-interest-bearing due from banks | 43,084 | | | 42,189 | | |
| Bank premises and equipment, net | 8,351 | | | 8,415 | | |
| Interest receivable and other assets, net | 88,096 | | | 59,071 | | |
| Total assets | \$2,464,736 | | | \$2,047,122 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| Interest-bearing transaction accounts | \$155,180 | \$100 | 0.13 % | \$97,943 | \$50 | 0.10 % |
| Savings accounts | 179,601 | 36 | 0.04 % | 162,175 | 31 | 0.04 % |
| Money market accounts | 597,868 | 452 | 0.15 % | 528,923 | 227 | 0.09 % |
| Time accounts including CDARS | 147,633 | 296 | 0.40 % | 146,501 | 285 | 0.39 % |
| Overnight borrowings ¹ | 116 | 1 | 1.84 % | — | — | — % |
| Subordinated debentures ¹ | 5,770 | 237 | 8.16 % | 5,627 | 217 | 7.67 % |
| Total interest-bearing liabilities | 1,086,168 | 1,122 | 0.21 % | 941,169 | 810 | 0.17 % |
| Demand accounts | 1,061,304 | | | 857,253 | | |
| Interest payable and other liabilities | 18,180 | | | 13,200 | | |
| Stockholders' equity | 299,084 | | | 235,500 | | |
| Total liabilities & stockholders' equity | \$2,464,736 | | | \$2,047,122 | | |
| Tax-equivalent net interest income/margin ¹ | | \$45,424 | 3.89 % | | \$37,213 | 3.82 % |
| Reported net interest income/margin ¹ | | \$44,733 | 3.83 % | | \$35,925 | 3.69 % |
| Tax-equivalent net interest rate spread | | | 3.77 % | | | 3.73 % |

¹ Interest income/expense is divided by actual number of days in the period times 360 days to correspond to stated interest rate terms, where applicable.

² Yields on available-for-sale securities are calculated based on amortized cost balances rather than fair value, as changes in fair value are reflected as a component of stockholders' equity. Investment security interest is earned on 30/360 day basis monthly.

³ Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the Federal statutory rate of 21 percent in 2018 and 35 percent in 2017.

⁴ Average balances on loans outstanding include non-performing loans. The amortized portion of net loan origination fees is included in interest income on loans, representing an adjustment to the yield.

Analysis of Changes in Net Interest Income

The following table presents the effects of changes in average balances (volume) or changes in average rates on tax-equivalent net interest income for the years indicated. Volume variances are equal to the increase or decrease in average balances multiplied by prior period rates. Rate variances are equal to the increase or decrease in rates multiplied by prior period average balances. Mix variances are attributable to the change in yields or rates multiplied by the change in average balances.

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| (in thousands) | Three Months Ended June 30, 2018 Compared to Three Months Ended June 30, 2017 | | | | Six Months Ended June 30, 2018 Compared to Six Months Ended June 30, 2017 | | | |
|---------------------------------------|---|------------|-------|---------|--|------------|-------|---------|
| | Volume | Yield/Rate | Mix | Total | Volume | Yield/Rate | Mix | Total |
| Interest-bearing due from banks | \$17 | \$ 100 | \$11 | \$128 | \$205 | \$ 137 | \$129 | \$471 |
| Investment securities ¹ | 959 | 211 | 86 | 1,256 | 1,631 | 401 | 139 | 2,171 |
| Loans ¹ | 2,411 | 501 | 72 | 2,984 | 4,571 | 1,151 | 159 | 5,881 |
| Total interest-earning assets | 3,387 | 812 | 169 | 4,368 | 6,407 | 1,689 | 427 | 8,523 |
| Interest-bearing transaction accounts | 10 | 11 | 6 | 27 | 29 | 13 | 8 | 50 |
| Savings accounts | 2 | — | — | 2 | 3 | 2 | — | 5 |
| Money market accounts | 16 | 94 | 12 | 122 | 30 | 173 | 22 | 225 |
| Time accounts, including CDARS | (5) | 6 | — | 1 | 2 | 9 | — | 11 |
| Overnight borrowings | — | — | 1 | 1 | — | — | 1 | 1 |
| Subordinated debentures | 3 | 11 | — | 14 | 6 | 14 | — | 20 |
| Total interest-bearing liabilities | 26 | 122 | 19 | 167 | 70 | 211 | 31 | 312 |
| | \$3,361 | \$ 690 | \$150 | \$4,201 | \$6,337 | \$ 1,478 | \$396 | \$8,211 |

¹ Yields and interest income on tax-exempt securities and loans are presented on a taxable-equivalent basis using the federal statutory rate of 21% in 2018 and 35% in 2017.

Second Quarter of 2018 Compared to Second Quarter of 2017

Net interest income totaled \$22.8 million in the second quarter of 2018, compared to \$18.3 million in the same quarter a year ago. The \$4.5 million increase was primarily due to the \$385.0 million increase in average earning assets from both the Bank of Napa acquisition and organic growth. Higher yields across all asset categories also positively impacted interest income for the current quarter.

The tax-equivalent net interest margin was 3.92% in the second quarter of 2018, compared to 3.85% in the same quarter of the previous year. The increase compared to the second quarter of 2017 is related to higher yields on earning assets, partially offset by an increase in lower yielding securities as a percentage of total earning assets.

First Six Months of 2018 Compared to First Six Months of 2017

Net interest income totaled \$44.7 million in the first six months of 2018, compared to \$35.9 million for the same period in 2017. The \$8.8 million increase primarily relates to a \$387.8 million increase in average earning assets compared to 2017. Additionally, the higher yield on investment securities, interest-bearing cash, and loans positively impacted interest income.

The tax-equivalent net interest margin was 3.89% in the first half of 2018, compared to 3.82% in the first half of the previous year. The increase compared to the first half of 2017 is related to higher yields on earning assets, partially offset by an increase in lower yielding cash and securities as a percentage of total earning assets.

Market Interest Rates

Market interest rates are, in part, based on the target federal funds interest rate (the interest rate banks charge each other for short-term borrowings) implemented by the Federal Reserve Open Market Committee ("FOMC"). Actions by the FOMC to increase the target federal funds rate by 25 basis points in December 2015, December 2016, March 2017, June 2017, December 2017, March 2018 and June 2018, have positively impacted yields on our rate sensitive interest-earning assets. The increase in June 2018, to the current target range for the federal funds rate of 1.75% to

2.00%, was the seventh rate hike since 2008. If interest rates continue to rise, we anticipate that our net interest income will increase. While short-term interest rates have risen and improved the Bank's yields on prime-rate adjustable assets, longer-term rates that influence competitive pricing for fixed-rate lending activities have moved to a lesser degree.

Impact of Acquired Loans on Net Interest Margin

Early payoffs or prepayments of our acquired loans with significant unamortized purchase discount/premium could result in volatility in our net interest margin. As our acquired loans from prior acquisitions continue to pay off, we expect the accretion income from these loans to continue to decline. The loans acquired from Bank of Napa are not expected to significantly increase the accretion income. Accretion and gains on payoffs of purchased loans are recorded in interest income and the positive affect on our net interest margin for the second quarter and first half of 2018 and 2017 were as follows:

| | Three months ended | | Six months ended | |
|--------------------------------|---|---|---|---|
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| (dollars in thousands) | Dollar Amount | Dollar Amount | Dollar Amount | Dollar Amount |
| | Basis point impact to net interest margin | Basis point impact to net interest margin | Basis point impact to net interest margin | Basis point impact to net interest margin |
| Accretion on PCI loans | \$84 1 bps | \$80 2 bps | \$1952 bps | \$1702 bps |
| Accretion on non-PCI loans | \$1332 bps | \$1783 bps | \$2332 bps | \$3283 bps |
| Gains on pay-offs of PCI loans | \$1 0 bps | \$84 2 bps | \$1291 bps | \$84 1 bps |

Provision for Loan Losses

Management assesses the adequacy of the allowance for loan losses quarterly based on several factors including growth of the loan portfolio, analysis of probable losses in the portfolio, historical loss experience and the current economic climate. While loss recoveries and provisions for loan losses charged to expense increase the allowance, actual losses on loans reduce the allowance.

Impaired loan balances totaled \$15.9 million at June 30, 2018 and \$16.9 million at December 31, 2017, with specific valuation allowances of \$503 thousand and \$513 thousand for the same respective dates. Classified assets (loans with substandard or doubtful risk grades) decreased to \$13.9 million at June 30, 2018, from \$27.9 million at December 31, 2017. The decrease in classified loans is primarily due to two borrowing relationships whose risk grades were upgraded from substandard to special mention in the second quarter of 2018. There were no loans with doubtful risk grades at June 30, 2018 or December 31, 2017.

There was no provision for loan losses recorded in the first half of 2018 and 2017, as the level of reserves was deemed appropriate for the portfolio. The two classified borrowing relationships that were upgraded in the second quarter (mentioned above) reduced the calculated general allowance for loan losses. This reduction was primarily offset by general allowances resulting from significant loan growth and refinement of certain loan concentration qualitative factors, and an increase in specific reserves related to a loan that was modified as a troubled debt restructuring in the second quarter. Net recoveries in the second quarter of 2018 totaled \$42 thousand compared to \$13 thousand in the same quarter a year ago. Net recoveries totaled \$46 thousand in the first half of 2018, compared to net charge-offs of \$210 thousand in the first half of 2017.

The ratio of loan loss reserves to total loans was 0.92% at June 30, 2018, compared to 0.94% at December 31, 2017. Non-accrual loans totaled \$385 thousand, or 0.02% of total loans, at June 30, 2018, compared to \$406 thousand, or 0.02%, at December 31, 2017.

For more information, refer to Note 5 to the Consolidated Financial Statements in this Form 10-Q.

Non-interest Income

The following table details the components of non-interest income.

| (dollars in thousands) | Three months ended | | Amount June 30, Increase (Decrease) | Percent Increase (Decrease) | |
|---------------------------------------|--------------------|---------|---|--------------------------------|---|
| | 2018 | 2017 | | | |
| Service charges on deposit accounts | \$455 | \$447 | \$ 8 | 1.8 | % |
| Wealth Management and Trust Services | 488 | 504 | (16) | (3.2) | % |
| Debit card interchange fees | 360 | 384 | (24) | (6.3) | % |
| Merchant interchange fees | 118 | 112 | 6 | 5.4 | % |
| Earnings on bank-owned life insurance | 230 | 210 | 20 | 9.5 | % |
| Dividends on FHLB stock | 192 | 176 | 16 | 9.1 | % |
| Gains on investment securities, net | 11 | 10 | 1 | 10.0 | % |
| Other income | 384 | 253 | 131 | 51.8 | % |
| Total non-interest income | \$2,238 | \$2,096 | \$ 142 | 6.8 | % |

| (dollars in thousands) | Six months ended | | Amount June 30, Increase (Decrease) | Percent Increase (Decrease) | |
|---------------------------------------|------------------|---------|---|--------------------------------|---|
| | 2018 | 2017 | | | |
| Service charges on deposit accounts | \$932 | \$899 | \$ 33 | 3.7 | % |
| Wealth Management and Trust Services | 1,003 | 1,007 | (4) | (0.4) | % |
| Debit card interchange fees | 756 | 756 | — | — | % |
| Merchant interchange fees | 198 | 208 | (10) | (4.8) | % |
| Earnings on bank-owned life insurance | 458 | 419 | 39 | 9.3 | % |
| Dividends on FHLB stock | 388 | 408 | (20) | (4.9) | % |
| Gains on investment securities, net | 11 | 10 | 1 | 10.0 | % |
| Other income | 734 | 504 | 230 | 45.6 | % |
| Total non-interest income | \$4,480 | \$4,211 | \$ 269 | 6.4 | % |

Second Quarter of 2018 Compared to Second Quarter of 2017

Non-interest income increased by \$142 thousand in the second quarter of 2018 to \$2.2 million, compared to \$2.1 million in the same quarter a year ago. The increase in other income was primarily due to an increase in fees on one-way deposits placed into deposit networks as a result of the rising market interest rate environment.

First Six Months of 2018 Compared to First Six Months of 2017

Non-interest income increased by \$269 thousand in the first half of 2018 to \$4.5 million, compared to \$4.2 million in the same period a year ago. The increase in other income was due to the reasons mentioned above.

Non-interest Expense

The following table details the components of non-interest expense.

| (dollars in thousands) | Three months ended | | Amount Increase (Decrease) | Percent Increase (Decrease) | |
|---|--------------------|---------------|----------------------------|-----------------------------|---|
| | June 30, 2018 | June 30, 2017 | | | |
| Salaries and related benefits | \$8,316 | \$7,287 | \$ 1,029 | 14.1 | % |
| Occupancy and equipment | 1,511 | 1,380 | 131 | 9.5 | % |
| Depreciation and amortization | 546 | 463 | 83 | 17.9 | % |
| Federal Deposit Insurance Corporation insurance | 191 | 162 | 29 | 17.9 | % |
| Data processing | 1,023 | 963 | 60 | 6.2 | % |
| Professional services | 810 | 522 | 288 | 55.2 | % |
| Directors' expense | 183 | 224 | (41) | (18.3) | % |
| Information technology | 264 | 186 | 78 | 41.9 | % |
| Provision for losses on off-balance sheet commitments | — | (208) |) 208 | (100.0) | % |
| Other non-interest expense | | | | | |
| Core deposit intangible amortization | 230 | 118 | 112 | 94.9 | % |
| Advertising | 130 | 131 | (1) | (0.8) | % |
| Other expense | 1,305 | 1,403 | (98) | (7.0) | % |
| Total other non-interest expense | 1,665 | 1,652 | 13 | 0.8 | % |
| Total non-interest expense | \$14,509 | \$12,631 | \$ 1,878 | 14.9 | % |

| (dollars in thousands) | Six months ended | | Amount Increase (Decrease) | Percent Increase (Decrease) | |
|---|------------------|---------------|----------------------------|-----------------------------|---|
| | June 30, 2018 | June 30, 2017 | | | |
| Salaries and related benefits | \$17,333 | \$14,762 | \$ 2,571 | 17.4 | % |
| Occupancy and equipment | 3,018 | 2,699 | 319 | 11.8 | % |
| Depreciation and amortization | 1,093 | 944 | 149 | 15.8 | % |
| Federal Deposit Insurance Corporation insurance | 382 | 323 | 59 | 18.3 | % |
| Data processing | 2,404 | 1,902 | 502 | 26.4 | % |
| Professional services | 2,109 | 1,044 | 1,065 | 102.0 | % |
| Directors' expense | 357 | 382 | (25) | (6.5) | % |
| Information technology | 533 | 384 | 149 | 38.8 | % |
| Provision for losses on off-balance sheet commitments | — | (43) |) 43 | (100.0) | % |
| Other non-interest expense | | | | | |
| Core deposit intangible amortization | 460 | 236 | 224 | 94.9 | % |
| Advertising | 308 | 204 | 104 | 51.0 | % |
| Other expense | 2,593 | 2,805 | (212) | (7.6) | % |
| Total other non-interest expense | 3,361 | 3,245 | 116 | 3.6 | % |
| Total non-interest expense | \$30,590 | \$25,642 | \$ 4,948 | 19.3 | % |

NM - Not Meaningful

Second Quarter of 2018 Compared to Second Quarter of 2017

Non-interest expense increased by \$1.9 million to \$14.5 million in the second quarter of 2018, compared to \$12.6 million in the same quarter a year ago. The increase was primarily due to higher salaries and benefits related to the addition of Bank of Napa employees, merit increases and filling open positions. Professional services increased due to

\$300 thousand in consulting expenses related to core processing contract negotiations that will result in future technology cost savings. The increase also relates to \$250 thousand in acquisition expenses (\$163 thousand in data processing, \$35 thousand in personnel severance, \$31 thousand in professional services and \$21 thousand in other expenses), as well as higher occupancy and equipment expenses related to rent for the two acquired branches from Bank of Napa, as well as the opening of the Healdsburg branch in August 2017. We expect additional Bank of Napa acquisition expenses to be minimal in the remainder of 2018. Additionally, we amortized \$127 thousand of the core-

deposit intangible ("CDI") that arose from the Bank of Napa acquisition. There was no provision for losses on off-balance sheet commitments in the second quarter of 2018, compared to a \$208 thousand reversal of the provision in the second quarter of 2017.

First Six Months of 2018 Compared to First Six Months of 2017

Non-interest expense increased by \$4.9 million to \$30.6 million in the first half of 2018, compared to \$25.6 million in the same period a year ago. The increase was primarily due to higher salaries and benefits related to the addition of Bank of Napa employees, merit increases and filling open positions, as well as higher stock-based compensation related to awards granted in 2018 with certain participants meeting retirement eligibility requirements. Professional services increased due to \$1.1 million in consulting expenses related to core processing contract negotiations that will result in future technology cost savings. The increase also relates to \$865 thousand in acquisition expenses (\$555 thousand in data processing, \$126 thousand in professional services, \$141 thousand in personnel severance and \$43 thousand in other expenses), higher occupancy and equipment expenses related to rent for the two acquired branches from Bank of Napa, as well as the opening of the Healdsburg branch in August 2017. Additionally, the Bank amortized \$254 thousand of the core-deposit intangible ("CDI") that arose from the Bank of Napa acquisition.

Provision for Income Taxes

The provision for income taxes for the second quarter of 2018 totaled \$2.7 million at an effective tax rate of 25.4%, compared to \$2.6 million at an effective tax rate of 33.2% in the same quarter last year. The provision for income taxes for the first half of 2018 totaled \$4.3 million at an effective tax rate of 23.3%, compared to \$4.8 million at an effective tax rate of 32.8% for the first half of 2017. The declines for the 2018 periods compared to the prior year periods reflect the reduction in the federal corporate income tax rate from 35% to 21% related to the enactment of the Tax Cuts and Jobs Act of 2017, effective January 1, 2018. Income tax provisions reflect accruals for taxes at the applicable rates for federal income tax and California franchise tax based upon reported pre-tax income, and adjusted for the effects of all permanent differences between income for tax and financial reporting purposes (such as earnings on tax exempt loans and municipal securities, BOLI, and low-income housing tax credits) as well as transactions with discrete tax effects (such as the exercise of stock options and disqualifying dispositions of incentive stock options). The resulting reduction in the federal statutory rate was partially offset by the effect of the higher level of expected pre-tax income in 2018 and elimination or reductions to the deductibility of certain meals, entertainment, parking and transportation expenses due to the Tax Cuts and Jobs Act of 2017. Lastly, excess tax benefits resulting from the exercise of non-qualified stock options, the disqualifying disposition of incentive stock options and vesting of restricted stock awards totaled \$426 thousand in the first six months of 2018, an increase of \$246 thousand from the first half of 2017. Except for these discrete tax effects, which reduced our effective tax rate in the first half of 2018 by approximately 2.3%, our income tax provision is reflective of our current expectation for the remainder of the year.

We file a consolidated return in the U.S. Federal tax jurisdiction and a combined return in the State of California tax jurisdiction. There were no ongoing federal or state income tax examinations at the issuance of this report. At June 30, 2018, neither the Bank nor Bancorp had accruals for interest nor penalties related to unrecognized tax benefits.

FINANCIAL CONDITION SUMMARY

At June 30, 2018, assets totaled \$2,465.0 million, a decrease of \$3.2 million when compared to \$2,468.2 million at December 31, 2017. Excess cash was mainly deployed into investment securities and new loans during the first half of 2018 as discussed below.

Investment Securities

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The investment securities portfolio totaled \$558.8 million at June 30, 2018, an increase of \$75.3 million from December 31, 2017. The increase reflects year-to-date purchases of investment securities that are either issued or guaranteed by the US government totaling \$123.3 million, which were partially offset by paydowns and maturities totaling \$34.2 million and sales of \$5.0 million. As part of our ongoing review of our investment securities portfolio, we reassessed the classification of certain securities issued by government sponsored agencies and transferred \$27.4 million of these securities from available-for-sale to held-to-maturity at fair value during the second quarter of 2018. We maintain liquidity to support our future loan growth by holding investment securities averaging less than 5 years duration and cash earning 1.95% at the Federal Reserve Bank as of June 30, 2018.

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The following table summarizes our investment in obligations of state and political subdivisions at June 30, 2018 and December 31, 2017.

| (dollars in thousands) | June 30, 2018 | | % of Total | | December 31, 2017 | | % of Total | |
|---|----------------|------------|----------------------------------|---|-------------------|------------|----------------------------------|---|
| | Amortized Cost | Fair Value | State and Political Subdivisions | | Amortized Cost | Fair Value | State and Political Subdivisions | |
| Within California: | | | | | | | | |
| General obligation bonds | \$ 17,834 | \$ 17,700 | 16.7 | % | \$ 19,634 | \$ 19,678 | 16.7 | % |
| Revenue bonds | 9,777 | 9,813 | 9.1 | | 11,660 | 11,776 | 9.9 | |
| Tax allocation bonds | 6,590 | 6,635 | 6.2 | | 6,099 | 6,234 | 5.2 | |
| Total within California | 34,201 | 34,148 | 32.0 | | 37,393 | 37,688 | 31.8 | |
| Outside California: | | | | | | | | |
| General obligation bonds | 64,219 | 62,624 | 60.0 | | 68,890 | 68,454 | 58.5 | |
| Revenue bonds | 8,567 | 8,506 | 8.0 | | 11,390 | 11,346 | 9.7 | |
| Total outside California | 72,786 | 71,130 | 68.0 | | 80,280 | 79,800 | 68.2 | |
| Total obligations of state and political subdivisions | \$ 106,987 | \$ 105,278 | 100.0 | % | \$ 117,673 | \$ 117,488 | 100.0 | % |

The portion of the portfolio outside the state of California is distributed among twenty states. Of the total investment in obligations of state and political subdivisions, the largest concentrations outside California are Washington (13.2%), Texas (12.0%), and Minnesota (8.5%). Revenue bonds, both within and outside California, primarily consist of bonds relating to essential services (such as public improvements, transportation and utilities) and school district bonds.

Investments in states, municipalities and political subdivisions are subject to an initial pre-purchase credit assessment and ongoing monitoring. Key considerations include:

- The soundness of a municipality's budgetary position and stability of its tax revenues
- Debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority of the issuer
- Local demographics/economics including unemployment data, largest taxpayers and local employers, income indices and home values
- For revenue bonds, the source and strength of revenue for municipal authorities including the obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, and credit enhancement (such as insurer's strength and collateral in escrow accounts)
- Credit ratings by major credit rating agencies

Loans

Loans increased by \$38.6 million and totaled \$1,717.6 million at June 30, 2018, compared to \$1,679.0 million at December 31, 2017. New loan originations in the first six months of 2018 of \$113.2 million were primarily in commercial real estate, including both owner-occupied and investor-owned, spread throughout our markets, and tenancy-in-common fractional interest loans. Loan pay-offs totaling \$68.8 million were due largely to the successful completion of construction projects and customer sales of assets financed by the Bank.

Liabilities

During the first six months of 2018, total liabilities increased by \$10.3 million to \$2,160.8 million. Deposits decreased \$10.9 million in the first six months of 2018, primarily due to fluctuations from large commercial clients' operational

cash flows. Non-interest bearing deposits increased \$43.6 million in the first six months of 2018 to \$1,057.7 million, or 49.5% of total deposits at June 30, 2018, compared to 47.2% at December 31, 2017.

Capital Adequacy

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements as set forth in the following tables can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on our consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and the Bank's prompt corrective action classification are also subject to qualitative judgments by the regulators about components of capital, risk weightings and other factors.

Management reviews capital ratios on a regular basis to ensure that capital exceeds the prescribed regulatory minimums and is adequate to meet our anticipated future needs. For all periods presented, the Bank's ratios exceed the regulatory definition of "well capitalized" under the regulatory framework for prompt corrective action and Bancorp's ratios exceed the required minimum ratios to be considered a well-capitalized bank holding company. In addition, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action as of March 31, 2018. There are no conditions or events since that notification that Management believes have changed the Bank's categories and we expect the Bank to remain well capitalized for prompt corrective action purposes.

In July 2013, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency ("Agencies") finalized regulatory capital rules known as "Basel III." The rules became effective beginning January 2015, and will be fully phased-in by January 2019. The guidelines, among other things, changed the minimum capital requirements of banks and bank holding companies, by increasing the Tier 1 capital to risk-weighted assets ratio to 6%, and introduced a new requirement to maintain a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%. By 2019, when fully phased in, the rules will require further increases to certain minimum capital requirements and a capital conservation buffer of an additional 2.5% of risk-weighted assets.

We have modeled our ratios under the fully phased-in Basel III rules, and based on present facts and the recently announced \$25 million share repurchase program, we do not expect that we will be required to raise additional capital as a result of the fully phased-in rules.

On May 24, 2018, The Economic Growth, Regulatory Relief, and Consumer Protection Act, also known as the Crapo Bill, was signed into law and will exempt banks with less than \$10 billion in assets from certain regulatory requirements. For those banks, it establishes a Community Bank Leverage Ratio ("CBLR"), which is calculated as tangible equity capital divided by the average total assets. The CBLR minimum requirement would be set between 8% and 10%, and if an exempt bank maintains CBLR above the threshold, it can opt out of reporting or complying with other regulatory capital ratios. We will evaluate whether to adopt this new regulatory capital framework once further details and guidance of the Crapo Bill are released.

The Bancorp's and Bank's capital adequacy ratios as of June 30, 2018 and December 31, 2017 are presented in the following tables. Bancorp's Tier 1 capital includes the subordinated debentures, which are not included at the Bank level. We continued to build capital in 2018 through the accumulation of net income. Our Share Repurchase Program announced on April 23, 2018 may affect future capital levels, as described in Item 1. Note 7, Stockholders Equity, of this Form 10-Q.

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| Capital Ratios for Bancorp (dollars in thousands) | Actual Ratio | | Adequately Capitalized Threshold ¹ | | Ratio to be a Well Capitalized Bank Holding Company | |
|--|--------------|--------|---|---------|---|----------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2018 | | | | | | |
| Total Capital (to risk-weighted assets) | \$300,015 | 15.15% | ≥ \$95,538 | ≥ 9.87% | ≥ \$98,013 | ≥ 10.00% |
| Tier 1 Capital (to risk-weighted assets) | \$283,244 | 14.30% | ≥ \$55,935 | ≥ 7.87% | ≥ \$58,410 | ≥ 8.00% |
| Tier 1 Capital (to average assets) | \$283,244 | 11.57% | ≥ \$7,925 | ≥ 4.00% | ≥ \$22,407 | ≥ 5.00% |
| Common Equity Tier 1 (to risk-weighted assets) | \$277,442 | 14.01% | ≥ \$26,233 | ≥ 6.37% | ≥ \$28,708 | ≥ 6.50% |
| December 31, 2017 | | | | | | |
| Total Capital (to risk-weighted assets) | \$287,435 | 14.91% | ≥ \$78,323 | ≥ 9.25% | ≥ \$92,782 | ≥ 10.00% |
| Tier 1 Capital (to risk-weighted assets) | \$270,710 | 14.04% | ≥ \$39,767 | ≥ 7.25% | ≥ \$54,225 | ≥ 8.00% |
| Tier 1 Capital (to average assets) | \$270,710 | 12.13% | ≥ \$9,285 | ≥ 4.00% | ≥ \$11,607 | ≥ 5.00% |
| Common Equity Tier 1 (to risk-weighted assets) | \$265,119 | 13.75% | ≥ \$10,849 | ≥ 5.75% | ≥ \$25,308 | ≥ 6.50% |

¹ The adequately capitalized threshold includes the capital conservation buffer that was effective January 1, 2016. These ratios are not reflected on a fully phased-in basis, which will occur in January 2019.

| Capital Ratios for the Bank (dollars in thousands) | Actual Ratio | | Adequately Capitalized Threshold ¹ | | Ratio to be Well Capitalized under Prompt Corrective Action Provisions | |
|---|--------------|--------|---|---------|--|----------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2018 | | | | | | |
| Total Capital (to risk-weighted assets) | \$267,138 | 13.49% | ≥ \$95,487 | ≥ 9.87% | ≥ \$97,961 | ≥ 10.00% |
| Tier 1 Capital (to risk-weighted assets) | \$250,367 | 12.65% | ≥ \$55,895 | ≥ 7.87% | ≥ \$58,369 | ≥ 8.00% |
| Tier 1 Capital (to average assets) | \$250,367 | 10.23% | ≥ \$7,904 | ≥ 4.00% | ≥ \$22,380 | ≥ 5.00% |
| Common Equity Tier 1 (to risk-weighted assets) | \$250,367 | 12.65% | ≥ \$26,200 | ≥ 6.37% | ≥ \$28,675 | ≥ 6.50% |
| December 31, 2017 | | | | | | |
| Total Capital (to risk-weighted assets) | \$283,885 | 14.73% | ≥ \$78,281 | ≥ 9.25% | ≥ \$92,737 | ≥ 10.00% |
| Tier 1 Capital (to risk-weighted assets) | \$267,160 | 13.86% | ≥ \$39,734 | ≥ 7.25% | ≥ \$54,189 | ≥ 8.00% |
| Tier 1 Capital (to average assets) | \$267,160 | 11.97% | ≥ \$9,275 | ≥ 4.00% | ≥ \$11,593 | ≥ 5.00% |
| Common Equity Tier 1 (to risk-weighted assets) | \$267,160 | 13.86% | ≥ \$10,824 | ≥ 5.75% | ≥ \$25,279 | ≥ 6.50% |

¹ The adequately capitalized threshold includes the capital conservation buffer that was effective January 1, 2016. These ratios are not reflected on a fully phased-in basis, which will occur in January 2019.

Liquidity

The goal of liquidity management is to provide adequate funds to meet loan demand and to fund operating activities and deposit withdrawals. We accomplish this goal by maintaining an appropriate level of liquid assets and formal lines of credit with the FHLB, FRBSF and correspondent banks that enable us to borrow funds as discussed in Note 6 to the Consolidated Financial Statements in ITEM 1 of this report. Our Asset Liability Management Committee ("ALCO"), which is comprised of independent Bank directors and the President and Chief Executive Officer, is responsible for approving and monitoring our liquidity targets and strategies. ALCO has adopted a contingency funding plan that provides early detection of potential liquidity issues in the market or the Bank and institutes prompt responses that may prevent or alleviate a potential liquidity crisis. Management monitors liquidity daily and regularly adjusts our position based on current and future liquidity needs. We also have relationships with third party deposit networks and can adjust the placement of our deposits via reciprocal or one-way sales, as part of our cash management strategy.

We obtain funds from the repayment and maturity of loans, deposit inflows, investment security maturities and paydowns, federal funds purchases, FHLB advances, other borrowings, and cash flow from operations. Our primary uses of funds are the origination of loans, the purchase of investment securities, withdrawals of deposits, maturity of

certificates of deposit, repayment of borrowings and dividends to common stockholders.

The most significant factor in our daily liquidity position has been the level of customer deposits. We attract and retain new deposits, which depends upon the variety and effectiveness of our customer account products, service and convenience, and rates paid to customers, as well as our financial strength. The cash cycles of some of our large commercial depositors may cause short-term fluctuations in their deposit balances held with us.

At June 30, 2018 our liquid assets, which included unencumbered available-for-sale securities and cash, totaled \$420.8 million, a decrease of \$81.1 million from December 31, 2017. Our cash and cash equivalents decreased \$127.3 million from December 31, 2017. The primary uses of liquidity during the first six months of 2018 were \$123.3 million in investment securities purchased, \$38.8 million in new loans net of collection, a decrease in net deposits of \$10.9 million, and \$4.2 million in cash dividends paid on common stock to our shareholders. The primary sources of funds during the first six months of 2018 included \$39.2 million in pay-downs and maturities of investment securities, and \$18.8 million net cash provided by operating activities. Management anticipates that our current strong liquidity position and core deposit base will provide adequate liquidity to fund our operations.

Undrawn credit commitments, as discussed in Note 8 to the Consolidated Financial Statements in this Form 10-Q, totaled \$458.2 million at June 30, 2018. These commitments, to the extent used, are expected to be funded primarily through the repayment of existing loans, deposit growth and liquid assets. Over the next twelve months, \$92.5 million of time deposits will mature. We expect new deposits to replace these funds. Our emphasis on local deposits combined with our well-capitalized equity position, provides a very stable funding base.

Since Bancorp is a holding company and does not conduct regular banking operations, its primary sources of liquidity are dividends from the Bank. Under the California Financial Code, payment of a dividend from the Bank to Bancorp without advance regulatory approval is restricted to the lesser of the Bank's retained earnings or the amount of the Bank's net profits from the previous three fiscal years less the amount of dividends paid during that period. The primary uses of funds for Bancorp are shareholder dividends and ordinary operating expenses. Bancorp held \$32.5 million of cash at June 30, 2018. In April 2018, Bancorp obtained a dividend distribution from the Bank totaling \$28.0 million, which is deemed sufficient to cover Bancorp's operational needs, share repurchases, and cash dividends to shareholders through the end of 2018. Management anticipates that there will be sufficient earnings at the Bank to provide dividends to Bancorp to meet its funding requirements for the near future.

ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Market risk is defined as the risk of loss arising from an adverse change in the market value (or prices) of financial instruments. A significant form of market risk is interest rate risk, which is inherent in our investment, borrowing, lending and deposit gathering activities. The Bank manages interest rate sensitivity to minimize the exposure of our net interest margin, earnings, and capital to changes in interest rates. Interest rate changes can create fluctuations in the net interest margin due to an imbalance in the timing of repricing or maturity of assets or liabilities.

We expect our net interest margin to increase if rates go up, primarily due to our cash earning the Federal Funds rate, adjustable rate loans and our significant non-interest bearing deposit base. Our net interest income remains most vulnerable to a falling interest rate environment.

To mitigate interest rate risk, the structure of the Consolidated Statement of Condition is managed with the objective of correlating the effects of interest rate changes on loans and investments with those of deposits and borrowings. The asset liability management policy sets limits on the acceptable amount of change to net interest income and economic value of equity under a variety of interest rate scenarios.

From time to time, we enter into interest rate swap contracts to mitigate the changes in the fair value of specified long-term fixed-rate loans and firm commitments to enter into long-term fixed-rate loans caused by changes in interest rates. See Note 9 to the Consolidated Financial Statements in this Form 10-Q.

ALCO and the Board of Directors review our exposure to interest rate risk at least quarterly. We use simulation models to measure interest rate risk and to evaluate strategies to improve profitability. A simplified static statement of condition is prepared on a quarterly basis as a starting point, using instrument level data of our actual loans,

investments, borrowings and deposits as inputs. If potential changes to net equity value and net interest income resulting from hypothetical interest rate changes are not within the limits established by the Board of Directors, Management may adjust the asset and liability mix to bring the risk position within approved limits or take other actions. At June 30, 2018, interest rate risk was within policy guidelines established by ALCO and the Board.

One set of interest rates modeled and evaluated against flat interest rates is a series of immediate parallel shifts in the yield curve. These are provided in the following table as an example rather than an expectation of likely interest rate movements.

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| Immediate Changes in Interest Rates (in basis points) | Estimated Change in Net Interest Income in Year 1, as percent of Net Interest Income | Estimated Change in Net Interest Income in Year 2, as percent of Net Interest Income | |
|---|--|--|----|
| up 400 | (0.7 |)% 8.0 |)% |
| up 300 | (0.4 |)% 6.2 |)% |
| up 200 | (0.2 |)% 4.3 |)% |
| up 100 | 0.2 |)% 3.0 |)% |
| down 100 | (5.8 |)% (10.1 |)% |

Interest rate sensitivity is a function of the repricing characteristics of our assets and liabilities. The Bank runs a combination of scenarios and sensitivities in its attempt to capture the range of interest rate risk including the simulations mentioned above. As with any simulation model or other method of measuring interest rate risk, limitations are inherent in the process and dependent on assumptions. For example, if we choose to pay interest on certain business deposits that are currently non-interest bearing, causing these deposits to become rate sensitive in the future, we would become less asset sensitive than the model currently indicates. Assets and liabilities may react differently to changes in market interest rates in terms of both timing and responsiveness to market rate movements. Further, the actual rates and timing of prepayments on loans and investment securities, and the behavior of depositors, could vary significantly from the assumptions applied in the various scenarios.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Bank of Marin Bancorp and its subsidiary (the "Company") conducted an evaluation under the supervision and with the participation of our Management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934 (the "Act")) as of the end of the period covered by this report. The term disclosure controls and procedures means controls and other procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information we are required to disclose in the reports that we file or submit under the Act is accumulated and communicated to our Management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

During the second quarter of 2018, we completed our integration and incorporation of Bank of Napa's business processes and systems into our overall internal control over financial reporting. During the quarter ended June 30, 2018, other than the Bank of Napa integration, there were no significant changes that materially affected, or are reasonably likely to affect, our internal control over financial reporting. The term internal control over financial reporting, as defined by Rule 15d-15(f) of the Act, is a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

PART II OTHER INFORMATION

ITEM 1 Legal Proceedings

Refer to Note 12 to the Consolidated Financial Statements in Item 8 of our 2017 Form 10-K and Note 8 to the Consolidated Financial Statements in this Form 10-Q.

ITEM 1A Risk Factors

There have been no material changes from the risk factors previously disclosed in our 2017 Form 10-K. Refer to "Risk Factors" in Item 1A of our 2017 Form 10-K, pages 10 through 20.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds

On April 23, 2018, Bancorp announced that its Board of Directors approved a Share Repurchase Program under which Bancorp may repurchase up to \$25.0 million of its outstanding common stock through May 1, 2019. For additional information, refer to Note 7 to the Consolidated Financial Statements in this Form 10-Q.

From April 23, 2018 to June 30, 2018, Bancorp purchased 1,398 shares at prices ranging from \$73.14 to \$75.00 for a total cost of \$104 thousand. The following table reflects purchases under the Share Repurchase Program for the periods presented.

(in thousands, except per share data)

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs | Approximate Dollar Value That May yet Be Purchased Under the Program |
|-------------------|----------------------------------|------------------------------|---|--|
| April 23-30, 2018 | — | \$ — | — | \$ — |
| May 1-31, 2018 | 1,398 | 74.06 | 1,398 | 24,896 |
| June 1-30, 2018 | — | — | — | — |
| Total | 1,398 | \$ 74.06 | 1,398 | \$ 24,896 |

ITEM 3 Defaults upon Senior Securities

None.

ITEM 4 Mine Safety Disclosures

Not applicable.

ITEM 5 Other Information

None.

ITEM 6 Exhibits

The following exhibits are filed as part of this report or hereby incorporated by references to filings previously made with the SEC.

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| Exhibit Number | Exhibit Description | Incorporated by Reference | | | Herewith |
|----------------|---|---------------------------|---------------|---------------------|------------------|
| | | Form | File No. | Exhibit Filing Date | |
| 2.01 | <u>Agreement to Merger and Plan of Reorganization with Bank of Napa, dated July 31, 2017</u> | 8-K | 001-33572 | 2.1 | August 2, 2017 |
| 3.01 | <u>Articles of Incorporation, as amended</u> | 10-Q | 001-33572 | 3.01 | November 7, 2007 |
| 3.02 | <u>Bylaws</u> | 10-Q | 001-33572 | 3.02 | May 9, 2011 |
| 3.02a | <u>Bylaw Amendment</u> | 8-K | 001-33572 | 3.03 | July 6, 2015 |
| 4.01 | <u>Rights Agreement, dated July 6, 2017</u> | 8-A12B | 001-33572 | 4.1 | July 7, 2017 |
| 10.01 | <u>Employee Stock Ownership Plan</u> | S-8 | 333-2182744.1 | | May 26, 2017 |
| 10.02 | <u>2017 Employee Stock Purchase Plan</u> | S-8 | 333-2212194.1 | | October 30, 2017 |
| 10.03 | <u>2017 Equity Plan</u> | S-8 | 333-2190674.1 | | June 30, 2017 |
| 10.04 | <u>2010 Director Stock Plan</u> | S-8 | 333-1676394.1 | | June 21, 2010 |
| 10.05 | <u>Form of Indemnification Agreement for Directors and Executive Officers, dated August 9, 2007</u> | 10-Q | 001-33572 | 10.06 | November 7, 2007 |
| 10.06 | <u>Form of Employment Agreement, dated January 23, 2009</u> | 8-K | 001-33572 | 10.1 | January 26, 2009 |
| 10.07 | <u>2010 Annual Individual Incentive Compensation Plan</u> | 8-K | 001-33572 | 99.1 | October 21, 2010 |
| 10.08 | <u>Salary Continuation Agreement for executive officer Russell Colombo, Chief Executive Officer, dated January 1, 2011</u> | 8-K | 001-33572 | 10.1 | January 6, 2011 |
| 10.09 | <u>Salary Continuation Agreement for executive officer Peter Pelham, Director of Retail Banking, dated January 1, 2011</u> | 8-K | 001-33572 | 10.4 | January 6, 2011 |
| 10.10 | <u>Salary Continuation Agreement for executive officer Tani Girton, Chief Financial Officer, dated October 18, 2013</u> | 8-K | 001-33572 | 10.2 | November 4, 2014 |
| 10.11 | <u>Salary Continuation Agreement for executive officer Elizabeth Reizman, Chief Credit Officer, dated July 20, 2014</u> | 8-K | 001-33572 | 10.3 | November 4, 2014 |
| 10.12 | <u>Salary Continuation Agreement for executive officer Timothy Myers, Executive Vice President and Commercial Banking Manager, dated May 28, 2015</u> | 8-K | 001-33572 | 10.4 | June 2, 2015 |
| 10.13 | <u>2007 Form of Change in Control Agreement</u> | 8-K | 001-33572 | 10.1 | October 31, 2007 |
| 11.01 | <u>Earnings Per Share Computation - included in Note 1 to the Consolidated Financial Statements</u> | | | | Filed |
| 31.01 | <u>Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> | | | | Filed |
| 31.02 | <u>Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> | | | | Filed |
| 32.01 | | | | | Filed |

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Certification pursuant to 18 U.S.C. §1350 as adopted
pursuant to §906 of the Sarbanes-Oxley Act of 2002

101.01* XBRL Interactive Data File

Furnished

*As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

SIGNATURES

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

Bank of Marin Bancorp
(registrant)

August 7, 2018 /s/ Russell A. Colombo
Date Russell A. Colombo
President &
Chief Executive Officer
(Principal Executive Officer)

August 7, 2018 /s/ Tani Girton
Date Tani Girton
Executive Vice President &
Chief Financial Officer
(Principal Financial Officer)

August 7, 2018 /s/ Cecilia Situ
Date Cecilia Situ
First Vice President &
Manager of Finance & Treasury
(Principal Accounting Officer)